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Franchising - an alternative European distribution strategy

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Introduction

The purpose of this article is to explain why franchising needs, at least, to be on the agenda for any business which provides goods or services to customers whether such customers are end users, consumers or business customers. There are several misconceptions about franchising which can result in the franchise format being discarded as a strategic option. These include:

-- franchising has been used successfully only in a limited number of industries such as fast food, parcels delivery and printing. In fact franchising has been used in over 70 different areas of business activity in the United Kingdom;

-- franchising works particularly well in relation to the delivery of goods or services to consumers; but franchising is growing particularly in the U.K.'s business to business sector;

-- franchising enables small businesses to distribute goods or services but is inappropriate for larger business. Increasingly major multinationals, including FTSE 100 companies, are seeking to franchise parts of their business or, indeed, to become franchisees in order to obtain know-how developed by third parties.

There are sound reasons why all commercial lawyers need to have some knowledge of franchising:

-- Franchising may well “bite” you when you least expect it. GKN, the major U.K. engineering company, acquired a small U.S. distributor of vehicle exhausts--Mieneke Muffler. This company operated through franchises. Some franchisees brought a claim against Mieneke Muffler and GKN and were successful at first instance in the U.S. courts. They were awarded damages in excess of U.S.$200 million, although GKN was subsequently successful on appeal.

-- The franchising formula may have advantages (which are discussed subsequently) which are not directly linked to the distribution of goods or services. It may be, for instance, that franchising is an attractive method of influencing a competitor in a situation where anti-trust regulations make an outright acquisition impossible.

-- There is some circumstantial evidence that franchising is a good way to expand internationally. Marks & Spencer, British Home Stores and Betterware, for instance, are all U.K.-based companies who do not franchise in the United Kingdom but who use the franchise format to expand overseas. The different methods of franchising internationally are discussed subsequently.

Definition

In some countries defining a franchise is of considerable importance because franchising, unlike other distribution methods, is heavily regulated. In the United Kingdom no such regulation exists and, indeed, in Europe only two countries currently seek to regulate franchising. In Spain, the Royal Decree 2485/1998 of November 13, 1998 regulates franchising by imposing substantial disclosure obligations. In France the Loi Doubin dated December 3, 1989 also imposes a disclosure requirement but affects all trading activities whereby a trading name or trade mark is licensed to a third party who is granted an exclusive or quasi-exclusive territory.

The existing block exemption for franchising--E.C. Commission Regulation No. 40878/88--also contains a definition of franchising as a "package of industrial or intellectual property rights relating to trade marks, trade names, shop signs, utility models, designs, copyrights, know-how or patents, to be exploited for the resale of goods or the provision of services to end users", but during 2000 the existing block exemption will be replaced by the proposed vertical restraints block exemption which, in its latest published form, contains no specific provisions on and therefore no definitions of franchising.

Notwithstanding the diversity of definitions business format franchising contains four essential elements:

-- the franchisor allows the franchisee to use a name which is associated with the franchisor;

I.C.C.L.R. 6 -- the franchisor exercises continuing control over the franchisee;

-- the franchisor provides assistance to the franchisee;

-- the franchisee has periodically to make payments to the franchisor.

Franchising should be distinguished from other types of distribution arrangements such as:

Distribution. A manufacturer or, more rarely, a supplier of goods appoints an independent third party to market its goods. The independent third party purchases the goods on his own account and trades under his own name as an authorised distributor. His business name will usually have no connection with the name of the supplier/manufacturer. Nor will the supplier regulate the way in which the distributor operates his business other than, perhaps, to oblige the distributor to reach minimum turnover levels, to maintain advertising and P.R. material, to maintain a minimum stock of both goods and spare parts and to employ experienced service personnel. These provisions should be compared to the much more extensive restrictions which a franchisor seeks to impose on its franchisees. Furthermore, no royalties are payable to the supplier by the distributor. The supplier's profit arises from the difference between the price at which he manufactures or which he pays for the goods and the price at which he is able to sell the goods to the distributor. Whilst a clear distinction can be drawn between franchising and distribution it should not be forgotten that franchising has developed from distribution agreements.

