

FRANCHISING AND ITS PLACE IN TODAY'S BUSINESS WORLD

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Abstract. In the past 50 years franchising has come to be predominant in world's economy and it covers a wide range of business categories. Although there are many examples of successful franchise, buying a franchise, however, does not guarantee a success, thus it is important to study advantages and disadvantages both from a franchisor's and a franchisee's point of view. This study seeks to provide an outlook of franchising in a business world. It also analyses situation in Lithuania and factors that cause franchise business lagging behind. Franchising has become popular in the world of a variety of business as distribution method. It is predicted that slower population growth, population shifts to new metropolitan areas, and the introduction of new technology will create new opportunities for franchises and make franchise business still far from reaching the stopping point.

Keywords: business model, economic growth, franchise, franchisee, franchisor, success rate.

Introduction

Many of us thought about starting the business, but mostly of that thoughts will never be implemented because of lack of determination, skill, knowledge, or just a good idea. When economic growth is slowing, it becomes more difficult for companies to invest in business development, thus they are increasingly relying on the world's well-known way to promote the name and business development – a franchise that is more attractive because of less business risk. Rapid recognition of the franchise business in various sectors of industry, its application in completely different markets all over the globe shows how easily this idea can be adapted.

Franchising is often advertised as “a successful business model” and this statement is reasonable. Standing spread of this idea in the past five decades is the greatest proof that one can really achieve the presumed goal. However, this does not mean that every risky business venture, called a franchise, will automatically be successful. Franchising may facilitate entrepreneur's entry into the world of business, but it does not always guarantee success.

Objective of research is to define franchising concept and to analyse its place in today's business world.

Tasks of article include:

- to learn about franchising and its history;
- to point out advantages and disadvantages of franchising;

- to clear up franchising situation in the world and Lithuania;
- to finish with generalizations and considerations about the future of franchising.

Used methods: analysis, comparisons, evaluations, graphical data representation, generalization.

Concept of Franchising

The International Franchise Association defines franchising as a continuing relationship in which the franchisor provides a licensed privilege to do business, plus assistance in organizing training, merchandising and management in return for a consideration from the franchisee.

F. Awoseila and O. A. Olotu (2011) define franchising as an agreement between organizations where a producer of product or service grant rights to independent business men to conduct business in a specified way, designated place and at a certain period of time.

Lideika, Petrauskas, Valiūnas (2010) describe a franchise as an agreement that establishes the undertaking of one party to provide another party with remuneration and, for a fixed or indefinite period, a package of exclusive rights (e. g. trade names and trade marks, know-how) to be used for commercial purposes. The franchisee undertakes to pay a franchise fee (Fig. 1). A franchise agreement may specifically define a territory or type of commercial activity where those exclusive rights may be exploited by the franchisee.

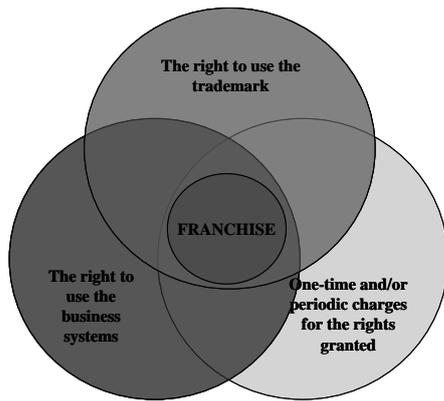


Fig. 1. A Franchise Concept (Source: Illetschko 2008)

In the past 50 years franchising has come to be predominant in the developed economy like USA and in more than 80 countries. Authors, such as F. Awoseila and O. A. Olotu (2011), J. G. Combs, D. J. Ketchen, J. C. Short (2011), describe that generally, franchising in the business environment is composed of three elements:

- the franchisor – owner of business and name in the system, he recognizes an opportunity and creates a new venture to exploit it;
- the system – the business in which investment is made;
- the franchisee – the investor who purchase the right of ownership, he sees value in the opportunity and purchase the right to replicate the venture in new geographic markets.

The interaction between these elements is carried out under a contractual agreement.

