

Franchising in China

Over the last two decades, the People's Republic of China has had the fastest growing market and GDP growth rate. China's growth, spurred primarily by domestic demand, has attracted numerous investors with potentially the largest consumer market in the world. China is hailed as one of the most important consumer markets of the 21st century, with a 9% GDP growth rate in 2003.

Franchising, as defined by the Regulation for Administration on Commercial Franchising, is "a type of business, in which, by contract, the franchiser licenses the franchisee to use the trademark, trade name, business format and other business resources which the franchiser has a right to license; and the franchisee carries on business under the uniform business operation system in accordance with the agreement, and pays franchise fees to the franchiser," is a booming sector in the Chinese economy. The franchising model, which allows people with limited capital to enter an established business, is well suited to a developing economy. China's franchising industry is set to enter a rapid but orderly development stage after the new Regulation of Commercial Franchise takes effect.

Development of Franchising in China:

Given the vast potential of China as a consumer and industrial market, it is no surprise that large numbers of foreign franchisers are either operating in China or giving serious consideration to doing so.

Franchising first emerged in China in the late 1980s, with the most notable being KFC's first Chinese outlet in Beijing. Since then, the franchising industry has experienced a period of chaotic development. With little or no law governing franchising, some franchisers conducted substandard business dealing and/or even defrauded franchisees of money. Franchisees, on the other hand, delayed payments to franchises and/or infringed on the intellectual property rights of the franchisers. However, in 1997, the Ministry of Internal Trade established the first Chinese franchise law, the Regulation on Commercial Franchise Business, which included guidelines on issues such as trademarks, copyrights, and intellectual property protection. This law failed to address specific provisions and subsequently blocked many international companies hoping to expand franchising businesses into China.

Despite the poor legal environment, many international franchises, such as 7-Eleven, McDonald's, KFC and Pierre Cardin have been successful in expanding into the Chinese market. Food franchise businesses, such as KFC, McDonald's, Pizza Hut, T.G.I. Friday's, Subway and Haagen Daaz, compose the majority of franchising businesses in China. Meanwhile, non-food brand names, such as Century 21, Kodak, Athlete's Foot and Kinko's, have also entered the market and expanded operations. Moreover, franchising has witnessed a growing enthusiasm within China. The macro-environmental conditions in China are also quite favorable for international franchising. The political system is stable and increasingly welcomes foreign investment. The legal system is evolving

quickly and providing the mechanisms necessary to encourage international franchise growth. China's membership in the WTO will lead to a more transparent and standardized market economy. In addition, the expanding body of potential franchisees and the large and growing middle class consumers create a wide scope of development for international franchising in a business still in its infancy in China.

In December 2004, the Ministry of Commerce (MOFCOM) announced the new Regulation on Commercial Franchise. The new law, which took effect February 2005, will stimulate business in terms of its scale and standardization. The new law will replace the inadequate 1997 measures concerning administration of commercial franchising as it delineates the manner in which foreign brands may operate franchise businesses in China. The new framework also improves the protection of brands and trade secrets and establishes clearer guidelines for recruiting franchisees. The new law is aimed at ensuring that franchise store managers carry out his/her commitment to the franchise brand owners and also ensures the quality of the stores. Franchise store managers are also protected by the new regulation in the event that the parent company declares bankruptcy. The new regulation could potentially create a sound legal environment, which would in turn encourage additional foreign franchisers into the local Chinese market.

Market Overview:

The franchise sector has seen huge successes in China. Franchising has become the latest craze amongst China's rapidly growing entrepreneurial class as it appeals to many business people with enough capital to take on a franchising operation.

China currently has 1,900 franchise systems, with 82,000 outlets, and is growing 49% annually. Today, there are nearly 200 franchise brands in China ranging from supermarkets and drug stores to fitness centers. Nearly 60 industries have applied for franchise operations, including the traditional sectors of catering, retailing and individual services, as well as newly developed fields of education, commercial services, family services and automotive care. In terms of the number of franchisers, the catering industry leads by 35%, while retailing accounts for 30%, laundry 10%, and auto sales, care and leasing 3%. Nearly half of the top 100 restaurant companies are utilizing franchise business models, and the profits of such business significantly surpass those of independently operated companies.

