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INTERNATIONAL EXPANSION: IS MASTER FRANCHISING THE BEST APPROACH?

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There are a lot of misconceptions amongst franchisors about how to expand internationally and the role of master franchising in that expansion. Franchisors may not be fully aware what a master franchise really is and does, and indeed whether it is the best choice for their expansion. Franchisors often do not know how and when to master franchise or whether other options should be considered for international expansion of their franchise systems.

Before expanding into other countries franchisors first need to consider a variety of business factors in deciding when and where to franchise, though that discussion is beyond the scope of this article. But once a target country has been selected and a local candidate to assist with the foreign expansion has been identified, franchisors need to determine what expansion method will work best for them and for their prospective foreign franchisees.

Characteristics of a Master Franchise Arrangement

This article focuses specifically on two extremes among the different international expansion alternatives: master franchising and area representatives. For greater clarity, in a master franchise model the franchisor enters into an initial franchise agreement with a franchisee in the target destination, and the franchisee is responsible for all further expansion in that area or country. In addition to the right to itself open one, or more, units, the franchisee, which is commonly known as the master franchisee, is also granted the right to sub-franchise. Usually the parties will agree on a mandatory development schedule requiring that a certain minimum number of unit franchises be opened each year. The unit sub-franchisees that it recruits each enter into sub-franchise agreements with the master franchisee and the master franchisee becomes the sub-franchisor, standing in the shoes of the franchisor in the foreign territory.

Characteristics of an Area Representative Arrangement

By comparison, if using an area representative instead of a master franchise model, the franchisor enters into an agreement with an area representative to recruit franchisees within an area or country. Area representative agreements may vary significantly in scope, but the focus of the agreement is the area rep's obligation to recruit franchisees. The area representative may or may not itself sign a unit franchise agreement with the franchisor for its own unit franchise, and its obligations to support other franchisees in the territory also varies. However, the key to this model is that the franchisor itself enters into and services all of the unit franchise agreements with the franchisees recruited by the area representative. Unlike the master franchise model, there is no sub-franchising involved. There is only one franchise agreement signed between the franchisor and franchisee. This requires a hands-on approach by the franchisor, but permits the franchisor tighter control over its international expansion efforts since the franchisor has entered into all of the unit agreements itself and there is no master franchisee acting as a middle man.

Often, and without giving this much thought, franchisors will seize on "master franchising" as the preferred model for their foreign expansion. But, the reputation and "aura" of that model to the lay person may distort the reality of just what to expect. Franchisors often have exaggerated expectations of master franchising both with respect to the size of the income stream and the amount of work involved on their behalf. They may well be so hung-up on the "master franchise" terminology that they still wish to call the franchisee a master franchisee even though the "master" may in reality prove to be something quite different. Master franchising is not always what it seems.

Advantages and Disadvantages of the Two Models

Master franchising is not always the best alternative, and the results may be surprisingly disappointing to a franchisor that might have had better success if it had selected a different model. In the author's view, more master franchises likely fail than succeed and this is often because the wrong expansion method may have been selected from the outset.

What are some of the innate advantages to master franchising that makes it so attractive to most franchisors? The franchisor can expand quickly if the right master franchisee is selected. The capital contributed for the expansion will also mostly come from the master franchisee, which also facilitates relatively rapid expansion without the need for a significant infusion of cash from the franchisor. And, of course, the franchisor can rely on the master's own cultural, linguistic and other experiences in the area or country. These may well align more closely with the new unit franchisees than if the units were sold to them by an offshore franchisor from a very different culture and legal system.

But there also can be real pitfalls to using this model for a franchise system's foreign expansion. All too often the goals and priorities of the parties are not well aligned with one another, and that can be a recipe for trouble. For example, the franchisor likely seeks rapid expansion of its network but at the same time it wants the help of the local party with nurturing the franchisees already placed in the area or country. A master franchisee with the pressure of a development schedule over it may be focused just on meeting its development requirements and may lose sight of supporting existing franchisees, to the detriment of the entire system.