Agency. Agents do not purchase products in their own names. All contracts are made either directly by the supplier and the customer or by the agent on behalf of the supplier. A supplier imposes relatively few restrictions on his agent and these normally relate to the agent's powers to bind the supplier. Most franchise agreements provide that no agency relationship is created but some franchises do contain an agency--principal relationship. This frequently occurs in parcel delivery franchises where contracts with customers are generally entered into by the franchisor but delivery and collection is effected through franchisees.

Licensing. Intellectual property rights or know-how are frequently licensed to another manufacturer to enable that manufacturer to produce and/or sell goods. Whilst most franchise agreements contain a licence to use the franchisor's trade mark, brand names and know-how, franchise agreements are unlikely to relate to the manufacture of products, and a franchisor will seek to regulate the way in which the franchisee operates his business (as opposed to quality control restrictions in relation to the goods to be produced pursuant to the licence) in much more detail than a simple licence agreement.

The advantages of franchising

The advantages of franchising for a distributor of goods or services are:

-- Franchising offers the opportunity to secure distribution for products or services faster than would be the case if the franchisor had to train its own employees and develop its own internal marketing, sales and distribution organisation.

-- The use of a franchisee's capital will facilitate the expansion of a network more quickly than would be the case if the franchisor had to find the funds itself.

-- Many companies involved in the supply of goods or services seek to motivate their employees by linking their remuneration to the sales they achieve. Franchising takes this one step further by linking the franchisee's financial well-being to the success of the franchisor's business.

-- Franchisors with their increased purchasing power and possibly also reduced overheads may be able to increase the profitability of small units.

-- Franchisors may be more likely to thrive in a recession than non-franchised businesses. A survey conducted for the British Franchise Association by Cranfield School of Management in June 1991 found that franchisors were 12 per cent more likely to have increased their profitability when compared with non-franchisors during a three-month period in the first half of 1991 when the United Kingdom was deep in recession. And for the first quarter of 1991 over 37 per cent of franchisors expected their profitability to increase, compared with the 17 per cent who expected a decrease. Further evidence of the generally positive financial performance of franchised outlets during “difficult” trading periods is provided by a report commissioned by the Royal Bank ***I.C.C.L.R. 7** of Scotland which

confirmed that during recessionary periods "where franchisors operated a mix of company and franchised outlets the latter had vastly outperformed the managed outlets. This was attributed to the high motivation and commitment of franchisees".

Disadvantages of franchising

However, franchising also has disadvantages for a franchisor.

-- The major disadvantage is loss of control. Whilst the franchise agreement will impose substantial restrictions on franchisees, it is important to remember that franchisees will be independent third parties who will be seeking to maximise their profits, sometimes at the expense of the franchisor. It is important for the franchisor to keep a very close control on franchisees because one "rotten egg" may well affect the good name and reputation of the entire franchise network.

-- Part of the franchisor's profit element is used in supporting an additional entity, the franchisee, in the distribution chain.

-- In involving third parties in their business, franchisors will, inevitably, have to divulge substantial know-how and information concerning their business. The franchise agreement will contain restrictions on the franchisee's ability to make use of this information for his own purposes but such provisions are often difficult to monitor and enforce.

-- The skills required to control franchisees and provide the back up required are different from those involved in operating a business through employees.

-- The standardised approach required in franchising has been criticised. In an article entitled "The Service-Driven Company" (*Harvard Business Review* , September-October 1991), Professors Leonard Schlesinger and James Heskett argue that McDonald's was one of many American service companies which was being penalised by what was once its greatest strength: a standardised, production-line approach which deliberately emphasises technology, machines and systems and seeks to minimise the role of people. The article observes that "front-line contract jobs are designed to be as simple and narrow as possible so that they can be filled by almost anyone--idiot proof jobs", and goes on to say, "in fact, the more that technology becomes a standard part of delivering services, the more important personal interactions are in satisfying customers and in differentiating competitors."