Though China has the most franchise systems in the world, the scale of franchise operations is still relatively small. Each system in China has an average of 43 outlets, compared to more than 540 in the United States.

Although not large in scale, the franchise sector has grown immensely, especially when compared to other sectors. Its sales growth hit 40% on average in the past three years, which is far more than the 10% annual growth of national consumer goods.

There is great potential for further growth, as the franchising business currently accounts for only 3% of China's total retail sales, starkly behind the 30% in the United States.

Market Trends:

Retail chain stores have used franchising as a major way of expanding into the China market. In the top 100 chain stores listed by MOFCOM last year, 61 enterprises were franchisers. Their 5,400 franchised outlets achieved a combined sales revenue of 27 billion yuan (\$3.26 billion). The franchisers saw faster growth than those applying for direct operations in outlet numbers and sales revenue.

With comparatively low costs and low risks associated with franchising an established brand name, the future looks bright for this sector. It is estimated that franchising generates about 50 billion yuan (\$6.04 billion) each year, which composes only 2% of all retail sales in China. In comparison, the world average is more than 40%. China's promising economic environment is leading to more companies adopting the franchising model. Increasing numbers of enterprises became qualified to market their franchise after improving brands, technology and management.

Market Entry:

The new law almost completely opens the market to foreign investors. The one stipulation, however, is that franchisers have at least "two company-owned outlets (or outlets owned by its subsidiary or holding company), which have been operating within the territory of China for more than one year" before they can franchise.

The entry process, also, has become clearer. Under the new regulation, foreign-invested enterprises must submit an application to the Ministry of Commerce for approval. No prior approval is required for domestic enterprises engaging in franchising before it registers at the administrative offices of industry and commerce. Foreign franchisers need to submit sample franchise agreements and operating brochures to the ministry. The ministry will give its response on applications in 30 days

Competition:

U.S. franchisers are playing the leading role in China's franchise market since its inception in 1987 when KFC's first Chinese outlet was opened in Beijing. Major U.S. franchisers in China include:

- Catering Sector: KFC, McDonald's, Pizza Hut, T.G.I. Friday's, Subway, Haagen Dazs, Starbucks Coffee
- Retailing sector: 7-Eleven,
- Real estate brokerage: Century 21
- Photo Developing: Kodak
- Printing service: Kinko's
- Footwear: Athlete's Foot

Herein below, I would like to briefly introduce some of the major U.S. franchisers in China's market:

McDonald's:

As the most successful franchiser in the world, 70% of McDonald's outlets were opened all over the world through franchising. However, in China, McDonald's is operating through a joint venture. McDonald's set up a joint venture with a local company in Beijing when it entered the Chinese capital in 1992. Up to now, McDonald's has about 600 outlets in China, but none are operating through direct franchising. In recent years McDonald's started to adjust its strategy on franchising in China. In 2004, McDonald's (China) Co., Ltd. opened its first franchise outlet in Tianjin and announced that batches of franchise restaurants are to be launched in the coming months. Besides the key cities, McDonald's is also planning to further expand its franchise business in the second-tier cities, middle and western regions or even in the countryside.

KFC:

KFC opened its first outlet in China in 1987 and now has over 1000 outlets in 200 cities all around China. At the beginning most KFC outlets were wholly owned by Yum Brands, which also owns Pizza Hut. Yum Brands registered a company in Shanghai and established dozens of subsidiary companies in various large cities. Following this model, Yum Brands, formerly known as Yum Brands, has full rights to control the overall operations of the business. In 1993 KFC opened its first franchise outlet in Xi'an. However, franchise outlets, today, are still a small part of Yum Brands' businesses.