The International Franchise Association, F. Awoseila, O. A. Olotu (2011) and K. Illetschko (2008) mark that it is important to identify the different types of franchising that include:

1. Product distribution franchises simply sell the franchisor's products and are supplier-dealer relationships. In product distribution franchising, the franchisor licenses its trademark and logo to the franchisees but typically does not provide them with an entire system for running their business. The industries where you most often find this type of franchising are soft drinks, automobiles and gasoline. Some familiar product distribution franchises include Coca-Cola, Goodyear Tires, Ford Motor Company.

Although product distribution franchising represents the largest percentage of total retail sales, most franchises available today are business format opportunities.

2. Business format franchises, on the other hand, not only use a franchisor's product, service and trademark, but also a complete method to conduct the business itself, such as the marketing plan and operations manuals, business format franchises are the most common type of franchise.

K. Illetschko (2008) and M. A. Sadi (2011) point out that franchise business advocates say that any idea, any business can be transformed into a franchise agreement, but in order to make this a reality, the product or service must have the following features:

- The product is of good quality and it is likely that demand will force it to re-order.
- The product is mentioned in reputable company trademark. On the other hand, it is possible to create a brand new (brand building is not just money - in terms of immediate consumables, it is quite difficult to achieve).
- Estimated market is steady, adequate in size and have the opportunity to grow further.
- The product has the potential to survive in the market, its demand is neither seasonal nor associated with short-term excitement.
- Managing market forces allow for acceptable margins. In addition, thinking about the main product market, the price is not as important as an indication of the brand and excellent quality services.
- Guaranteed access to raw materials and production capacity, when it is not known to any other supply constraints.
- If efficient product distribution depends particularly on a certain area, wide access to those places is ensured.
- Fairly easy to transfer know-how needed for the new user of franchise rights, and so the average person with little or no previous experience at all in that segment, can take it over during a certain length of training period.
- The process has been properly recorded in one or more that the user of franchise rights could copy the success of the franchise.

History of Franchising

Few historians believed that the word franchising comes from old French meaning privilege of freedom from servitude. Franchising has been traced back to the Middle Ages, when the Catholic Church granted franchise to the tax collectors (Awoseila, Olotu 2011). They would

receive a portion of the revenue and turned over what remained to the Pope. This was also noticed during the feudal times. Individuals were also given franchises to sponsor markets and fairs, and observed further that, in 18th century England, royalty and parliament awarded franchises to noblemen who agreed to meet specific responsibilities. This concept was extended to the kings granting a franchise for all manner of commercial activities and over time the regulations governing franchise became a part of European common law. F. Awoseila, O. A. Olotu (2011), K. Illetschko (2008) describe that the concept of franchising dates back to the Middle Ages, but the widespread use of franchise strategies began in the United States around 1850 when Singer Sewing Machines, located in New England, decided to market its products throughout the United States. At the time, the “franchising” element (Product and Brand) consisted only of the right to use the brand name at the store and sell the product. Towards the end of the century General Motors and Coca-Cola began to use the franchising concept to expand the markets to which they could sell their products. Throughout the twentieth century, franchising expanded gradually into other industries. In 1917 the first franchised grocery store, the Piggly Wiggly went into business while Hertz began franchising automobile rentals in 1925, the first fast-food franchise, A&W opened in the same year (Sharp, 2009).

The largest expansion of franchising occurred in the late 1940's at the end of World War II when many veterans returned home desiring to open their own businesses. In the 1950's, major fast-food chains like Burger King, McDonald's and Dunkin Donuts began to appear. By the 1960's onward, these and other American fast food chains began their expansion into international markets (F. Awoseila, O. A. Olotu 2011).

Advantages of Franchising

F. Awoseila, O. A. Olotu (2011), D. E. Holmes (2003) distinguish franchising advantages from a franchisor's and a franchisee's standpoint. Advantages from the franchisor's point of view:

1. Franchising creates another source of income for the franchisor, through payment of franchise fees, royalty & levies in addition to the possibility of sourcing private label products to franchisees. This capital injection provides an improved cash flow, a higher return on investment and higher profits. Other financial benefits that the franchisor enjoys are reduced operating, distribution and advertising

costs. Of course that also means more allocated funds for research and development. Additionally, there will always be economies of scale with regard to purchasing power.