The use of franchising to expand internationally

Research has been conducted on the reasons why U.S.-based franchisors have sought to expand overseas as well as the perceived disadvantages of international expansion. The conclusions which the research reached are set out below:

Reasons for overseas expansion	%

Additional growth/expansion	28.2
Added revenues/profits, improved ROI, or other direct financial gain	28.0
Larger market, more market penetration, more market share	16.9
International identity, greater name recognition	10.5
No/less competition	5.9
Untapped potential	5.1
Added exposure (in general)	5.1
Other categories of benefits	17.5
No benefits	7.9
Perceived disadvantages	**%**
Lack of control/accountability	35.5
Difficulty of supporting/servicing franchisees, operating challenges	14.4
Cost/expense	13.6
Distance, time difference	10.0
Culture/language difference, difficulty of judging local needs	9.5
Government regulations, laws, difficulty of repatriating royalties	8.7
Quality control	6.0
Logistics/supply problems/costs	5.4
Resource drain, spread too thin	4.1
Time needed to develop/implement a plan	3.5
Increased risks/uncertainties	3.3
Complications/trouble (in general)	3.0
Adapting product/marketing to new markets	2.7
Other categories of drawbacks	15.7

No drawbacks	1.9

Notwithstanding the difficulties facing those businesses using franchising as a method of international expansion, franchising is increasing in popularity as a means of international expansion. Indeed many businesses who do not use the franchising format in the United Kingdom adopt one of the franchise methods set out below to expand overseas. These methods are:

-- Direct franchising--whereby a business grants franchises to franchisees in another country;

-- Establishing a subsidiary/branch in the target country which grants franchises to franchisees in that country;

-- Establishing a joint venture with a local partner to grant franchises;

-- Entering into a master development or master franchise agreement. Under a master franchise agreement the master franchisee undertakes to grant sub-franchises to third parties. Under a master development agreement, the master developer undertakes to open outlets itself rather than by way of sub-franchising.

Direct franchising

Direct franchising is generally only possible when:

-- a relatively small number of franchisees are to be appointed.

-- the franchise is “simple” so that franchisees can be trained easily and there is no constant need for assistance.

-- the target country is both geographically and culturally similar to the country of the “home” business.

The advantages of direct franchising are:

-- the franchisor has, in theory at least, substantial control over franchisees because there is a direct contractual link between the franchisor and the franchisee.

-- there are no formalities although in countries which regulate franchising the fact that the franchisor is “foreign” will not relieve the franchisor of the obligations to comply with regulations.

-- it is potentially more profitable than other forms of franchising because the franchisor does not have to “share” its profits with any intermediaries.

The disadvantages of direct franchising are:

-- it is an essential element of franchising that the franchisor provides adequate consultation, back-up and assistance and in most cases this will not be possible if the franchisor is situated in another country.

-- the franchisor may have little information and knowledge about the target country;

-- difficulties may arise in enforcing strict adherence to the franchise agreement and manual if the franchisor is resident in another country and is as a result unable to exercise

day to day control.
-- prospective franchisees, bankers and suppliers may be sceptical about the foreign franchisor's commitment if direct franchising is used.
By reason of the above it is unusual for a franchisor to seek to expand by direct franchising. In Europe direct franchising occurs most commonly between the United Kingdom and the Republic of Ireland, France and Belgium, within Scandinavia and between Germany and Austria.

Branch/subsidiary

There are, of course, substantial legal differences between setting up a branch office and setting up a subsidiary in a foreign country. The tax implications of a branch will have to be considered carefully because a franchisor which sets up a branch operation in some jurisdictions may be liable to tax in the target country on part of its worldwide taxable profits. Perhaps more importantly, if the expansion in the target country is unsuccessful the franchisor's financial position in his home country could thereby be affected. A subsidiary, being an independent legal entity could, should the need arise, be liquidated. A further disadvantage of establishing a branch office is that the filing requirements of the target country may require full details of the franchisor to be disclosed to the authorities. If a subsidiary is set up, only information about the subsidiary is usually required to be disclosed.
A foreign franchisor will tend to set up a branch or subsidiary in broadly the same situations as direct franchising--where the risks are small.
The advantage of a branch or subsidiary operation is that the franchisor remains in control of the franchise operations and does not have to share any of the revenue with a third party. The franchisor can also introduce local knowledge by employing individuals with this knowledge in the branch or subsidiary.

