Franchising in Frontier Markets

| What's Working, What's Not, and Why |

Dalberg

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Foreword

by Steven R. Beck, Senior Fellow, John Templeton Foundation

The John Templeton Foundation (JTF) was founded 20 years ago to serve as a philanthropic catalyst for discovery in areas engaging life's biggest questions. The Foundation funds rigorous scientific research and related cutting-edge scholarship on a wide spectrum of core themes, including entrepreneurship and enterprise-based solutions to poverty.

Among poverty interventions, microfinance has become the private enterprise approach *du jour*. Yet, microfinance – the provision of standard financial services to the poor – seems to have limited systemic impact, typically smoothing tenuous household cash flows and supporting family-based, subsistence businesses operating in the informal economy. The critical challenge remains how to scale small businesses in order to provide greater employment, wider economic vitality, and a growing indigenous tax base.

Some researchers and practitioners have begun to promote franchising, and its younger cousin "microfranchising," as a higher order strategy with much greater impact. Franchising seems to have a lot to offer frontier markets that seek to grow private enterprise. Franchise businesses are designed for replication, require less experienced entrepreneurial talent to run a proven business format, and provide business-learning opportunities within a defined support structure. As we look at low-income markets, there seems to be a proliferation of microfranchise businesses – those where the franchisee is small (even a single person) or those that are serving the base of the pyramid with public goods such as healthcare and education. But there are relatively few large-scale international franchises operating in the frontier markets of sub-Saharan Africa.

So we are left with the question: Is franchising an underexploited business model in frontier markets? Could franchising be the "next big thing" in development?

To address these questions and others, early in 2009 the JTF made a grant to Dalberg Global Development Advisers to explore whether franchise business models – large and small – have the potential to stimulate economic growth, create jobs, and develop entrepreneurial skills in frontier economies. The study was designed to bring greater understanding of what is actually working in the field and what is not. The objective was to separate the myths from the realities, promote investment in effective franchise business models, and identify areas for further fruitful research.

We are grateful to Dalberg's Wouter Deelder and Robin Miller for their research efforts, and to the experts that granted them time to be interviewed, to compile the findings presented below.

We are also grateful for the support of the International Finance Corporation (IFC) and the World Bank Group. On September 16, 2009, the IFC hosted a one-day workshop that brought together more than 50 practitioners, investors, researchers, and consultants to review the team's preliminary findings. Bringing together practitioners and experts in large-scale commercial franchising with those practicing and studying franchising from a development perspective yielded a spirited debate and enhanced understanding – both ways. The workshop helped the team sharpen and refine the initial findings and highlighted additional areas for research. And plans were made during the meeting for future opportunities for dialog and learning. We are indebted to the workshop participants and trust that the time invested in the workshop and this report will assist future efforts.

Preface

Sustainable economic growth and vitality depend on private enterprise and entrepreneurship. People taking innovative approaches to development in frontier economies are increasingly using private-sector mechanisms to address development challenges, ranging from failures along the supply chain to the provision of essential services.

As the World Bank argued in its seminal *World Development Report 2005: A Better Investment Climate for Everyone*:

> Private firms are at the heart of the development process. Driven by the quest for profits, firms of all types – from farmers and micro-entrepreneurs to local manufacturing companies and multinational enterprises – invest in new ideas and new facilities that strengthen the foundation of economic growth and prosperity. They provide more than 90% of jobs – creating opportunities for people to apply their talents and improve their situations. They provide the goods and services needed to sustain life and improve living standards. They are also the main source of tax revenues, contributing to public funding for health, education and other services. Firms are thus central actors in the quest for growth and poverty reduction.

In this context, our research addressed pertinent questions about franchising, especially in frontier markets:

- Is franchising the next big thing in development?
- Is franchising an underexploited opportunity to accelerate the growth of successful businesses, thereby stimulating economic growth? What is actually working on the ground, and what is not working?

- What are the conditions for franchising success? What are the barriers and enablers?
- What is the potential for franchise business models to effectively – and sustainably – deliver "public" goods and services at scale?
- Do micro-franchises offer an effective way to reach (and employ) the base of the pyramid in frontier markets?
- What are the synergies between micro-finance networks and micro-franchise businesses?

This report is based on a research effort initiated in May 2009 by Dalberg Global Development Advisors, with support from the John Templeton Foundation and the International Finance Corporation. Between May and October 2009 – the team performed research, assembled case studies, conducted interviews with over 40 practitioners, investors, and researchers (the full list of organizations profiled, interviewees and workshop participants can be found the Annexes) and engaged in a stakeholder workshop hosted by the International Finance Corporation (IFC), seeking answers to the above questions. The geographic scope of the study focused primarily on sub-Saharan Africa and South Asia but also included perspectives from Latin America.

The report aims to provide insights for investors and donors, researchers, practitioners, and policy- makers to inform and guide efforts while stimulating additional innovation and research.

A draft version of the report informed the proceedings of a workshop hosted by the International Finance Corporation on September 10, 2009, in Washington D.C. The workshop was attended by investors, researchers, and practitioners who significantly contributed to the final report.

Despite our best efforts, errors will almost certainly have crept into this document, and of course we take responsibility for them.

Executive Summary

There is a growing interest in franchising as a mechanism for catalyzing business growth, economic development, job creation, and skills development in frontier markets. Dalberg Global Development Advisors, with support from the John Templeton Foundation, conducted a 3-month study to explore franchise models in frontier markets and the factors critical to their success. The study's direct aim is to:

- Is franchising the next big thing in development?
- Is franchising an underexploited opportunity to accelerate the growth of successful businesses, thereby stimulating economic growth? What is actually working on the ground, and what is not working?
- What are the conditions for franchising success? What are the barriers and enablers?
- What is the potential for franchise business models to effectively – and sustainably – deliver "public" goods and services at scale?
- Do micro-franchises offer an effective way to reach (and employ) the base of the pyramid in frontier markets?
- What are the synergies between micro-finance networks and micro-franchise businesses?

The findings of the report will be of interest to the following audiences:

- Capital providers (investors and donors), with the aim to inform and guide capital allocation to franchises.
- Policy-makers, to inform and guide efforts to stimulate franchising in frontier markets.
- Researchers, to identify promising areas for further research.

- Practitioners, to share opportunities, challenges, and recommendations for successful franchising in frontier markets.

Despite the understandable appeal of franchising as a potential business accelerator in frontier markets, our research shows that franchising per se is not the "next big thing" in development. There are too many formidable obstacles to successful business format franchising in the frontier markets we researched. In particular, most frontier markets lack the purchasing power, access to capital, legal & regulatory framework and technical advisory services that enable most business format franchises to grow profitably.

Indeed, we researched numerous socially-motivated attempts to pursue franchised expansion in arguably the most difficult and problematic sector of all – healthcare. Most of these attempted to franchise before developing a self-sustaining (that is, profitable) business model at the unit level. Thus, their growth has been limited by an ever-expanding requirement to raise grant capital to grow scale and social impact. These grant-maintained health franchise operations may still offer quality healthcare at a lower cost than the current alternatives, but we are concerned that their external grant subsidies have inhibited an aggressive search for more creative and locally sustainable alternatives.

Having noted the difficulties, we did nevertheless observe promising replicable business models that have flourished in very challenging markets. In particular, we studied a number of profitable traditional micro-franchises – that is, very small-scale, often single person franchisees profitably distributing standardized branded products or services (think "Avon" rather than "McDonalds") – in a variety of frontier markets in Africa and South Asia. The simplicity of the business model meeting an underserved market need is the key to their success.

As ever, the reality is more varied, nuanced and complex than we would like. Further research is required, particularly into the creative possibilities around the delivery of traditional "public goods" like healthcare and education through self-sustaining franchise business models. Meanwhile, investors and donors need to be highly selective, remembering the proven rules of franchise success in developed markets. The basic lessons of the last five to six decades of franchising in the West apply in frontier markets and need to be heeded.

A careful study of successful franchising in developed markets generates important lessons for franchise businesses in frontier markets:

- Companies franchise to overcome financing and monitoring challenges and to leverage entrepreneurial skills and incentives, while individuals become franchisees because of the perceived lower risk and greater rewards.
- Successful businesses build and manage a hybrid network of franchised and company-owned outlets.
- Successful franchised chains grow in a predictable manner:
  - » Successful franchises first develop a profitable, sustainable, and scalable business model.
  - » The path to franchise success is long, typically requiring 5-10 years of proving and customizing a concept and business model before attempting to franchise it.
  - » Successful franchised chains are subsequently able to grow exponentially over time.
- A number of misconceptions about franchising exist, especially those related to the risk profile and the franchisee profile:
  - » Franchising is not the only way to achieve rapid scale
  - » Franchisors often choose a mixed-model approach, including both company-owned and franchised units in order to maximize system wide profitability.
  - » Franchising does not automatically create first-time business owners; in frontier markets, franchisees are often established businesspeople and entrepreneurs with access to the capital necessary to own and operate a franchise.
  - » Business risks for franchisees are not necessarily lower than for independent growth; risks vary considerably in franchising. For a franchisee, franchising risks are higher than for independent entrepreneurship when the chains are smaller and newer, and lower when the chains are mature.

Investors and donors considering franchising in frontier markets should consider that:

- Achieving profitability and sustainability from the first outlet is a critical first step before any attempt to franchise is made.
- The impact of franchising on the overall profitability of the business is limited.
- Franchising is not the optimal choice for all expansion trajectories, with timing, sector, and geography each playing an important role in evaluating whether franchising is the appropriate option.
- Franchising in frontier markets does not always entail lower risk than independent growth and entrepreneurship profile.

Challenges for franchising are multiplied in frontier markets

Franchising is not a silver bullet for private sector development in frontier markets. It offers selective opportunities for players considering expansion into or replication within frontier markets, but also comes with a distinct set of barriers and challenges:

- Franchising creates the opportunity to leverage the entrepreneurial skills and local adaptation required for frontier markets.
- Franchising requires, rather than generates, a profitable business model. The lack of purchasing power and market density in frontier markets are thus a limiting factor.
- Business format franchising requires a complex ecology to flourish. This ecology includes the availability of reasonably priced capital for franchisees, sophisticated legal and regulatory frameworks, technical and legal advisory services, and the availability of qualified franchisees. The lack of such ecology in frontier markets significantly increases the risk and (agency) costs of franchising, thereby impeding a franchising strategy.
- The lack of relative profitability and scalability, as well as the perceived risks with regards to legal and regulatory environment, has resulted in very few Western chains expanding into frontier markets. For example, outside of South Africa, only 4 of the 10 top international franchise chains in 2008 have expanded into Sub-Saharan Africa (SSA), with approximately 30 outlets between them.[1]
- Within frontier markets there is wide variability of "franchise friendliness," driven by the provision of finance, the ease of entrepreneurship, and the sophistication of contractual, intellectual property (IP), and regulatory frameworks. For example, Mauritius, Namibia, and Botswana score significantly higher than other countries in Sub-Saharan Africa on franchising friendliness.

The implications for policy-makers are to focus on the wider enabling environment for the growth of SMEs rather than on franchising per se. A first focus on the general factors of access to finance, ease of opening a business, and enforcement of contracts will benefit all scale-up, regardless of whether through franchising or company-owned expansion. If these factors are in place, further measures can be taken that specifically benefit franchising (for example, franchising regulation and IP protection). Policy-makers will see greater benefits from building the enabling environment than from "picking winners" and supporting individual chains.

Investors should be cautious of the challenges with regard to successful franchising in frontier market. The market potential and density, as well as hurdles with regard

1 Rankings conducted annually by Entrepreneur.com.

to access to finance, ease of entrepreneurship, and the wider enabling environment should feature prominently in the due diligence. However, investors should note as well the stark difference that might exist in franchising friendliness between different countries and different sectors.

A set of promising franchise models exist in frontier markets

There are a number promising franchise models that are well adapted to the conditions in frontier markets and have demonstrated the ability to thrive amidst the challenges. These models are often home-grown (incubated locally rather than being established abroad), are based on the simpler traditional format franchising (rather than business format), and are flexible in customizing and mixing different elements of franchise models.

Home-grown chains are better positioned than Western chains, due to tailored products and pricing, lower overhead costs, and a better alignment with the enabling environment. Nando's provides an example of how a frontier market chain has prospered in these more challenging markets.

Traditional format franchising, and especially, traditional format micro-franchising, seems to be better suited to frontier markets than business format franchising, due to fewer franchisor/franchisee conflicts, lower capital requirements, and less dependence on favorable legal and policy environment requirements. SPOT Taxi (India), Fan Milk (Ghana), BlueStar Ghana, Coca-Cola's Manual Distribution Centers (Africa), Natura (Brazil), and Kegg Farms (India) are a few examples of successful micro-franchise chains utilizing the traditional model. These traditional franchises also have the benefit of increasing employment and building assets at the base-of-the-pyramid micro-chains.

Entrepreneurs have developed solutions to overcome challenges in the enabling ecology with regard to access to finance, access to human resources, and lack of regulatory frameworks:

- Access to finance can be addressed, if the capital requirements are relatively low, by joint-ventures and partnerships between franchisors and micro-finance institutions. However, these partnerships should focus on the provision of financial services, and not push micro-finance institutions into the separate and different business of distributing goods and services.
- Access to human resources challenges for the franchisee can be mitigated by approaches including management contracts, whereby the franchisor provides skilled and trained staff members. Marriott Hotels provides an example of a company that deploys management contracts.

- Master franchise contracts allow the (international) franchisor to interact with only one established (local) counterparty, who is responsible for the management of local franchisees. The master franchise relationship is more easily managed and enforced in environments with less-developed regulatory frameworks.
- Technological solutions can strengthen the power of the franchisor in conflicts with franchisor, and decrease the risks of a lack of contractual frameworks. Vodacom and Spot Taxis show how technology can be applied to exclude franchisees if needed.

Investors will want to search for indigenous franchise chains that have adapted their business model and products and services to the local market conditions. Franchising concepts that require lower financing and a less advanced enabling environment, such as traditional micro-franchising concepts, will tend to be more successful. For all chains, the due diligence should focus on understanding unit level profitability and outlet growth potential, potential franchisor/franchisee conflicts, and barriers in the enabling ecology.

Good as the enemy of great: the promise and challenge of franchised delivery of public goods and services

Franchising has been of interest to development practitioners as a potentially more efficient and scalable distribution model for "public" goods and services like healthcare and education, due to its assumed potential to provide rapid scale-up, foster local ownership and create a strong brand and quality standards. This approach has been referred to as "social franchising."

However, franchised chains that focus on the provision of public goods and services have been hampered by the lack of profitability, and continued to be grant-dependent, inhibiting their ability to achieve large-scale social impact. The lack of profitability is driven by:

- Problematic sector economics in health and education, due to limited tradition and/or ability to pay and competition from subsidized alternatives.
- Elevated overhead costs, and a location and product-market strategy that assigns priority to social impact over financial returns.

Evidence suggests that a reliance on grant capital reduces the incentive to discover and design creative, profitable business models that can scale up without requiring an increasing subsidy. Moreover, grant-dependent models tend to cultivate a culture and mindset that regards profitability as a "nice-to-have" at best rather than as a survival imperative.

The franchises we studied that distributed public goods made the decision to scale-up through franchising too early – before establishing financial profitability and sustainability, which causes:

- Untenable demands for fundraising and grant-financing, which inhibit the scale of social impact that can be achieved.
- An increase in potential conflicts between franchisees and franchisor, especially with regard to how to grow, improve, and expand the business model.
- Subsidized competition for other entrants who might otherwise be able to serve the market profitably.

This leads to a situation where good becomes the enemy of great. In other words, it may be good to continue with a grant-subsidized delivery model if quality services are delivered more cost effectively than purely public or aid funded models; but the grant subsidy may impede the innovative and urgent search for a profitable great business model that would otherwise be driven by unadulterated business survival requirements.

Other franchises delivering public services, such as the HealthStore Foundation, have recently decided to shift from a grant-based, non-profit model to a for-profit entity, because they realized that achieving scale was not feasible in a grant-based model that suffered from a lack of entrepreneurship and managerial ambition.

Capital providers and franchise operators will want a clear economic model, transparent subsidies, and a cooperative creative search for local or national alternatives to the external aid subsidy. Franchising models that remain unprofitable should be evaluated within the framework of cost-effectiveness and aid-effectiveness in order to ensure that the good does not become the enemy of the great.

Areas for further research

Through this study, we identified a number of questions that would benefit from further research and exploration:

- What is the impact of franchising on profitability?
- What are the conditions for franchising friendliness across industries, across market segments (for example urban/rural and income strata), and across geographies?
- What is the relative impact of international franchise chains on homegrown franchise growth and development? In the case of traditional format microfranchising, are concepts developed in Western countries more successful than indigenous models?

- What are the relative merits of grant-subsidized franchise models vs. purely commercial franchise business models for the delivery of public goods and services? How can franchising be best used to deliver public goods and services at scale? What is the role of alternative forms of financing to support franchising?

This list is not meant to be exhaustive and we hope that, by disseminating this report and sparking the discussion, we will continue to add to this list.

Chapter 1: Introduction to Franchising

1

The history of franchising shows how significant growth can be achieved despite barriers of geographic distance and limited available capital. McDonald's and Subway may be symbols of franchising in the twenty-first century, but one of the oldest franchise models is the expansion of the Catholic Church. Centuries before Subway's sandwich artists, the Catholic Church used a franchise model to expand its geographic coverage.[2] And although it is a much more recent global phenomenon, Coca-Cola has been franchising its bottling processes for over 100 years to extend its geographic reach.[3] In the following section we aggregate the various models into business format and traditional franchising, consider key aspects of the franchise decision, and examine the impact of the franchising model.

Defining franchising

Franchising is commonly understood as a "contractual agreement between two legally independent firms in which one firm, the franchisee, pays the other firm, the

2 See www.whichfranchise.org/article.cfm?articleID=255.

3 Ibid.

franchisor, for the right to sell the franchisor's product and/or the right to use its trademarks and business format in a given location for a specified period of time."[4]

The franchise format has evolved over time to include variations ranging from the basic rights to sell a product, to a more complex agreement that might include branding, manufacturing, sales, distribution, and all operational processes associated with running a business. Avon, for instance, rapidly increased its business by franchising the sale of its cosmetics using Avon Ladies who took a door-to-door sales approach. The route McDonald's took to franchising, in contrast, includes most facets of operating and running the business, ranging from menu selection to real estate to product inputs and operating procedures.

Different types of franchising

Within the field of franchising, there are basically two sub-categories – traditional (or product) format franchising, and business format franchising.

Traditional format franchising is, as the name suggests, the oldest form of modern franchising. It involves a relationship between a company and a franchisee in which the company owns a particular product and offers exclusive sales rights (or distribution rights) to the franchisee. The value of traditional format franchising is the marriage between a successful product provided by the franchisor and an outsourced distribution network owned by the franchisee.

In most traditional format franchise businesses, the franchisor is a manufacturer who sells finished or semi-finished products to its dealers/franchisees. In turn, the franchisees resell these products to consumers or to other firms. The franchisor's profit is the margin placed on the sale of products and services to the franchisees, usually with no additional royalties levied. The most common traditional franchise models are bottling companies, car dealerships, and petroleum stations.[5] Examples include the bottling operations of Coca-Cola, Avon cosmetics, and BP service stations.

Business format franchising is characterized by licensing a business model, rather than products or services, to the franchisee. The franchisor charges a fee for the use of its business model and brand to franchisees. The contractual relationship is complex, and it encompasses the right to adopt an entire business process, with predefined roles and responsibilities, for both franchisee and franchisor, for marketing and advertising, operational standards and procedures, monitoring and quality control, and product distribution. The franchisor's revenues are usually collected as

4 Francine Lafontaine and Roger D. Blair, Economics of Franchising (Cambridge, UK: Cambridge University Press, 2005).

5 William E. Metzger is said to have been the first franchisee in automotive retailing; he obtained a franchise to sell steam automobiles from General Motors Corporation in 1898 (Justis and Judd 1998: 1-9). Coca-Cola sold its first bottling franchise in 1899.

a percentage of total franchisee sales. The most frequently cited examples of business format franchises are within hospitality, restaurants, and retail, and include Subway, Holiday Inn, and Jani-King.

For purposes of this study of franchising in frontier markets, we considered several other dimensions (see Figure 1):[6]

- **The products and services offered**, especially whether there is a focus on public goods and services.
- **The size of the franchisees**, whether they are micro, macro, or anything in between.
- **The objective of the franchise**, especially whether there is a profit or not-for-profit objective.

6 This report concentrates on understanding franchising's various applications across frontier markets. We rely on the World Bank's definition of frontier markets, which is based on national income classifications. Broadly speaking, frontier markets include two subsets - emerging markets and developing markets. Specifically, emerging markets include both upper- and lower-middle-income economies, and developing countries include all lower-income economies. The table in Annex 2 offers a sample of frontier markets using this classification.

Figure 1: Four Dimensions of Franchising

Dimension	Option	Option
Type of franchising	Business Format: Replication of entire business models, extensive franchisee-franchisor relationships; franchisees pays royalties	Traditional format (also known as product franchising): Focused on distribution, less complex relationship between franchisor and franchisee, franchisee pays no royalties (but purchases products under contract)
Size of the franchised unit	Macro: Fixed infrastructure, high investment costs, and significant number of staff members	Micro: Limited infrastructure and investment; owner is the only employee
Products and services offered	Public goods: Goods and services traditionally provided or subsidized by the state like healthcare and education	Commercial goods: All other products and services
Profit objective	For-profit: Objective is to create profits for the owners	Non-profit: No direct objective to create profits; primary objective is social impact

Source: Dalberg analysis.

This framework helps place the often-cited – and equally often-confused – concepts of "micro-franchising" and "social franchising" into context:

- *Micro-franchising* refers primarily to the size of the franchisee – and is typically a single person in a traditional franchise relationship.[7]
- *Social franchising* refers to franchises whose primary objective is to deliver public goods and services; they are most often subsidized by grant capital.

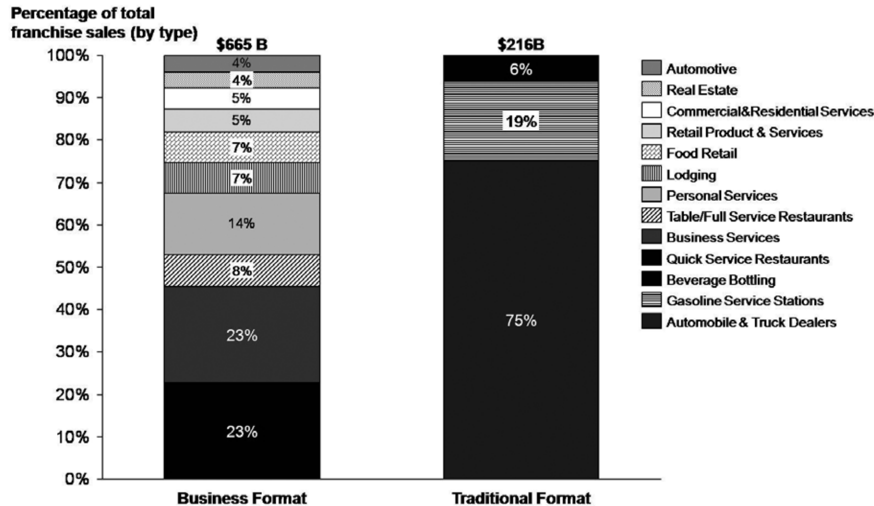
The economic contribution of franchising

In 2005, contribution of sales from business format franchising was more than three times the economic output as traditional format franchising in the United States. Business format franchising accounted for nearly six times as many units

7 The micro-franchising concept has been studied in detail by Jason Fairbourne and BYU's Marriott School, according to whom "the overall objective of microfranchising is to promote economic development by developing sound business models that can be replicated by entrepreneurs at the base of the pyramid; therefore, the start-up costs of microfranchises will be minimal. The key principle is replication, replicating success to scale."

and nearly four and a half times as many jobs. Franchisees owned most (73%) of the establishments that operated under a business format franchise. Traditional format franchising is predominantly linked to the auto industry, with 94% of total sales emanating from auto and truck dealers and gasoline (petrol) service stations (see Figure 2).

Figure 2: U.S. Franchising Landscape across Industries by Total Sales[8]



Source: International Franchise Association, Price Waterhouse Coopers, 2005. http://www.franchise.org/uploadedFiles/Franchisors/Other_Content/economic_impact_documents/EconImpact_Vol2_HiLights.pdf.

Scale: The case for franchising in frontier markets

Small and medium size enterprises (SMEs) are private firms that can make a vital contribution to economic development. They often struggle to grow and expand in frontier markets, however, creating a missed opportunity to boost economic activity. This failure to achieve scale also affects SMEs that focus on resolving human development challenges. Many innovative market-based solutions have proved successful on a small basis in frontier markets, but most have not managed to achieve the larger scale needed to make a real impact.[9]

8 International Franchise Association, Price Waterhouse Coopers, 2005. See www.franchise.org/uploadedFiles/Franchisors/Other_Content/economic_impact_documents/EconImpact_Vol2_HiLights.pdf.

9 This report concentrates on understanding franchising's various applications across frontier markets. We rely on the World Bank's definition of frontier markets, which is based on national income classifications. Broadly speaking, frontier markets include two subsets - emerging markets and developing

The franchise model – with its inherent characteristic of replication – intuitively seems to offer the potential of helping an enterprise reach larger scale. Franchising is seen by many as a business model uniquely positioned to facilitate development objectives, such as imparting new skills, encouraging entrepreneurship, and creating jobs.[10] Franchise associations around the world promote the unique ability of franchising to provide franchisors with an affordable, accelerated growth strategy, while offering franchisees a pre-packaged, low-risk business model and training provided through the franchise system. Franchising could in this way potentially support SME growth in frontier markets, both for purely commercial chains as well as for chains that deliver such public goods and services as education and healthcare.