2. The franchisor can have a smaller central organization when compared to developing and owning locations themselves. Franchising also means uniformity of procedures, which reflects on consistency, enhanced productivity levels and better quality. Effective quality control is another advantage of the franchise system. The franchisee is usually self motivated since he has invested much time and money in the business, which means working hard to bring in better organizational and monetary results. This also reflects on more satisfied customers and improved sales effectiveness.
3. To the franchisor, franchising means the spreading of risks by multiplying the number of locations through other people's investment. That means faster network expansion and a better opportunity to focus on changing market needs, which in its turn means reduced effect from competitors.
4. With a smaller central organization, the business maintains a more cost effective labour force, reduction of key staff turnover and more effective recruitment.

Advantages from a Franchisee's point of view:

1. Avoiding the unnecessary trial and error period in starting and operating a new business.
2. Lower financial risk, compared to other ventures, because investment costs are lower and profit margins are higher.
3. The franchisee has an opportunity to run a proven business concept with a successful operational track record.
4. The opportunity to learn the latest developments and changes in the local and global market from the franchisor and focus entirely on developing the sales revenues.
5. The benefit of operating under a recognized trade name/trademark, which can have better marketing results.
6. The franchisee has access to accumulated business experience and technical know-how in managing the business.

Disadvantages of Franchising

According to W. Edwards (2011) and D. E. Holmes (2003), there are several disadvantages from a franchisor's point of view:

1. Considerable capital allocation is required to build the franchise infrastructure and pilot operation. At the beginning of the franchise program, the franchisor is required to have the appropriate resources to recruit, train, and support franchisees.
2. At the beginning of the franchise program there is a broader risk that the trade name can be spoiled by misfits until such time the franchisor is capable of selecting the right candidate for the business.
3. There is a risk that franchisees exercise undue pressure over the franchisor in order to implement new policies and procedures.
4. The franchisor has to disclose confidential information to franchisees and this may constitute a risk to the business.

Disadvantages from a franchisee's point of view (Edwards, 2011; Holmes 2003):

1. The requirement to pay the franchise fees and royalty to the franchisor, which in some cases can be exaggerated.
2. The transfer of all goodwill built in the local market to the franchisor upon expiration or termination of the franchise contract.
3. The necessity of abiding by the franchisor's operating systems, standards, policies and procedures.
4. Reduced corporate profit margin due to payment of royalties and levies.

Franchising in Today's World

Over the past decade the franchise boom is marked all around the world. According to the European Franchise Federation, among countries, that best exploit franchise opportunities and have the most experience in this field, are referred France, Great Britain, Germany, Spain, Greece, Italy, Finland and Sweden. Franchising covers a wide range of categories, such as cars, business services, education, food, health care, hotels, recreation, technology, training, financial services. There are more than 6500 active franchises in Europe and it is believed that the volume of this type of business will grow rapidly in the near future (Malkin, Žilinskis 2008).

The International Franchise Association presents franchise a number of facts and statistics:

- Franchising creates almost \$2,000,000,000,000 (2 trillion) revenue every year worldwide.
- More than 75 industries use franchising to distribute goods and services to consumers.
- Franchise business account for nearly 50% of all retail sales in the United States.
- 1 out of every 12 businesses is a franchised business.
- Franchise businesses employ more than 15 million Americans.
- Nearly 90% of all franchises opened in 60 industries during the past 5 years are still under the same ownership.
- A new franchised business is opened every 8 minutes of every business day.

According to the Franchise Business Economic Outlook: 2011, growth in franchise establishments and employment was sluggish in 2010. Economic output by franchised businesses increased in 2010 after being relatively flat in 2009. In 2011, there were faster growth in establishments, employment and economic output in nearly all franchised business lines (Fig. 2).

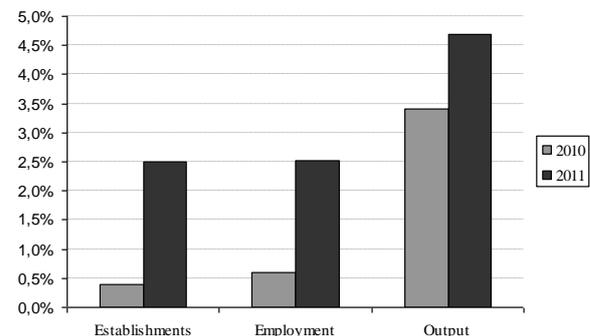


Fig. 2. Franchise Business Growth in 2010 and 2011 (Source: the Franchise Business Economic Outlook: 2011)

Franchise companies, regardless of size, are judged by the same criteria: objective, quantifiable measures of a franchise operation. The most important factors include financial strength and stability, growth rate and size of the system. They also consider the number of years a company has been in business and the length of time it's been franchising, start-up costs, litigation, percentage of terminations, and whether the company provides financing. According to Entrepreneur's 33rd Annual Franchise 500, here are the top 10 franchises of 2011:

1. Hampton Hotels;
2. Ampm;
3. McDonald's;

4. 7-Eleven;
5. Supercuts;
6. Days Inn;
7. Vanguard Cleaning Systems;
8. Servpro;
9. Subway;
10. Denny's.

