International Franchising

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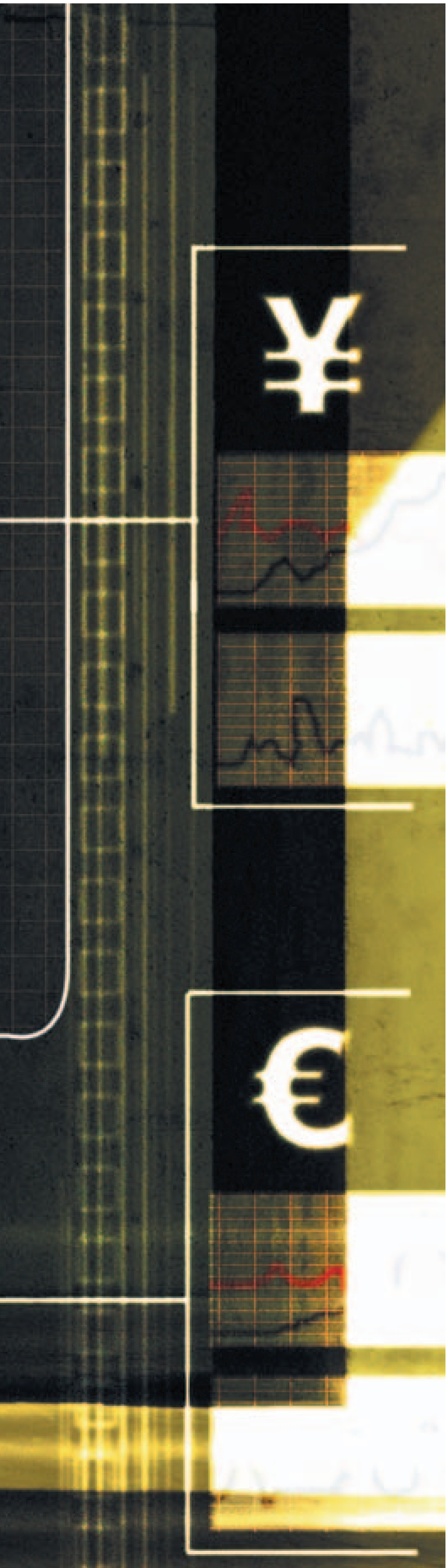

Expanding to Emerging Markets

INTERNATIONAL FRANCHISING HAS GROWN SIGNIFICANTLY IN RECENT YEARS due to domestic saturation, increased competition, and diminishing profits within the United States. International franchising provides the domestic franchisor a tremendous potential for franchise growth. The process of international franchising requires that the franchisor assess and identify potential international franchise markets and franchisee partners, negotiate and implement international franchise agreements, and specifically consider a range of social, political, and legal issues faced when entering certain emerging markets. Initially, expansion of U.S.-based franchises was to culturally-similar, politically-stable, and economically-rich countries. In recent years, however, opportunities have diminished in these countries, and international franchisors have begun to seek development opportunities in emerging markets such as China, India, Africa, and Russia. Emerging markets account for over 80 percent of the world's population, and the U.S. Department of Commerce estimates that over 75 percent of the expected growth in the world's trade over the next two decades will come from emerging markets.

Assessing International Franchise Markets

Assessing the economic potential in emerging markets is important for international franchisors because it allows the franchisor to prioritize expansion opportunities. Some of the most commonly used factors in this assessment include GDP per capita (Gross Domestic Product divided by the level of population), level of population, and growth rate of the target economy.

GDP per capita is often used to classify emerging markets because it signifies the level of income and the state of the economic and political stability of a country. However, if interpreted incorrectly, it can distort the view of the country's economic potential. Therefore, it is important to adjust GDP per capita relative to the purchasing power of the population of an emerging market to accurately compare one emerging market with another.

Level of population is another factor used to measure the economic potential in emerging markets. However, the franchisor must carefully consider the demographics of the population of an emerging market, and not assume that a large population equates to a large franchise growth potential. For example, with populations of about one billion people, China and India are considered to be among the most attractive locations for expansion. Nevertheless, the majority of the population in these countries does not earn sufficient income to afford western-style products and services, and does not live in the major urbanized areas in which international franchisors are often accessible.

Finally, the economic rate of growth should be analyzed in assessing the merits of franchising in an emerging market. While developed markets exhibit very low, single-digit growth rate, many emerging markets sustain high levels of growth, both in the GDP and in the GDP per capita. These economic factors should be viewed favorably by international franchisors because they suggest the development of unspent demand for western-style goods, a lessened political risk and social discontent of the citizenry, and an emergent middle class. Valuable information concerning economic factors of emerging markets is available from the U.S. Department of Commerce, the World Bank, the United Nations, and the International Monetary Fund.

