Your Way into China

China's massive potential is large to to be ignored and attracting increasing interest from Western franchisors. China expert Bill Edwards assesses the market

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China's middle class will rise to more than a third of its population by 2030, with consumer spending expected to reach the level currently seen in the European Union, according to the Economist Intelligence Unit.

As Chinese consumers earn more discretionary income, they want the quality, brand, convenience, and service associated with Western brands. They often buy goods and services at stores, restaurants, and service establishments that are franchises, thus US franchises help fill the needs of China's fast-growing middle class.

Franchising started in China in the late 1980s. In 1987, KFC's first unit opened in Beijing. As of March 31, 2019, there were 4,534 franchises officially registered in the Department of Commerce of China with more than 5 million jobs nationwide and with 400,000 outlets in operation. Here are the number of franchises by sector:

+ **Retailing:** 1,470
+ **F&B:** 1,596
+ **Home Service:** 400
+ **Education:** 250
+ **Hotel:** 101
+ **Real Estate:** 110
+ **Business Services:** 601

In 2015, total sales of the top 100 franchisors in China reached a record high of RMB 435 billion (US$63 billion), according to the China Chain Store & Franchise Association (CCFA).

When KFC and McDonald's entered China in 1980s and 1990s they initially owned all their outlets. KFC began granting franchises in smaller cities in 1992. McDonalds' started franchising in 2004. *'China Briefing', Dezan Shira & Associates, January 2019.*

"Typically franchisors view China as an alluring destination, but make the mistake of treating it as one single market, when in reality it is many. Granting one master franchisee for the country may be appealing but often fails to achieve the results required under the system's development schedule", says Jason Gehrke, Director, Franchise Advisory Centre, Australia. Australia franchisors who have entered China include Boost Juice, The Coffee Club Donut King, Gloria Jean's Coffees, Jamaica Blue and Ray White Real Estate.

Franchising opportunities also abound in non-F&B industries. The best prospects include car rental and services, education, senior care, health and fitness. *USCS Country Commercial Guide (CCG)*. Tupperware has 7,000+ units, Century 21 has 5,300+ units, 7 Eleven has 800+ units and Super 8 hotels has 1,200+ units.

Home and senior care in China

The United Nations predicts that China's population over 60 will reach 438 million by 2050 – one out of every three Chinese. According to PWC, Chinese people will spend over US$1.5 trillion from 2016-2020 on senior care increasing 17% per year. U.S. Commercial Service 2018 statistics. In recent years both Right At Home and Home Instead have entered the China market. An ongoing challenge is to get the middle and upper class consumer to pay for senior care despite there being no government support for this service.

The role of foreign education franchises

"The growth of the middle class and the high value of American education in China made our entry into the Chinese marketplace readily accepted. Rainbow Station China offers middle class parents the opportunity to provide American-style preschool education for their children. Taught in English, our classes focus on critical thinking, creativity, and leadership development—concepts parents want. We started with corporate schools owned by our joint venture partnership before franchising our concept and evolving into full day kindergartens." **Gail Johnson, Chairwoman, Leaf Spring Schools**.

The brand entered China in 2013 and has 15 full schools and three kindergartens open as of early 2019.

Water Babies, a United Kingdom children's education fitness franchise, entered China through a country licensee based in the southern coastal city of Zuhai in 2016. Today Water Babies has seven aquatic centers in Shenzhen, Shanghai and Zuhai. Paul Thompson, CEO of Water Babies UK, advises that the most important lesson they learned when entering China was to find a local law firm and/or consulting firm in China to help determine how best to enter the country considering the cultural differences from western countries.

"When we brought our Abrakadoodle art education franchise brand into China in 2010, we knew there was great interest in educational programs for children. We found highly motivated parents seeking the best in educational opportunities for their children and very motivated franchise candidates who understood the market potential. Now with over 400 locations in China that run Abrakadoodle programs, the market has not disappointed us!" **Rosemarie Hartnett, President & Co-Founder, CFE.**

International F&B franchises

"While Carl's Jr. has successfully penetrated over 30 countries for 25+ years using traditional area development franchising, China presented unique challenges that required different approaches. As Carl's Jr. gained experience as a multi-unit operator in China, the company has done business in various formats: as part of a joint venture, as a franchisor and as an operator of over a dozen company-owned restaurants. The emergence of sophisticated multi-brand operators, major real estate developers forming operating companies and private equity financing have all emerged and this diversifying trend seems to be enduring." **Marc Mushkin, Vice President of Global Development, CKE Restaurants**.

In China, Starbucks originally had a JV but has retained full corporate ownership for several years now. "In China this will definitely help them unlock growth quickly while protecting their brand". **Mike Hudspeth, former President of Starbucks® Eastern Europe and presently Chief Operating Officer of Brinker International**.

McDonald's sold its mainland China and Hong Kong businesses to a consortium between the state-owned Chinese conglomerate Citic and the American private equity giant Carlyle Group for $2.03 billion. Among the key points of the deal was that it gives franchising control to the Citic/Carlyle consortium in the PRC for a period of 20 years. *IPO Pang Xingpu law firm, February 3, 2017.*

Supply chain development and management

"Supply chains in China are distinguished by separately-managed regional and even local divisions across the markets – pivotal to any franchisor's success is the need to retain supply chain expertise in the country that has mastered this difficult puzzle of distributors, suppliers and government agencies. This means a likely answer is to recruit the proven expert from a brand already successful in China." **Joyce Mazero, Partner, Posnielli**.

