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Foreign franchises are reaching more Chinese consumers over larger segments of the country.

The Pros and Cons of Franchising in China

US companies must jump hurdles to operate successful franchises in China, but the potential benefits are too great to ignore.

William Edwards

Western and local franchise brands have developed significantly in China over the past 15 years, as the Chinese consumer has become an engine of economic growth and the country's business environment has improved. In the early 1990s, the word "franchise" had still not been directly translated into Chinese; the closest translation was "chain of stores." In addition, the PRC government did not formally regulate franchising. To help develop the industry, the PRC government in 1997 issued the Interim Measures on Regulating Commercial Franchise Operations. The China Chain Store and Franchise Association (CCFA)—a quasi-government nonprofit membership association for Chinese and foreign retailers, franchisers, and well-known foreign brands—also formed. The industry association now has 900 members with 180,000 outlets across China. The total annual sales of CCFA members reached nearly $300 billion in 2010—about 13 percent of total retail sales in China. CCFA has also monitored the top 120 franchises in China to gain a clearer picture of franchise development. In 2010, these 120 companies operated 111,477 franchise stores, an increase of 17.6 percent over 2009. Total sales of the top 120 franchisors reached $52.4 billion in 2010, up 8.9 percent over 2009.

Quick Glance

- China's economic boom has enabled more Chinese consumers to frequent franchises and more Chinese investors to buy franchise licenses.
- Because many foreign brands are viewed in a positive light in China, foreign franchises may perform well—if they cater to the tastes of local consumers.
- Foreign companies must prepare for various obstacles to expansion, however, such as weak intellectual property enforcement and shortages of skilled franchise managers.

Franchising, a business development method for expanding a company and distributing goods and services using an established business system and a recognized brand name, has advantages and disadvantages. On the positive side, franchises give individuals an opportunity to start a business with a proven success rate at minimal risk. The franchisor (owner of the business that provides the product or service) gives the franchisee (independent party) training, support, and marketing programs. In addition, the business can be a highly recognized foreign brand known for quality and service. On the negative side, to open a franchise a franchisee must pay an initial fee to acquire the brand, business system, and other resources; pay on-going royalties; and follow the franchise system. In the United States, unit franchise licenses may run $10,000–$50,000, and country or regional licenses may cost $200,000–$500,000. In China, the fees typically run $250,000–$750,000.

Filling consumer needs

As Chinese consumers earn more discretionary income, they want the quality, brand, convenience, and service associated with Western brands. Consumers often buy goods and services at stores, restaurants, and service establishments that are franchises, thus many US franchises help fill the needs of China's fast-growing middle class. This group is largely a young, upwardly mobile, and aspirational two-income family demographic with one child and considerable discretionary income.

Food service

As with franchise development in other emerging markets, food franchises first came to China from the United States. The Yum Brands, Inc. chains KFC Corp. and Pizza Hut, Inc. entered China in 1987 and 1990, respectively, and have been in the country for more than 20 years. McDonald's Corp. also entered the country in 1990. None of these brands initially franchised their outlets in China, however; they were company-owned and operated, in some cases with a joint venture (JV) partner. KFC began granting franchises in lower-tier Chinese cities in 1992, and McDonald's began franchising in China in 2004. Today, Yum has more than 3,700 restaurants, mostly KFC outlets, in China. McDonald's announced plans late last year to double the number of its restaurants in China to 2,000 by 2013.

Many other food franchises have entered and expanded in China, some of which grant a regional license to a Chinese company, which builds, owns, and operates units by itself. Burger King Corp., which entered China in 2005, has 33 restaurants in the country. Starbucks Corp., which opened its first shop in Beijing in 1999, has roughly 450 stores in China. Papa John's International, Inc. announced plans in fall 2010 to increase the number of its restaurants in China from 155 to 300 in three years. Carl's Jr. (operated by CKE Restaurants, Inc.); Cold Stone Creamery, Inc.; and International Dairy Queen, Inc. are just a few of the other major US franchise brands developing across China, though some brands will license to local companies or sub-franchise, which allows an owner of an area license to sell franchise licenses to other parties.

Business service franchises

US business service franchises, such as AlphaGraphics, Inc. and Sir Speedy, Inc., began entering China in the 1990s, mainly to serve the increasing number of foreign representative offices in eastern cities. Before these US brands entered China, there were few places where Chinese or foreign companies could get printing service; print shops were not fully equipped and staff did not speak English.

After a slow start, many US hotel brands have entered China—some by granting franchise licenses and some through JVs. First, hotel brands built five-star hotels for foreign business travelers in large, first-tier cities. But in recent years, US companies have also been building hotels for

Chinese business travelers in second- and third-tier cities. US hotel brands that grant franchises in China include Hilton Worldwide, Inc.; Howard Johnson International, Inc.; Sheraton Hotels & Resorts; and Super 8 Motels, Inc.

Customer service franchises

Auto, education, and real estate franchises soon followed business services franchises. As Chinese consumers started to buy cars, they began to need professional service centers for car repair and maintenance. And when home ownership boomed in China, real estate firms such as Century 21 Real Estate LLC and RE/MAX, LLC launched franchises.

Helping to boost the popularity and supply of education and fitness programs for children and young adults in China, My Gym Enterprises, a US franchise focused on children's health, entered China in 2008. The Crestcom International, LLC management education franchise, which boosts adults' managerial skills and is especially helpful to young adults who want to improve their careers, entered a few years later. In addition, the Virginia-based Abrakadoodle Remarkable Art Education children's art franchise is setting up in China this year and will cater to the new generation of one-child families who want to supplement their child's education and give them an edge in getting into the best schools.