This year's Franchise 500 list shows that Americans continue to seek out affordable products and services – an indication, no doubt, of a still-challenging economy. The Top 10 franchises earned their spot by listening to their customers and franchisees, and giving them what they want.

Although there are many examples of successful franchise, such as “McDonald's”, “Statoil”, “RE/MAX”, “Radisson”, buying a franchise, however, does not guarantee a success. Every year failures occur in both franchise sales companies, as well as in companies which are buying franchise.

However, compared with independent business, the International Franchise Association's research shows that franchise businesses are exponentially more likely to succeed than individual new start-ups, particularly if studying the figures over a five or seven year period, after seven years about 90% of new franchises are still in business, as compared to only about 20% of individual new start-up businesses (Fig. 3).

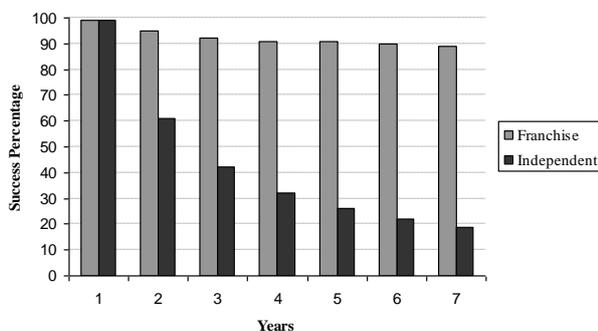


Fig. 3. Success Rate of Franchised vs. Independent Start-Up Business (Source: the International Franchise Association)

Although pioneers of the franchise business were people working in a fast-food industry, this business advantage is that other industries and sectors may easily follow their example. Franchising has become popular in a variety of business as distribution method. Even doctors used the idea in particular market niches by creating clinics networks offering a wide range of services (Illetschko 2008).

Soon after conquering the United States market, the franchise business easily spread to other parts of the world. Mostly there were exported the United States model-based, tried and tested systems of ideas, commonly – using the owner's license agreement.

Rapid recognition of the franchise business in various sectors of industry, its application of completely different markets all over the globe show, how really easily the idea can be adapted. Although it was developed in the United States, at first - as response to local demand, the franchise holders from other countries did not have any problems when using it. Based on the same principles, they developed local networks and in most cases – very successfully (Combs, Ketchen, Short 2011; Holt 2004).

Situation in Lithuania

According to the European Franchise Federation, franchise business in Lithuania is lagging behind. In our country, franchising is poorly distributed and most entrepreneurs do not have even basic knowledge about it. Many have no idea about the franchise business model possibilities and yet wary of opportunities to develop business franchising. Franchising is one of the best ways to expand domestically and abroad, but in Lithuania relatively narrow choice of franchises is offered (Malkin, Žilinskis 2008).

Franchising is popular in well-developed countries, but in our country it is only taking the first steps. However, it can be said, that the recent Lithuania's public interest in franchising is growing. First franchise systems established in Lithuania, such as “McDonald's”, “RE/MAX”, “Office 1”, “Radisson”, “Statoil”, the vast majority of brand-name clothing stores and others, came from abroad. However, franchises with Lithuanian origin can be found in the market: “Pegasus”, “Senukai”, “AJ Šokoladas”, “SBA Idėjos namams”, “DnB Nord būstas”, “ICG Kompiuteriai” and a few others. Some of them even are expanding overseas. These facts demonstrate that in Lithuania franchise expansion is possible (Malkin, Žilinskis 2008).