Pizza Hut:

Pizza Hut is also wholly owned by Yum Brands and has about 120 outlets throughout China. Yum Brands announced that because Pizza Hut is operating very well with satisfactory profits and little competition, the Yum Brands does not plan to open its franchise business to Chinese companies.

Starbucks Coffee:

Starbucks Coffee entered China's market in 1995. Now there are 111 Starbucks Coffee franchise outlets. At the beginning, these outlets were owned by three Chinese franchisees and Starbucks only received the franchise fee according to previous agreements. Since 2003, Starbucks has negotiated with its Chinese franchisees to increase Starbucks' shares in Chinese operation. In July 2003, Starbucks bought 45% of its shares from Shanghai Uni-President Group which subsequently changed its relationship with the Uni-President Group from

franchiser and franchisee to joint venture partners. Now Starbucks is negotiating with Beijing Mei Da Coffee Company on a purchasing issue. Starbucks is planning to fully control the operations of all Starbucks Coffee outlets in China within five years.

Century 21:

Century 21 China Real Estate has developed 500 franchisee offices within four years with a total of 4000 brokers. As the world's largest and most recognized real estate organization owned by New York-based Cendant, Century 21 is cashing in on a boom in home ownership, economic growth and franchising in China. It expects its China franchisees to reach 800 in 2005, putting China in line to become its second-largest overseas market, after France. It is reported that the total sales of Century 21 in China has surpassed RMB 10 billion.

Kodak:

In 1998 Kodak invested USD 1.2 billion to set up joint ventures with major sensitization enterprises in China. Within three years, Kodak film's market share in China has surpassed 50%. At the same time, Kodak China spares no efforts in expanding franchise photo developing shops. Up to now, Kodak has almost 10,000 franchisees all over China.

Once the international franchiser has decided to commit resources to the Chinese market, it will have to establish a business presence in the country. This is true whether the franchiser will be engaging in direct franchising, master franchising, or some variation of these. It is therefore useful to briefly discuss the most likely options for establishing a business entity in China:

Joint Venture- a limited liability corporation in which both partners invest in and manage operation through a Board of Directors. In this arrangement the partners share the profits/losses in proportion to investment. ***For example, McDonald's.*** This form is more suitable for foreign franchisers who is able to locate a strong local partner, in that the franchisers can fully focus on developing the business while the Chinese partners' advantages of dealing with local officials and building relationships can be fully taken.

Wholly Foreign Owned Enterprises- All capital is provided by the foreign investor who has full control over the operations of the enterprise. This form has become an increasingly popular entry vehicle into China. ***For example, Yum Brands, which owns KFC and Pizza Hut.*** Many experts believe that this, as well as the JV model, may be one of the best entry strategies for foreign franchisers when they build their brands in China at the beginning, as they can make sure the brands are developed in a properly and professional manner.

Master Franchising- Many international franchisers sell master franchising rights to interested Chinese companies. This leaves the international franchiser with the critical decision of finding the right local partner and using the appropriate entry structure. In many ways, successful market entry depends upon the quality of the local partner. Local knowledge and connections are extremely valuable for both short-term and long-term success. ***For example, Century 21 China Real Estate.*** However, only franchisers already operating in China can take this given that the new laws stipulates that franchisers must have at least “two company-owned outlets (or outlets owned by its subsidiary or holding company), which have been operating within the territory of China for more than one year” before they can franchise.

Best Prospects of Franchising Sectors:

The following five franchising sectors are most attractive to Chinese investors:

- A. **Catering Industry-** the catering industry is the most popular investment item as the operation is relatively simple and the market is vast. According to China Statistics Bureau, China fast food industry increased 20% annually over the last two decades. Besides the most famous foreign brands such as KFC and McDonald’s, other new foreign brands, such as T.G.I. Friday’s and Subway, also have developed quickly in China via franchising.
- B. **Education and Training-** Investment in the education industry will become very popular in the future. China’s fast growing economy creates a sound and budding environment for foreign language training. EF (English First) is a franchise education organization operating successfully in China. With the growing demands for foreign language training, teamwork training and business training, there will be great market potential for education and training.
- C. **Real Estate Brokerage-** China’s economic reforms have ended decades in which homes and apartments were provided by the government. The country’s prosperity is also creating affluent upper and middle classes whose members not only buy their homes but also upgrade and invest. However, only about 15% of Chinese buyers use a real estate broker, compared with about 90% in the U.S. Thus, the market for real estate brokerage has vast potential
- D. **Commercial Service-** Besides supermarkets and convenience stores, printing and post/communication services also have good market prospects in China. Although China will not open its post business to foreign investment in short term, PostNet International Franchise Corporation has already, in 2000, launched in Shanghai. China’s membership in the WTO will also lead to fair competition in the commercial service sector.

Suggestions to U.S. Enterprises:

Despite the great economic potential, doing business in China can be difficult for many foreign companies, evidenced by the many failures of multinational companies. Some suggestions and advice might be helpful to those new-to-China U.S. franchisers. They include, but are not limited to, the following items:

Register the brand when entering the China market at inception. Without the official registration, even a well-known company can find itself in a difficult position when someone else has registered its brand name. Starbucks filed a trademark infringement suit against a Shanghai coffee chain in 2004. But lawyers and industry executives say things are moving in the right direction.

Carefully seek local partners who can help navigate the local business environment. A partner in the same industry with channels of distribution, industrial connections, and *guanxi* (personal connections) can greatly help facilitate the success of the franchiser as China is governed by a relationship-oriented economy, with many connections not transparent to outsiders.

Understand the cultural differences and adjust market access strategies accordingly. For those franchisers that can navigate China's way, the prizes can be large. Unlike in other countries, where KFC helps franchisees set up stores, KFC is taking a different approach by selling well-established profit-making stores to Chinese franchisees in order to effectively reduce the risk of damaging the brand name. Flexible expansion strategy is also very important. You are in China and cannot simply copy the U.S. format here. Even McDonald's is changing. Unlike in other countries, where McDonald's helps franchisees set up stores, McDonald's is taking a different approach by selling well-established profit-making stores to Chinese franchisees. Needless to say, this is a completely new strategy, which is tailored to suit China's specific national conditions.

Have an ability and willingness to localize your product if necessary, without changing the core product. Baskin-Robbins, for instance, has implemented modifications in their traditional ice cream line-up, offering uniquely Asian flavors such as green tea and lichee sherbet. Subway, perhaps the most feted franchise in the U.S., and other sandwich makers, may find the going tough because many Chinese consider bulky and cold sandwiches less than appetizing. Foreign franchise restaurants should think about fine-tuning their menu if they want to better accommodate a nation that loves chicken and pork.

Minimize the price of the final product and the franchising fee to achieve rapid expansion and mass acceptance. The Chinese are price-conscious because their income is substantially lower than that of an American. Thus, the franchiser should attempt to minimize the price of the final product by using locally

produced ingredients. Both McDonald's and KFC once ran 1-yuan ice-cream specials to lure customers to the stores (equivalent to about 12 U.S. cents). Similarly, franchisers should attempt to minimize the franchising fee to achieve rapid expansion. There are not as many Chinese who have \$1 million and are interested in the franchise business. Thus, it is vital to the new-the-China U.S. franchisers to lower the franchise fee.

Conclusion:

China's WTO accession means more service sectors in the country will have to be opened to foreign service providers. We urge more non-food and beverage franchisers to explore the huge market potential. Car rental service, education and training, laundry and many other areas are widely considered good opportunities for franchising as Chinese people's incomes continue to rise. However, foreign franchisers must also be aware that Chinese consumers, especially those in large cities, are no longer as enthusiastic about every Western brand name. Instead, such consumers make judgments based on quality and whether or not a foreign brand can bring variety and improvements into his/her life. For that purpose, foreign franchisers should have the means to invest heavily before a return is seen. Such investments includes not only money, but more importantly, time and patience.