Foreign franchises face opportunities…

Many trends indicate that the China market is ripe for franchises.

- **The consumer class is expanding fast.**

The large group of middle- and upper-class consumers can afford to buy more than basic necessities, and many members want to show their wealth through what they buy—for example, by purchasing a cup of expensive foreign-branded coffee and walking around with it. They are purchasing big-ticket, branded items—often on their credit cards.

- **Western brands are highly regarded.**

Many consumers perceive Western brands as providing quality, convenience, and customer service. This is true especially in the retail and food sectors, where most major food franchises are either already present or are entering China (see p.18).

- **Western franchises bring new and modern business systems.**

Successful US franchises bring a complete business system, management processes, job training, and the potential for healthy and reproducible bottom line margins. US franchises in China thus have high potential to succeed.

- **Second- and third-tier cities are open to franchising.**

First-tier cities offer developed infrastructure, business-friendly governments, and a multitude of services and internationally standard amenities. These cities are generally "easy" for newcomers to enter, but labor and real estate prices have risen and competition has intensified in recent years. Second-tier cities have millions of potential consumers and often have lower labor and real estate costs and local governments that encourage the creation of new businesses (see the *CBR*, November–December 2010, p.12). In addition, US food franchisors are increasingly allowing small companies to own franchises—a trend that KFC and Papa John's started in second- and third-tier cities in the last few years.

…and challenges

Foreign franchises must also overcome problems that are specific to the China market.

- **Intellectual property protection is uneven.**

Weak intellectual property enforcement and an inadequate legal framework are key reasons early foreign brands opened as company-owned stores or JVs, instead of franchises, in China. Many US brands have seen local companies take their name and logo and open fake, unapproved outlets. For example, after a local coffee store chain violated Starbucks's trademark by nearly duplicating its name and logo, Starbucks took the company to court and won the dispute in 2006. China has a range of intellectual property laws, and landmark court cases have defined the right of foreign brands to protect their trademarks and business systems. Intellectual property laws, however, are not uniformly enforced throughout the country.

- **Local managers lack strong management skills.**

Franchises in China often experience difficulties finding local managers who understand how to run a business. Training costs are high and so is the rate at which good employees quit to take higher paying jobs after they receive Western business training (see the *CBR*, April–June 2011, p.20).

- **Finding and evaluating licensee candidates is tough.**

The most important part of franchising a brand is finding, evaluating, and signing a qualified company as the local, regional, or country franchisee. Due diligence resources to fully check on a local company are improving,

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but it is still difficult to find companies with the management skills, business track record, and capital to acquire and properly develop a US franchise business. To help find appropriate licensees, companies can check with various organizations, such as US Commercial Service offices in China, legal firms with US ties, consulting firms, or American Chamber of Commerce offices.

in China. The regulations also state that the Chinese franchisee must own and operate units for at least a year before it can sub-franchise to others. This revision ensures the licensee will learn how to manage the business correctly before it can franchise it to someone else—increasing the chance that the foreign franchise will succeed in China.

Some franchises face difficulties in China when they do not adapt—or are slow to adapt—to the needs and tastes of Chinese consumers.

China has many markets.

The sheer size of China, and its diversity of business and food culture, makes franchise development difficult. Companies that function well in one region seldom function as well elsewhere in China. Accordingly, franchisors rarely grant companies a country franchise for China. More typically, franchisors grant regional franchises (for a province or group of provinces) or first-tier city franchises (such as for Shanghai). This means the US franchisor must manage multiple licenses in China, requiring more time and energy than for other large countries, such as Indonesia, where it is common to grant one license for the whole country.

The regulatory environment is evolving.

Unclear and changing regulations have created uncertainty for foreign franchisers that wanted to enter China in the past. The country's regulatory environment for franchising is evolving and improving, however. After releasing the 1997 interim measures on franchising, the PRC government issued the 2005 Administrative Measures on Commercial Franchising. The 2005 measures allowed foreign companies to establish wholly foreign-owned franchises, instead of being limited to joint ventures, thus fulfilling one of China's World Trade Organization commitments. The measures, however, required foreign franchisors to open and operate at least two units in China for more than one year before it could sign a franchisee. Though the regulation aimed to prevent franchisors from selling a franchise and then failing to return or provide support, the requirement proved cumbersome, difficult, and expensive.

In 2007, China released new franchise regulations, which offered more favorable licensing terms to foreign companies. For example, the new regulations require that the foreign franchisor has owned and operated at least two units anywhere in the world, including in its own home country, for at least one year before it can grant a franchise

Franchises must adapt their products to new markets.

Some franchises face difficulties in China when they do not adapt—or are slow to adapt—to the needs and tastes of Chinese consumers. For example, restaurants should conduct appropriate research before planning their menu and offerings. Sales may increase simply by adding chicken dishes and rice to the menu, or by changing a spice or bread. Adding a trendy "foreign" item to the menu, such as coffee or ice cream, may also increase sales.

In addition, foreign companies should take care when translating their brand names into Chinese. Ideally, the Chinese name should convey what the brand is and sound similar to the English pronunciation.

The bottom line

Many signs indicate that franchising will become easier in China over the next few years. China's regulatory and investment environment is developing and becoming more transparent. Lower-tier cities are becoming ripe markets for franchises, and China's rapidly rising middle- and upper-class consumer base desires Western brands with their well-known name and association with convenience, quality, and service. In addition, more Chinese are reaching an income and savings level that will allow them to invest in a franchise.

Despite the challenges of the China market, the opportunities are too great to ignore, and US franchisors are entering China in great numbers. Quality franchises will create good business systems, jobs, products, salaries, and services. 完

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