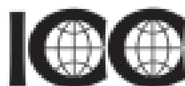
Guide to Export-Import Basics

Vital Knowledge for Trading Internationally

Third Edition



International Chamber of Commerce
The world business organization

4. International franchising

The basics: Franchising is a form of shared investment in the expansion and replication of successful business systems. International franchising allows franchisors to grow rapidly in foreign markets with minimum capital investments. "Unit" franchises confer the right to exploit a single operation, while "master franchises" and "area development" agreements confer the right to sub-develop and/or grant sub-franchises in a particular territory. Master franchises are particularly suitable internationally because they permit local supervision of networks. Franchising contracts can be complex and in some jurisdictions are subject to local laws for the protection of franchisees.

4.1 Introduction

Franchising is based on the attractive notion of replicating success. The origin of most franchises is in the development of a business system so efficient and competitive that it that has superior chances of succeeding in new territories. However, in order to grow rapidly, business networks need large infusions of capital. Rather than invest his own capital, the franchisor enters into agreements with (usually) local entrepreneurs – the franchisees. The franchisor grants to each franchisee the right to exploit all or part of the franchisor's business system, including trademarks, logo and distinctive signs, intellectual property, technical know-how and processes. In return, the franchisee usually makes a "front money" payment in order to enter the franchise network, invests a minimum amount in setting up and operating the business, pays the franchisor fees and royalties, and adheres to the franchisor's standards for quality of services. The combination of the franchisor's reputation and expertise with the franchisee's capital, local knowledge and motivation, can result in explosive growth.

Well-known examples of franchising success are McDonald's, Holiday Inn, Yves Rocher and Hertz, but there are countless others. Franchising has become one of the primary distribution channels for products and services in developed economies, where image and service reputation can determine market share. Franchising is found in industries as diverse as fast food chains, computer retail sales, real estate services, automobile rental and service stations, to name but a few. According to the International Franchise Association, more than one-third of all retail sales in the United States are conducted through franchises, accounting for hundreds of millions of dollars in annual sales and hundreds of thousands of jobs. Even outside the top franchise markets of the United States, Canada and the United Kingdom, franchising is becoming one of the most popular methods for business expansion.

In addition to the advantages described above, franchising can offer cost savings from the decentralization of management and financial controls. A further attraction for the franchisor is that franchisees are usually familiar with national labour, safety, health and technical standards. However, one of the corresponding risks for the franchisor is that the franchisee may eventually set up his own firm and become a competitor of the original franchise. Therefore, franchising contracts often contain special non-competition clauses.

Franchising, like agency, has in some countries raised political sensitivities. Some organizations have expressed concern that local franchisees, like agents, have little bargaining power against large franchisors and therefore require mandatory legal protection. Thus, in certain countries there are strict regulations dealing with such things as the amount of disclosure that must be made by franchisors when recruiting franchisees. It does happen that franchisees claim to have been "lured" into franchises by a franchisor's inflated, fraudulent statements as to likely returns on investment.

4.2 Different types of franchises and franchising structures

Product (or trademark) franchising involves granting the right to manufacture and/or market a product under a specific trademark to the franchisee. Business format franchising covers a complete system of doing business, including service concepts and operations, in addition to trademark and logo rights. In production (or manufacturing) franchises, the franchisee manufactures according to the franchisor's specifications and sells the goods under the franchisor's trademark. In a service franchise, the franchisee provides a service developed by the franchisor under the franchisor's service mark. Under a distribution franchise arrangement, the franchisor manufactures the product and sells it to the franchisee for resale to the final consumer.

The franchisor may structure a franchise network in terms of either unit or territorial franchising. In the case of unit franchising, the franchisor enters into an agreement directly with each franchisee. Under a territorial franchise, an entire geographical area is developed by a master franchisee or area developer responsible for a number of outlets.

International franchising is generally conducted in the following ways: 1) direct/unit franchises, 2) through a franchisor's branch or subsidiary, 3) through a development agreement, 4) through a joint venture, 5) through master franchises. Unit franchising is most common in domestic markets – it facilitates maximum control by the franchisor over the individual outlets, with promotion of the franchise system and trademarks usually remaining in the hands of the franchisor. In an international context, however, a unit franchise approach runs counter to one of the underlying business principles of franchising – minimizing costs via decentralization. The costs of supervising an international network from a single headquarters could prove onerous. In the international context, therefore, it is generally only advisable to franchise directly when the target country is geographically, culturally, linguistically and/or legally proximate to the franchisor's country.

Territorial franchises cover multiple outlets in a specified area and may be granted through either a franchise development agreement or a master franchise agreement. Under a typical development agreement, the developer/franchisee is required to open and operate a certain number of units in the assigned geographical area (usually a particular country) within an agreed time frame. The franchisor benefits from dealing with a manageable number of franchisees. Area developers usually have sufficient financial and human resources to manage the set-up and day-to-day operation of the business with a relatively high degree of independence from the franchisor. Training costs can also be reduced, because the franchisor only trains the developer; the developer in turn trains the unit franchisees.