Identifying International Franchisee Partners

Once an international market is identified, one effective way to target prospective franchising partners within that market is the trade mission. Trade missions are sponsored by organizations such as the International Franchise Association and can provide franchisors with introductions to a number of qualified franchisee candidates in each country. The sponsoring organization is responsible for the introduction only, and the franchisor is typically responsible for expenses, follow-up, and negotiations.

An option for franchisors interested in international expansion is the use of brokers. Brokers work by promoting a franchise within a particular market, and will often employ a strategy of directly contacting the best potential partners to determine interest. Generally, brokers will not ask the franchisor to visit the country until they have generated serious interest. A broker will typically derive the bulk of his/her fees based on success. Fees generally range between 10 and 20 percent of the initial franchise fees collected from the franchisee.

As a final option, an international franchisor may rely upon the U.S. government to assist in international franchising through programs such as the "Gold Key" program services provided by the Commercial Service of the U.S. Department of Commerce. Through the Gold Key program, experienced trade professionals in a target country will arrange appointments for the franchisor with prescreened contacts whose interests and objectives match that of the franchisor. The service is now available in more than 70 of the world's best export markets, at fees ranging from $150 to $600.

Structuring the International Franchise Relationship

Once a franchisee partner is located, the relationship between the franchisor and franchisee must be carefully structured. One consideration is whether the relationship will grant the franchisee franchise rights for an entire country, or at least a substantial territory. The barriers and costs involved in entering the emerging market may make individual business unit franchising unfeasible for the franchisor. In such cases, franchise arrangements can be structured so that the partner franchisee would not only develop individual franchise units, but would also sell franchises much the same as the international franchisor. Franchisors typically are compensated in these arrangements through a combination of initial fees, ongoing fees, and unit-opening fees.

A second structural consideration for the international franchisor is the relationship between performance requirements and expense recovery. For example, the speed with which the franchisor is able to establish the foreign franchise organization will be a critical element in determining when the franchise will achieve positive cash flow. If the franchisee is unwilling or unable to commit to an aggressive development schedule, provisions in the franchise agreement should be included requiring the franchisee to cover all direct expenses until a certain number of franchises have been established within the target country.

Implementing the International Franchise Agreement

When implementing an international franchise agreement, many legal issues must be considered. For example, the franchisor needs to protect its intellectual property in the foreign country. U.S. trademark registration may not extend beyond U.S. borders, so a franchisor should explore international trademark registration early in the process. In addition, the U.S.-based franchisor needs to conduct a due diligence investigation of the international franchisee partner in order to comply with the U.S. Patriot Act.

In addition to its U.S. counsel, the franchisor also needs to select and hire competent legal counsel in the relevant country. The local counsel can assist in modifying existing U.S. franchise documents for use in the foreign country. This may include translating documents into a foreign language and preparing a financial disclosure statement in a format different from the applicable U.S. Uniform Franchise Offering Circular. Legal counsel for the franchisor may also need to register the franchise with certain foreign governmental offices. Some countries may also require governmental approval of each franchise agreement.

Expanding to Emerging Markets

China

The Chinese Ministry of Commerce recently promulgated the Measures for the Administration of Commercial Franchise Operations (Measures), which came into force on February 1, 2005. The Measures contain special provisions regarding franchising undertaken by Foreign Investment Enterprises (FIEs), thereby opening up this formerly closed sector to international franchisors.

Fast Facts

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The Measures distinguish between two franchising models. In the first model, the franchisor directly grants the franchise rights to the franchisee, who then invests in the establishment of a franchising network and engages in business operations. In this model, the franchisee does not have the right to sub-franchise. In the second model, the franchisor grants exclusive franchise rights for a specified area to the franchisee. The franchisee has the right to sub-franchise to others and establish its own franchising network within the specified area.

An international franchisor in China must also satisfy specific conditions. These include being a lawfully established enterprise or other economic organization; having business resources such as a trademark, trade name, and business model that it is entitled to license for use to third parties; and having a capacity to provide to the franchisee long-term operational guidance and training services. The franchisor must also show that it directly operates at least two shops that have been in business for a minimum of one year within China. In addition, if the franchising requires the franchisor to supply goods, the franchisor must have a goods supply system that is stable and capable of guaranteeing quality.

The Measures also specify the contents of a franchise contract. For example, the minimum term of a franchise contract is three years. After termination of the franchise contract, franchisees may not continue to use the registered trademark, trade name, or other marks of the franchisor. If an existing FIE wishes to begin operating a franchise in China, it is necessary to apply to its original examination and approval authority to amend its scope of business to include the phrase, "to engage in commercial activities through the franchising method."