Joint venture

In order to overcome some of the disadvantages of a subsidiary/branch operation franchisors often consider setting up a joint venture particularly in “medium” risk territories. The partner in such a joint venture would be an existing business or entrepreneur in the target country with knowledge of the market in that country.
There are substantial disadvantages to a joint venture operation, which are not unique to franchising and relate to such matters as: who has control; what functions are performed by each of the joint venturers; what is to happen should there be a dispute; what will be the dividend policy of ***I.C.C.L.R. 9*** the joint venture (one party may be seeking capital appreciation whilst the other may be looking for an income stream) and how will board/shareholder approval/consent to major decisions be made; but the advantages are

that a joint venture does enable a foreign franchisor to tap into local knowledge and, perhaps, local funding whilst retaining control or involvement in the operation and taking a larger share of the profits than would be the case in a "pure" master franchise or development agreement. Often franchisors strengthen their position by requiring the joint venture company to enter into a master franchise agreement, and possibly also a trade mark licence, in respect of the trade mark to be used in the franchise business.

Master franchise and master development agreement

In those territories which contain a substantial risk for franchisors, most franchisors seek to pass on this risk to a master franchisee or master developer. In such situations it is the master developer/franchisee who funds the overseas expansion and who provides the management and other resources in order to develop the operation. As already indicated there are substantial differences between master franchise and master development agreements but, generally, the issues surrounding the two are similar. Usually, however, a master developer is appointed when a franchisor is approached by a business with substantial resources to enable that business to fund the development itself and not through the resources of franchisees and third parties.

The major advantage of master franchise/ development agreements are, as already indicated, that a franchisor can make use of the knowledge and finances of the developer and franchisee but the disadvantages are considerable. These are:

Control is lost. The master developer/franchisee is granted rights, almost always exclusive, for a considerable period of time--usually 20 years. Whilst the "master" agreement contains obligations on the master franchisee/developer, in practice relatively few master agreements are terminated for breach.

Termination. If a franchisor has to terminate a master agreement the consequences can be severe because that franchisor has up until then had little contact with the target country and may be unable to take over the franchise outlets.

Profitability. The profitability of a "master" arrangement is less than direct franchising because clearly the master developer/franchisee must obtain a return for its investment.

Risk. There is the danger that a franchisors "eggs are in one basket". If either the master franchisee or developer fail to live up to their commitments, this could have a very substantial knock on effect on the franchisor's ability successfully to expand in that country.

Not franchising. In the case of master development agreements (but not master franchise agreements), a developer undertakes to open outlets itself using its own employees. Such an arrangement is not franchising and the advantages of franchising set out above will not be available.

Further potential advantages of franchising

Clearly franchising has both advantages and disadvantages as a method of distributing goods or services, but there are other factors which can influence the use of franchising:

Non-core activities. Some businesses require non-core businesses to enhance their core business activities. Forte, for instance, operates a substantial number of highly successful hotels, but its hotel restaurants were failing to attract the desired level of customer interest. As a result Forte entered into franchise agreements to operate Mongolian Barbeque franchises in some of its non-luxury hotels, and its luxury hotels entered into similar arrangements with leading chefs such as Nico Ladenis or Raymond Blanc.

Yorkshire Electricity adopted another approach to non-core activities. Yorkshire Electricity employed a significant number of maintenance personnel who carried out extensive maintenance duties at its sites. Whilst such maintenance was an essential part of Yorkshire Electricity's business, it was not core. Yorkshire Electricity decided to encourage a management buy-out in which it retained a shareholding. Ex Yorkshire Electricity maintenance employees were offered franchises by the buy-out company--Freedom Maintenance. Some employees decided not to take the franchise but those who did undertook maintenance work for Yorkshire Electricity which was Freedom Maintenance's major customer along with maintenance work for ***I.C.C.L.R. 10** third parties. The difficulties that Yorkshire Electricity had previously experienced in supervising the activities of its maintenance employees who carried out their activities a considerable distance from Yorkshire Electricity's main premises had, by use of the franchise format, been eliminated.

Funding. Franchising may be used as a method of raising finance. In the case of Freedom Maintenance, redundancy payments made to employees by Yorkshire Electricity were reinvested by way of franchise initial fees in Freedom Maintenance in which Yorkshire Electricity had a shareholding. This undoubtedly reduced the amount of funding required by the management buy-out team as well as ensuring for Yorkshire Electricity that redundancy payments were invested into business activities which benefited York-shire Electricity.