Micro-franchising, in part because of its intuitive linkage with micro-financing, has received extensive attention from the development community. Micro-franchising is seen as a natural extension of micro-financing, because it builds a bridge between the formal and informal economies, promotes enterprise growth, and increases per capita incomes. As Katherine Terrell, Professor of Business Economics and Public Policy at the University of Michigan, states:

> Micro-franchising has enormous promise. First, [it] makes sense: it fits the reality of the [base] of the pyramid, has the right incentive structure, and can enable more [employment opportunities] than the microfinance model (which truly requires entrepreneurial talent). Second, the [micro-franchising] model allows social entrepreneurs to invest in poor countries, allowing them to "do well and do good" at the same time.[11]

This chapter has outlined a brief history of franchising, its different forms, and its impact. The next chapter will draw critical lessons for franchising in frontier markets from this history.

markets. Specifically, emerging markets include both upper- and lower-middle-income economies, and developing countries include all lower-income economies. The table in Annex 2 offers a sample of frontier markets using this classification.

10 First National Bank, "Franchise Think Tank White Paper: Pioneering Changes in the Franchise Sector of South Africa," 2009.

11 Please Copy! Franchising as a Development Tool. Allianz Knowledge Partner site. http://knowledge.allianz.com/en/globalissues/microfinance/alternative_finance/microfranchising_microfinance.html. Accessed 22 June 2009.

Chapter 2: Lessons Learned from History

2

Lessons from franchising in developed markets illustrate both the advantages and disadvantages of franchising versus company-owned expansion and help us understand franchising in today's environment. Below we look at the growth curves of successful franchised chains, and their common characteristics around timing and business model. The final lessons focus on commonly held misconceptions about the franchisee profile and the risk profile of franchising.

Advantages and disadvantages of franchising

There are distinct reasons why a company would choose to franchise or choose to pursue growth through a company-owned replication strategy. The following section explores the key questions that a business owner must explore when deciding whether or not to franchise.

Companies franchise to overcome financing and monitoring challenges and to leverage entrepreneurial skills and incentives. A company can expand and grow its number of outlets in two ways: add more outlets it manages and owns (known

as company-owned units), or add franchised units under the management and ownership of the franchisee.[12]

Businesses choose a franchise growth strategy over other forms of expansion to access capital, lower the costs of performance monitoring, and make the most of entrepreneurial incentives. The main reasons to choose the franchising path include:

- **Financing for growth**. Franchising overcomes limitatations for the franchisor in accessing financial resources for expansion. This argument, sometimes referred to as the resource-based view of the firm,[13] is thought to be somewhat less relevant in today's capital markets, where franchisors have less trouble attracting capital.[14]
- **Incentives and monitoring costs**. Franchising turns corporate managers into profit-sharing owners, changing incentives and the costs of monitoring. While the franchisor requires less expenditure on monitoring than is necessary in a company-owned chain, he or she must nonetheless monitor the franchisee's adherence to the franchising contract and standards. But overall, monitoring costs are reduced, making the argument for franchising more attractive.[15]

Individuals become franchisees because of the perceived lower risk and greater rewards. People choose to become franchisees because franchising offers them higher rewards than being a salaried manager and lower risk than being an independent entrepreneur. Those wanting to become franchisees believe franchising offers them the potential for a financial upside along with the entrepreneurial freedom that salaried employment as a company manager cannot offer. They also see lower risk and more chance to succeed compared to independent entrepreneurship – the operational model is already defined and is supported by a strong brand. The franchisor usually provides training and operational support. Several franchisees indicated to us that they would not have started businesses on their own.[16]

Successful businesses build and manage a hybrid network of franchised and company-owned outlets. A company that grows successfully requires an ongoing

12 Hybrid forms that mix-and-match elements of company and franchised systems exist.

13 "Towards Operational Excellence in Franchising," SAM Advanced Management Journal, 2008.

14 As discussed later, in frontier markets the franchisee's access to finance might be lower than that of the franchisor, creating a barrier for franchising

15 Monitoring costs and misalignments of incentives in a franchised setup, however, can be significant. Because the franchisor is concerned about all outlets, while the franchisee thinks primarily about his or her own outlet, conflicts can occur, such as encroachment, intellectual property infringements, and free-riding.

16 Roger Blair and Francine Lafontaine, "The Economics of Franchising," citing work done by Hunt (1972) and Stanworth (1977), who state that half (Hunt) and one-third (Stanworth) of franchisees would not have started up a business themselves.

evaluation of benefits and costs, and must monitor costs and any misaligned incentives. Franchising is not a final, once-and-for-all decision. It is common for successful chains to continually adjust the balance between franchised and company-owned outlets.

The expansion from one to many outlets will, regardless of the chosen model, give rise to agency costs. The owner (the principal) will need to hire individuals (agents) for the other outlets, creating costs incurred in monitoring and managing them, and these are what go into agency costs.

The nature and size of the agency costs involved is an important consideration in the decision to use franchising as opposed to adopting company-owned expansion, and it will strongly influence whether franchising is the best business model. In a company-owned setup, agency costs aim to avoid any lack of effort or entrepreneurship on the part of salaried managers (so-called "shirking"). In a franchised setup, in contrast, the objective is to reduce and monitor any misalignment between franchisor and franchisees.

Potential conflicts between franchisor and franchisees usually concern the various incentives, but mostly revolve around profit vs. revenue and one outlet vs. many outlets. (The following side box explains these conflicts in more detail.)

Side Box 1: Potential Conflicts in Franchising

Potential conflicts between franchisor and franchisee usually concern the various incentives surrounding profit vs. revenue and single vs. multiple outlets.

Profit vs. revenue misalignment arises because the franchisor is compensated through revenues (royalties), while the franchisee is compensated through (residual) profits. Royalties are calculated as a percentage of revenue, because revenue is easier to monitor and track than profits. The franchisor thus has an opportunistic incentive to push products that maximize revenue rather than profits. This tension is illustrated in franchisor-mandated discounts and price wars against competitors, of which the effects are felt much more strongly by the franchisee than by the franchisor. Amidst the "cheeseburger war" with Burger King, for instance, McDonald's was forced to raise the price of its double cheeseburger from $1 to $1.19 as a "response to pressure from franchisees, whose profit margins were being crimped."[17]

Single vs. multiple outlet misalignment arises when the franchisee tries to optimize his or her outlet profits, but the franchisor wants to optimize the results for the entire system (all outlets). This shows itself in issues on free-riding, encroachment, and innovation/adjustment.

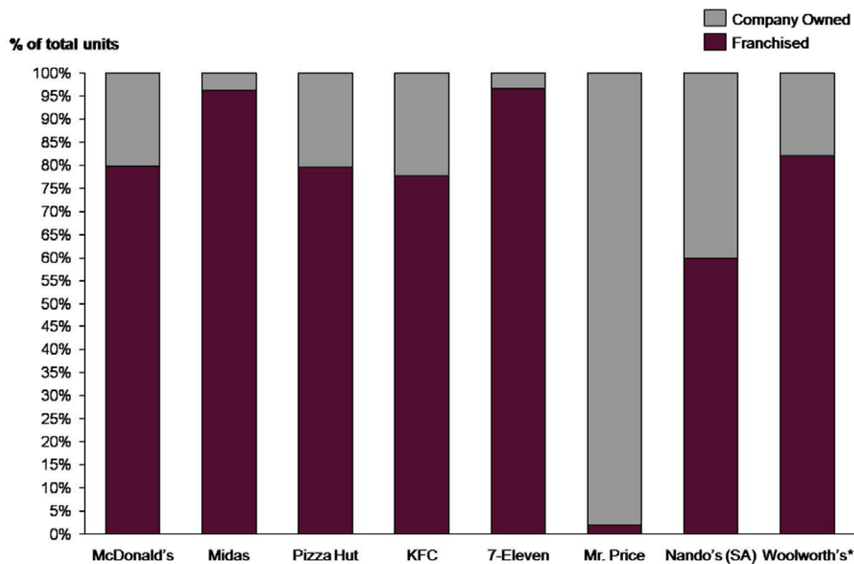
Free-riding refers to underinvestment in brand-building activities such as marketing, as the franchisee will largely incur the benefits of the brand even if he or she does not make investments (e.g., "the tragedy of the commons"). More seriously, franchisees might be tempted to engage in brand-eroding activities, such as using inferior ingredients, producing inferior products, or offering less service, because in such cases it will incur the full monetary benefits, but only part of the costs. Chances of this conflict occurring are especially strong if the franchise has a large group of one-off (i.e., not returning) consumers, such as in airports or train and bus stations.

Encroachment is the (opportunistic) incentive franchisors have to increase overall system revenue by inviting new franchisees into a territory already occupied by existing franchisees. This behavior will increase fees and royalties for the franchisor, but reduce revenues and profits for the individual franchisees.

Adaptation and innovation refers a to franchisee incentive to maximize his or her outlet profits by adjusting services and products to the local environment. Although this is likely to increase franchisee profits and franchisor royalties, it diminishes standardization across the chain, the economies of scale, and the value of the brand. Too much local adjustment can in the long run endanger the franchise chain's sustainability. Most chains are circling around an equilibrium in which franchisees have a certain amount of tactical freedom (e.g., opening hours, promotions), but cannot make larger innovations to the product offering and business concept. Franchisors, on the other hand, are often equally restricted in making large-scale changes and innovations, especially if some, but not all, franchisees would benefit.

The difference in agency costs between franchising and company-owned expansion, the opportunity to develop and incubate new product concepts, and the potential shift in profitability over time cause many chains to opt for a mixed model, with both company-owned and franchised outlets. Chains tend to shift between franchising and company-owned expansion at different times. Mixed models are chains that operate a mixture between franchised and non-franchised (company-owned) units. Figure 3 illustrates this mixture for eight leading franchise chains.

Figure 3: The Mixed Model – Eight Examples



Source: www.entrepreneur.com; Mr. Price and Nando's data taken from interviews. Woolworth's 2003 data taken from company website. All data is 2008 with the exception of Burger King, which is 2005 data. See www.woolworths.co.za/caissa.asp?Page=ITB4_RHContext&Post=FAT_Business_Local_Disclosure.

The advantages of this approach are:

- *Optimization of monitoring costs* in company-owned units located where the performace-monitoring costs are relatively low. Chains often retain ownership of locations that are close to headquarters, and can be easily managed and monitored.
- *Minimization of risks* by retaining ownership of units where the risks of incentive conflicts would be the highest. For example, chains retain ownership of locations

17 Chicago Tribune, August 28, 2009; http://www.chicagotribune.com/business/chi-biz-burger-king-mcdonalds,0,5653780.story.

with one-time visitors, such as airports, in recognition that franchisees may be otherwise tempted to free-ride on the brand and provide inadequate service / quality.
- *Rollout of new innovations*, thereby using company-owned stores as an incubator for new products, services or systems, allows the franchisor a greater degree of flexibility to test changes to the business model or introduce new product innovations.
- *Facilitation of benchmarking* by using the management of company-owned units as gauge for estimating future profitability of franchisees.

Coca-Cola and PepsiCo (see Side Box 2) provide good examples. Facing an increase in agency costs in a changed strategic environment (buyer concentration, marketing requirements), both companies decided to switch from franchising back to company-owned expansion.

Side Box 2: Managing the Mixed Model – Soft Drink Bottling Example

Large soft-drink manufactures, especially Coca-Cola and PepsiCo, have historically used traditional franchising agreements with their bottling companies. Coke and Pepsi can exploit economies of scale in procurement (e.g., caramel, sugars) and protect their secret recipes, while their franchisees have superior local market knowledge for distribution and marketing.

Pepsi and Coke have taken different bottling strategies. Pepsi has aggressively converted its traditional bottling franchisees into company-owned structures. Pepsi currently owns a large majority of its bottler operations, concluding a buying spree with an $8 billion deal in August 2009 in which it acquired its two largest bottlers.

Pepsi's rationale is an increased need for standardization and sophistication in its marketing strategy. This standardization is easier to achieve in a company-owned than a franchised setup. In the marketing war with Coke, Pepsi requires that all bottlers support and promote the same complex advertising and marketing campaigns. The "Pepsi Challenge" required a uniform roll-out. Some bottlers also interact with the same consolidated retailers (e.g., Wal-Mart), and require a standardized approach.

Coke has followed suit, but has been less aggressive in buying back bottlers. Coke has benefited from the stronger consolidation of its US and EU bottling operations, and has had to coordinate its marketing strategy among far fewer franchisees, reducing the case for company ownership. Coke nevertheless maintains significant equity stakes in most of its bottlers, giving it a large say in how operations and marketing campaigns are run.

Source: Besanko, Dranove, and Mark Shanley, Economics of Strategy (New York: John Wiley, 2000); interview with Coca-Cola CFO, Gary Fayard: http://www.flex-news-food.com/pages/24241/Coca/unlike-pepsico-coca-cola-need-buy-bottling-partners-says-coke-cfo.html.

Only limited information is available about the prevalence of mixed models in frontier markets, by either commercial or franchise chains delivering public goods. The study of prevalence and drivers will be an interesting area for further research.

The implications for investors interested in franchising in frontier markets are:

- Profitable growth is the overall goal, and to achieve this goal, the franchising decision must be periodically re-evaluated. Franchising should be seen as one business concept, among others, to reach scale, and is not the be-all-and-end-all.
- Franchising is not the optimal choice for all expansion trajectories, with timing, sector, and geography each playing an important role in evaluating whether franchising is the appropriate option.

How franchises grow

Another lesson from history focuses on a franchise's growth curve, from the first (profitable) outlet to the rapid growth at the end of the curve. The growth paths of successful franchised chains share common factors in terms of profitable business model and timing.

Successful franchises start with a profitable and sustainable business model. Successful franchised chains achieve profitable business models on a small scale (e.g., the first outlet), before they contemplate growth. Replication takes place when the model shows profitability and potential. We found no examples of chains that started with a loss-making initial outlet but continued to franchise and managed to grow into profitability.

A firm's growth increases profitability, primarily through economies of scale and to a much less extent due to franchising.

Economies of scale inherent in a larger size chain can have a drastic impact on profitability. Bronson and Morgan[18] have shown that the difference in profitability between independent entrepreneurs and franchised businesses in the travel industry can be largely explained by scale economies. The impact of size on profitability was also shown by Buzzel and Gale, who demonstrated that the largest firms in an industry had on average a profit margin over 3 times larger than the fourth smallest firm in a given industry.[19]

There is little information on the impact of franchising on overall chain profitability. Firms will choose franchising or a certain mixed model in the belief that

18 James W. Bronson and Cyril P. Morgan, "The Role of Scale in Franchise Success: Evidence from the Travel Industry," *Journal of Small Business Management* Vol. 36 (1998).

19 David Besanko David Dranove, Mark Shanley, and Scott Shaefer, *Economics of Strategy* (3rd ed.; New York: Wiley, 2003).

this will positively affect their long-term profitability. The impact of franchising is, however, likely to be significantly less than the achievement of scale economies. At the outlet/franchisee level, a shift toward franchising may increase profitability slightly if the business is highly systematized and the franchisees are more disciplined in managing inputs and reducing waste. A large fast-food franchisor indicated that the cost levels of a franchisee are approximately 0.5% to 1% lower than those of a company-owned outlet. At the franchisor level, the agency costs are reduced. However, these agency costs are only a small part of the overall franchisor cost-curve. In summary, although precise data is not available, our research indicates that the impact of franchising on profitability is very limited.

The findings of this study have three important implications for investors and donors considering franchising in frontier markets. First, it is difficult to establish a profitable business model. Thus, businesses that are unprofitable in the first outlet, with plans to achieve profitability through larger scale, should be viewed with a great deal of suspicion. Second, scale, size, and market share will have a significant impact on a chain's profitability. And finally, the impact of franchising on overall profitability will be limited.

Preparation to franchise takes significant time and effort. Figure 4 shows the start-up phase for a range of franchise chains, and indicates:

Figure 4: Growth Data for Sample Set of Large International Franchises

Company	Founded	Franchised	Total Units	Years until first franchise	Units before franchising
7-Eleven	1927	1964	33,818	37	60
Avis Rental Car	1946	1948	4,900	2	2
Blockbuster Video	1982	1984	250	2	4
Burger King (2005 data)	1953	1961	11,112	8	5
Domino's	1960	1967	8,624	7	1
Holiday Inn	1952	1957	1,338	5	1
Impresario (Mocha Coffee India)	2000	2004	35	4	1
Jani King	1969	1974	13,001	5	1
KFC	1930	1952	14,892	22	1
Kipp Schools	1994	2000	82	6	2
Kumon Math and Reading Centers	1955	1958	25,151	3	2
McDonald's	1940	1955	31,967	15	1
Midas	1956	1956	2,544	0	1
Mr. Price	1885	2007	820	122	900
Pizza Hut	1957	1959	12,877	2	1
Subway	1965	1974	29,612	9	16
Supercuts	1975	1979	2,133	4	6
Taco Bell	1962	1964	5,820	2	3

Source: Data drawn primarily from Entrepreneur.com in 2008; most recent available data based on company websites.

- Growth from one to two outlets often takes several years. Replication toward a small chain of units often takes between five to ten years. This time is spent testing the profitability and sustainability of the business model, and preparing the processes, products, and procedures for replication.
- Some firms start with a constellation of company-owned units before moving to franchising. A number of chains, such as Subway and 7-11, have started with company-owned outlets, presumably to further test and adjust the business model, before moving to franchising. Other chains, such as Dominos and KFC, have immediately used franchising from the second outlet they opened. A direct franchising strategy likely yields the fastest growth, but carries a higher risk profile, as adjusting the business concept will be more difficult than in a company-owned setup.

The implications for franchising in frontier markets are that investors and entrepreneurs need to be patient and invest significant time and effort in the first 5-10 years of operations to develop and refine the optimal business model before attempting to franchise. In their ambition to expand solutions to address development issues, social entrepreneurs, social investors, and donors need to beware of wanting to grow too fast, too soon.

Successful chains experience exponential growth, but it takes time. Once the preparation phase is completed, subsequent expansion can be very rapid. Figure 5 compares the unit growth of four major chains between the first and second decades of operation, with growth rates in the second decade often a factor of 5 to 10 higher.

Figure 5: Growth of Leading Large-Scale Chains

	First decade of operation	Second decade of operation
McDonald's	2 units	1,000 units
Subway	16 units	~600 units[20]
Holiday Inn	>100 units	1,000 units
Taco Bell	24 units	<800 units

Source: Company websites and Wikipedia.

20 http://www.google.com/search?q=subway+sandwiches+history+1985&hl=en&rlz=1C1CHNG_enZA323ZA323&tbs=tl:1&tbo=u&ei=U2KlSsD0EpPMMrar2fEH&sa=X&oi=timeline_result&ct=title&resnum=11&ved=0CCEQ5wIwCg.

As noted earlier, encroachment – or the franchisor's incentive to add more outlets close to existing franchisee outlets – is a common conflict of interest within franchising. Starbucks takes encroachment to the next level, and it has been suggested that it pursues this as a deliberate competitive strategy. This strategy, referred to as "cluster-bombing," entails aggressively increasing the number of outlets in a location to eliminate competition, and afterward removing some outlets. It would be very hard to pursue this strategy with franchised rather than company-owned outlets. Starbucks has, however, still managed to compile an impressive growth curve.[21] (Examples of growth curves of other chains are included in Annex 9.)

Misconceptions about franchising

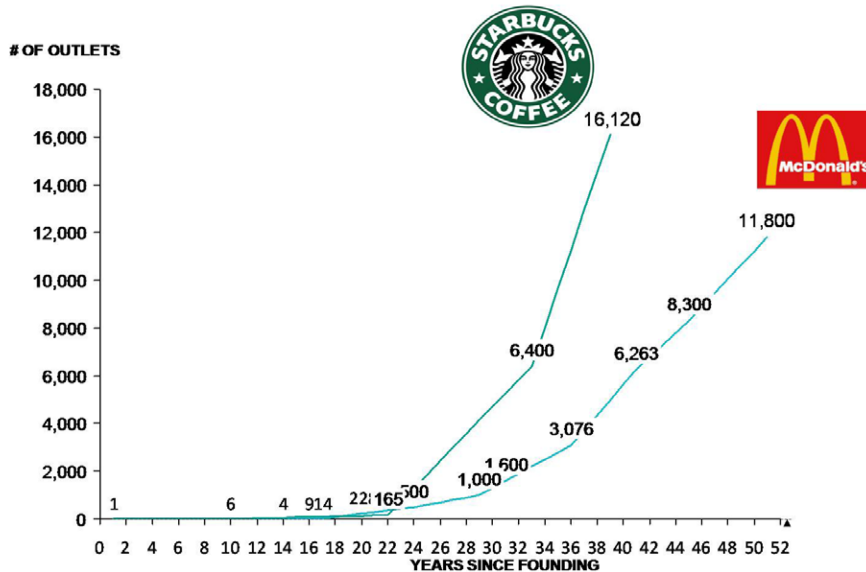
The final lessons for franchising focus on commonly held misconceptions about the franchisee profile, the risk profile, and the historic growth of the model.

Misconception: Franchising is the only way to achieve rapid scale. The growth of an individual chain can be exponential. Figure 6 shows this curve for McDonald's, and also indicates – through the illustrative example of Starbucks – that company-owned chains can grow even faster. Starbucks stands as a compelling contrary data point to conventional wisdom on franchising. Starbucks is fully company-owned, likely because of the company founder's zealous focus on standardization and "quality, quality, quality."[22] The aggressive expansion strategy of Starbucks might be difficult, or very complicated and costly, to accomplish with a franchising strategy.

21 Despite this rapid growth, Starbucks announced 600 store closings in 2008 to cope with increased competition and a more budget-conscious population. Shrinking Starbucks, Portfolio.com, July 1, 2008. See http://www.portfolio.com/news-markets/top-5/2008/07/01/Starbucks-Closes-600-Stores/.

22 http://www.msnbc.msn.com/id/15420414/.

Figure 6: Growth of Outlets Over Time: Starbucks (Company-Owned) vs. McDonald's (Franchised)



Source: Company websites and Wikipedia.

Franchising does not automatically create first-time business owners; franchisees are often established businesspeople and entrepreneurs. It is commonly assumed that franchising creates opportunities for first-time entrepreneurs and business owners, but most often this is not the case. The majority of franchised units that enter the market are taken up by franchisees who already own one or several units ("mini-chain owners"). This might, however, reflect the career path of franchisees, and is not necessarily a negative phenomenon.

In frontier markets, however, franchisees are often wealthy individuals who operate a portfolio of businesses, often across several brands and multiple concepts. Even a relatively well-developed franchising community such as the Franchise Association of South Africa acknowledges that most franchises are still owned by wealthy, educated elites who already own and operate businesses. A representative of Domino's Pizza indicated that in most frontier markets, franchisees are not "the budding entrepreneurs that work themselves up through the system," but rather are established and well-off businesspeople who are able to start up because of high entry costs and their superior access to financing.

Investors and policymakers should recognize that franchising will not necessarily stimulate first-time business ownership in frontier markets. If there is an objective

to promote first time business ownership, there will need to be creative financing solutions.

For a franchisee, the risks of franchising are higher than for independent entrepreneurship when the chains are smaller and newer, and lower when the chains are older and established. Franchising is often positioned as low-risk by franchise organizations, franchisors, and industry forums.[23] Franchisees are encouraged to adopt a business concept that has been tried and tested, has a defined business model and operating procedures, and in which support from the franchisor is readily available.

Francine Lafontaine and Roger D. Blair have challenged this low-risk notion as reported by industry associations and franchise publications. They analyzed entries and exits by US franchise chains between 1980 and 2001. Of the firms that started franchising in a given year, 60% dropped out after ten years. These exits occurred for a variety of reasons, such as franchisors and franchisees canceling or not renewing contracts, conversion to company-owned units, and chain bankruptcies, with half of those failing altogether (rather than continuing as company-owned chains). A separate analysis by Bates on other data concluded that 34.7% of franchised businesses fail, as opposed to 28% for independent entrepreneurs, over a 5-year period.[24] The average failure comprises both leading, established chains, and newer, start-up chains. The failure rate of large chains is significantly lower, with 4.4% of all franchised units exiting each year. This implies that for newer, start-up chains, the failure rate might be even significantly higher than 34.7%.

Substantial business risks exist for franchisees, franchisors, and investors in franchises. Franchising is, on average, no safer than independent business ownership, and a strong difference exists between leading, established chains (less risky) and new, small, recently franchised chains (more risky). In the case of recently franchised chains, the franchisee faces not only the risk that his or her own franchised unit might not succeed, but also confronts a significant risk that the franchisor might bankrupt the entire chain. This high risk is compensated for by a higher upside if all works out well. The risk of joining an established, mature chain is lower than standalone entrepreneurship, but so is the probability that becoming a franchisee will be

23 "Entrepreneurs who are looking for a less grueling route to success should consider franchising. This boom sector of British industry offers readymade solutions to the uncertainties of business. The big attraction is that you start up as part of an already established company, meaning you need less capital and can hit the ground running. Usually, the company or brand is a known name, and you get ongoing training. This removes a lot of the risk and increases your chances of not just surviving, but prospering. The formula speaks for itself: about 90 per cent of franchise businesses are profitable within five years, when many other start-ups fail. Another bonus is that you do not need to have a business track record to prove yourself." http://www.the-franchise-shop.com/articles/The-low-risk-route-into-business_7.html.

24 Francine Lafontaine and Roger D. Blair, *Economics of Franchising* (Cambridge, UK: Cambridge University Press, 2005).

unexpectedly profitable. The relative risks should be reflected (that is, "priced") in the franchise fee and other terms between the franchisee and the franchisor.

The truths and misconceptions about franchising have two important implications for donors and investors considering franchising in frontier markets. First, despite conventional wisdom on the topic, franchising in frontier markets does not automatically ensure a low-risk profile. The risk/return trade-off is linked to the size, age, and maturity of the chain. And second, just like any other business investment, many start-up franchise chains will fail. Investors, especially grant-giving donors, should be careful not to throw good money after bad.

This chapter looked at lessons learned from franchising in developed markets. The next chapter will take these lessons learned, and look more specifically at the rationale and challenges of franchising in frontier markets.

Chapter 3: Franchising in Frontier Markets: Rationale and Challenges

3

Franchising is not a silver bullet for private-sector development in frontier markets. While it is an interesting option for businesses considering expansion or replication into frontier markets, it also comes with a distinct set of barriers and challenges. Often, because the large distances between outlets in frontier markets can make performance monitoring difficult, people believe franchising will work better than other forms of business. In some cases, franchising also stimulates entrepreneurial skills by encouraging local adaptation of business processes and operations to meet consumer demands across different markets.