Another issue is that the profitability of the model may become a real question when using a master franchise model. The franchise fee and royalty pie that would have belonged entirely to the franchisor now must be shared with the master franchisee, meaning lower returns ultimately for the franchisor. The master also must be sufficiently well compensated to make the opportunity a worthwhile investment for it. Since it only gets a shared piece of the pie, if the return on its investment is insufficient from its sale of units and from its share of ongoing royalty revenue, it may not have the financial wherewithal to succeed.

A third significant issue is a loss of control for the franchisor. Once the master franchise agreement is executed, the franchisor typically steps out of the picture with respect to the day-to-day management of the system, as it is the master franchisee that will be the "franchisor" in the subsequent unit franchise agreements that are signed in the area or country. The franchisor has no direct contract with those franchisees and, therefore, it is the master franchisee that must enforce system standards, trademark compliance and payment of all monies owing. The master franchisee will localize the training, conduct the period inspections of franchisee locations, conduct local meetings and conventions, translate manuals, advertising materials and other items used both internally in the franchise system and externally - all things the franchisor does in its home market and that allows it to control that the franchise system is being implemented according to its standards.

The franchisor is often forced to look on in frustration if the master is not as diligent as it should be, or worse still, if the master does not keep the franchisor fully informed (whether due to its negligence or intentionally).

And if the master falters significantly or if steps must be taken to terminate the master franchise, what happens to all of the unit franchise agreements signed directly with the master? Most often, the franchisor is not a party to the sub-franchise agreements, leaving it with limited options. The unit agreements do not automatically get transferred back to the franchisor unless the master franchise agreement provides for this. And even if the franchisor manages to recover the unit franchisees for itself on any termination of the master, the franchisor may in some countries lose the ability to "cherry pick" (keeping just those unit franchisees that it believes would be advantageous to it and to the system as a whole).

An often overlooked alternative to master franchising is the "area representative" model. In some cases it may work just as well and maybe a whole lot better than a typical master franchise. First, if using an area representative model, the franchisor can be less concerned about alignment of the master franchisee's vision of how to expand with its own. The area representative will be focused on its development schedule since its main role is just recruitment. The area rep can be given a greatly reduced role in how the franchisor intends to operate its system in-territory Second, in an area rep model the franchise fees and royalties are paid to the franchisor and it keeps a greater percentage of them, as there is no master interposed to "share in the pie." Of course, how material an advantage that is will depend on the extent of payments that the franchisor must pay to the area rep. There may be a fixed fee payable (akin to a broker fee) or there may be a percentage payable. But since the area rep's duties are significantly less than those of a master who has oversight and contractual obligations to its sub-franchisees, it stands to reason that any percentage payable should be substantially less than the fees payable to a master franchisee. And maybe the most important difference is that there is really no loss of control at all for the franchisor over the unit franchisees and over how the franchisor's system will be implemented in the territory, since the unit agreements are all entered into directly with the franchisor. In the area rep model the franchisor alone makes all operational decisions about its system.

Furthermore, many of the same advantages that can be achieved from a master franchisee could also be obtained from an area rep. It is in the best interest of the area rep to provide its own local perspective and advice to the franchisor on what will work and what won't in the territory. If the system is functioning properly and existing franchisees are happy, it makes the area rep's job of recruiting new franchisees that much easier. And, not to be overlooked, while a master's role has both operational aspects to it (in managing the local sub-franchisee network) and sales aspects to it (in recruiting new sub-franchisees into the system), those two skill sets may not always be well aligned. Someone who is good at management and operational details may not be as effective in selling franchises, and vice versa. The area rep's role is really limited to just recruitment, so as long as the area rep has good sales skills there should be greater chances for success.

Of course an area representative model does not solve all problems that are typical to a master relationship either. One example is who performs and pays for all of the daily supervision and control of the local unit franchisees. If a master is not interposed into the model, then of course the franchisor itself must bear all of these costs and it must invest the time itself that it takes to deal with the local franchisees on an ongoing basis.

Foreign expansion is not a walk in the park, and what worked "at home" may not work abroad. Traditionally, expansion internationally has used a master franchise model. Given the number of master franchisees who fail, and the costs of such failures to franchise systems, maybe it is time to re-think this strategy and consider area representatives as an alternative.