Regulation. Whilst franchising in many countries is substantially regulated, the generally benign view of competition authorities to franchising does offer potential advantages. The European Commission believes that many European distributors use the franchise format within the European Union to take advantage of the generally more favourable treatment afforded to franchising under the franchising block exemption over other distribution methods.

Franchising can also enable a business in a powerful market position to exert control over another business which it would be prevented from doing if it simply acquired the target either by virtue of merger regulation provisions or provisions regulating dominant positions. British Airways appointed its first franchisees--City Flyer Express--in 1993.

Under the franchise agreement aircraft were reliveried, cabin crew had to wear British Airways uniforms, British Airways safety requirements were enforced, City Flyer's service were marketed by British Airways, and customers were able to use Airmiles and other British Airways benefits on City Flyer flights. Whilst City Flyer was able to set its own fares, schedules and routes, in practice it complied with British Airways requirements. The franchise agreement was not subject to anti-trust regulation at the time it was entered into but when British Airways, at the request of City Flyer, sought to acquire the airline some five years later, the acquisition itself was subject to the merger provisions of the Fair Trading Act 1973, but it is doubtful whether City Flyer was any more under the control of British Airways after its acquisition than it was under the terms of the British Airways franchise agreement.

European franchise market

Finally this article looks at franchising activity within Europe. The European Franchise Federation has jointly with NatWest Bank undertaken a detailed survey of European franchising (European Franchise Survey, August 1997). It subsequently produced a supplement in 1998 updating the findings from the previous year. Graph 1 sets out the number of franchise systems in the countries surveyed.

Graph 1: Franchising in Europe.

The countries reporting the highest increase in franchise systems from the previous year were Spain, Austria and the United Kingdom. Growth in franchise systems in Hungary, Germany, Italy and France was average whilst both Denmark and Portugal showed a substantial reduction in the number of systems.
Graph 2 sets out the total franchise turnover in the countries surveyed. The domination of France probably relates to the fact that it has a far greater number of large retail outlets adopting the franchise format than the United Kingdom where ***I.C.C.L.R. 11** franchising is often used for the supply of business to business services.

Graph 2: Total franchising turnover in European countries.

In absolute terms taking no account of population differences, franchising is dominated in Europe by Germany, the United Kingdom and France. Between them these countries account for some 40 per cent of franchise systems, 50 per cent of franchisees, 60 per cent of total employment and 55 per cent of turnover. Within the three, France dominates with its turnover of 28.3 billion ECU which is nearly twice the turnover of Germany and almost three times the turnover of the United Kingdom.

Graph 3 looks at franchising in the four largest markets broken down into three categories: domestic franchises, in-bound franchises and outbound franchises.

Graph 3: Domestic, in-bound, and out-bound franchises.

Germany and the United Kingdom followed by France and Italy have the largest number of purely domestic systems--those franchise systems which neither originate from nor operate in another European Franchise Federation country. France and Germany provide the most franchise systems to other European Franchise Federation countries, with the United Kingdom some way behind in third place.
In a recent survey published by the University of Westminster and sponsored by the Royal Bank of Scotland plc (Franchising: Breaking into European Union Markets, December 1998), the U.K. franchising community was surveyed showing that 14 per cent of U.K. franchisors had expanded into Europe--for the purposes of the survey expansion into the Republic of Ireland was disregarded; 27 per cent were planning to do so within the next three years; and 59 per cent had no current plans to expand overseas. Of those that were actively involved in Europe, 56 per cent were trading in Ireland, 52 per cent in Germany, 43 per cent in France, 40 per cent in Spain and 26 per cent in Italy. For those considering expansion the percentages were: 71 per cent in Germany, 66 per cent in France, 63 per cent in Ireland, 42 per cent in Spain and 21 per cent in Italy.

Conclusion

Franchising may not be the right route for many businesses, but it should not be rejected without some investigation of its advantages. Indeed, all commercial lawyers should be aware of the opportunities which franchising could provide for their clients.