However, franchising faces a number of challenges in frontier markets, including limited disposable income, lack of market density, access to finance, access to qualified human resources, and legal and regulatory issues. Potential franchisees often have difficulty accessing the financing they need to invest in franchises, which severely limits the available pool of talented franchisees. Franchising also calls for a relatively sophisticated legal and regulatory environment needed to manage conflicts between franchisors and franchisees. A non-conducive environment can significantly increase the risk and costs of franchising, and could thwart a franchising strategy. The absence of large-scale, western, franchising chains from Sub-Saharan Africa is a result of the difficulties of franchising in frontier markets.

Franchising addresses the challenge of large distances between outlets and the need for local adaptation in frontier markets. The lack of market density makes franchising an interesting strategy for growth in frontier markets. When units are farther apart and farther away from headquarters, the cost of monitoring performance and the risk of "shirking" – defined as neglecting duty or responsibilities in a company-owned setup – increases. Cultural and contextual circumstances are also often more diverse across the different outlets, creating a strong case for adapting products and services to local needs. Franchise chains in developed countries, therefore, tend to franchise units in rural areas, farther away from headquarters and farther away from other outlets. In frontier markets, lacking market density and having large distances between outlets, franchising should therefore offer some advantages. Western chains have for these reasons, for their few units in Sub-Saharan Africa, preferred franchising over company-owned expansion.

However, the lack of profitability and market density presents fundamental issues for franchising in frontier markets. These issues are shared with other forms of outlet-based expansion in frontier markets. Specific environmental challenges to franchising can also present problems.

Struggle for profitability. Profitability can in itself be a daunting challenge in frontier markets, especially when the target customer is low-income or part of the "base of the pyramid." Frontier markets have many profitability barriers to overcome. The general challenges of doing business in frontier markets (including lack of infrastructure, corruption, and the like) are described in depth in publications such as the World Bank Group's *Doing Business* publications.[25] These challenges include, for example, the incorporation of the business, registration of property, contract enforcement, cross-border trading, lack of enabling infrastructure, and obtaining credit.

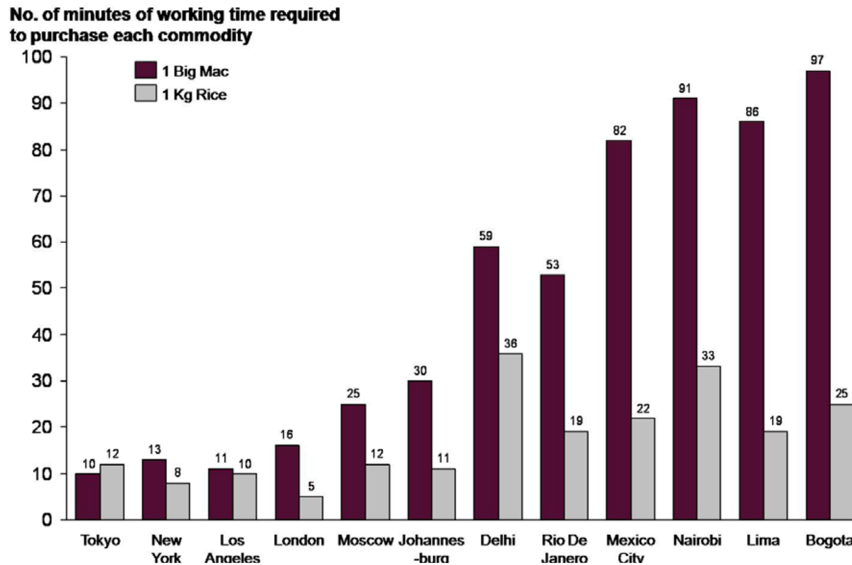
Targeting consumers at the base of the pyramid brings additional challenges to reaching profitability, especially finding and accessing these consumers and their limited ability to pay.2 The struggle for profitability is even harder in certain "public good" segments, such as education and health. Across these sectors, in addition to the ability of pay, the competition created by subsidized public-sector alternatives complicates the potential to reach profitability.

Limited profitability. Limited profitability is key reason for non-entry of Western large-scale franchising chains in Sub-Saharan Africa. The low profitability in frontier markets is a key reason why most western large-scale franchising chains are absent from Sub-Saharan Africa. Consumers have only limited purchasing power for the regular, standardized, products. The lack of purchasing power is shown in Figure

25 See www.doingbusiness.org.

7, comparing average minutes of required labor to buy a hamburger in different economies.

Figure 7: Working Time Required to Purchase a Big Mac vs. 1 kg of Rice



Source: UBS Report, Prices and Earnings, 2006 edition. Methodology: Price of the product divided by the weighted net hourly wage in 14 professions.

Products are frequently not adjusted to meet local market conditions (as opposed to the adapted business processes such as operations, sourcing, and marketing), because variation in a franchising setup, especially in relatively small markets, is expensive. A smaller factor that affects the profitability equation for large-scale Western franchising chains operating in frontier markets is the cost of goods sold. The ingredients of the standard uniform product (for example, cheese on a pizza) might be significantly more expensive in a frontier market. Demand for the franchise product (and the available market) is influenced by how well the product offering matches consumers' preferences and their willingness to pay. Franchisors must decide to what extent they will allow local adaptation to conflict with their global standardization.

Local adoption requires investment in research and development for new products and services, and increases the costs of monitoring. The costs of monitoring quality and performance will increase because the franchisor will have to make additional efforts to understand the performance of the altered franchisee offering. In some emerging markets, where making product and service adjustments to meet local

needs can reap significant financial returns, adaptation can be lucrative. Where the market is smaller, as is the case across many frontier markets, however, it is more difficult to justify deviations from standard.

Franchising in frontier markets causes relatively high overhead costs for large-scale Western franchising chains due to training costs, agency costs for monitoring and quality assurance, and systems and managerial support costs.[26] Training costs are higher because trained resources are less available, and the cost of monitoring quality increases because of the large distances between outlets and from HQ. Overhead costs can be spread out over a limited amount of revenue and outlets, which increases the share of overhead over revenue.

This combination of limited revenue and significant overhead creates relatively low profitability, and can inhibit market entry. For example, Eric Parker, co-founder of Nando's and former head of marketing for KFC, estimates that larger countries in sub-Saharan Africa can – at a maximum – generate market demand to sustain six to eight outlets. For smaller and poorer countries, this number would be significantly lower, with perhaps the potential to support only one or two. At the same time, our interviewees noted that breaking even on overhead costs in most countries would require at least ten outlets.[27] Profitability therefore becomes difficult in many cases.

Nando's, however, is one example of a South African Afro-Portuguese chicken restaurant that has successfully achieved profitability across developing, emerging, and advanced economies. We outline this home-grown success story in more detail in the next chapter and the Nando's case study can be found in Annex 10.

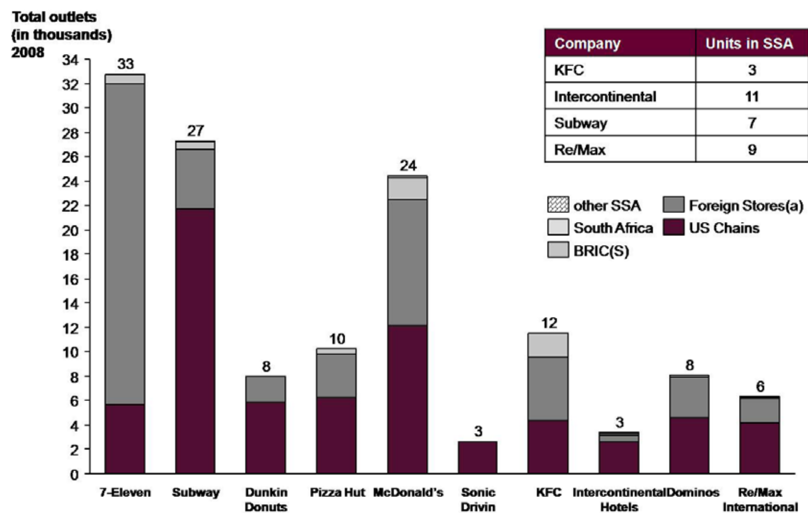
26 These costs include setting up supply chains, and due to their one-off characteristic, they should be (partly) seen as investments.

27 As we point out in Chapter 2, franchises headquartered in Southern Africa might be less susceptible to the limitations of high overhead costs. They are often able to utilize headquarter operations that are hosted in South Africa. This geographic advantage will significantly reduce the cost of monitoring, training, and quality control, as demonstrated through reduced travel and labor costs.

Side Box 3: Presence of Large-Scale, Western-Based, Commercial Chains in Sub-Saharan Africa

Large-scale, Western-based, commercial franchise business models have so far largely ignored sub-Saharan Africa, focusing instead on opportunities in other advanced or emerging markets. With increasing domestic saturation, rising competition, and diminishing domestic profits, many large, US-based franchises have begun to expand their operations into international territories, but have yet to reach sub-Saharan Africa. Figure 9 shows the international expansion of Entrepreneur.com's 2008 top-ranked franchise businesses. They have a worldwide presence, with more than 76,500 franchise and company-owned outlets, and combined generate revenue of more than $28 billion.[28]

Figure 8: Entrepreneur.com's 2008 Top 10 Global Franchises



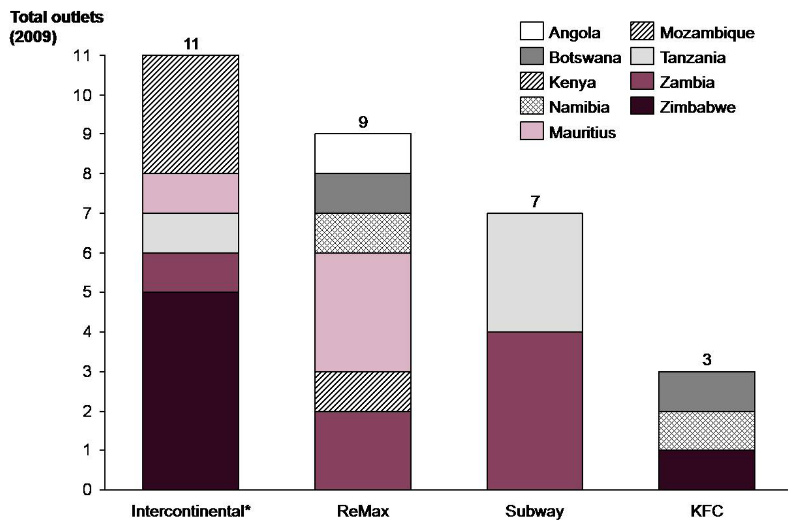
Company	Units in SSA
KFC	3
Intercontinental	11
Subway	7
Re/Max	9

Source: Number of units from Entrepreneur.com, 2008 rankings; country presence from Wikipedia. http://www.entrepreneur.com/franchises/rankings/franchise500-115608/2008,-1.html; company websites and Wikipedia. (a) Not including BRIC(S) or SSA.

28 Thomas Ehrmann and Georg Spranger, "Franchise Versus Company Ownership – An Empirical Analysis of Franchisor Profit," in *Economics and Management of Networks* (2007).

While large-scale Western franchises grew strongly across the BRIC(S) countries, expansion into developing regions such as sub-Saharan Africa was almost nonexistent. As illustrated in Figure 10, the number of units in sub-Saharan Africa is very low compared to those in emerging markets. The countries in which they are present overlap strongly with the analysis on franchising friendliness, with Mauritius, Namibia, Botswana, Kenya, Zambia, and Tanzania scoring good marks on franchising friendliness. Mozambique, Angola, and Zimbabwe are less strong, but probably benefit from their proximity to South Africa.

Figure 9: Top 10 Global Franchise Chains in Sub-Saharan Africa (Not Including South Africa)[29]



Source: Company websites and Wikipedia; www.remax.com/residential/find_an_office/ http://world.subway.com/Countries/frmMainPage.aspx?CC=ZAM.

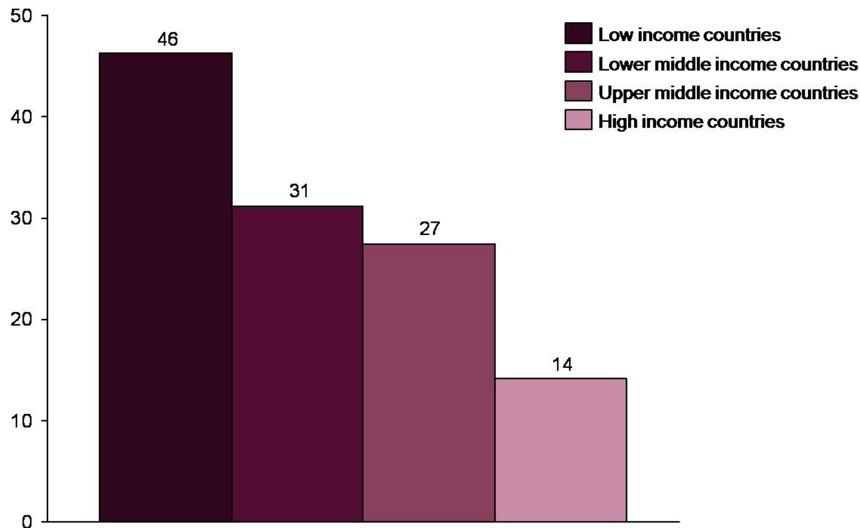
Access to financial resources: Access to financial resources continues to be a constraining factor for growing micro-enterprises and small market enterprises. Microfinance has made headway in recent decades, although it still fails to reach the majority of the rural poor.[30] A large gap exists in financing options between microfinance and traditional corporate lending. This gap, referred to as the "missing middle," encompasses access to finance for capital needs between $10,000 and $1

29 Actual number of units for KFC not available at time of report; data reflects national country presence.

30 Brian Milder, Closing the Gap: Reaching the Missing Middle and Rural Poor through Value Chain Finance, (Enterprise Development and Microfinance, December 2008). See also Latifee (2006)

million.[31] Most SMEs have financing requirements in this range, and therefore, as shown in Figure 10, still perceive access to finance as a major constraint.

Figure 10: Access and Cost of Finance for Small Businesses in Developing Countries. Average % of businesses rating access to finance/ cost of finance a major constraint to current operations



Source: World Bank Enterprise Surveys; World Bank List of Economies; Dalberg analysis. Countries weighted equally within income groups to calculate overall average.

Franchising shifts the financing requirement from the franchisor to the franchisee, but the franchisee may struggle (even more so than the franchisor) to access capital in frontier markets. Especially for business-format franchising, the start-up franchise fees required to open a new franchise outlet, as shown in Figure 12, lies within the "missing middle" for most industries.[32] In traditional franchising, the capital requirements are often significantly smaller and below the missing middle zone. In addition, the franchisee too frequently lacks the credentials and track record to secure capital, in contrast to the franchisor. The missing middle in access to finance therefore creates a significant constraint for expansion through franchising.

31 Ibid.

32 Thorsten Beck and Asli Demirguc-Kunt, "Small and Medium Size Enterprises: Access to Finance as a Growth Constraint" (2008).

Figure 11: Average Start-Up Franchise Fees across Selected Frontier Markets, 2002

Sector	South Africa	Egypt
Fast-food, restaurant	$9,773	$14,992
Retail services	$11,471	$1,300
Automotive, building & home services	$3,150	N/A
Business, education & training	$22,344	$3,300
Average	$12,358	$12,807

Source: African Development Bank, Enhancing Development in Africa: Franchising Report (2002).

Access to human resources. Franchisors struggle to find the right quality and quantity of franchisees. In any market, it is difficult to find the perfect franchisee – someone with the right amount of entrepreneurial flair who will still adhere to a prescribed format. A certain level of formal education and business skills is often required, which is not commonly found in frontier markets. A number of base-of- the-pyramid focused chains have a social imperative, and want to work with undereducated and underprivileged individuals, making franchisee selection and training even harder. And with the access-to-finance hurdle, noted above, the pool of prospective franchisees in frontier markets is further reduced. Interviewees commented that lack of readily available finance means that most franchisees in frontier markets are necessarily members of a wealthier upper class, rather than the wider spectrum of lower and middle-class applicants.

Access to technical and advisory resources. Franchisors in frontier markets have less support from specialized consultants, lawyers, and industry associations than their Western counterparts. In Western markets, these advisory groups play an important role in helping franchisors establish a sound business model and navigate the regulatory environment. They also facilitate knowledge transfer and build the capacity of both franchisors and franchisees.

At the most basic level, advisory services help franchisors and franchisees navigate disclosure laws and contract development. The general importance of input factors in the development of clusters (geographic concentrations of interconnected companies) has been acknowledged by business strategy experts such as Michael Porter. Over the course of the study and during the IFC Workshop, participants indicated that the lack of access to franchise consultants, lawyers, and other technical support is a challenge for franchisors in frontier markets. This gap appears significant for micro-franchises working across sectors, such as health or education, where a

number of organizations grapple with designing a sustainable business model and have the least experience running franchise operations.

Regulatory environment. Lack of a strong regulatory environment can decrease the feasibility of franchising in frontier markets. Both franchisor and franchisee benefit from a regulatory environment that limits the complexity of procedures and red tape for opening new businesses. Yet a clear regulatory framework and mechanisms for enforcement are necessary to protect both franchisor and franchisee and ensure that incentive conflicts are resolved.

From the franchisor perspective, franchising entails the delivery of goods or services that require strict standardization of basic inputs, as well as uniform operating procedures and coordinated branding. To safeguard against violation of contract agreements or brand infringement, franchisors may need legal recourse. From the franchisee perspective, protection against franchisor actions that might undermine profits, such as encroachment, is required. Both parties therefore benefit from an advanced and reliable regulatory environment.

An unsupportive regulatory environment significantly increases the risk for both franchisees and franchisors, and raises franchising costs. Costs that are too high can tip the balance among potential market entrants toward purely company-owned outlets, or to hybrid approaches such as master franchising. Under master franchising, one individual gains the rights to the franchise across a particular geographic area. The master franchisor might run a chain of "company-owned units" – or might choose to sub-franchise.[33] This setup reduces risks, as the sub-franchised chain only has to interact with one larger and established party. Annex 3 provides an overview of a variety of international expansion strategies.

The lack of a supportive regulatory environment is especially challenging for business format franchising. Compared to traditional format franchising business format franchising depends on deeper and more complex relationships between franchisor and franchisee, and emphasizes intellectual property rights. A strong regulatory and legal framework to settle disputes and protect intellectual property is essential. Annex 9 illustrates the examples of Kaldi's Coffee, an Ethiopian coffee shop that used the Starbucks brand to build its own successful coffee business.

The perceived risks in the legal and regulatory environment for large-scale Western chains were cited by both entrants and non-entrants as problematic for franchising in sub-Saharan Africa. Some large-scale Western chains have opted for master franchising to address some of the risks.

33 Robert Justis, "Master Franchising: A New Look," *Journal of Small Business Management* (1986).

The difference in enabling environments between countries

Across frontier markets, we found substantial differences between enabling environments and the potential for franchising. We have scored countries on indicators linked to three criteria:[34]

- **Access to capital**: Availability of financing for small and medium-sized enterprises.
- **Ease of doing business**: The ease of starting up a business and the procedural and legal requirements involved.
- **Regulatory environment**: The enforcement of contracts, and the time, cost, and number of procedures involved from the moment the plaintiff files the lawsuit until settlement.

The results by region are shown in Figure 12.

Figure 12: Ranking of "Franchisability" by Region (Including Developing and Emerging Markets)

Ranking	Latin America	Sub-Saharan Africa	Southeast Asia and the Pacific
1	Chile	South Africa	Thailand
2	Panama	Mauritius	Malaysia
3	El Salvador	Namibia	Fiji
4	Jamaica	Botswana	Mongolia
5	St. Vincent and the Grenadines	Kenya	Tonga
6	Mexico	Zambia	Vietnam
7	Peru	Tanzania	Vanuatu
8	St. Lucia	Ghana	China
9	Dominica	Nigeria	Marshall Islands
10	Dominican Republic	Rwanda	Sri Lanka

Source: Dalberg analysis.

34 Access to capital, ease of doing business, and regulatory environment (contract enforcement) indicators were taken from World Bank's Doing Business Report 2009. Sufficient indicators for access to human resources were not available.

Unfortunately, no global data is currently available to rank frontier markets on more specific regulatory indicators such as the sophistication of contract law, franchise regulation, or intellectual property frameworks. However, a snapshot based on USAID data shows significant variation and gaps across several African markets (see Figure 13). Unfortunately, the USAID data did not include the presence of specific franchise regulation.

Figure 13: Overview of Strength of Regulatory Environment across a Sample of African Countries[35]

Country	Contract Law	Intellectual Property (IP) Law
Burundi	Weak – laws are difficult, and court system is slow and lacks capacity	Unknown – likely rudimentary
Ethiopia	Medium /weak – written law on contracts is comprehensive and reasonably well-thought-out; most other components critical to an efficient culture of commercial contracts are either nonexistent or seriously underdeveloped	Strong – but enforcement mechanisms too dispersed and lack coordination
Ghana[36]	Strong – including ability to enforce	In place – with strong overall enforcement
Kenya	Medium/strong – but ineffective due to inefficient judicial system	In place – but awareness and enforcement are very weak
Rwanda	Medium /strong – but enforcement perceived as very difficult	Law in draft (June 2008) – but enforcement perceived as difficult
Tanzania	High – both in framework and enforcement, although costs are relatively high	In place – but enforcement weak (lack of knowledge)
Uganda	Medium/High – enforcement can be time-consuming; mostly for large parties	Nascent – both in law as in enforcement.

Source: USAID, Business, Climate, Legal and Institutional Reform Reports, 2008 (from website, www.bizclir.com).

35 USAID, Business, Climate, Legal and Institutional Reform Reports, 2008 (from website, www.bizclir.com).

36 Only Agriculture report available.

Implications for policymakers – building an enabling environment

Policymakers can influence a country's franchise friendliness, but basic, widespread reforms in SME promotion are required before franchising-specific initiatives can yield results. As shown in Figure 14, franchising calls for an enabling environment above and beyond what is required for regular SME promotion, so policymakers should first focus on the following:

- Increasing the ease and speed of opening new businesses by reducing red tape and restrictive registration, licensing, and permit laws.
- Strengthening contract frameworks, with special attention to actual enforcement.
- Expanding access to finance for SMEs – for instance, through credit facilities and loan guarantees.

The framework below outlines the relative importance of six key factors for various business models in frontier markets. As illustrated below, business-format franchising requires the strongest enabling environment.

Figure 14: Importance of Enabling Environment Conditions for Franchising

Environmental Factors/ Eco-system	SME Growth	Company-owned growth	Traditional franchising	Business format franchising
Ease of Starting a Business	◑	●	◑	●
Access to Finance	◑	◕	◑	●
Contract Framework[a]	◑	●	●	●
IP Framework[a]	◑	◑	◑	●
Franchising Framework[a]	N/A	N/A	◕	●
Technical/ Advisory Services	◑	◑	◕	●

● High ◑ Medium ○ Low

Source: Qualitative estimates based on Dalberg analysis.
a Includes the strength of the franchising regulation, including disclosure agreements and franchise-specific laws related to registration, purchase, and sale.

Once the foundation is in place, policymakers can support franchising by taking the following three steps:

1. Adopt frameworks to protect and enforce intellectual property.
2. Apply franchise-specific regulations, such as mandatory disclosure (required provision of information for both franchisor and franchisee).
3. Promote franchise associations as a mechanism for marketing, endorsing, and supporting franchising; franchise associations can also play an important role in building a deeper understanding of franchising to facilitate consistent interpretation of contracts and franchise law.

Implications for practitioners – Choosing the appropriate franchise model

Companies looking to expand internationally have a variety of options with varying degrees of risk and control. Depending on the strategic goals of the company, several entry models can be pursued. The decision of which model to use is driven by the perceived financial risk, the franchisor's decided expansion rate, legal restrictions or requirements, and capital investment requirements.[37] Figure 15 defines seven modes of entry for International franchise expansion.

Figure 15: Modes of Entry into Frontier Markets

Type	Definition	Advantages over single unit franchising
Company-owned expansion	Agreement whereby a foreign-owned company establishes fully owned business units in a foreign market. The business owner retains full control over business operations and responsibility over all legal, financial, and HR decisions.	Company-owned expansion offers an advantage in terms of monitoring and quality because the business owner retains full control (and liability) for operations.
Single-unit franchising[a]	Franchise agreement whereby the franchisor sells rights to a single franchisee, who owns and operates one franchise at one specific location or within a specified territory. Most franchisees start with one franchise unit.	N/A

37 African Development Bank, Enhancing Development in Africa: Franchising Report (Private Sector Development, 2002).

Type	Definition	Advantages over single unit franchising
Multiple-unit franchising	Franchisor allows franchisees to purchase and operate multiple units based on demonstrated success in the first unit.	Multiple-unit franchising offers improved access to human resources by leveraging the capacity of high-performing franchisees across multiple outlets, thereby reducing the cost of additional HR sourcing and lowering the risk of failure (proven track record of franchisees). Multiple-unit franchising will also shift the risk of legal and regulatory challenges due to fewer franchise contracts.
Joint ventures[b]	Franchisor establishes a corporate body in the host country, then acquires master franchising rights for the host country from the international franchisor. Combines direct investment of franchisor capital and management resources with capital and resources of the local entrepreneur. (E.g., China and Russia created joint ventures via local government.)	Joint venture model offers shared responsibility for accessing both human and financial resources, which reduces the overall risk for the franchisor.
Area development[c]	Area developers are granted the right to open a pre-determined number of outlets in a certain geographic territory. Area developers can either own a large territory that is subdivided into multiple franchises, or initially purchase several franchises in a particular geographic area. The franchisee then develops these individual franchise locations within a specified time frame.	As with multiple-unit franchising, the area development model offers improved access to human resources by maximizing the capacity of high-performing franchisees in a particular market. Area development may reduce the complexity of legal and regulatory challenges due to fewer franchise contracts. But may also increase risk to the franchisor if a significant investment list in too few contracts.