The new Chinese middle class family puts health for their children number one on their priority list. That is why they prefer international F&B brands because the brands do not cut back on quality in the countries they enter. In 2013, YUM Brands' KFC stores had a major decline in sales because the company's suppliers had injected growth hormones and antiviral drugs into chicken beyond food safety limits. This went viral on social media. In 2014 McDonald's beef supplier for many years sold them expired meat that they had repackaged. *Financial Times, 2013 and 2014.* Very strong quality assurance of in-country food production and distribution resources is critical for foreign F&B brands doing business in China.

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Legal issues

China adopted its first franchise law in 1997, but foreign franchising remained mostly a gray area at that time until a new law was announced in 2005, which eliminated legal restrictions on foreign investment in franchising. Now, China's franchise law is clearer by virtue of the 2007 law. *'China Briefing', Dezan Shira & Associates, January 2019.*

"For foreign franchisors, compared to a few years ago, they are certainly dealing with more sophisticated consumers, and by the same measure, more sophisticated franchisees. It would not be a surprise if we see multi-brand franchise operators flourish in the Chinese market in a few years; some already exist, although not on the scale as large as those in the Middle East. In addition, joint venture has become an increasingly common entry mode preferred by both foreign franchisors and the well-established Chinese franchisees." *Tao Shu, Partner, DLA Piper*

"Challenges to U.S. franchise firms include a relatively weak regulatory system, increasing costs of labor and real estate and a lack of qualified Chinese franchisee candidates. The most recent legislation released by the Ministry of Commerce stipulates that franchise firms can start franchising in China as long as they own and operate two company-owned stores for one year in any part of the world. In addition, franchise firms must file with the local commercial authority for record within 15 days after the execution of the initial franchise contract." *U.S. Commercial Service China Country Commercial Guide, 2017.*

Edward Chatterton, Partner, DLA Piper, Hong Kong, says "China

is a high risk IP jurisdiction in which registering IP remains the best defence against infringement and brand dilution. Before any of this is shared and before substantive negotiations begin, the parties should enter into robust non-disclosure and confidentiality obligations. It is expected that, with the introduction of the 2019 E-commerce Law, there will be an increasing number of successful cases in which brand owners defeat brand pirates in China. China's newly-revised Anti-Unfair Competition Law has introduced additional offenses for IP, commercial secrets and other market conduct-related violations."

Successful Chinese franchises

Local Chinese franchise brands are growing in size and quality. International brands have been educating the market for years and their staff left and joined local brands with higher salaries. Here are some outstanding Chinese franchise brands.

I Do, which sells engagement rings to Chinese middle and upper class millennials, is an outstanding combination of luxury retailing with franchising. In 12 years they have developed nearly 800 units across 200+ cities in China with 90% are franchised by multi-units owners. (**www.hiersun-ido.com**)

Fornet is the number one local laundry franchise in China, with 1,600 units over 1,600 of which90%+ units are franchised. (**www.fornet.com.cn**)

Huazhu Hotel, a leading local hotel franchise chain, with hotels over 4,200 and 70%+ are franchised. (**www.huazhu.com**)

The Meiyijia Convenience Stores is the premier local convenient store franchise with 15,000 units and 98%+ are franchised. (**www.meiyijia.com.cn**)

The M&G Stationery chain has 8,500 units (**www.mg-pen.com**) **Miniso** sells household items and 3,600 units across China (**www.miniso.cn**)

Aesthetic is a local beauty care brand with 8,200 units (**www.kpbeauty.com.cn**)

Hanhuang shoe care franchise has 3,200 units (**www.hanor.com.cn**)

HomeInn, with 4,000+ units, has joint ventured with Hyatt hotels to meet the evolving needs and aspirations of a growing number of young travelers in the upper-midscale segment in China, providing them with a seamless and premium travel experience. (**www.bthhotels.com**)

Juewei Snacks has over 10,000 units selling special local flavor snacks (**www.juewei.cn**)

Innovation is required

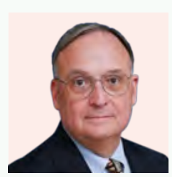
No-Cash Credit card payments have made consuming easier and faster. China is now the leading country in consumer wireless payments. Franchised stores must offer cashless payments to succeed.

A very strong online ordering and constantly updating social media presence is essential for doing business in China today. While Chinese consumers do not have Facebook and Google, they do have WeChat which had 495 million Chinese users in 2017 and was used on 79% of the cell phones in the country. WeChat is used for communication, ordering, buying and cashless paying in stores.

For new start-up franchises, lower investment will increasingly be key. This probably means fewer new restaurant brands and more service concepts. For mature franchises, continued growth means finding multi-unit owners who have existing infrastructure, capital and staff to take on new units.

New franchise development has already moved away from the very large, very high cost cities like Beijing, Guangzhou and Shanghai to such (still large cities) as Tianjin, Wuhan, Chengdu, Hangzhou, Nanjing and Chongqing. There are approximately 125 cities in China that have more than 1,000,000 population.

In summary, franchising is alive and well in China due to the fast growing middle class consumer who prefers brands they can trust and despite legal and government bureaucracy challenges. The almost 400 million middle class Chinese consumers cannot be ignored by the global franchise community.



THE AUTHOR

William Edwards, CEO of Edwards Global Services, Inc. (EGS), has lived in seven counties and has 45 years' experience doing international business. He lived in China from 1982-1985 and was then the AlphaGraphics quick print chain China country licensee from 1990-1992. Subsequently, Mr. Edwards has taken numerous U.S. education, F&B, retail and service franchises into China. He has written numerous article on doing business in China and lectured on this subject at several universities. In 2014, EGS established an office in Beijing. The data on emerging Chinese franchises was supplied by James Liu, EGS' Beijing based Greater China Managing Director. Contact Bill Edwards at **bedwards@edwardsglobal.com** or on +1 949 375 1896.