

Franchising Industry in China

1. An Overview of Franchise Development in China

Franchising first emerged in China in the late 1980s. In 1987, KFC's first Chinese outlet was opened in Beijing, the capital city of China.

Franchising industry in China experienced a period of disordered development in the early days. In the poor legal environment, some franchisers conducted substandard business or even defrauded franchisees of money. In some cases, franchisees delayed payments to the franchisers or infringed on their intellectual property rights.

In 1997, the Ministry of Internal Trade established the first Chinese franchise law, the Regulation on Commercial Franchise Business, which included guidelines on such issues as trademarks, copyrights, and intellectual property protection. A lack of specific provisions in the 1997 version governing foreign direct franchising allowed relatively few major international companies to have significant franchise businesses in China.

Although many of these international brands such as 7-Eleven, McDonald's, KFC and Pierre Cardin, normally do business through franchising, in China foreign franchising was still a grey area before the new rule was published.

Because franchising typically does not involve investing in equities, the Chinese Government used to put less focus on such business. But the government came to find that franchises are a good business model for China to help solve its job problems and its scattered private capital. China's capital markets are underdeveloped and franchising is one method that allows the assembly and concentration of capital from a wide capital base through investment in franchises. China has a great number of qualified potential Chinese franchisees with strong sources of funding. Franchising makes up for the commercial inexperience of the Chinese franchisers by linking their investments to completed training within a well-tested operating system.

The new Regulation on Commercial Franchise, announced by the Ministry of Commerce on December 30th 2004 and which took effect on February 1, will stimulate business in terms of its scale and standardization. The new regulation for franchises, to replace the 1997 measures concerning administration of commercial franchising, defines more clearly the way foreign brands operate franchise businesses in China. The new rule should help build a sound legal environment and invite additional foreign franchisers into doing the local business.

The franchising model, which allows people with limited capital to enter an established business, is well suited to a developing economy. China's infant

franchising industry is set to enter a rapid but orderly development stage after the new Regulation of Commercial Franchise takes effect.

2. Main Figures Related to Franchising Industry in China

With potentially the largest consumer market in the world and an accelerating economy, China is hailed as one of the most important consumer markets of the 21st century. China's GDP expanded by 9.3% in 2004, the best among the world's biggest economies. According to the estimation of State Information Center, the Chinese retail sector will grow at a stable speed of 8 to 10 percent from 2005 to 2010 and the retail amount of social consumption will exceed RMB 20 trillion in 2020. This increase in consumption is why many enterprises are eyeing China's profitable franchise market. Large numbers of foreign franchisers are either operating in China or giving serious consideration to doing so.

China currently has 1,900 franchise systems, with 82,000 outlets, growing 49% annually. Nearly 60 industries have applied for franchise operations, including traditional sectors of catering, retailing and individual services, as well as some 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 their business earnings significantly surpass those of independently operated companies.

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

There is a great deal of potential for further growth, but now the franchising business only accounts for 3 percent of China's total retail sales, starkly behind the 30 percent in the United States.

Although not big in scale, the franchise sector has witnessed rocketing success in China. Its sales growth hit 40% on average in the last several years, far more than the 10% annual growth of national consumer goods.

Appendix 1: Growth of Major Franchising Industries in 2004

Industries		Average Growth Rate of Outlets %		Average Growth Rate of Turnover %	
		No. of Franchisers	No. of Franchisees	Turnover of Franchisers	Turnover of Franchisees
1	Real Estate Brokerage	75.48%	79.06%	150%	190%

2	Home Decoration	48.7%	85.2%	58%	62%
3	Education	31.2%	41.8%	30.2%	30.5%
4	Book and Audio-Video	8.51%	7.43%	8.12%	7.28%
5	Laundry	24.81%	21.43%	46.43%	45.66%
6	Chinese Restaurant	34.72%	37.92%	27.28%	24.59%
7	Garments	18.07%	15.54%	26.19%	28.22%
Average		33.18%	37.87%	33.94%	40.15%

(Source: China Chain Store & Franchise Association)

3. Market Position of U.S. Franchisers

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: Wal-Mart, 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. But in China McDonald's is operating through a joint venture at present. 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 of them is operating through direct franchising. In recent years McDonald's started to adjust its strategy on franchising model in China. In 2004, McDonald's (China) Co., Ltd. opened its first franchise outlet in Tianjin, and it announced that a batch of franchise restaurants are expected to be launched in coming months. Besides the key cities, McDonald's is also planning to further expand its franchise business in the second-tier cities or middle and western regions, even in the country.