Type	Definition	Advantages over single unit franchising
Area representative	Franchisor hires an area representative (usually paid on commission as percentage of the franchise fee) who provides opening and continuing support to the franchisees. In many instances, the area rep also pays the franchisor a market development fee in return for the right to provide his/her services in a particular area. The area representative does not enter into a contractual arrangement with either the franchisor or franchisee.[d]	The area representative model allows the franchisor to improve access to human resources by offering ongoing support and assistance to franchisees. However, this model may also reduce overall profitability for the franchisor if the commission fee is not set based on market value across the area.
Master franchising	Master franchisee also purchases a large area or region and develops a number of franchises within a certain time frame. The difference between an area developer and a master franchisee is that the master franchisee is granted the right to sell franchises within the territory to other people, and train and support those franchisees. Master franchising is the most common approach to frontier market franchise development.	As with multiple-unit franchising, the area development model offers improved access to human resources by maximizing the capacity of high-performing franchisees. However, master franchising may increase the potential risk of legal and regulatory challenges by relinquishing control of franchise sales to the master franchisor.

Each franchise model has the potential to address particular challenges of franchise development to a varying degree. Figure 15 provides a preliminary assessment of the relative impact of each model on the key challenges to franchising in frontier markets.

This chapter has shown the application of franchising models in frontier markets comes with a distinct set of challenges and risks. Not all forms of franchising are equally suitable, and in order to franchise successfully in frontier markets, specific models and adaptations to overcome barriers are required. The next chapter will focus on these promising models.

Chapter 4: Promising and Profitable Models

4

Several promising franchise models are well adapted to the conditions in frontier markets and have demonstrated the ability to thrive amidst the challenges. The most promising models we have identified are: (1) home-grown (rather than foreign-based) chains; (2) traditional format (rather than business format) micro-franchising; and (3) innovative approaches that are flexible in customizing and mixing different elements of franchise models, such as fractional licensing.

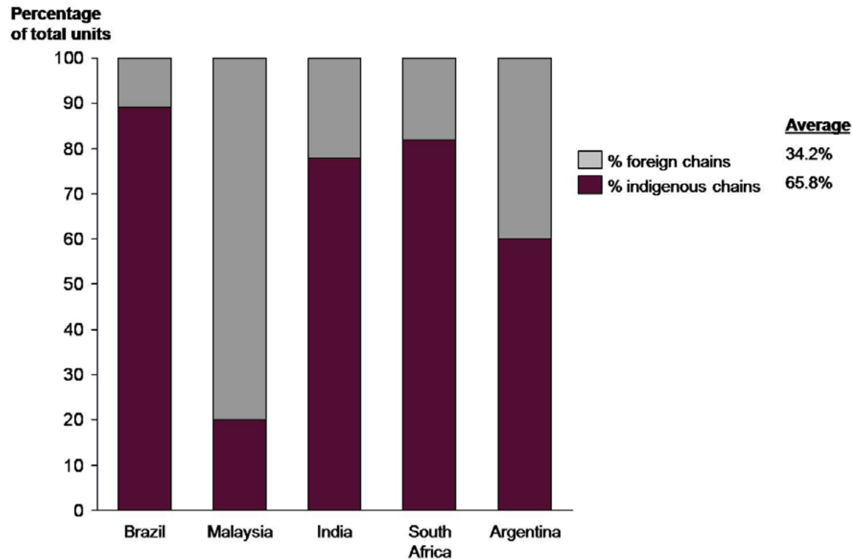
Home-grown chains

Home-grown chains are better placed than foreign franchising chains to prosper with a franchising concept in frontier markets. Home-grown chains already make up a significant proportion of franchised chains in frontier markets, with Nando's a salient example of chains that expanded across sub-Saharan Africa. Primary competitive advantages include locally adapted and tailored products and pricing, lower overhead and monitoring costs due to proximity, and better alignment with the local community (such as currency fluctuations, foreign direct investment (FDI) regulation, and contract enforcement).

An extensive and varied landscape of franchising chains exists in emerging markets and developing countries, some of which have successfully expanded internation-

ally. Figure 16 illustrates, for five frontier markets, that the percentage of indigenous chains is much greater than foreign chains.

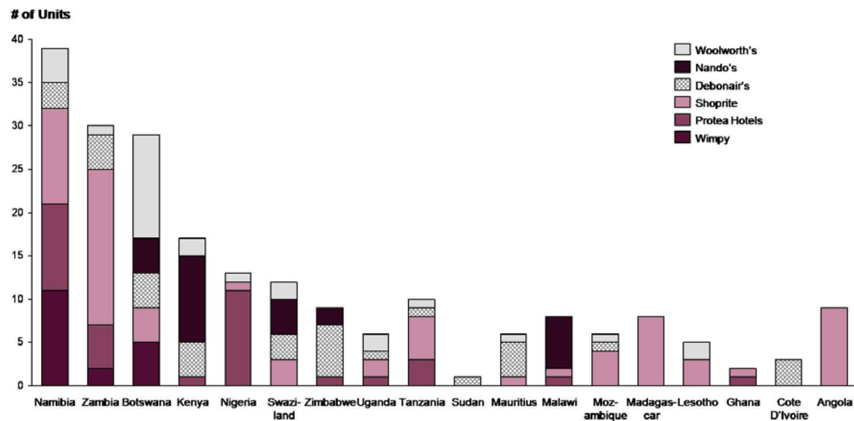
Figure 16: Ratio of Foreign vs. Home-Grown Franchise Chains in Selected Emerging Markets, 2002



Source: *Enhancing Development in Africa, Franchising Report*, AfDB Private Sector Development, 2002.

A significant number of these indigenous chains are expanding internationally, often into places where traditional Western chains have barely ventured. Figure 17 illustrates the regional presence of a set of large southern Africa-based franchise businesses across sub-Saharan Africa. In comparison with the penetration of Western chains, there is a higher overall penetration, a similar strong presence in the southern cone (due to the proximity to South Africa), and a presence in western Africa (Nigeria, Ghana, and Cote D'Ivoire), where Western chains are largely absent.

Figure 17: Selected Large-Scale African Franchise Businesses across Sub-Saharan Africa



Source: Company websites, Wikipedia, interviews. Note: Shoprite stores part of larger Shoprite Holdings Ltd., which includes brands such as Hungry Lion, OK, and Shoprite. Data in graph contains only Shoprite stores.

Local adaptation of products and services. Home-grown chains capture relatively more revenue at a relatively lower cost per good sold, because they are better able to tailor their products and services to local preferences and supply chains. As one practitioner told us, "It is distinctly different to be a local Southern brand in the fashion industry. The seasons, fabrics, and colors are very different. For example, we create our designs for 10 or 11 months of summer, in contrast to 6-7 months for Northern fashion brands. This affects colors and styles."

In contrast to foreign chains, which need to evaluate the costs and benefits of adjusting their standardized, Western-oriented products[38] for frontier markets, homegrown chains are, by definition, adjusted to the local environment. Their customization stretches across prices, product offerings, and services, and is especially important in business format franchising. Nando's, for instance, believes that its growth is due partially to the fact that its spice mix appeals more to the African palate than do Western fast-food products.

Home-grown chains have an advantage over Western chains in accessing low-cost inputs, especially if Western chains are still operating on a small scale in the market. Home-grown chains access local sourcing and supply chains, reducing the cost of goods sold. In contrast, Western chains build products with Western ingredients, and

38 This argument assumes that average preferences are different in frontier markets vs. developed markets, and that these taste preferences are relatively fixed and cannot be changed in the short term. Our interviews as well as emerging research (e.g., Kitter and Sucher 2008) seem to support these assumptions.

rely – especially in the start-up phase – on Western suppliers and elaborate supply chains. Only over time, with bigger scale, might they switch to local suppliers. After start-up, for example, McDonald's created a complex supply chain hub (dubbed McComplex) in Russia, which aimed to source locally all the ingredients, some of which (such as iceberg lettuce) were hardly available in Russia.[39]

Lower overhead costs. Home-grown chains can leverage the lower cost economies in which they operate to get support services at lower costs. They use a smaller set of support services than Western chains, due to fewer regulatory requirements (such as those for financial accounting). Most important, they operate on a fully "off-shored" overhead structure, because they source support services in relatively low-cost local economies.

Lower exposure to risks in the enabling environment. Home-grown chains are exposed to a smaller set of risks than Western chains. Several risks are not applicable to home-grown chains, such as currency fluctuations and changes in FDI regulations.

The franchising-specific risks, and the potential lack of enforcement of intellectual property (IP) claims, apply to home-grown chains as well. As one interviewee told us, "There needs to be a framework that prevents me from creating my own competitors." But even with contract enforcement and IP protection, local players have an advantage over Western chains due to greater familiarity with the relevant actors through both formal and informal channels. They are not being perceived as, as one interviewee put it, "the big bullying foreign guy."

Traditional micro-franchising

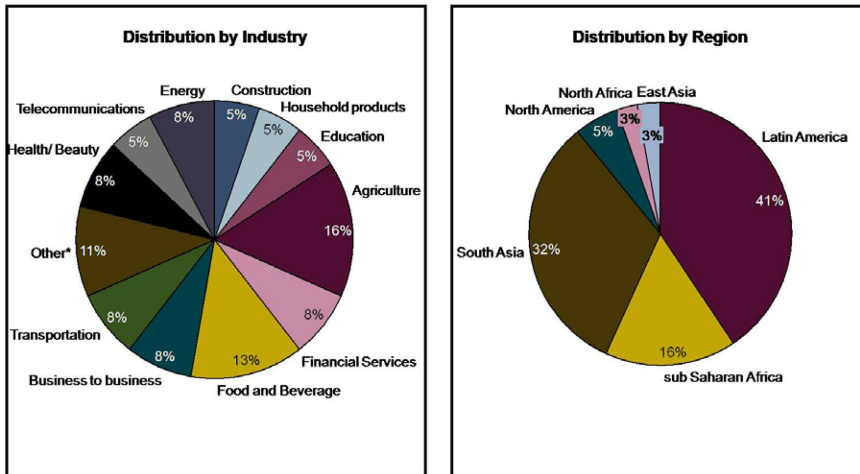
Traditional franchising, especially micro-franchising, is better adapted to frontier markets due to lower financing needs, reduced agency costs, and less stringent legal and regulatory requirements.

A vast array of traditional micro-franchises operates in frontier markets. Micro-franchises are small-scale, for-profit businesses that mostly work under a traditional franchising setup. They often create one-person companies (also referred to as agent-based networks) involved in the distribution of goods and services. Familiar examples include Avon, FanMilk, and MPESA.

Figure 19 provides an overview of micro-franchises as documented by Kirk Magleby in 2006. Although this is merely a snapshot in time of existing micro-franchises, it shows their distribution across sectors and geographies. It also indicates an especially high adoption rate in Latin America and southern Asia, which is probably due to a more hospitable enabling environment (such as good access to financing). The spread across industries hints at the wide applicability of the micro-franchising model.

39 http://goliath.ecnext.com/coms2/gi_0199-4919898/CASE-STUDY-McDonald-s-Russia.html.

Figure 18: Traditional Micro-Franchising – Distribution by Industry and Geography



Source: Kirk Magleby, "60 MFO Possibilities with Existing Franchisor."
See http://www.microfranchises.org/file.php?id=45 (accessed 30 July 2008).
Note: Other includes categories with only one example, such as cleaning services, textiles, tailor services et al.

Micro-franchising has lower financing requirements than business format franchising. This increases the feasibility of the model in an environment with restricted access to finance. Examples of the financing requirements for micro-franchises are shown in Figure 19. Franchisees find it easier to access the lower sums of required capital, often helped by financing arrangements that franchisors have made with micro-finance institutions. (Annex 6 provides examples of these micro-finance collaborations.)

Figure 19: Financing Requirements of Five Micro-franchises

Organization	Investment required	Initial capital requirement for franchisee ($USD)
Grameen Village Phone	GSM mobile handset, airtime	220
FanMilk	Bike and daily inventory	55
Vision Spring	Initial inventory wit h20 glasses including display and carry case, eye charts, uniform, repair kits, ad sign	130
Vodacom	Phone shop, phone lines and equipment (all in modified shipping container)	3450
Ugandan shoe shiners	Rent of polish kits, shoe polish, shoe brushes	200
Living Goods	Product portfolio of health, personal care and "safe money, make money" products, as well as training and coaching	100-250

Source: Kirk Magleby, "60 MFO Possibilities with Existing Franchisor." See http://timbuktuchronicles.blogspot.com/2007/12/fanmilk-microfranchising.html (accessed 30 July 2008).

The decision to franchise, based on agency costs, is often more clear-cut for traditional micro-franchises than for business-format franchising. In a traditional setup, the franchisee is usually part of the distribution or sales channel. Effort by the outlet owner is hard to monitor in a company-owned outlet. Performance-based compensation can serve as a partial solution, but management information systems are often lacking in frontier markets. Based on agency costs, therefore, traditional franchising frequently emerges as a preferred option. For example, SPOT Taxis chose a traditional format because it would have been difficult to monitor taxi drivers in a large, company-owned chain structure in which the company owned the taxis. However, the role of technology is starting to play a significant role in monitoring.

Traditional micro-franchising is less restricted by a lack of legal and regulatory frameworks than business-format franchising, because they would expect to encounter fewer potential misalignments, less intellectual property disruption, and easier contract termination. The differences in incentives between franchisee (one unit, or a few) vs. franchisor (all units) still exist, but fewer misalignments are likely to occur.

The roles and responsibilities of the franchisee toward supporting the chain (such as marketing) tend to be more limited. The franchisee handles less intellectual property, again reducing the scope for misalignments. It is easier to dissolve a relationship, due to lower capital investment, the few assets involved, and a stronger bargaining position of the franchisor. For example, it is much easier for FanMilk to cut off or stop selling to a franchisee, than it is for Nando's to remove a franchisee. Traditional franchising can thus more easily prosper in an environment with a weaker legal and regulatory framework, where a business franchising arrangement might suffer.

Traditional-format franchises must ensure that their products and services effectively meet customer demand by understanding frequency and velocity of sales and the impact of purchasing on planned household expenditure. Velocity of sale assumes that there are some products that will sell quickly and easily while others will require consumer education and social marketing before a purchase is made. For example, health product distributors serving low-income communities quickly learned that the sale of soap – a familiar periodic purchase – is a much faster and more frequent sale than solar lanterns – an unfamiliar product that requires a larger financial investment. Understanding how these product dynamics vary is essential to reducing the "lumpiness" of agent sales and ensuring a sustainable microfranchise product selection. In communities where disposable income is low, the ability to plan and vary household expenditure will also influence the introduction of new or unfamiliar products.

Side Box 4: Coca-Cola Manual Distribution Centers (MDC)

The use of a product distribution franchise model is one form of distribution that has allowed Coca-cola to effectively scale across Africa while creating thousands of jobs. Coca-Cola Sabco (CCS) – one of Coca-cola's leading bottling companies in Africa – first developed the Manual Distribution Centre (MDC) model in order to respond to the challenge of serving small-scale retail outlets in densely populated areas where truck or road delivery was untenable. By using independently owned pushcarts, the MDC model overcomes the barriers of poor road infrastructure, meets the needs of low-volume, high-restock outlets, and lowers distribution costs. The MDC model, first introduced in 1999, has developed over 2,500 MDCs in Africa, and it is the predominant source of distribution across most of East Africa where it accounts for 83% of total sales in Ethiopia and 93% of CCS sales in Tanzania.

The MDC model overcomes the traditional challenges of access to human resources by creating a business model that can be run by primary-school-educated franchisees. In turn, franchisees are compensated based on a set profit margin for each case sold. Consumer processes are set centrally by CCS across all MDCs, resulting in a focus on high-volume distribution.

Despite the rapid growth of the model, MDCs also face challenges related to access to finance and employee retention, two issues that plague the sector. Franchisees are required to secure start-up financing of somewhere between $6,000 and $15,000, which is predominantly sourced from personal funds. To address the challenge of MDC owner retention, some MDCs are starting to explore the use of salary plus commission-based income rather than commission-based alone, which reduces income fluctuations.

SPOT Taxi is a good example of a traditional micro-franchise that has successfully navigated the challenges of agency costs and access to finance. The performance monitoring costs of running a company-owned chain were deemed too high once the chain had more than 25 drivers, and a franchising model was required. Through training, customer feedback, and frequent spot-checks, it monitors adherence to the brand by drivers in terms of quality and service levels. Agency conflicts, such as drivers free-riding on the chain (not paying royalties while keeping the brand), or helping imitators to falsely carry the brand, are limited, because the majority of the business is managed through the dispatch center, and non-performing drivers can be simply cut off. Access to finance (to purchase a cab, for instance) is arranged through established relationships with banks by the franchisor. The driver then purchases the car on installment from the franchisor.

Innovative solutions to frontier market franchising challenges

Entrepreneurs have developed solutions to overcome challenges in frontier markets for access to finance, access to human resources, and lack of regulatory frameworks.

Innovative solutions: Access to finance

- *Partnerships between franchisors and micro-finance institutions (MFIs).* These partnerships, when focused on provision of financial services, can play an important part in overcoming the access to finance hurdle, especially for traditional micro-franchises. It is important to note that we do not advocate that MFIs themselves become a franchising channel for non-financial products and services. This is a fundamentally different business, with different required capabilities, costs, and competitors. These businesses are for these reasons separated in the developed world, and should be as well in frontier markets. However, there is clear potential for MFIs to provide capital to franchisees (access to finance hurdle) and to provide information about potential franchisees (access to human resources hurdle). The franchisor benefits from having the MFI provide the required capital to the franchisees, while the MFI benefits from the expansion of its customer base. The risk profile for the MFI will not significantly increase when only a small subset of its loan customers is affiliated with a single franchise chain.
- *The franchisor underwrites loans to shift ownership of critical assets to the franchisee.* In some cases, the franchisor owns key franchisee assets. For example, McDonald's retains ownership of most of its physical assets (the restaurants). Some franchisors, however, require that the franchisees take ownership of the local assets. For example, SPOT Taxi requires its drivers to own their own taxis. Because this is not always financially feasible for the driver, SPOT decided to work with a third party to underwrite loans for the franchisee. The franchisor would borrow to finance the assets (cars), and the franchisees (drivers) would purchase the assets on installments paid monthly (financing costs included in their monthly franchise fee). This creates a gradual path between company-owned assets to franchise-owned assets over time.
- *Consignment supply*. VisionSpring uses an "on-consignment" model to disperse its core assets (glasses, training materials, and supplies) to its Vision Entrepreneurs (see Case Study). Under this model, the franchisee is given a start-up sample of the products and required eye screening materials, and only repays the loan once the glasses are sold. This approach places the financial risk on the franchisor, but eliminates the access-to-financing barrier for the franchisee (although the financing costs will need to be included in the franchising fee).

Innovative solutions: Access to human resources

- *Management contracts*. In this configuration, the franchisor provides trained human resources to the franchisee, while leaving the ownership and economic risk with the franchisee. The benefits are especially significant in situations where the franchisor has better access to a specialized labor pool of highly trained resources, such as in the hospitality industry. The application of management contracts by Marriott are provided in Side Box 5.

Side Box 5: Marriott Hotel International's Use of Management Contracts

Using an alternative franchising approach, Marriott International is one example of how some hotels are providing "management contracts" that allow hotel proprietors to retain ownership and allow Marriott Hotels to increase their control over the delivery of high-quality business standards and human resources.

Management contracts are characterized by distinct factors related to ownership, fee structure, and risk. The ownership structure of a management contract allows hotel proprietors to retain ownership of the business while outsourcing management, service delivery, and branding. For example, rather than engaging in the construction of a new Marriott Hotel, the company would identify an existing facility and offer its hospitality services, under the auspices of the Marriott name brand, to the proprietor. The fee structure of a management contract is characterized by two revenue streams for Marriott – a base fee and an incentive fee. The base fee is often equated with a fee for service and is usually defined as a percentage of total revenue. The hotel owner might also include an incentive fee based on gross profit or profit margins. Finally, management contracts can be characterized by their unique diversification of risk, whereby the owner is ultimately responsible for operational risk while reputational risk resides with the management company.

Management contracts maintain standardization by delivering a set of commonly accepted (and valued) operating procedures alongside improved access to human resources. From the hotel owner's perspective, the ability to procure management services that are recognized and valued on an international scale offers the promise of increased patron traffic. In addition, Marriott takes on the burden of attracting, training, and deploying qualified hotel staff, with the objective of reducing the hotel owner's cost of accessing human resources.
Management contracts ease the challenge of access to human resources by creating qualified talent pools combined with standard operating procedures that come with a proven track record. As noted above, a specialization in service delivery allows the franchisor to train "batches" of human resource personnel with a generic skill set that can be easily deployed across several locations. The ability to deploy pre-trained staff also reduces costs for the hotel owner and ensures the hotel owner that each staff member will be equally familiar with business processes and procedures.

Unfortunately, the specialization of skills, the complexity of ensuring standardization, and the importance of generating repeat customers suggest that management contracts may not be applicable outside the hospitality sector. Hospitality is a highly specialized services industry that requires advanced training, as indicated by a significant number of hotel management degrees offered at leading universities around the world. Hotel management is also a labor-intensive industry in which brand reputation is highly correlated with the high-touch services provided by the staff. And finally, the industry relies heavily on its ability to generate repeat business. In many cases, patrons may be completely unfamiliar with a particular location, and will purchase accommodation based on reputation or past experience. These three characteristics create an environment conducive to management contracts in the hotel industry, but may act as barriers for its applicability across other sectors.

Source: http://www.answers.com/topic/marriott-international-inc; http://sofiaecho.com/2009/06/24/743038_marriott-to-enter-bulgaria-with-three-of-its-brands.

- *Fractional franchising*. Fractional franchising allows the franchisor to work within the premises of a larger business, rather than establishing a stand-alone unit, which reduces the burden of sourcing and selecting franchisees. For example, Marie Stopes International's BlueStar health network in Ghana provides subsidized sexual and reproductive health (SRH) commodities, marketing, training, and technical support to existing clinics, chemical shops, and pharmacies throughout Accra. In exchange, the shops agree to routine monitoring, reporting, and payment of an annual franchise fee. The commodities constitute only a small portion of the shop's full business. The family planning commodities typically constitute 3% to 7% of the shop's total sales, a proportion that BlueStar aims to raise to 10% to 15%.
- *Partnerships with micro-finance institutions*. MFIs have visibility among a large pool of lenders, and can help franchisors find suitable franchisees among their lender portfolio. MFIs can actively approach lenders about whether they are interested in a new business format, which needs to align with the skills and the risk attitude of a particular MFI.

Innovative solutions: Risks in the regulatory and legal environment

- *Master franchise contracts, which allow the (international) franchisor to interact with only one established (local) counterparty*. The master franchisor is subsequently responsible for recruiting and managing local sub-franchisees. The master franchise relationship is more easily manageable and enforceable in locales with less developed regulatory frameworks. It offers a greater ability to settle conflicts and, if needed, enforce contracts, because any interaction is with one, large, established party. In addition, the master franchiser might have superior local knowledge, as well as have better access to finance. Disadvantages of the model are increased costs (compensation for master franchiser), a loss of control over the expansion strategy, and the changed risk profile due to putting all eggs in one master franchisor basket.
- *Technological solutions* can strengthen the power of the franchisor in conflicts with franchisee, and decrease the risks of absent contractual frameworks. Good contracts are needed, from the perspective of the franchisor, to disband a bad relationship with a franchisee in case of conflicts, and to prevent non-franchisors from imitation and infringing on intellectual property. Vodacom Community Phone Service Shops and SPOT Taxis illustrate how technological solutions can help quickly cut off franchisees and block imitators. Vodacom can simply cut off the phone connections to non-performing franchisees. SPOT Taxis can do the same with its dispatch service – while imitators can paint a SPOT logo on their taxis, they cannot access the dispatch service to obtain jobs.

Innovative solutions: Recommendations for company-owned chains

- *Performance-related compensation*. Lessons learned and innovations made in franchising could even benefit chains that have opted for company-owned expansion. Entrepreneurial activity by isolated company managers in frontier markets can be stimulated by an increased share of performance-related compensation. Bridge International Academies has launched a chain of private primary schools serving poor communities in Kenya. They are implementing a company-owned model, but seek to emulate the incentive structure and entrepreneurial motivation of franchises while running a company-owned model. They have made local manager compensation performance-related, with the aim to leverage entrepreneurial skills and incentives as much as possible.

Implications for investors

Our overview of successful models has given us the chance to synthesize recommendations for investors in their due diligence (pre-investment) and performance-improvement (post-investment) activities. These recommendations should be seen as additions to general best practices in mergers and acquisitions, as well as to the practices in frontier market investing:

- **Target selection**. Home-grown chains (traditional or business format) and traditional format micro-franchises are likely to be the best investments. In the latter case, franchisors are the natural investment targets, due to the small financing requirements of franchisees. Even so, a significant number of micro-franchisors might still be too small for Western-based investors. The market potential, and market density, for the goods and services distributed through micro-franchises should be a key priority in the due diligence process.
- **Understand unit-level profitability**. The sustained demonstration of unit-level profitability, ideally within a constellation of multiple units, is an essential building block of scaling and franchising. Investors need to understand completely the unit-level profitability of a micro-franchise. Lack of unit profitability, especially with limited scale and operating history, significantly increases the risk of failure, and therefore should be adjusted in the acquisition price/expected return.
- **Focus on outlet growth**. Outlet growth is a key profitability driver once the business model is determined, especially because unit-level profitability is difficult to adjust in the short term in a franchising setup. The standardization of the format and the risk-aversion of franchisees make it difficult to change price points and product mix. Outlet growth is often the key to return on investment. In the due diligence phase, significant attention needs to be paid to the possibility of rapidly increasing the number of outlets.

- **Manage agency costs**. Analyzing agency costs can identify potential cost savings and risks. Investors need to identify all agency costs – especially outlet monitoring costs – and analyze ways to reduce them (for example, through hybrid models and application of technology). Hybrid models, such as master franchising and area development agreements, need to be considered in countries and regions where neither pure franchising nor company-owned expansion is ideal from an agency cost perspective. Monitoring costs could potentially be reduced by using more customer feedback and applying information technology. Any good analysis of agency costs should specify likely areas of conflict between franchisees and franchisors. Business models that have many areas of potential conflict are inherently more risky, which should be included in the valuation.
- **Focus on reducing barriers**. Investors need to understand the height of barriers to outlet growth, and the potential to reduce them, such as access to finance, human resources, and contract enforceability. Specific initiatives, such as coalitions with third-party financiers (access to finance) and management contracts (access to human resources), can lower barriers and increase expected growth and chain valuation.