India

India is a large market with a thriving class of more than 500 million potential consumers. India has no specific legislation regulating franchise arrangements, but there are a number of areas of the law that affect the franchisor-franchisee relationship. Intellectual property, taxation, labor, competition, property, and exchange control regulations all influence franchising.

The government of India permits foreign franchisors to charge royalties up to one percent for domestic sales and two percent on exports for use of the foreign franchisor's brand name or trade mark, without a transfer of technology. In effect, this means that by lending just their brand name or trademark to an Indian company, foreign companies can receive royalties. However, a foreign company must approach the Reserve Bank of India—India's banking regulatory authority (which is also responsible for exchange control regulations)—if royalties exceeding prescribed limits are sought.

The government of India has also specified a formula for calculation of royalties that must be adhered to before the foreign company can remit funds out of India. If the franchise agreement proposes royalties or lump sum fees beyond the specified limits, the approval of the Foreign Investment Promotion Board is required.

Africa

Africa may be considered the new frontier in franchising. In recent years, the international franchise community has worked closely with many African governments to inform them of the importance of franchising within the small and medium business market. Job creation, poverty alleviation, economic growth, and native empowerment rank high on Africa's economic recovery agenda, and franchising, with its advantages of skills transfer, start-up support, and ongoing operational assistance, is rapidly emerging as the preferred type of business to address many of these challenges.

For many years, the Franchise Association of South Africa has been operating as a voluntary organization that has set standards for ethical franchising in Africa, and has successfully steered franchising in Africa to where it is today.

Russia

The franchising sector of the Russian economy has been identified as one possessing a significant potential for development and offering vast opportunities for international franchisors. Growing domestic consumption and demand for high-quality services in the country has led to an increase of interest in franchising.

Before 2001, almost any economic activity in Russia was subject to some sort of licensing. The adoption of a new licensing law in 2001 reduced the scope to a list of 104 activities potentially harmful to individuals, public health and safety, and the nation's security, thereby easing licensing requirements.

Despite these improvements, several problems complicate market access for international franchisors within Russia. One is the lack of transparent franchising regulations in Russia. Chapter 54 of the Civil Code of the Russian Federation is the only law regulating franchising in Russia. Although Chapter 54 does not impose direct limitations on business activities in franchising, the absence of transparency in the legal regulations creates uncertainty and negatively affects the development of franchise businesses in Russia.

Other Russian laws require certification of certain products imported into Russia as an acknowledgement of their conformity with established national requirements. The process of certification is often complicated and lengthy. Certification may be mandatory or voluntary, depending on whether there is a necessity for strict observance of requirements of existing standards or other normative conditions.

Several associations within Russia have franchisors and franchisees among their member organizations. The Russian Franchise Association (RFA), established in 1997 as a non-profit organization for the promotion of franchising as a business concept, lobbies for the amendment of the Civil Code and of the procedure governing the registration of contracts for commercial concession and leasing. RFA membership consists of franchisors, franchisees, government agencies, business support organizations, non-government funds, banks, accounting firms, and consultants who are optimistic about the potential impact of current government changes.

Precautions

International franchisors face a number of risks that should be taken into account before entering a target market. For example, a franchised concept may not "translate" well in another country. In addition, the goodwill associated with the franchise in the U.S. may be non-existent in another country, and consumers may be biased against foreign brands for certain products and services.

The franchisor's net revenues from international franchising are often lower than domestic net revenues due to increased expenses and sharing of revenues with master franchisees. Revenues from international franchising may also be affected by international tax treaties and fluctuations in currency exchange rates.

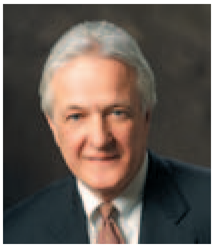
International franchising may require more management resources than the franchisor can spare. In addition, supporting and supplying international franchisees can be more difficult and expensive.

Conclusion

The process of international franchising involves considerable research involving the demographics of emerging markets. Factors such as GDP per capita relative to purchasing power of the population, population size, and the rate of economic growth should be considered in evaluating and prioritizing potential emerging markets for franchise growth. Upon identification and assessment of potential international franchise markets, the international franchisor must then consider locating potential franchisee candidates. In doing so, the franchisor may rely on the use of third-party services such as brokers, trade mission, or programs managed by the U.S. Department of Commerce.

After assessing emerging market opportunities and potential franchisee candidates, the international franchisor must consider the structure of the franchise relationship. This relationship may provide regional or territorial rights to the franchisee beyond that of a single franchise unit. In addition, the negotiation of the franchise agreement will likely require the assistance of local counsel to ensure that a proper franchise offering circular is prepared.

Today, many jurisdictions, including China, India, Africa, and Russia, represent significant opportunities for international franchise development. While some of these countries have created regulations with respect to franchising, all of the countries maintain sufficient economic, political, and legal environments that support international franchise development. ◆



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