🕒 **KFC**

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

🕒 **Pizza Hut**

Pizza Hut is also wholly owned by Tricon Group and it has about 120 outlets all over China. Tricon Group announced that as Pizza Hut is operating very well with satisfactory profits, and in China there is not yet other franchiser who can compete with Pizza Hut on its level, so Tricon Group does not plan to open its franchise business to Chinese companies at this stage.

🕒 **Starbucks Coffee**

Starbucks Coffee entered China's market in 1995. Now there are 111 Starbucks Coffee franchise outlets in China. At the beginning these outlets were owned by three Chinese franchisees and Starbucks can only get the franchise fee according to the agreement. Since 2003 Starbucks started to negotiate with its Chinese franchisees to increase Starbucks' shares. Starbucks bought 45% shares from Shanghai Uni-President in July 2003 so that changed its relationship with Uni-President Group from franchiser and franchisee to joint venture partners. Now Starbucks are still negotiating with Beijing Mei Da Coffee Company on a purchasing issue. Starbucks are planning to fully control the operations of all Starbucks Coffee outlets in China within five years.

🕒 **Wal-Mart**

As the first leading retailer in the global market, Wal-Mart entered China's market in 1996. In November 2004, Wal-Mart set up its 40th branch in Wuhan, a city of strategic importance in Central China. Its total investment in China has exceeded RMB 1.6 billion and the total staff number in its 40 Chinese chains stores has reached 20,000, and it also plans to open over ten new shops annually in China in the coming three years.

🕒 **Century 21**

Century 21 China Real Estate has developed 500 Chinese franchisee offices within four years, with totally 4000 brokers. As the world's largest and most

recognized real estate organization owned by New York-based Centant, 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 have almost 10,000 franchisees all over China.

To sum up, U.S. franchisers in China are most likely to be engaged in the following franchising models.

- ☞ **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 in the profits/losses in proportion to their investment. ***For example, McDonald's.*** Although this form may be suitable for some franchisers, it is often problematic in that a well-know international franchiser may be unwilling to share profits with a local partner. Conversely, a strong local partner may be unwilling to work with a weak international franchiser.
- ☞ **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, Tricon Group, which owns KFC and Pizza Hut.***
- ☞ **Master Franchising** – Many international franchisers sell master franchising rights to interested Chinese companies. This leaves the international franchiser 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.***

4. Best Prospects of Franchising Sectors

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

- A. **Catering Industry** – Catering industry is remaining the most popular investing item because the operation is relatively simple and the market is vast. According to the statistics of 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 developed fast in China through franchising.
- B. **Education and Training** – Investment in education industry will become one of the hot spots from now on. China's fast growing economy creates a sound developing space 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 in China.
- 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. But only about 15% of Chinese buyers use a real estate broker, compared with about 90% in the U.S. So real estate brokerage has a big market to educate.
- D. **Commercial Service** – Besides supermarkets and convenience stores, printing service, post and communication service 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 launched in Shanghai in 2000. China's membership in the WTO will lead to fair competition in commercial service sector too. It also brings expects to foreign franchisers aiming at China commercial service market.
- E. **Network Technology** – Franchise in network technology sector is still a brand-new model. Some Chinese enterprises or government agencies are not able or not willing to build their own Internet website so they have to seek the support from professional network service provider.

5. Suggestions to U.S. Enterprises

Despite the great economic potential, doing business in China can be difficult for many foreign companies, evident by the many failures of multinational companies. The following suggestions might be helpful to those new-to-China franchisers:

- ③ **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 their 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.
- ③ **Carefully seek local partners who can help them navigate the local business environment.** Needless to say how important it is to choose a partner in the same industry with channels of distribution, industrial connections and good relationship with government organizations.
- ③ **Understand the cultural difference and adjust market access strategy accordingly.** For those franchisers that can navigate China's way, the prizes can be big. 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 brand names. 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.
- ③ **Minimize the price of the final products and the franchising fee to achieve rapid expansion.** The Chinese are price-conscious because their income is substantially lower than that of American. It is the same for Chinese investors. Actually there are not so many Chinese people who have one million USD and are interested in franchise business. So it is important to the new-to-China U.S. franchisers to lower the franchise fee.

6. 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 & 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. But foreign franchisers also need to be aware that Chinese consumers, especially those in big cities, are no longer crazed about every Western brand name. Instead, they try to judge if a foreign brand can really bring something different to their lives. For that purpose, foreign franchisers should have the means to invest heavily before they could see a return. Such investment includes not only money, but more importantly, time and patience.