This chapter, together with the previous one, has outlined the general challenges and opportunities for franchising in frontier markets. The case-study on Spot Taxis that follows will provide further illustration of these challenges and ways to overcome them. Chapter 5 focuses on a specific and interesting sub-set of chains – the social franchising chains – and examines their potential and challenges in more detail.

Case Study: SPOT City Taxis

SPOT City Taxis demonstrates how one of India's largest radio taxi operators applies innovative financing and a franchise-like model to facilitate the social and economic growth of its profitable, scalable, business model. By delivering a business model that is profitable at both the unit (owner cum driver – OCD) and system (company) level, SPOT is also able to feed its social mission: to create jobs while delivering high-quality, organized transport.

History: Emerging model, emerging competition

SPOT City Taxis was established in 2002 with 18 taxis. Its objective was to create a highly profitable employment opportunity for its drivers while ensuring high quality standards, including efficiency and punctuality. By 2009 the fleet had grown organically to over 300 taxis across Bangalore. Recently, new international entrants to the market (namely an international company called MERU) have increased competition and put pressure on the socially driven SPOT model.

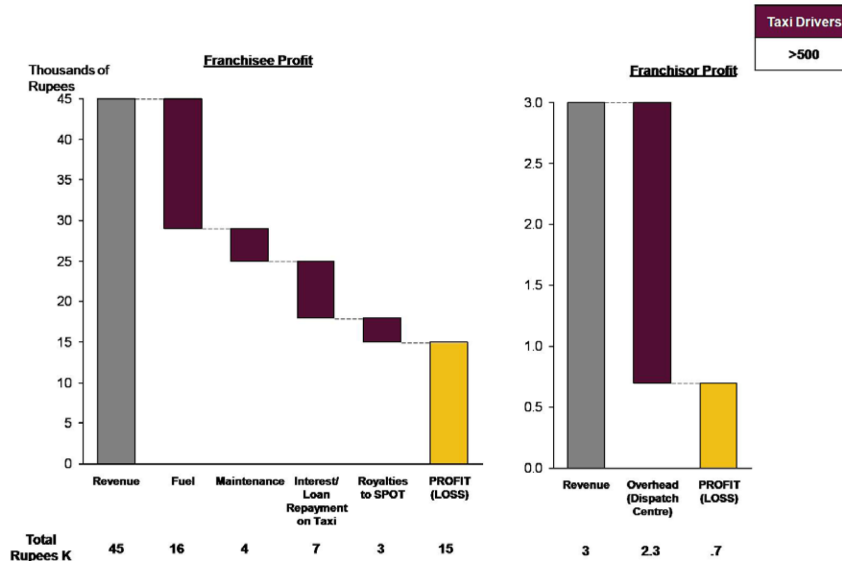
Business model: Asset ownership, the core of the SPOT model

The SPOT City Taxi radio dispatch service creates a link between high-quality taxi drivers (OCDs) and the high demand for transport services across Bangalore. This attracts potential drivers. SPOT also helps potential drivers gain access to capital with which to purchase a SPOT Taxi vehicle, customer service training, fleet management support, and a brand that generates a reliable customer base. In return, the OCDs pay a monthly fee and conform to a clear set of quality and service standards. From the customer perspective, SPOT guarantees consistent, punctual, high-quality mobility services on demand.

The SPOT model is highly profitable for both the franchisee and franchisor. The company has demonstrated an ability to define unit economics that maximize both

the OCD and company revenue while maintaining relatively low overhead and agency costs. Figure 20 provides estimates of OCD and company profitability in 2008.

Figure 20: SPOT Taxi Profitability (2008 Estimates)



Source: Interview with SPOT Founder, Collin Timms. Note: 1 Rupee = $0.02, Sept. 3, 2009.

Consistent revenue for both franchisor and franchisee

For the potential OCD, SPOT City Taxi offers an established network of pooled customer demand and fleet management services that create an environment for sustainable self-employment. The SPOT offering includes a dispatch call center that channels customer requests directly to the driver and informally ensures that each driver receives approximately 150-200 km of business per day. This daily average equates to roughly 10,000 rupees in revenue per month, which is over three times higher than the average income level in India.

At the company level, SPOT generates airtime and service charge revenues equal to 3,200 rupees ($66) per month per driver, which yields an average of 700-1,000 rupees ($14-$21) in profit per taxi. This net profit allows the company to break even with a fleet of approximately 70 taxis.

Keeping organizational overhead low

By placing ownership of the key asset – the taxi – in the hands of the driver, and centralizing dispatch services, SPOT keeps its overhead relatively low. Basic over-

head costs and value-added services for the drivers consist of the radio dispatch call center, fleet management services, and general administrative costs, including the office. Because SPOT can centralize thousands of customer requests across a large geographic area, it quickly achieves economies of scale. In addition to basic demand management, SPOT also shoulders the cost of its training and fleet management services, which include onsite support to protect against potential driver harassment, such as corruption and bribery.

OCD overhead costs include airtime and service charges, bank loan repayments, maintenance, and taxi tariffs. As noted above, monthly airtime and service charges paid to SPOT are 3,200 rupees ($66) per month, and bank loan repayments average 7,000 rupees ($130) per month. Maintenance and tariffs equate to approximately 4,000 rupees ($80). These costs allow the drivers to realize a profit margin of 20%-30% per month.

Finding franchisees through referrals

SPOT's desire to facilitate job creation and self-employment has increased its ability to access human resources and deliver on its social objective. Through a referral system – including recommendations from church leaders, community members, family, and friends – SPOT identifies potential OCDs with high levels of credibility in the community. A simple background check also requires a valid driver's license. Following the referral process, SPOT offers new drivers a refresher driver training course, which includes tips on such things as customer service, baggage handling, opening doors, and general courtesy. As a result of the company's training and social business model, the job is lucrative to OCDs, and SPOT currently has an extensive waiting list.

Access to finance through loan guarantees

SPOT's ability to support its franchisees with financing also helps it expand its potential pool of taxi drivers. SPOT drivers own their own taxis, but – given the challenges of accessing capital in frontier markets – SPOT either facilitates a loan guarantee or identifies third-party financing options for the driver. With this mechanism in place, SPOT has very few problems with the financing aspect of their OCD entrepreneurs.

Managing agency costs through asset ownership

Managing a fleet of taxi drivers with the reputation many people hold as "bandits on wheels" can be very difficult. But by transferring vehicle ownership to the driver and centralizing dispatch, SPOT has created an environment that helps it minimize agency costs. The personal ownership of the taxi encourages OCDs to maximize the value of this asset. By centralizing business through a dispatch system, SPOT

can quickly punish poor performers by disconnecting service. This internal quality-control mechanism also reduces the need to take measures through the court system.

Replication

Over the next few years, SPOT will consider opportunities to replicate its model across other Indian states and locations outside the region. SPOT believes that the model can be replicated across other regions through a joint venture model, recognizing that cultural and contextual differences will require a strong local presence. For replication into the next five or six cities, SPOT will continue along the path of organic growth, but it will aim to reduce overhead costs by establishing a centralized national call center.

Conclusion

SPOT's ability to deliver a highly profitable franchised business model suggests that franchising might be uniquely positioned to support businesses in the transport sector. Sector-specific conditions, such as growing demand across frontier markets, along with SPOT's unique application of asset transfer, third-party financial backing, and low overhead costs, brings franchisor and franchisee incentives into line and generates substantial returns for both parties.

Chapter 5: Good as the Enemy of Great

5

Development practitioners have long been interested in the potential of franchising to distribute public goods and services traditionally delivered by government, such as healthcare and education. But franchised chains that provide public goods and services have been hampered by a lack of sustainability due to sector economics, elevated overhead costs, and flawed incentives.

Decisions to scale up through franchising before establishing profitability and sustainability leads to grant-dependent, unsustainable chains, increased conflict between franchisees and franchisors, and below-market subsidized competition, inhibiting new entrants to the market. Overall, grant-dependent, unprofitable chains struggle to reach necessary scale, and therefore fail to maximize the social benefit objectives that are the primary motivation of the investor (donor) and franchisor.

In this situation, good becomes the enemy of great. While it may be good to use a grant-subsidized delivery model when quality services can be delivered more cost-effectively than purely public or aid-funded models, the grant subsidy can impede innovation and the urgent search for a great business model driven by business survival requirements.

Lack of profitability

> *"80-90% of social and micro-franchises are not profitable." – Practitioner*
>
> *"Getting the business model right is a baseline truism for all enterprises, but the nature of low-income markets is such that the margin for error is particularly slim."*
>
> – Monitor, "Emerging Markets, Emerging Models" (2009)

Most franchise models aimed at distributing public goods and services to the poor, often called "social franchising" models, have failed to achieve profitability. Only if we consider goods such as telecoms "public" do we start to see a few profitable examples. A few start-up companies, such as Living Goods and Bridge International Academies, have projections to achieve profitability in the next few years, but time will tell.

The emerging research from UCSF suggests that the only profitable health franchises serving the poor will either offer a niche service or serve high-density urban populations with higher income levels[40]. A sample of 47 social clinical franchises shows that 100% of the businesses rely on subsidies or grant capital. Across some sectors, profitably delivering goods and services to the poorest of the poor without a third party payor of some kind may not be feasible. Recognizing these challenges, many NGOs are looking to focus on cost efficiency. Clinical health franchising is one example. For some social clinical franchises the objective will shift from profit maximization toward alignment of health outcomes and cost efficiency to maximize social return and reduce the fundraising burden.

Lack of profitability can largely be explained by the economics of the relevant sectors, by social orientation, and by international organization structures. On the revenue side, a lack of profitability may be driven by highly subsidized industries or challenges related to the purchasing power of the target market. On the cost side, it is driven by relatively high costs for labor, marketing, and distribution, and high overhead, as well.

Public-goods sectors are challenging for profitability

Franchises that deliver public goods to base-of-the-pyramid markets, where the margins – and thus the margin for error – is already low, struggle to find a profit-

40 D. Montagu et al., *Clinical Social Franchising: An Annual Compendium of Programs, 2009* (University of California San Francisco, Global Health Sciences, Global Health Group, 2009).

able business model.[41] In social sectors such as education and health, revenue and margins can be even further limited. The demand for these services can be very high. Yet other public and non-profit organizations might provide these services at or below their real cost. This can create subsidized competition against private-sector initiatives, and push prices (and potential profit) down. This competition has a secondary effect on the labor force, with international donors and nongovernmental organizations (the competitors) driving up wages for the limited pool of qualified people in the health and education sectors.

Social objectives: Location, product mix, and clients

The social benefit objectives of franchisors and franchisees might have implications for outlet locations, product mix, and client selection.

Location of new outlets is one of the key decisions affecting unit profitability. In all large chains, these decisions are made by senior management, and in many chains, such as KFC, the CEO personally approves all new sites.[42] Entrepreneurs who select locations and catchment areas where the social need is the highest will most likely suffer a negative impact on revenues and profitability.

The product mix offered by social franchises might reflect what donors think is necessary, rather than what consumers are willing to pay for, which also has a negative impact on profitability. As observed by Dominic Montagu, Global Health Group at the University of California at San Francisco (UCSF), clinical services for HIV and sexual reproductive health may be heavily funded by donors but not seen as first priority by consumers.

A franchise's social objectives might be to include and serve, rather than exclude, those with the highest needs and the lowest ability to pay. This naturally increases distribution costs and limits revenues due to their aim to reach poorer, rural, and less connected target populations. The lack of infrastructure and supply chains increases costs, and in some cases even requires building distribution networks from scratch. For example, the HealthStore Foundation's CFW shops experienced significantly higher distribution costs in serving rural customers versus the peri-urban customers.

Emerging research from UCSF suggests that, when serving the poor, there are inherent trade-offs between scale, quality, cost effectiveness, and equity. The research also suggests that the only profitable health franchises serving the poor will either offer a niche service or serve high-density urban populations with higher income levels.

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41 Ashish Karamchandani, Michael Kubzansky, and Paul Frandano, *Emerging Markets, Emerging Models: What the Models Tell Us: Market-Based Solutions to the Challenges of Global Poverty* (Monitor Group, March 2009).

42 Jeffrey L. Bradach, Franchise Organizations (Cambridge: Harvard Business School Press, 1998), p. 65.

International headquarters and foreign-based overhead

A number of social franchise chains have a significant overhead burden, including headquarters, marketing, and distribution costs. Although overhead will become less burdensome as scale increases, the percentages from our sample were high compared to industry benchmarks, with an average of approximately 25%.[43]

Having an international headquarters drives up overhead costs for BoP chains, as they both increase direct costs (labor, rent) as well as indirect costs (agency costs, travel costs). For example, in 2007 VisionSpring's headquarters cost totaled 367% of company revenues. One analysis of the social health franchises indicated that nearly 75% had a partial operational presence in foreign or Western countries, which might also increase overhead costs.[44]

Sustainability

The lack of profitability, and the wider difficulty in implementing market-based solutions, is not resolved by franchising. As we noted earlier, franchising does not significantly enlarge the profit pool per se, and therefore will not turn unprofitable models into profitable ones. Lack of profit in social chains implies that they rely on philanthropic grants/donor funding to survive. This creates a large barrier to scaling up, because with each additional outlet, net losses increase. The struggle to reach the necessary scale will impair reaching the social benefit objectives. At a certain stage, donors may no longer be willing or able to fund expansion, or will pull out altogether, with clear impacts on sustainability.

The sustainability of an unprofitable enterprise can be improved through the introduction of a third-party payor such as government or a private-sector company. A third-party payor is an entity other than a patient or healthcare provider who is involved in the financing of personal health services (e.g. through private or state-funded health insurance schemes). For example, a TB voucher system might offer reimbursement for each TB test administered rather than offering grant capital in the form of general programmatic support. This would create an incentive structure in which overhead is minimized and the number of tests administered is maximized. This alignment of incentives between patient, provider, and local or national third-party payor creates an inherent social contract often lacking between foreign donors, foundations, and grantees.

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43 William Bedsworth, *Non-profit Overhead Costs: Breaking the Vicious Cycle of Misleading Reporting, Unrealistic Expectations and Pressure to Conform* (Bridgespan Group, April 2008).

44 D. Montaguet al., *Clinical Social Franchising: An Annual Compendium of Programs, 2009* (University of California at San Francisco, Global Health Sciences, Global Health Group, 2009).

Franchisee incentives

Lack of profitability also has negative effects on franchisee incentives, retention, and motivation. Profitability should always be analyzed at the level of the chain, because through royalties and transfer pricing, profit and losses can be shifted between the franchisor and the franchisees. Unprofitable chains sometimes chose to move the losses to the franchisor, because franchisees need to be cash-positive to be motivated and remain with the chain. In non-profit, grant-financed chains, the only way to achieve this is by transferring part of these grants toward the profits of the franchisee.

In a traditional franchise, this can be done by selling goods below the cost price, and in a business franchise by supplementing the franchisee's income and/or not charging a franchise fee (a royalty in reverse). Franchisors, investors, and donors will, however, face a trade-off between financial sustainability and franchisee profits, and may want to cap the amount of these transfers/franchisee profits. This will reduce the attractiveness of the franchise from the perspective of the franchisee. The good franchisees might leave the chain, or not join in the first place, as they realize the non-sustainability and risk inherent in grant-financed profits.

Competition and entry

A reliance on grant financing undermines franchisor incentives. For existing franchisors, grant funding can mute the survival imperative and incentives to implement creative, new, and profitable business models are lessened. For new franchisors, the presence and competition of grant-subsidized franchising chains make it more difficult to enter the market.

Conclusion

Social franchising chains are often unprofitable, and therefore struggle to scale-up successfully. While it may be good to continue with a grant-subsidized delivery model if quality services are delivered more cost-effectively than purely public or aid-funded models, the grant subsidy impedes the innovative and urgent search for a profitable great business model driven by business survival requirements. Social chains should focus significant efforts on improving business models and finding creative ways, such as third-party payors, to boost profitability without relying on international fundraising efforts.

Implications for donors and philanthropic investors

- Profitability is the only guarantee of scalability and sustainability, and is required to operate a successful franchising model. Managers should be spurred and given incentives to look for innovative ways to achieve profitability. Donors should consider models that provide a more sustainable balance between social and

financial objectives, such as mixed-models that serves both middle-class as well as base-of-the-pyramid customers.

- Where market conditions and sector economics may make profitability untenable, the use of third-party payor systems are preferred over international grant funding. The role of the third-party payor system is to maximize the alignment between achieving health outcome and financial efficiency.
- Donors should be cautious about funding social franchises with grant capital, believing that their capital is catalyzing a business that will sustain itself. No examples were found of chains that started with grant funding and moved to a fully profitable business model. Donors should be aware of the "dependency" that grant moneys can create. Opportunities may exist to leverage grant funding as upfront seed capital or investment in R&D during a start-up period with a longer term aim of weaning off grant capital. However, further research on the feasibility of doing this is needed as no successful examples were found so far.
- Unprofitable and grant-based chains might still appear to be more efficient and effective than other, purely public-money funded, interventions. They should, however, be evaluated in the framework of cost- and aid-effectiveness. Furthermore, they inhibit the entry of other, purely market-based solutions, and this negative competitive effect should be incorporated in the evaluation of grant-funding.
- Funders should closely evaluate, especially in outlet-based setups, whether the scale-up, increased funding, and long-term sustainability of grant-dependent chains can be guaranteed.

Case Study: The HealthStore Foundation®

The HealthStore Foundation® (HSF) illustrates the challenges of shifting from a non-profit to a for-profit approach to establish a sustainable franchise business in the health sector. To date, despite operating a franchise network of over 80 units in Kenya in fulfillment of its charitable mission, HSF has not pursued the self-sustainability of its franchisor, but only of its franchisees. Going forward, HSF will clearly delineate the for-profit and non-profit segments of the business; HSF will launch a for-profit organization that will no longer be subject to the misaligned incentives and unsustainable practices embedded in a non-profit model.

As of August 2009, HSF's operational restructuring plans included a fundamental shift from not-for-profit status funded by grants and donations to a for-profit model financed by private investment capital. The most significant change to the business model is opening new Child and Family Wellness (CFW) franchised clinics in different geographic areas that will result in increased revenue to the franchisor. In addition, HSF's new for-profit entity in East Africa will minimize overhead costs through efficiencies and professional business practices required to meet its goal of profitability. HSF's restructuring is designed to lead to a commercially viable franchise network in East Africa, projected to break even at 225 outlets in 2015 and to reach a sustaining annual profit of $205,000 in 2018.

History: Addressing market failure through micro-clinics

HSF was established in 1997 with a non-profit charitable mission to address the market's failure to deliver essential drugs and medicines in developing countries at the quality standard necessary to provide effective treatment. Around the world, nearly 30,000 children under age five die each day—more than 10 million a year—because

they lack access to high-quality, affordable medical care.[45] When Scott Hillstrom co-founded HSF, he believed that the same business format franchise model so successful in distributing goods and services, from gasoline to French fries, might be the most effective way to scale-up access to medical care for Africa's poor, all the while maintaining the quality standard necessary to effective treatment—HealthStore's primary mission. So he and his team launched the CFW network of franchised drug shops and medical clinics in Kenya.

As a condition of using HealthStore's CFW brand and franchise operating system, franchisees are required to maintain HSF's quality and business standards. Each franchisee is given incentives to maintain quality standards and adhere to business operating procedures with the risk of losing the franchise brand if quality suffers. This incentive is HealthStore's key to maintaining consistent standards across all of its franchise networks around the world and it is the key element to fulfilling HealthStore's mission.

Following incorporation in 1997, HSF opened its first 11 outlets in 2000 and by 2008 had grown the network to 82 franchised medical clinics and medicine shops in rural, peri-urban, and slum urban Kenya, plus three in Rwanda. HSF franchisees pay an initial franchise fee to acquire a CFW franchise, while HSF lends the balance necessary to open a clinic. HSF also provides training, inventories, marketing support, and the usual things that franchisors do for their franchisees. In the past, clinics were located in communities based on the local need and an available franchisee. Care was taken to ensure that franchisees would become self-sustaining, but little effort was made to make HealthStore's non-profit franchisor in Kenya—Sustainable Healthcare Foundation ("SHF")—self-sustaining.

In 2008, for example, of 59 CFW outlets operating all year, 88% reported a profit. However, a negligible amount of SHF's operating costs were covered by revenue from franchisees. The rest of SHF's operating costs were paid for by grants and charitable contributions.

Restructuring in pursuit of self-sustainability

Since early 2008, HSF has been dramatically changing course. The first phase of this was management change at SHF and a reduction of SHF's headcount from 38 to 14 employees, along with the opening of an additional 15 CFW clinics in fall 2008.

The second phase was a formal restructuring designed to yield long-term financial sustainability. A new for-profit entity—HealthStore East Africa (HSEA)—will

45 "2005 UN Millennium Development Goals Report," p. 18. Drugs are widely available in Africa; more than $2 billion worth of drugs are sold annually. But only a very small percentage of Africans have ready access to high-quality, affordable medicine; most receive drugs of dubious quality at best and counterfeit at worst.

open new CFW outlets in different geographic areas, with a view toward becoming a self-sustaining network of approximately 300 outlets. Meanwhile, the existing 82 CFW outlets will continue under the umbrella of SHF—a non-profit entity supported by donations—with the hope that some but not all might be transferred to the for-profit entity as their performance improves. Administrative personnel and associated costs of approximately $150,000 – $200,000 per year will be borne by the non-profit entity.

Founder Scott Hillstrom acknowledges that an increase in philanthropic giving—as opposed to a restructuring to a for-profit company—could help the CFW network in Kenya reach breakeven, but notes the challenges associated with non-profits that led to HSF's decision to restructure instead:

> This pattern could be resolved by more focus on fundraising—enough grant funding would produce a positive bottom line – but it would not achieve HealthStore's mission. As a grant funded NGO, SHF (the Kenyan franchisor) did not maintain the high business standards necessary to achieve profitability of a normal business, much less to scale the franchise network to hundreds and, eventually, thousands of locations. Grant funders tend to specify particular deliverables and do not hold grantees accountable for overall performance as shareholders do in similar size companies. Furthermore, HSF personnel are necessarily preoccupied with fundraising and donor support activities while neglecting the support of franchisees, patients and customers. And grant funding is unreliable and inconsistent, making it impossible to reliably predict whether and when growth capital will become available. Finally, the key people who are skilled and experienced to actually build the franchise network—a very full time job—are not focusing on doing that when they are going through extensive efforts to obtain grants which can take months or even years to obtain.

HSF decided to focus on three key elements: (1) ensuring standards; (2) accelerated growth ("geometric scaling"); and (3) leveraging economies of scale. Ensuring clinical and business standards will help HSF establish a core brand based on the delivery of high-quality services. By creating a strong brand and high-quality clinical and business standards, HSF believes that it can more effectively package the business for replication and growth. HSF expects that time spent on establishing clinical standards and processes in the short term will lead to rapid growth in the medium term. HSF is also concentrating on achieving economies of scale. As

the CFW network grows, the organization will find ways to cut the costs per unit, resulting in higher profits for both the franchisee and franchisor.

Unit economics

Unit economics—that is, the economic performance of the franchised CFW clinics—are the key to HSEA's pursuit of self-sustainability. One of the fundamental changes to HSF's revenue model will be the implementation of franchise, royalty, and advertising fees, which are common in large commercial franchise businesses. These fees will include 5% royalties on gross sales, an increased initial franchise fee, and an additional 2.5% charge on gross sales that will be allocated to a companywide CFW advertising fund. These fees, along with higher margins on products sold from HSEA to CFW franchisees, will be the main sources of revenue for HSEA. HSEA revenue goals are, in turn, set to cover its expenses to support the franchisee network and will yield enough profit to generate a return of and a return on the capital invested to support the franchisor's business.

Operational changes

HSEA's projected profitability is based on the following key operational changes, among others:

1. **Site selection**: All new CFW clinics will be located in more densely populated urban slums and rural towns, as opposed to the types of rural villages where most existing CFW clinics are located. HSF believes these new locations have much greater patient and customer potential.
2. **Franchisee selection**: HSEA will select new franchisees not only according to their clinical qualifications and skills, but according to their business acumen and entrepreneurial drive.
3. **Outsourcing**: HSF has outsourced procurement, storage, and distribution functions to a high-quality drug distributor in Kenya. This has improved the quality of its drug procurement and distribution processes, and will allow HSEA to avoid staff costs not directly linked to its core business of recruiting, training, and supporting CFW franchisees.
4. **Efficiency**: Aside from the addition of one full-time field representative per twenty new CFW outlets, HSEA plans to add only two more full-time employees while expanding to 300 outlets, modeling its efficiency after successful franchisors.

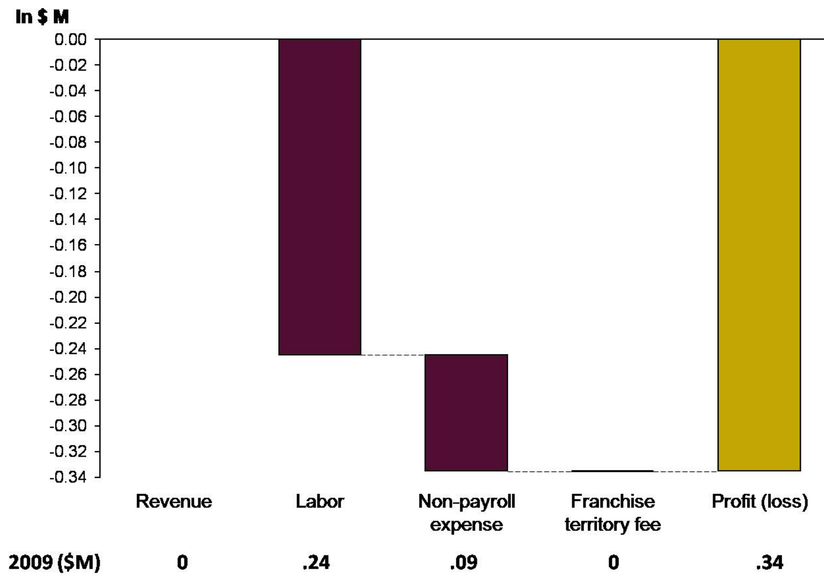
Organization structure

HSF plans to establish HealthStore Holdings, a wholly owned subsidiary and for-profit holding company. HealthStore Holdings will sell licensing rights to HealthStore

East Africa (HSEA) in exchange for fees in three areas: (1) a franchise fee for the territory ($10,000); (2) an ongoing royalty (1% of total franchisor revenue); and (3) allocated expenses incurred on behalf of HSEA ($10,000 per year). HSF intends to finance HSH and HSEA through social venture capital investments.

Based on the plan outlined above, HSF projects that HSEA will break even at 225 outlets in 2015 and will reach a sustaining annual profit of $205,000 in 2018. Figures 21 and 22 portray the projected growth of HSEA from start-up phase in 2009 to sustaining annual profit in 2018.

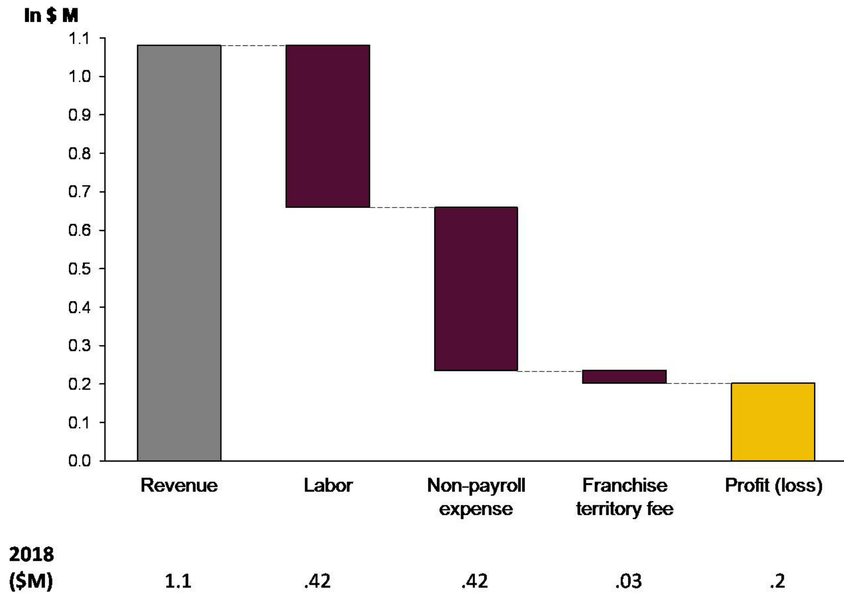
Figure 21: HealthStore East Africa Profit/Loss, 2009, Projected (82 Units)



Source: HealthStore Foundation.

Note: Revenue is projected at $0 in 2009 because this model excludes the existing 82 units.

Figure 22: HealthStore East Africa Profit/Loss, 2018, Projected



Source: HealthStore Foundation.

The HealthStore Foundation Restructuring Plan is has not yet been implemented, and the team recognizes that its hypotheses related to financing and access to human resources will need to be tested as the new model is implemented. At the organizational level, HealthStore will need to ensure it is able to attract social investors interested in a low-profit, high-risk business designed to achieve a social mission. To deliver the most cost-effective organization, HealthStore aims to reduce overhead spending but will need to continuously measure the impact of fewer staff and reduced overhead expenditure. And finally, finding suitable franchisees and arranging loan financing for approximately $5,000 per franchisee will be a critical step in ensuring appropriate human resources.

Case Study: VisionSpring

VisionSpring—a reading-glass company–highlights the difficulty of balancing business-unit profitability with an entire system's sustainability. This challenge plagues many micro-enterprises attempting to use franchising to deliver goods and services to the base-of-the-pyramid market.

History: Market failure in awareness, access, and affordability of reading glasses

Dr. Jordan Kassalow established VisionSpring in 2001 to address the Indian market's failure to provide affordable reading glasses. He saw a lack of awareness, access, and affordability for the treatment of presbyopia, a visual condition that impairs close vision in nearly 400 million people worldwide. Although presbyopia can easily be addressed with a pair of basic reading glasses, Dr. Kassalow recognized a lack of consumer awareness, and he invested in educating people about alternatives. Because many customers live in rural India, where the infrastructure is poor, establishing an effective delivery system that made access readily available was essential. So was the need to keep price affordable.

By combining the three principles of awareness, accessibility, and affordability, VisionSpring designed a "business-in-a-bag" solution that trains rural entrepreneurs with limited skills to start profitable businesses. These entrepreneurs create market awareness by first educating their customers, and then providing access by distributing glasses on foot across the remote reaches of their villages. In this way the Vision Entrepreneurs (or agents) deliver reading glasses at a price that is affordable for customers and profitable for the entrepreneur.

VisionSpring's decision to adopt an agent-based distribution model stemmed from a desire to address market failure by establishing a market-based solution, the ease of packaging the eyeglass business, and the fact that many low-income people

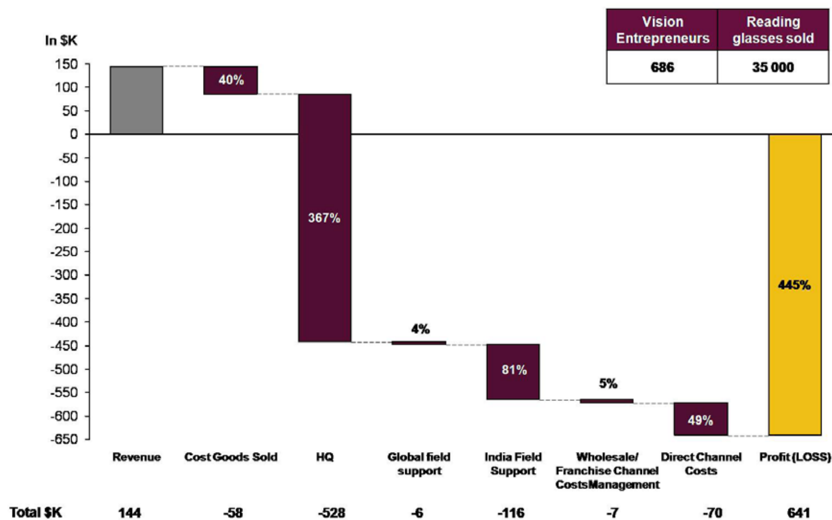
living in rural India were in an excellent position to penetrate their rural communities by capitalizing on neighborly trust. Dr. Kassalow recognized the potential for sustainability through market-based solutions, but his primary focus was to create a blueprint for success that could easily be packaged and replicated.

VisionSpring has its own direct network of Vision Entrepreneurs and also distributes its eyeglasses through two other channels—wholesaling, and business franchising to networked partners. As a wholesaler, VisionSpring sells its eyeglasses directly to retailers who, in turn, sell the eyeglasses across their extensive chains. VisionSpring also franchises its entire business model to NGOs with extensive reach across rural frontier markets, such as BRAC, PSI, and Freedom from Hunger, which in turn offer the business-in-a-bag model to their entrepreneur networks. In the traditional franchise model, VisionSpring sells business-in-a-bag to its Vision Entrepreneurs, who purchase instructions, equipment, products, and training on consignment for direct sale to customers.

Since 2001, VisionSpring has launched operations in nearly a dozen countries across southern Asia, South and Central America, and Africa, trained over 1,000 vision entrepreneurs, and sold more than 100,000 pairs of reading glasses.

Despite this early success, VisionSpring knew it needed to improve the model's sustainability. As Figure 23 illustrates, VisionSpring's system-wide economics could not be sustained without significant philanthropic subsidies.

Figure 23: VisionSpring Profitability, 2007 (Excluding Philanthropic Support)



Source: "VisionSpring 2008 Growth Capital Offering."

In 2008, VisionSpring began a 5-year capital investment strategy aimed at improving the overall economic viability and sustainability of its business – developing reliable revenue sources, optimizing sales, enhancing operations, improving supply chains, and increasing its social return for investors. Several key factors will affect this effort.

Revenue limitations: Frequency of sales and sustainability of demand

VisionSpring and its Vision Entrepreneurs face two challenges to maximize revenue generated by eyeglass sales: sales frequency, and sustainability of demand. Eyeglass sales require a long lead time and are more erratic ("lumpy") due to the close interaction required between the seller and the customer. People buying eyeglasses — unlike commodities — must consider several variables before making the decision to purchase. Buyers are also less likely to be repeat customers.

The purchasing decision includes not only the results of the eye exam, but also selection of style and fit, any one of which could delay the purchase. Vision Entrepreneurs must therefore manage cash flow carefully. The demand for eyeglasses is relatively finite, especially when disposable income is low. As Vision Entrepreneurs sell eyeglasses in their immediate communities, they will soon have approached everyone who might need eyeglasses, requiring them to find customers elsewhere or seek other income sources.

To address this sales "lumpiness" and finite demand, VisionSpring wants to increase its product mix. By introducing commodity-like or complementary items, an expanded product mix has the potential to balance erratic cash flow. For example, the addition of pre-paid cell phone airtime cards, a high-demand, high-frequency product, would likely increase Vision Entrepreneur sales. This would create more predictable income and also increase customer interaction, which creates trust and has the potential to improve the likelihood of more expensive purchases.

Expanding the product mix also has the potential to improve the organization's overall profitability. The willingness and ability of customers to pay in low-income markets is often not high enough to cover the basic cost of goods sold. By complementing unprofitable products with higher margin items, VisionSpring might offset the high cost of its less profitable product (reading glasses) and reduce the organization's subsidy requirements.

Improving cost of goods sold through better design

VisionSpring expects its 5-year strategic plan to improve the company's economics and accelerate the provision of its business-in-a-bag model by maintaining logistics costs and lowering cost of goods sold. Although the unit cost of reading glass sales supports a quick return on investment for the Vision Entrepreneur, sales revenue

from this direct channel delivers only a low margin on goods sold to VisionSpring. To increase this return, VisionSpring expects to maintain its logistics expense at 10% of total cost of goods sold, and work with manufacturers, designers, and consumers to design lower cost, higher quality glasses that will improve unit cost by 2%. Overall, VisionSpring plans to reduce the fully loaded cost per unit of reading glasses by 51% by 2012.

Relatively high overhead costs

VisionSpring's total organizational overhead costs include local and regional headquarters and supply chain management costs, but are disproportionally driven by the cost of global headquarters' (HQ) operations. In 2007, the expense incurred by VisionSpring's global HQ – including 3.3 full-time equivalents, office rent, and general and administrative expenses – was 367% of total system-wide revenue and approximately 67% of total expenses. As these costs should be relatively fixed, they should decline as a percentage of the total as sales increase.

Challenges of attracting and retaining Vision Entrepreneurs

VisionSpring faces two major human resources challenges: attracting and retaining talent, and defining the key attributes that guarantee success for Vision Entrepreneurs. To address these challenges, VisionSpring carefully monitors and evaluates the sales patterns, profiles, and habits of its Vision Entrepreneurs. By analyzing the actions and characteristics of successful Vision Entrepreneurs, VisionSpring has been able to incorporate new training approaches and adjust its recruitment tactics to improve performance and cut the turnover rate from 80% to 40%.

Like any franchise working across frontier markets, this approach to attracting and retaining top talent is not only difficult but also expensive, a challenge that VisionSpring aims to address by codifying its learning. Over the next five years, the VisionSpring team will provide additional support to its franchisees by packaging its learning, including: (1) training, recruiting, and management support to increase Vision Entrepreneur sales; (2) techniques to assess market potential in new territories; (3) improved product offering; and (4) reducing staff turnover within the sales and marketing team.

Access to financial resources on consignment

VisionSpring's model avoids the issue of access to finance for its Vision Entrepreneurs by offering the business-in-a-bag on consignment, with the understanding that the agent will make payment only when the goods have been sold. The cost is

approximately \$11.[46] However, as sales grow, the working capital requirement on VisionSpring will grow substantially requiring significant access to low cost capital.

Funding shifts toward repeatable philanthropic sources

VisionSpring will continue to require significant philanthropic support, but it is shifting its fundraising strategy to a more cost-effective focus on *repeatable philanthropic sources.* Such sources are more likely to provide annual repeat funding. VisionSpring assumes this approach will reduce overall staff time and generate higher donations, yielding a higher return on investment. As VisionSpring notes in its prospectus, current capital investment efforts require a significant amount of senior management time and are a "distraction from enacting VisionSpring's ambitious growth plan."[47] In the long term, VisionSpring aims to achieve full profitability, and management calculates it can eventually break even at a volume of approximately 8 million units sold per year. This breakeven point is more than 80 times VisionSpring's sales during its first 7 years of operation and more than 13 times the sales volumes projected by 2012.

Side Box 6: Excerpt from VisionSpring Prospectus

"As illustrated by the mass market for reading glasses in the United States, significant scale must be achieved before a purely earned revenue model becomes viable. For example, the 47 million units sold per year on the US market produces an average retail price of \$15, whereas VisionSpring operates at an average retail price of approximately \$4.

"With one-one-thousandth as many units to absorb overhead expenses, and with retail price levels that are less than one-third as high, VisionSpring clearly needs to go a great distance before it can match the economic norms that make the US marketplace profitable. Nevertheless, VisionSpring is confident that a 100% earned revenue business model can eventually be achieved."

Source: "VisionSpring 2008 Growth Capital Offering."

Franchisee vs. system wide profitability

From the franchisee's perspective, VisionSpring offers a lucrative business opportunity that offers profitability within the first few months of sales. VisionSpring's

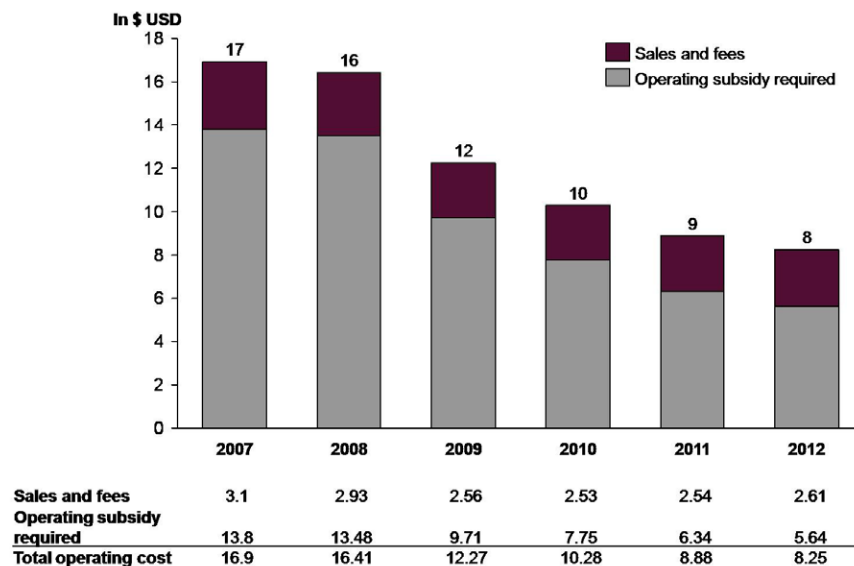
46 "Restoring Eyesight in Rural India through the Direct Selling of Reading Glasses," in *What Works: Scojo India Foundation* (WDI Case Study, June 2007).

47 "VisionSpring 2008 Growth Capital Offering: 5-Year Prospectus," 2008.

business-in-a-bag is available on consignment for a cost of $11, and includes an initial 20 pairs of eyeglasses, supplementary training, and additional equipment, such as mirrors and uniforms. Vision Entrepreneur generate approximately $1 in gross profit per pair of eyeglasses, so only a dozen sales are required to capture the investment outlay. VisionSpring estimates that high-performing Vision Entrepreneurs will sell 11 units per month.

At the system wide level, however, VisionSpring's unit economic profitability operated at a significant loss in 2007. With an overall loss of -445%, each unit sold required an additional $13.80 in subsidization for every $3.10 in revenue received. Through adjustments to both revenue and expense activities, VisionSpring plans to lower this loss to -216%, and reduce the philanthropic subsidy required from $13.80 to $5.64 by 2012. Figure 24 highlights the reduced operating subsidy from 2007 to 2012.

Figure 24: Vision Spring Operating Subsidy Required 2007-2011



	2007	2008	2009	2010	2011	2012
Sales and fees	3.1	2.93	2.56	2.53	2.54	2.61
Operating subsidy required	13.8	13.48	9.71	7.75	6.34	5.64
Total operating cost	16.9	16.41	12.27	10.28	8.88	8.25

Source: "VisionSpring 2008 Growth Capital Offering."

VisionSpring's revenue and expense adjustments will allow it to reduce the total subsidy requirements down to 116% of total revenue. These adjustments include increasing the revenue per unit of wholesale and direct sales, total volume of franchise sales, and the fee for service received for market feasibility studies and pilot program support to franchise partners. These improved economics will produce

revenues to cover approximately 30% of the organization's total operating costs.[48] Figures 25 and 26 show the specific revenue and expense adjustments planned over the next 5 years.

Figure 25: Adjustments to Franchisor Revenue, 2007 – 2012

Activity (USD K) (% of revenue)	2007	2012	Drivers of change
Total reading glasses	*35K*	*198K*	
Wholesale	$10 (7%)	$75 (11%)	• Grow from 4 to 10 accounts • Increase order volume per account by 20% annually • Grow rev. per unit 4% annually from $1.22 to $1.49
Franchise	$50 (35%)	$363 (53%)	• Reduce sales per VE-month from 3.5 to 2.8 units • Reduce avg. revenue per unit from $3.80 to $2.68 • Increase BRAC from 381 to 4,000 VE's • Grow from 9 to 20 franchise partners • Increase other partner VE's from 184 to 1,012
Direct	$44 (21%)	$166 (24%)	• Increase VE headcount by 38% • Raise average productivity to 2007 top quartile rate (from 11 to 24 pairs per month) • Grow rev per unit 3% per year from $3.04 to $3.55
Service fees	$40 (28%)	$84 (12%)	• Increase number of paid franchise feasibility & pilot studies from 6 to 10 • Increase revenue per study by 4% per year
TOTAL EARNED REVENUE	**$144**	**$688**	

Source: "VisionSpring 2008 Growth Capital Offering."

Figure 26: Adjustments to Franchisor Expenses, 2007 – 2012

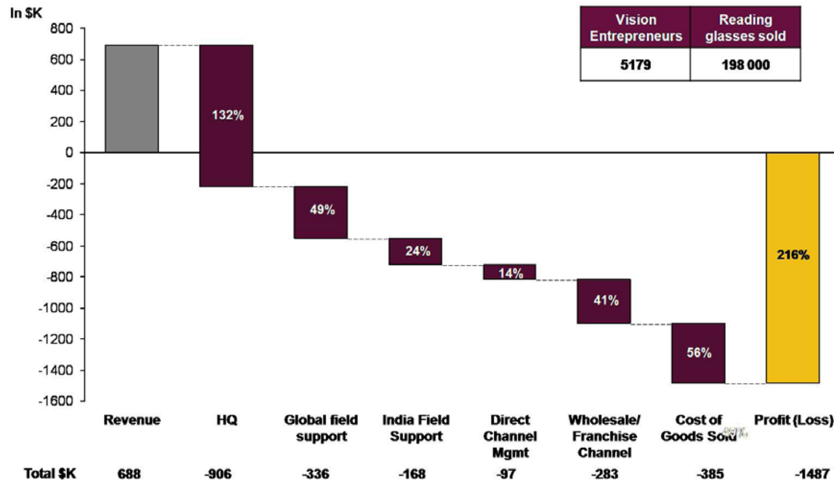
Expense (USD K) (% of revenue)	2007	2012	Drivers of change
Total reading glasses	*35K*	*198K*	
NY HQ	$528 (367%)	$906 (132%)	• Increase FTE's from 3.3 to 5.8 • Upgrade Director role to Executive Director • New office location • 3% real and 3% inflation expense growth per year
Global field support	$6 (4%)	$336 (49%)	• Upgrade/shift COO role from New York to India and add Assistant • Maintain logistics expense @10% of COG's • 3% real and 7% inflation expense growth per year
India field support	$116 (81%)	$168 (24%)	• Add Manager of Sales Innovation and Bookkeeper • 3% real and 7% inflation expense growth per year
Total HQ Costs	**$650**	**$1410**	
Wholesale/franchise channel mgmt	$7 (5%)	$283 (41%)	• Add 4 channel managers • 3% real and 7% inflation expense growth per year (except for 1 NYC-based channel manager)
Direct Channel management	$70 (49%)	$97 (14%)	• Add 2 District Coordinators and 2 Identification / Training Managers • 3% real and 4% inflation expense growth per year
Cost of Goods Sold	$58 (40%)	$385 (56%)	• 5.4x growth in units • 7% inflation offset by 2% unit cost improvement per year
TOTAL EXPENSES	**$785**	**$2175**	

Source: "VisionSpring 2008 Growth Capital Offering."

48 "VisionSpring 2008 Growth Capital Offering: 5-Year Prospectus," 2008.

By investing in more efficient revenue sources, optimizing sales, enhancing operations, improving supply chains, and increasing its social impact, VisionSpring plans to improve its economics so that revenues will cover approximately 30% of the organization's total operating costs by 2012.[49]

Figure 27: VisionSpring Projected Profitability, 2012 (without philanthropic support)



Source: "VisionSpring 2008 Growth Capital Offering." Note: % of total revenue reflected in each bar. Vision Entrepreneurs from both Direct and Franchise Channels. Franchise Channel expected to grow from 565 to 5,012 by 2012.

VisionSpring is not unique in the challenge it faces with regard to achieving pure profitability while serving the poor. The evolving business model highlights the difficulty of balancing profitability for the franchisee with profitability for the franchisor and the ultimate aim of delivering social benefit at scale. This obstacle plagues many micro-enterprises attempting to use franchising to deliver goods and services to the base-of-the-pyramid market.

49 Ibid.

Chapter 6: Areas for Further Research

6

Many areas, ranging from support for specific business concepts to targeted investment in the policy and regulatory environment, have emerged through this study and would benefit from additional research.

What is the impact of franchising on profitability? Our study found that franchising does not significantly increase the profit pool vs. company-owned expansion. However, current evidence is incomplete and requires a more robust analysis to prove or disprove this.

What is the franchising friendliness in frontier markets across industries, across market segments, and across geographies? Our analysis revealed a few regulatory conditions (such as contract enforcement) that support franchising, but the complexity of each industry, geography, and market segment should be explored in more detail. A global dataset incorporating missing key dimensions (such as IP frameworks per country) would be very helpful for investors, franchisors and policymakers.

What policy interventions will have the greatest impact on improving the enabling environment for franchising? Consideration should be given to which general interventions will directly address the challenges facing franchising. Given the overlap between challenges for franchising and the wider SME enabling environment, researchers and policymakers need to consider which interventions will bring about

the most significant change. The issue of policy standardization across countries (such as regional trading blocks) deserves special attention.

Is the decision to franchise accelerated or slowed by the complexity of the business model and industry? The length of time taken to decide whether or not to franchise may be directly linked to the complexity of the underlying business model and industry, but this question calls for a more detailed analysis. The answer might help practitioners decide when to start considering a franchise growth strategy and help investors assess the "readiness" of potential franchise investments.

What is the role of alternative forms of financing to support franchising? What business model maximizes the impact of grant capital? Although grant-subsidized franchise models show limited ability to achieve and maintain large scale, there might be alternative forms of financing that are well positioned to support key areas of franchise development. Researchers should consider which types of funding are best suited to promote particular aspects of franchise development. Alternative forms of capital, such as "soft" funding, impact investments, grant capital, or patient capital might be appropriate to support innovative approaches, capacity-building, or turnaround strategies for unprofitable social franchise models.

What is the relative impact of international franchise chains on homegrown franchise growth and development? Part of this study considered the relative influence of Western franchise chains on homegrown franchise businesses, but it is unclear whether international chains inhibit or positively influence franchise growth in frontier markets. Our study also noted that the largest microfranchise enterprises are international concepts established in a frontier market. Assessing the impact international chains have on national markets and the key success factors of foreign concepts could strengthen the ability of policymakers and regulators to fortify the enabling environment.

Annex 1: Common Definitions

Sub-type	Definition
Business format franchise	Format in which the franchisor company moves beyond the direct sale of a product or services to include a particular way of doing business. Includes systems, operating procedures as well as product purchase and sales.
Conversion	Franchise model in which a business format franchise contract is applied to the conversion of an existing business
Fractional licensing	Commonly seen in health franchise models. Refers to a clinic or outlet in which only part of the services or products are regulated by the franchise.
Full franchise	Clinic or outlet in which all services and products are franchised (similar to business format franchise)
Management contracts	Model in which management and service delivery is provided by the franchisor while franchisee retains overall ownership over the business.
Microfranchising	May include a variety of franchise types but aims to impact poverty by facilitating job creation, economic activity and distribution of goods and services to base of the pyramid markets
Social franchising	Franchise model that does not generate profit. These models commonly deliver public goods and services
Traditional format franchising	Also referred to as 'product' franchising can be characterized by a relationship established between a company and a franchisee in which the company has ownership over a particular product and offers exclusive sales rights (or distribution rights) to the franchisee

Business format vs. traditional format franchising

Key Differences	Traditional	Business-format
Schematic overview	Supply chain: Franchisor → Franchisee distribution → Customer	Franchisor → Franchisee Business, Franchisee Business, Franchisee Business
Revenue stream for franchisor	Margin on products sold to franchisee	Royalty on franchisee sales (ongoing) and franchisee fee (start-up)
Contractual relationship	Franchisee obtains right to produce and/or distribute products Potential responsibility to support branding and marketing activities	Franchisee obtains right to implement an entire business format (from sourcing to marketing) according to predefined standards
Examples	Coca-cola bottling, BP, Avon, VisionSpring, Grameen Village Phone	Subway, Holiday Inn, Midas Mufflers, Jani-King, HealthStore Foundation

Annex 2: Presence of Franchise Systems in Advanced and Emerging Markets

Presence of Franchising in Advanced Markets[50]

Country	Franchise Systems	Franchise Units	Franchise Associations	Franchise Regulation
US	2,500	600,000	Yes	Yes
Japan	803	199,328	Yes	No
Germany	1,115	33,000	Yes	No
UK	665	35,600	Yes	No
France	571	32,000	Yes	Yes
Canada	1,300	76,000	Yes	Yes
Australia	747	49,400	Yes	Yes

50 Chantal Zimmerman, "Franchising in Europe," Franchise Symposium 2002 and various Franchise Association Websites by country of origin; AfDB, "Enhancing Development in Africa: Franchising Report," 2003.

Presence of Franchising in Emerging Markets[51]

Country	Franchise Systems	Franchise Units	Franchise Associations	Franchise Regulation
Indonesia	253	2,000	Yes	Yes
Brazil	894	46,534	Yes	Yes
Mexico	500	25,000	Yes	Yes
Philippines	500	4,000	Yes	No
South Africa	478	23,625	Yes	No
Morocco	85	N/A	Yes	No
Chile	80	300	Yes	No

51 Ibid.

Annex 3:
Micro-Franchise Organizations Referred to in the Report

Organiza-tion	Franchise Format	Primary Operations	Sector	Description
HealthStore Foundation	Business/ mi-crofranchise	Kenya	Health	Network of micro pharma-cies and clinics
Nando's	Business format	South Africa (30 countries)	Food/ restau-rant	Afro-Portuguese chicken restaurant chain.
SPOT Taxi	Business format	India	Transpor-tation	Radio dispatch taxi service based in Bangalore
VisionSpring	Traditional format/ mi-crofranchise	India (13 other coun-tries)	Health	'Business in a bag' eyeglass sales through Vision Entre-preneurs
BlueStar Ghana	Fractional Franchise	Ghana	Health	Sexual reproductive health products and services
Bridge International Academies	Business format/ company-owned chain	Kenya	Educa-tion	Low-cost for-profit private primary schools to serve low income communities
FanMilk	Traditional format/ mi-crofranchise	Ghana	Food	Nutrition and refreshment products, mainly dairy
Vodacom's Commu-nity Services Phone Shops	Business format	South Africa	Telecoms	Entrepreneur owned and operated telephone shops that serve under-serviced, disadvantaged communities
Vodafone's MPESA	Traditional format/	Kenya	Telecoms	Mobile phone based money transfer services

Annex 4:
UCSF Annual Compendium of Clinical Social Franchises 2009

Franchise Name	Country	Coordinating Organization	Date Founded	No. of Clinics	Franchise Fee	Location of Umbrella Organization	Family Planning	HIV	Sexual Reproductive Health	Maternal and Child Health	TB	Malaria
AMUA	Kenya	Marie Stopes International	2004	144	Yes	London	Yes					
ARV Care	South Africa	BroadReach	2002	4500	N/A	US		Yes				
Biruh Tesfa	Ethiopia	Pathfinder International	2000	130	N/A	US	Yes		Yes			
Blue Star (Bangladesh)	Bangladesh	Social Marketing Company	1998	3600	N/A	London	Yes					
BlueStar (Ethiopia)	Ethiopia	Marie Stopes International	2007	107	Yes	London	Yes		Yes			
BlueStar (Ghana)	Ghana	Marie Stopes International	2008	102	Yes	London	Yes		Yes			
BlueStar (Malawi)	Malawi	Marie Stopes International	2008	59	Yes	London	Yes	Yes	Yes			
BlueStar (Philippines)	Philippines	Marie Stopes International	2007	66	Yes	London	Yes		Yes			
BlueStar (Sierra Leone)	Sierra Leone	Marie Stopes International	2008	70	Yes	London	Yes					
BlueStar (Vietnam)	Vietnam	Marie Stopes International	2007	32	Yes	London	Yes		Yes			
CFWshops Kenya	Kenya	Child and Family Wellness Shops CFW	2000	67	Yes	US and KE		Yes	Yes	Yes		
CFWshops Rwanda	Rwanda	Child and Family Wellness Shops CFW	2008	2	Yes	US and KE		Yes	Yes			
Confiance	Congo	Population Services International	2004	78	N/A	DC	Yes					
DiMPA Network	India	PSP-One	1998	1150	N/A	US	Yes					
FriendlyCare (Philipines)	Philipines	FriendlyCare	1999	6	N/A	philippines	Yes					
Gold Star	Kenya	Family Health International	2006	279	Yes	US	Yes	Yes			Yes	Yes
Greenstar	Pakistan	Population Services International	1995	8000	N/A	DC	Yes		Yes	Yes	Yes	
Key Clinics	India	Population Services International	2004	701	N/A	DC			Yes		Yes	
K-Met (Kenya)	Kenya	K-MET	1995	200	Yes	Kenya	Yes		Yes			
Merrygold Health	India	Hindustan Latex FP Trust	2007		N/A	India	Yes		Yes	Yes	Yes	
Mexico (Community Doctors Program	Mexico	Mexfam	1986	300	N/A	Mexico	Yes					
New Start (Lesotho)	Lesotho	Population Services International	2004	6	N/A	DC		Yes				
New Start (South Africa)	South Africa	Population Services International	2007	11	N/A	DC		Yes				
New Start (Swaziland)	Swaziland	Population Services International	2003	16	N/A	DC	Yes	Yes				
New Start (Zambia)	Zambia	Population Services International	2002	8	N/A	DC	Yes					
New Start (Zimbabwe)	Zimbabwe	Population Services International	1999	41	N/A	DC	Yes	Yes			Yes	
Operation Light House	India	Population Services International	2002	12	N/A	DC		Yes				
ProFam (Benin)	Benin	Population Services International	2004	30	N/A	DC	Yes		Yes	Yes		Yes
ProFam (Cameroon)	Cameroon	Population Services International	2004	25	N/A	DC	Yes	Yes				
ProFam (Mali)	Mali	Population Services International	2005	33	N/A	DC	Yes					
PSI Togo	Togo	Population Services International	2002	13	N/A	DC		Yes				
PSI Uganda	Uganda	Population Services International	2007	2	N/A	DC		Yes				
Red Plan Salud	Peru	INPPARES	2002	1668	N/A	Peru	Yes	Yes	Yes	Yes		
Sangini	Nepal	Nepal CRS Company	1994	2928	N/A	Nepal	Yes		Yes	Yes		Yes
SkyHealth / SkyCare Centres	India	World Health Partners	2008		Yes	India	Yes		Yes			
Smiling Sun	Bangladesh	Chemonics International	2008	40	Yes	US	Yes			Yes		
Society for Family Health	Nigeria	Population Services International	2006		N/A	DC	Yes					
Sun Quality Health (Cambodia)	Cambodia	Population Services International	2002	164	N/A	DC	Yes		Yes			Yes
Sun Quality Health (Myanmar)	Myanmar	Population Services International	2001	846	N/A	DC	Yes		Yes			Yes
Surya Clinic	India	Janani/DKT International	1998	564	Yes	DC	Yes		Yes			
Top Reseau	Madagascar	Population Services International	2001	155	N/A	DC	Yes	Yes	Yes			
Well-Family Midwife Clinics	Philippines	Well-Family Midwife Clinic	1997	100	N/A	philippines	Yes			Yes		

Annex 5:
Sample Set of Micro-franchises[52]

Rank	Organization	Country	Distribution network	Type
1	Amul	India	8,000,000 dairies; 10,000 co-operatives	MNC
2	Avon	Brazil, global	750,000 local sales agents	MNC
3	Natura	Brazil	400,000 local sales agents	DC
4	Grameen Village Phone	Bangladesh and 2 other countries	200,000 phone ladies	MFI
5	Unilever	Vietnam and 3 other countries	145,000 sales agents	MNC
6	Lijjat	India and many other countries,	25,000 producers	IF
7	Kumon Schools	Japan and 45 other countries	23,000 tutors	MNC
8	Paleterias La Mi-choacana	Mexico and many other countries,	16,000 frozen confection-ers	IF
9	Honey Care Africa	Kenya and 2 other countries,	7,800 beekeepers	SE
10	Jani-King	US and 50 other countries,	7,500 cleaning contractors	MNC
11	Tropical Sno	US and 40 other countries,	5,500 flavored ice vendors	MNC

52 Source: Kirk Magelby, "60 MFO Possibilities with Existing Franchisor," http://www.microfranchises.org/file.php?id=45 (accessed 30 July 2008). Needs to be source

Rank	Organization	Country	Distribution network	Type
12	Vodacom Phone Centers	South Africa	5,000 phone centers	MNC
13	Grameen Uddog,	Bangladesh,	4,500 textile weavers.	MFI
14	Arvind Mills, Ruff 'n Tuff Jeans,	India	4,000 tailors.	DC
15	Farmacias de Similares,	Mexico and 8 other countries,	3,400 pharmacies.	DC
16	Desk to Desk Deliv-ery Service,	India,	3,000 couriers.	DC
17	NLogue,	India,	2,700 information, commu-nication and entertainment technology ICET centers	IF
18	ES Coffee,	Ecuador and 3 other countries,	2,500 coffee producers.	IF
19	Aptech Schools,	India and 33 other countries,	2,500 computer based training (CBT) centers	MNC
20	O Boticario,	Brazil,	2,400 cosmetics stores.	IF
21	Grameen egg ladies,	Bangladesh,	2,000 egg producers.	MFI
22	Coca-Cola,	South Africa,	1,850 beverage vendors.	MNC
23	Wizard, ALPS	Brazil,	1,500 language schools.	IF
24	Shell Breathing Space,	Guatemala and 8 other countries,	1,000 stove dealers.	MNC
25	Shell Solar,	Thailand and 4 other countries,	900 solar installers and technicians.	MNC
26	Amanco Irrigation,	Costa Rica and 5 other countries,	800 product reps.	MNC
27	Gamarra Mer-chants Association,	Peru,	750 merchants.	DC
28	Grameen Motsho Fish Farms,	Bangladesh,	600 ponds.	MFI
29	Holanda,	Mexico,	600 ice cream restaurants.	IF
30	Drishtee	India,	550 ICET centers.	SE
31	ForesTrade Spices,	Indonesia,	500 spice gatherers.	SE

Rank	Organization	Country	Distribution network	Type
32	Play Pumps,	South Africa and 3 other countries,	500 water pumps.	SE
33	Cemex Patrimonio Hoy,	Mexico and 3 other countries,	500 local promoters serving 120 000 construction job sites	MNC
34	Unilever Annapur-na Salt,	Ghana and 1 other country,	8 salt plants and 400 local sales agents	MNC
35	Nacho King,	Philippines,	400 snack food vendors.	IF
36	Hawaiian Paradise,	Mexico,	367 flavored ice vendors.	IF
37	Farmacias Comuni-tarias, Cruz Azul,	Ecuador,	310 pharmacies.	DC
38	Julies's Bake Shops,	Philippines and 1 other country,	300 bakeries.	IF
39	Janini Medical,	India,	260 clinics.	IF
40	Pride Africa,	Kenya and 4 other countries,	250 micro finance agents.	MFI
41	Blaze Flash Delivery Service,	India,	225 couriers.	DC
42	VisionSpring,	El Salvador and 3 other countries,	200 vision entrepreneurs.	SE
43	Reyes Barbers,	Philippines and 1 other country,	200 barber shops.	IF
44	UMU,	Uganda,	125 micro finance agents.	MFI
45	Magitek,	Tanzania and 2 other countries,	120 village water systems.	SE
46	Dormimundo,	Mexico,	120 sleep centers.	DC
47	UV Water,	Philippines and 2 other countries,	100 village water systems.	SE
48	Porta Newcell,	Ecuador,	100 cell phone stores.	IF
49	Ingles Individual,	Mexico,	70 language tutors.	IF
50	Health Stores,	Kenya,	56 pharmacies.	SE
51	Super 1,	Colombia,	50 car care technicians.	IF
52	Pañaleras Pototin,	Ecuador,	45 diaper stores.	IF

Rank	Organization	Country	Distribution network	Type
53	Grameen Shakti,	Bangladesh,	40 solar installers and technicians.	MFI
54	Holcim Cessa,	El Salvador,	35 building materials dealers.	MNC
55	Yogurt Persa, Yogurt Tito,	Ecuador,	35 restaurants.	IF
56	Cellular City,	Philippines,	33 cell phone stores.	IF
57	Ferns ’n Petals,	India,	32 floral shops.	IF
58	Temasol,	Morocco,	31 solar installers, technicians.	SE
59	Unilever,	Indonesia,	25 soybean farmers.	MNC
60	GlensCare Africa,	Tanzania,	25 transportation agents.	SE
61	HP Photo,	India,	25 village photographers.	MNC
62	Casa por Casa,	Mexico,	18 advertising agents.	IF
63	Valet Taxis,	Peru,	10 owner operators.	DC
64	Vodafone M-Pesa,	Kenya,	10 financial service agents.	MNC
65	One Roof,	Mexico and 1 other country,	8 community information centers.	SE
66	Cebicherias Chiqui,	Peru,	5 lunch stands.	SE
67	Maharlika Drug Stores,	Philippines,	3 pharmacies.	SE
68	Ink Patrol,	Philippines,	1 ink refilling station	SE

Annex 6: Financing Mechanisms for Sample Set of Micro-franchises

Organiza-tion	Start-up costs	Financing mechanism
Grameen Village Phone	GSM mobile handset given on subscription. Franchisee responsible for phone maintenance, use and local marketing for per-minute fee charged from customer $220 pays for equipment and incidental expenses, monthly subscription charge (min$3),	Grameen Bank lease finance program
Vision Spring	Initial inventory granted on consignment w/ 20 glasses including display and carry case, eye charts, uniform, repair kits, ad sign US $130 initial set up	Either pro-vided for free or on consign-ment basis
Butterfield bakery (SA)	Baking equipment and shop interior is included in start-up fees Starting cost R800K (approx. $100K). Minimum 20% contribution by franchisee	Franchisor provides con-tacts to banks for loan
Shuilong Ying Puri-fied Water Outlet in resident communi-ties (China)	Direct (5year agreement) and indirect (3year) use of trademark, including commitment to protect business concept Ongoing royalty fees Franchisee acquires purification machine and equipment (e.g. water station layout and decoration with fee) 41 500 RMB (for 5 years)	Cooperation with local BSSCs that provide access to microcredit

Organiza-tion	Start-up costs	Financing mechanism
Transport operators Coop-erative (Rwanda)	Uniforms, Motorcycles Membership in co-op costs 200 FRW/day (75% opera-tion costs, 25% forced savings)	Unclear
Ugandan shoe shin-ers	Full and part time membership share allows members to use name of cooperative; no branding Provision of brushes, cupboard, umbrella and aprons underway Rent of polish kits, shoe polish, shoe brushes $200 USD (includes equipment)	Cooperation with Ugandan Cooperative Savings and Credit Unions (savings and loans)

Annex 7: Growth Curves of Successful Franchise Chains

McDonald's

McDonald's, perhaps the most well-known franchise in the world, may be an exception due to its quick franchising decision, but it was only after the demonstration of eight well-performing franchisees that the company was approached by the external businessman responsible for McDonald's Corporation exponential substantial growth.

Founded in 1940 by two brothers, McDonald's grew steadily over the first ten years and realized accelerated growth after selling exclusive nationwide franchise rights to businessman Ray Kroc in 1957.[53]

The McDonald brothers first franchised the business after only one unit but dramatic company expansion took shape under the direction of external businessman Kroc, who formulated the systems and structures necessary to rapidly expand. In 1953, Kroc established the legal structures (including the McDonald's Corporation structure), and created a senior management team that quickly positioned the company for rapid franchise growth. Less than ten years later, McDonald's was celebrating the opening of its one thousandth unit.

Kroc purchased exclusive franchising rights to expand McDonald's across the country[54] and immediately hired senior management and legally structured the appropriate systems and structures for growth. McDonald's Systems (later changed to McDonald's Corporation') was registered in the same year. Today, the corporation refers to Kroc as the founder, perhaps due to the company's accelerated growth, international expansion as early as the 1970s.[55] Kroc, who was named by *Time* as

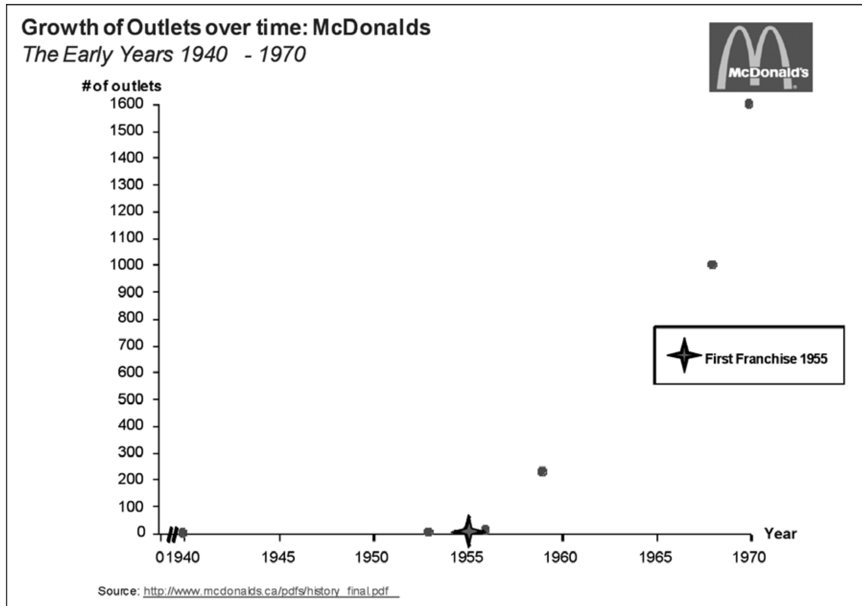
53 http://en.wikipedia.org/wiki/History_of_McDonald's

54 http://www.mcdonalds.ca/en/aboutus/faq.aspx

55 Ibid.

one of the 100 Most Important People of the Century[56], served as Chairman until his death in 1984.[57] The figures below illustrate McDonald's slow and steady growth in the 1940s and rapid acceleration under the franchised guidance of Kroc.

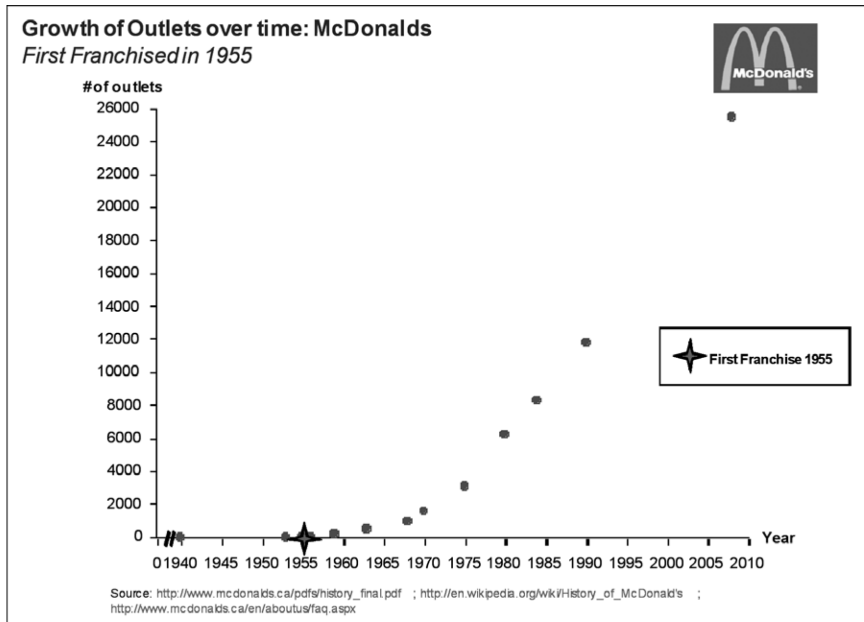
McDonald's Growth – The First 25 Years



56 http://www.time.com/time/time100/leaders/index.html

57 http://www.time.com/time/time100/builder/profile/kroc.html.

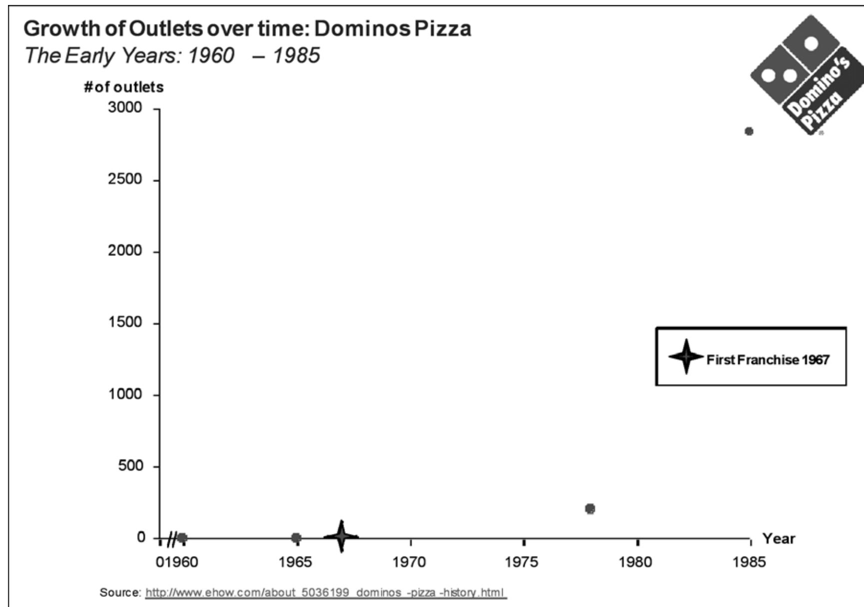
McDonald's Growth – 1940-2008



Dominos

Similar to other corporate giants, Dominos was founded as a family operation and grew slowly in the first decades of operations, followed by rapid growth through franchising. The company was founded with only one restaurant operated by two brothers, and first franchised in 1967. Early growth may have been inhibited by intellectual property disputes with Domino's Sugar, but by 1980 when the infringement accusations were resolved, the company was already on track for accelerated growth. The figure below outlines Domino's company growth over the first twenty-five years.

Domino's Pizza, the First 25 Years (growth of outlets over time)



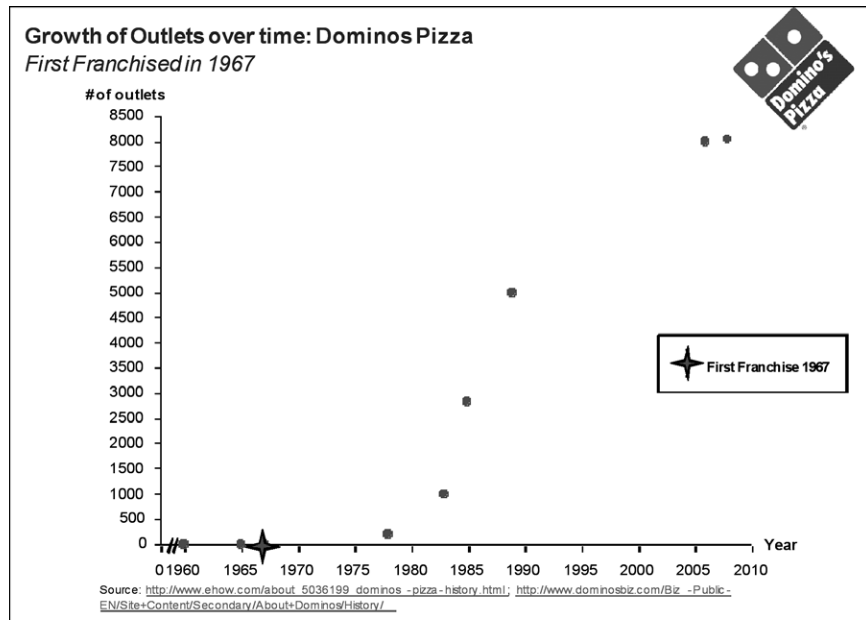
Domino's slowing growth in the 1980s might be explained by challenges related to intellectual property, monitoring, and marketing. For example, in 1980 Domino's completed a 5-year battle over trademark infringement claims posted by Dominos' Sugar. In addition, the success of the company's "30 minutes or it's free" delivery scheme – introduced in the 1960s- was rescinded in the early 1990s due to complaints about reckless driving and accidents caused by reckless drivers. Compounding the struggles with monitoring, the company was hit with very negative press when a man created a hostage situation in one of its Atlanta restaurants, believing that the company's "Avoid the Noid" marketing campaign was a personal insult.[58]

Despite slowed national growth in the late 1980s, Domino's international focus and majority sale to Bain Capital allowed the company to grow steadily through the late 1990s into the 2000s. In 1983, Dominos had opened its first international store, and by 1995, the company had over 1,000 stores outside the US. In 1998, the Domino's founder, Tom Monaghan, retired and sold 93% of the company to Bain Capital. Subsequently, Domino's recorded record growth in 1999 and continued its

58 http://www.ehow.com/about_5036199_dominos-pizza-history.html.

international expansion with 3,000 international stores by 2006.[59] The figure below shows the company's growth between 1960 and 2008.

Domino's Pizza Growth: 1960-2008



Holiday Inn

The phased growth of Holiday Inn hotels demonstrates an evolution of franchise management focused on quality and standardization. Holiday Inn was founded in 1952 with an aim to deliver high-quality, inexpensive family accommodation to travelers within the United States.

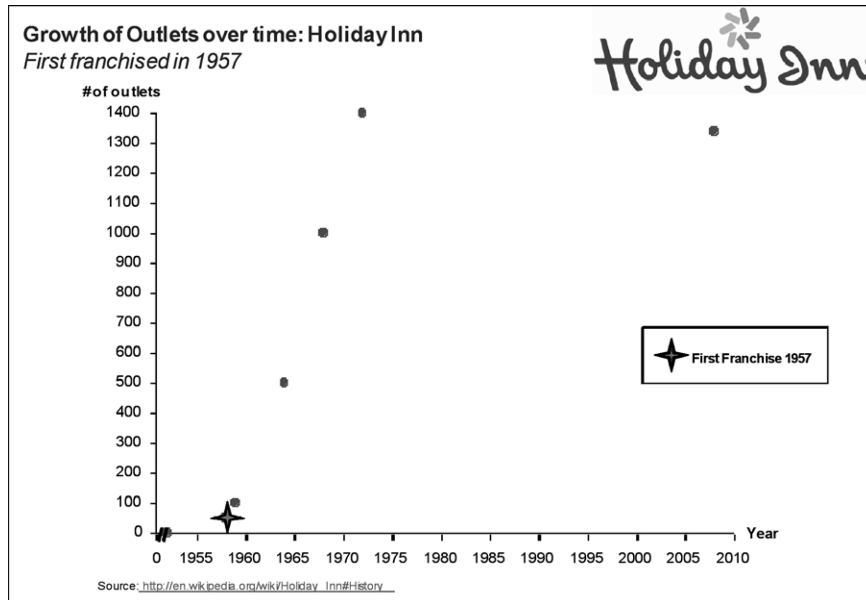
Five years later, in 1957, founder Kemmons Wilson decided to apply a franchise that would ensure standardized, clean, accessible, family-friendly accommodation to travelers. The franchise strategy realized accelerated growth over the next ten years, with 1,000 hotels by 1968.[60] In the late 1980s, following the founder's retirement, the company was split off into multiple brands. Today Holiday Inn – a brand owned by the Intercontinental Hotel Group – has shifted its strategy significantly to focus on licensing and management agreement contracts. As a result of a deteriorating brand over the past two decades, the company is also currently undergoing a significant

59 http://www.dominosbiz.com/Biz-Public-EN/Site+Content/Secondary/About+Dominos/History/.

60 http://en.wikipedia.org/wiki/Holiday_Inn#cite_note-USAToday-2.

operational downsizing. The figure below illustrates the rapid growth and strategic adjustments over the past 60 years.

Holiday Inn Growth 1952 – 2008



In order to refocus on quality, Holiday Inn has refocused its strategy away from franchising and property management to franchisee licensing and third-party hotel management agreements.[61] In recent years, the company has also initiated one of the largest downsizing strategies of a single chain in order to restore the quality and reputation of the brand. By 2009, the company aims to reduce nearly half of the 1,100 franchised properties it had in 2004.

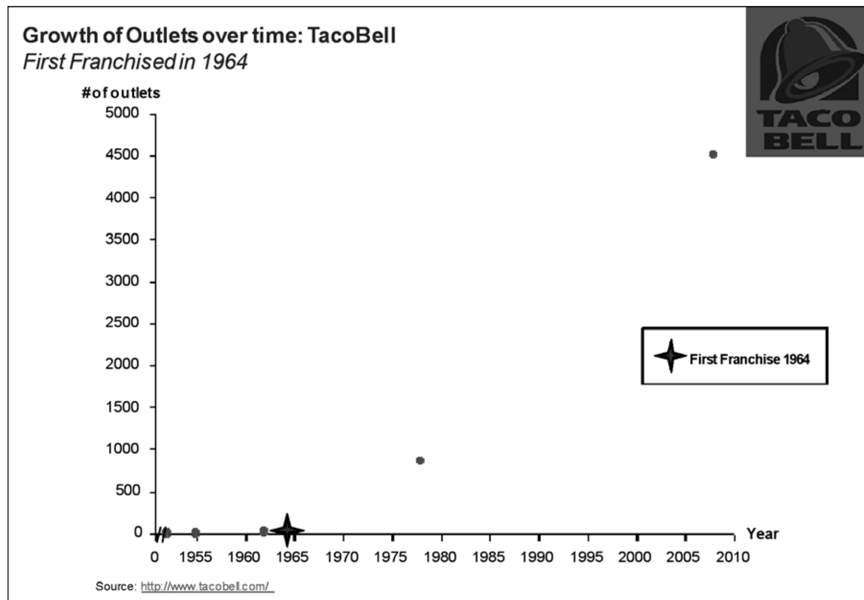
Taco Bell

The history of Taco Bell demonstrates the role of experimentation, location, and financing necessary to establish a business poised for franchise growth. The founder of Taco Bell, Glen Bell, began designing the "perfect" food stand in the early 1950s. The first element of establishing his business focused on the method of preparation and service, with an aim to perfect Mexican take-out. Second, he identified the

61 Barbara De Lollis, "Holiday Inn Chain Gives Itself a Face-Lift," *USA Today*, http://www.usatoday.com/travel/hotels/2007-07-19-holiday-inn_N.htm (accessed July 2009).

appropriate location to trial the tacos, positioning himself in a Mexican neighborhood where competitors might overlook the opportunity he created. And third, Bell needed to address the challenge of financing, which started with a partnership that financed three Taco Tia stands and the El Taco restaurants in the mid 1950s. In 1962, the El Taco's were sold to other partners, and Bell established the first Taco Bell. Two years later, the first Taco Bell franchise was sold. The company went public in 1966 and grew to 868 units, which were sold to PepsiCo in 1978 (later spun off to TriCon Global Restaurants, which became Yum! Brands in 2002). The figure below illustrates Taco Bell's slow experimental early growth and subsequent rapid scale-up under the PepsiCo/Yum! Brand management.

Taco Bell Growth, 1952 – 2008



Annex 8: Kaldi's and Starbuck's – IP Challenges

Imitation may be the greatest form of flattery… but it is also a brand risk

Branding is one of the defining characteristics of a franchise model but protecting intellectual property is a critical consideration for both franchised and company-owned chains. Branding is a key consideration for large scale companies that drives sales and profitability by creating customer loyalty, company image and differentiation amongst competitors. In most developed countries, brands can be legally protected through Intellectual property rights (IP) which establishes legal protection against theft, damage or reputation risk.

However, many developing countries lack IP laws which creates a significant risk for franchises and other companies that rely on their reputation and image to drive sales. The lack of these laws make it much more difficult to protect and enforce trademarks and copyrights which poses a significant threat to the brand. And in turn, the risk of lower quality services at an imitation store may result in customer perception that will influence future purchasing decisions. The example of Kaldi Coffee in Ethiopia is just one example of a copycat scenario that is not uncommon in developing countries.

The servers wear grocer-like aprons, the logo is a circular green emblem and the experience of visiting Kaldis, an Ethiopian coffee chain, is, at first glance almost undistinguishable from Starbucks. But its not the real thing. The owner, Tseday Asrat, is also not shy about the fact that her store was inspired by Starbucks. Her inspiration went so far that, despite a denied request for licensing from the Seattle Company, she set up her café anyway.

But Asrat also notes that there are distinct differences between Kaldi's and Starbucks that cater to the Ethiopian customer base. For example, customers prefer their coffee to be served by waiters and waitresses to their tables rather than the pickup style

of the Western chain. Further, you won't find extensive parking at most Starbucks chains but drive-in style service is critical at Kaldi's in order to draw in the younger crowd who prefer coffee straight from their cars. The owner of Kaldi's is open about her use of the Starbucks look and feel but argues that her ability to tailor her business model to create Ethiopian 'coffee ceremonies' is what sets her business apart.

Starbucks bottom line is not dramatically impacted by the Kaldi shop, but the Company is nonetheless concerned by the misappropriation of its name. In a 2005 NYT article by Marc Lacey, a Starbucks spokes person responded by saying "Even where it may seem playful…it is both derivative and dilutive of…trademark rights." In fact, the impact of the current financial climate has seen Starbucks undergoing significant downsizing. However, the company is still concerned that the copycat behavior could have a damaging effect on its reputation. Whether Starbucks will eventually take legal action is unclear, but for now Kaldi's copycat approach has been so successful that it aims to open a second shop and is a prominently recommended in the favorable Lonely Planet tourist guides.

Imitation is not uncommon in developing countries, and is a challenged faced by both large scale chains and micro enterprises. For example, a second large scale trade mark breach is that of 7-11 convenience stores which operate in both Ethiopia and South Africa but are neither linked to each other, nor providers of the famous 7-Eleven Slurpee that gained notoriety in the US based chain which has achieved significant global scale. In fact, the U.S. based company confirmed in an email that "7-Eleven does not operate any stores in Africa, and based on our research and our strategic expansion plan, we are not currently pursuing opportunities within Africa." Second, even at a micro-enterprise level, imitation is a risk. International Development Enterprises, who developed the 'treadle pump', a small-scale irrigation device for farmers, have integrated the provision for copy cats into their marketing and growth strategies. "Imitation is the best form of flattery" say IDE founder Paul Polak, "we simply need to differentiate ourselves from the customers through quality, customer education and ongoing innovation of design." IP rights do not exist in Bangladesh, but IDE is still able to profitably sells its pumps at nearly 10% higher price than imitations.

While imitation may be the best form of flattery, the lack of IP in certain countries may be a significant barrier for companies looking to invest in developing countries. There are two main reasons for this. The first is that poor quality of services or products will create a lasting image associated with the companies brand which could deter future customers. And second, even though Starbucks and 7-Eleven made a conscious decision not to expand into Ethiopia and South Africa, the lack of IP may create a barrier to their future entry into these markets.

Annex 9: Case Study: Nando's

Nando's is one of the few examples of a large-scale, home-grown franchise restaurant chain that has successfully expanded into Sub-Saharan Africa. Nando's success has been achieved by applying three different expansion structures and applying a focused, disciplined, and innovative approach to managing revenues and costs. From the beginning, Nando's focused on its role as a global brand committed to its roots in Africa. This is illustrated through the company's decisions about geographic focus and international expansion. Nando's has maintained rigid operational discipline throughout its global expansion, which allows it to ensure the delivery of consistent, high-quality meals and restaurant service. And finally, through innovative approaches to marketing, branding, and staff training, Nando's managed revenues and costs in a way that allowed for operational expansion into over 30 countries across 5 continents. This case study focuses on the key factors for Nando's success as a home-grown chain in frontier markets relative to large-scale Western chains.

Afro-Portuguese History

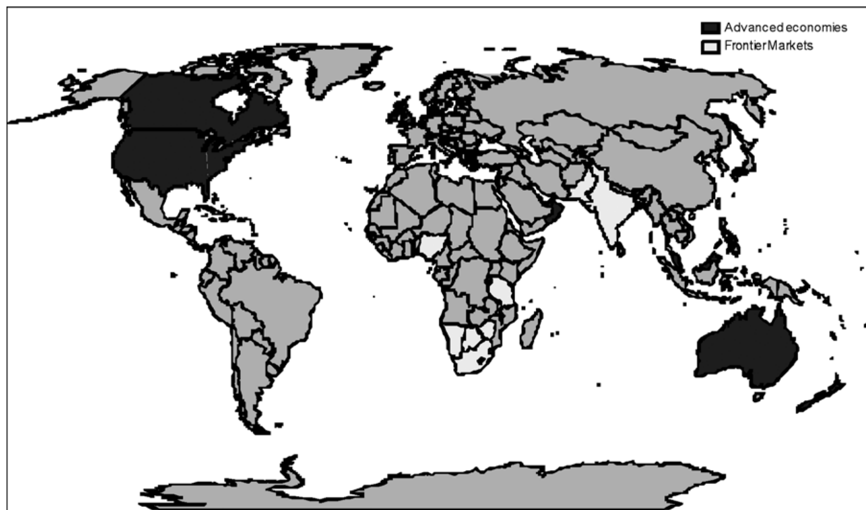
Nando's Afro-Portuguese roots date back to 1987 in a northern suburb of Johannesburg where Robert Brozin and his friend Fer'Nando' Duarte discovered the fiery Portuguese spice called peri-peri, which immediately crystallized a global vision. In less than six years, the company had expanded into the UK and Africa. Between 1988 and 2004 Nando's established nearly 160 units across 9 countries in sub-Saharan Africa, including a distribution partnership that leveraged the continental reach of Exxon Mobile through food courts established by a holding company called InnScor.[62]

62 "Franchising – SMEs for Strategic Development of African Markets," African Development Bank Joint Africa Initiative Workshop, 2004.

The company describes itself as an "aspirational" chicken restaurant known for its spice and sass, and has since grown its operations to over 240 restaurants in South Africa and 360 locations in more than 30 countries, and established itself as one of the largest home-grown restaurant chains on the African continent. Nando's currently operates in 13 frontier markets across both Africa and South Asia, and has significant expansion plans focused on North Africa in countries with a high-potential customer base and a conducive regulatory environment.

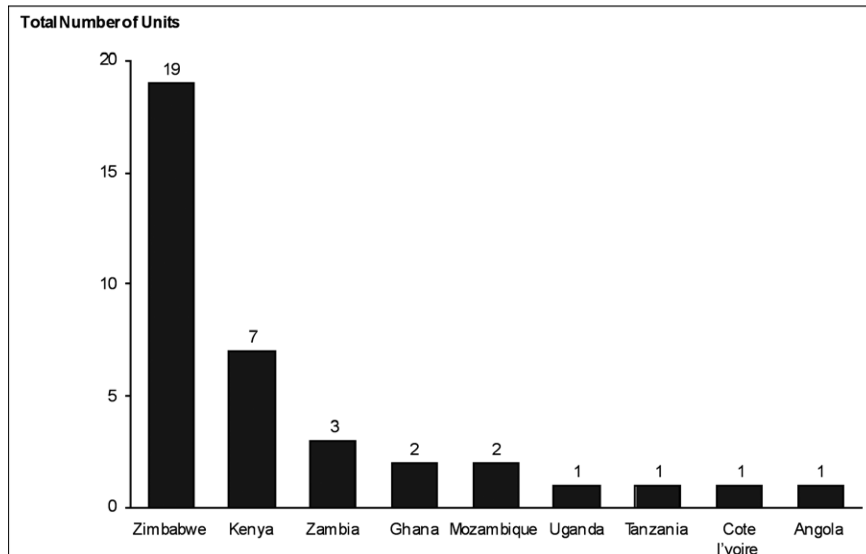
The figures below illustrate Nando's current global presence and rapid expansion between 1988 and 2004.

Nando's Global Presence, 2009



Source: Nando's company website.

Nando's Presence with InnScor across Sub-Saharan Africa, 2004



Source: "SMEs for Strategic Development of African Markets," 2004; http://www.afdb.org/en/resource-materials/course-materials/franchising-within-sme-dev-strategy/.

Maximizing revenue through marketing and quality control

Nando's ability to maximize revenue can be linked to the company's unique marketing and its ability to deliver a high quality cuisine that is familiar across a broad base of African cultures and attractive to emerging middle class consumers.

Nando's popularity for its brash, sarcastic marketing, a core component of the business model, also creates value for the brand. As noted by founder Robert Brozin, "*A unique approach to marketing is always a key part of the group's growth strategy. From the very beginning, Nando's has embraced marketing as a core business driver*.[63] " For example, in 2009, the company officially registered itself as a political party and ran advertisements mocking the President of the ANC Youth League which were quickly opposed and subsequently banned. Nando's branding pushes the boundaries on taste and challenges issues such as politics and religion, an approach that requires a deep understanding of the cultural debates. This ability to understand and demonstrate a familiarity with local culture may also be attributable to its ability to success in SSA.

63 http://www.sunnewsonline.com/webpages/columnists/brandtalk/brandtalk-april20-2006.htm.

> “*The philosophy behind our advertising is to create campaigns that make people think. They are intelligent and definitely out of the box. We also look at ways of developing and enhancing new media in a bid to provoke and make people think. We aim to make the impossible possible, which is a reflection of the history of Nando’s itself. After all, from the start the company never should have worked. The original restaurant was on the wrong side of town, we had no experience in food, and the model was not developed in accordance with any university business case study. To suggest back then that it was going to develop into a global business would have been unthinkable.*”[64]
>
> – Robert Brozin, Founder

With Afro-Portuguese roots, Nando’s use of chicken and spice, a key staple across many African diets, and a condiment applicable across African, Asian and Portuguese cultures – may have offered Nando’s additional advantage over other large Western chains. Across the continent, chicken based food chains appear to be prevalent than other types of fast food restaurants which may be linked to both cultural preference as well as the lower cost, higher quality and availability of chicken meat. For example, KFC is the largest western fast food chain across sub-Saharan Africa and the two most familiar (and perhaps largest) fast food chains in South Africa and Kenya, are Chicken Licken and KenChic. In addition, the generous use of spice and low fat preparation of Nando’s chicken provides a healthier alternative that appeals to emerging middle class consumers in both developing and Western markets. Nando’s ability to tap into both sets of consumers while delivering the same high-quality products allows it to increase revenue at minimal cost.

Quality control through centralized operations

In order to ensure high quality products, Nando’s retains strict centralized control over both procurement and distribution. In order to ensure the highest quality products, Nando’s retains 100% control of its primary inputs, namely spices and sauces, which are managed and distributed from South Africa. This allows the company to ensure thorough quality control across the globe. Centralizing procurement of products and equipment also allows the company to ensure consistent quality and realize cost savings through bulk purchasing[65]. From a cost standpoint, Nando’s

64 http://www.franchisebusiness.com.au/articles/The-story-of-the-Nando-s-franchise_z49522.htm.

65 Mike Pycraft, Operations Management (Southern Africa Edition; Pearson Education South Africa, 2000), interview with Jeff Max Bloch, Nando’s International, p.. 763.

location in South Africa may also reduce costs as compared to large international chains looking to procure and distribute products across the continent.

Using a quality assurance team to reduce agency costs

In order to ensure the value of its brand, Nando's agency costs, namely quality assurance and monitoring, are also centralized in South Africa, where a team of Nandocas is responsible for the monitoring service quality and staffing levels. The Quality Assurance Team is responsible for 3-4 site visits per year to each of the global franchise locations. The frequency of these visits have increased overtime, however, Nando's attributes the ability to closely monitor franchisee operations with the delivery of high quality food and restaurant experience.

Access to capital poses minimal threat

Nando's aims to continue its expansion across the African continent but has not yet encountered the challenges associated with franchisee financing. According to company executives, identifying strong partners with financial resources to launch the brand has not yet been a barrier. However, discussions with existing franchisees indicate that accessing capital for expansion into new territories may be a future challenge, especially when seeking to open operations in predominately cash-based countries such as southern Africa.

Developing Nandocas – Training and support reduces turnover and improves staff retention

Talent development and staff retention are two aspects of the business that have allowed Nando's to ensure access to provide high quality human resources. In a 2006 report, Nando's was acknowledged for its management coaching, new employee training, internal communications and "buddy" system of training[66]. The article continued to correlate Nando's emphasis on training with increased staff morale and suggested that training is a key contributor to Nando's globally superior retention rates (as compared with the sector[67]). For example, in 2001, only 21% of managers were promoted internally and the company was experiencing 35% turnover. By applying a GROW model management/leadership training, Nando's was able to reduce the company's management turnover down to 20% and promote 40% of its management team internally. Both percentages are above average for the sector.[68]

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66 "Nando's Tastes Success through Training: Expanding Restaurant Firm Retains a Family Feel," *Human Resource Management International Digest*,Vol. 14, Issue 2(2006).

67 Ibid.

68 Jane Glasser, "Customers Top Pecking Order at Top Chicken Eatery," *Executive Perspective* (2007).

> "*It has always been a challenge everywhere to attract good people, but we live by the simple maxim that good people find good people. Generally, if you have a good system, a good offer and good people running that offer, the right people will find you. It would not be right to say that globally there is a shortage of good people. The real issue in attracting the right people is how good the franchise is.*"[69]
>
> – Robert Brozin, Founder

Three options for ownership structure

Nando's global expansion can be characterized by the use of three modes of entry into new markets – 1) Company ownership 2) Joint venture and 3) Franchising. Through company ownership – a model used across high income markets in South Africa and the entire UK – Nando's maintains full control over the rights and profits generated by the restaurant. Under a joint venture, Nando's identifies a strong partner with whom it shared the financial and management risk as well as the returns. And finally, Nando's most common ownership structure is franchising – a model used across the bulk of frontier markets – allows the company to generate revenue from local entrepreneurs in exchange for the rights to use its brand, products and full set of business operating procedures.

Nando's selection of the appropriate ownership structure is driven by its ability to enhance the brand, generate significant capital growth, leverage risk capital and establish high quality partnerships in each territory. The opportunity to enhance the brand and generate significant capital growth is most attractive in highly visible markets such as the UK and Australia and thus, Nando's selected a company owned expansion in order to maintain full control over the brand. In countries where Nando's growth or ability to extract trade returns was restricted by government regulation, the company opted for a joint venture model. And finally, in markets further afield, where the potential is less certain and local knowledge is essential, Nando's opts for the franchise approach. Through franchising, Nando's is able to transfer financial risk and leverage local knowledge in exchange for rights to the business and the brand. Within South Africa nearly 60% of its 240 units are franchised and outside of its home territory 100% of Nando's African operations are franchised.

Nando's anticipates that once consistent profitability is demonstrated it will aim to buy back its stores. Thus, the use of franchising is primarily a mode of entry that allows Nando's to aggressively expand while minimizing capital risk to the company.[70]

69 http://www.franchisebusiness.com.au/articles/The-story-of-the-Nando-s-franchise_z49522.htm.

70 Personal interview with Lawrence Rock, General Manager, Nando's Africa, July 3, 2009.

Conclusion

Nando's ability to successfully penetrate emerging and developing country markets highlights the potential for building a successful franchise model in frontier markets. By diversifying its ownership structure, tapping into the tastes and preferences of target markets such as the emerging middle class, and applying a strict standards to monitoring and quality control, the company has successfully built a global brand that is realizing success in frontier markets and beyond.

Annex 10: Interviews Conducted as of 15 October 2009[71]

Name	Position	Organization
Allan Yates	Franchise Director	Mr. Price
Ann Rogan	Manager	Drishtee
Bendeta Gordon	Consultant	Franchize Directions
Carlo Gonzaga	Managing Director	Scooters Pizza
Charles Slaughter	Founder	Living Goods
Chris Walker	GAIN; former Acumen Fellow	GAIN; 1298
Collin Timms	Founder, Director SPOT Taxis	SPOT City Taxis
David Lehr	Consultant/Fellow	Acumen Fund
Dean Karlan	Economist	Yale University
Dominic Montagu	Global Lead, Health Systems Initiative; Assistant Professor	UCSF Global Health Sciences, Global Health Group
Eric Parker	Founder, Former Head Marketing, former Chairman	Nandos, KFC, FASA
Francine Lafontaine	Economist, Professor	University of Michigan
Gavin Bell	Kenya FASA; AfDB, WB, IMF	Africa Franchise consultant
Irfan Keshavjee	Founder	HoneyCare, WhiteRose Dry Cleaning, Karibou Homes
Jack Lowe	CEO	Blue Orchard

71 Includes interviews completed as of 29 July 2009.

Name	Position	Organization
Jason Fairborne	Director	BYU
Jeff Bradach	Founder	Bridgespan Group
John Hatch	Founder	FINCA
Jordan Kassalow	Founder	VisionSpring
Kirk Magleby	Founder	Microfranchise Ventures
Lawrence Rock	General Manager, Africa	Nando's
Lea Werbel	Program Officer	Grameen Foundation, Technology Centre
Leora Klapper	Economist	World Bank
Michael Seid	Consultant	MS Associates
Mike Lawton	Executive VP International Operations	Domino's Pizza
Nick Sullivan	editor MIT innovations	MIT Innovations
Paul Polak	Founder	Windhorse international, International Development Enterprises
Pauline Vaughn	Head of MPESA	Safaricom
Phil Frei	co-founder	Bridge International Academies
Reuben Abraham	Director, Senior Advisor	ISB Center for Emerging Market Solutions; SONG Fund
Riaan Fouche	Franchise Director	First National Bank, South Africa
Robert Zegers	Senior Expert, Franchising	African Development Bank
Rolene Govindasamy	Franchise Manager	Standard Bank
Satyan Mishra	Executive Director	Drishtee
Scott Hillstrom	Founder	HealthStore Foundation
Sean DeWitt	Technical Program Manager	Grameen Foundation, Technology Centre
Ted London	Researcher	University of Michigan, WDI
Varun Sahni	Director, Acumen India; Founder Impressario Entertainment and Hospitality	Impressario Entertainment and Hospitality, Ziqitza, Acumen Fund

Name	Position	Organization
Vera Valasis	Director	Franchise Association of South Africa
Yasmina Zeidman	Communications Director	Acumen Fund

Annex 11: IFC Workshop Participants

Name	Organization
Aubrey Hruby	The Whitaker Group
Andrew Stern	Dalberg Global Development Advisors
Betsy Bassan	Chemonics International
Brendan Dack	International Finance Corporation (IFC)
Celia Ortega	WBG
Claude Alexander	Independent Investor
Dan Runde	IFC
Dileepan Siva	Synergos
Dominic Montagu	University of California, San Francisco (UCSF) Global Health Sciences, Global Health Group
Don Eberly	Social Capital Ventures
Elena Heredero Rodriguez	Inter-American Development Bank
Elizabeth Jenkins	IFC
Elizabeth Davidsen	IADB
Eriko Ishikawa	IFC
Gina Lagomarsino	Results for Development
Gretchen Zucker	Ashoka
Henry Jackelen	Private Sector Division/Partnerships Bureau, UNDP
Holly Kirschke	TechnoServe

Name	Organization
Holly Wise	Living Goods
James Emery	IFC
Jason Fairbourne	BYU Marriott School of Management
Jennifer Barsky	IFC
Jim Kramer	VP, Intl Franchising, McDonalds
Jock Noble	World Vision
John Costello	CNFA
John Reynolds	President, IFA's Educational Foundation
Jonathan O'Connor	LifeNet
Josh Kwan	David Weekley Family Foundation
Josh Mailman	Serious Change
Kojo Taylor	MicroClinics
Lea Werbel	Grameen Foundation
Leora Klapper	World Bank/IFC
Lily Dorment	Rockefeller Foundation
Louis Pope	Yehu Microfinance
Mauro De Lorenzo	John Templeton Foundation
Max Aitken	IFC
Michael Seid	Consultant, MS Associates
Michael Spraggins Jr.	LifeNet
Mildred Callear	SEAF
Omer Imtiazuddin	Health Portfolio Manager, Acumen Fund
Pamela Riley	Abt Associates
Pamela Roussos	WORTH
Peter Tynan	Partner, Dalberg Global Development Advisors
Scott Hillstrom	Healthstore Foundation
Scott Lehr	IFA
Sean DeWitt	Grameen Foundation
Sid Feltenstein	Health Store Foundation

Name	Organization
Peter Tynan	Dalberg Global Development Advisors
Robin Miller	Dalberg Global Development Advisors
Steve Beck	John Templeton Foundation
Wesley Wilson	Mars
Wouter Deelder	Dalberg Global Development Advisors

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Annex 13:
Acronyms and Abbreviations

Acronym	Definition
AfDB	African Development Bank
BoP	Base of the Pyramid
BRIC (S)	Brazil, Russia, India, China, South Africa
CFW	Child and Family Wellness
FP	Family Planning
HSF	HealthStore Foundation
IFC	International Finance Corporation
IP	Intellectual Property
JTF	John Templeton Foundation
MCH	Maternal and child health
MFI	Microfinance institution
MSME	Micro, small, medium sized enterprise
OCD	Owner cum driver (SPOT taxi model)
PMTCT	Preventing mother-to-child transmission
RH	Reproductive Health
SME	Small, medium sized enterprise
SSA	Sub-Saharan Africa
TB	Tuberculosis
USAID	United States Agency of International Development