UAB “Čilija” can be referred as one of the most successful franchise business models in Lithuania. “Čili” restaurants, established by using franchising, appeared in Vilnius, Kaunas, Klaipėda, Panevėžys, Palanga, Šiauliai, Nida, Utena, Druskininkai, Marijampolė, Alytus, Kėdainiai, Palanga in Lithuania, Riga, Liepaja, Jelgava, Valmiera, Ogre, Sigulda in Latvia and St. Petersburg in Russia. “Čilija” quite actively is using franchising for its

development. To open one of the “Čili” brand restaurant, franchise costs can vary widely and depend on the area and a restaurant's size. An estimate is presented below, which could be used as an investment in Lithuania (Sharp 2009):

- one-time franchise fee 30 th. LTL;
- initial marketing costs 3-15 th. LTL;
- kitchen and bar equipment 160-220 th. LTL;
- initial inventory and current asset 30 to 50 th. LTL;
- advertising signs 15 to 20 th. LTL;
- construction and repair works 150-220 th. LTL;
- ventilation and air conditioning 40-150 th. LTL;
- interior and furniture 150-230 th. LTL;
- various other costs 40-50 th. LTL.

Considering the degree of unpopularity of the franchise in Lithuania, number of reasons one can be distinguished. Maybe this business model is hiding inside the nuances that make this model inadequate in our market, and many prefer the absolute independent entrepreneur's path, or remain as employee in his warm chair, never dared to dream to be the boss of his own. Also, only a small part of the public is properly informed about the franchise concept, its potential and there is still not enough confidence in supervisors when trying to find answers to franchise-related issues. Or there is just a general lack of ideas that could be brought to Lithuania (Malkin, Žilinskis 2008). Although franchise business in our country is only in establishment phase, it is expected that Lithuania will take interest in smaller and cheaper international franchises, that will help with overall market growth of franchising.

Future of Franchising

Based on the success companies have enjoyed since the franchising boom began in the 1950s, the future of franchising is positive. It is predicted that slower population growth, population shifts to new metropolitan areas, and the introduction of new technology will create new opportunities for franchises. Mergers and acquisitions will increase as larger franchisors take over smaller ones. Schools and universities are adding franchising studies to their business curricula. These factors, combined with the low rate of franchise failure, stability in the industry, and a considerable return on everybody's investment, have made franchising a major force in world's economy to this point. Some of the emerging franchise businesses expected to drive the

growth of franchising tend to offer customers added convenience such as to-the-door services offering everything from dry cleaning and pet care to window coverings and furniture repair. In addition, other franchise trends of the future will include education and training businesses, second-hand merchandise stores, office support services, and health service providers (Sharp 2009).

Franchising in this century will be highly influenced by technology and Internet. Technology improvements, notably in telecommunications, computers and the Internet, are having a major influence on franchised businesses. Technological developments including the Internet are having a profound effect on franchising. The Internet is still relatively new, yet it is rapidly altering the business environment, changing the way we gather information, interact and conduct business. An increasing number of franchised businesses are racing to get on-line, and to consider an appropriate Internet strategy (often in that particular order). They are looking to explore and exploit the opportunities this new technology provides (such as, increased sales), whilst simultaneously attempting to protect themselves from a new class of threats (e.g., new, often global competitors) accompanying it (Shah 2011).

Conclusions

Over the past decade the franchise boom is marked all around the world while entrepreneurs are increasingly relying on the world's well-known way to promote the name and develop business - a franchise that is attractive with its less business risk.

Rapid recognition of the franchise business in various sectors of industry, its application of completely different markets all over the globe show, how really easily the idea can be adapted.

In Lithuania franchising is only taking the first steps. Many have no idea about the franchise business model possibilities and yet wary of opportunities to develop business franchising. However, it can be said, that the recent Lithuania's public interest in franchising is growing.

Although the food franchise sector will remain among the leaders, it is believed that other franchise trends of the future will include education and training businesses, second-hand merchandise stores, office support services, and health service providers.

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FRANŠIZĖS IR JŲ VIETA ŠIUOLAIKINIAME VERSLO PASAULYJE

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Santrauka

Per pastaruosius 50 metų franšizavimas tapo dominuojantis pasaulio ekonomikoje ir jis apimta platų verslo kategorijų spektrą. Nors yra daug sėkmingų franšizių pavyzdžių, nusipirkta franšizė dar negarantuoja sėkmės, todėl yra svarbu išanalizuoti

privalumus ir trūkumus tiek iš franšizės teikėjo, tiek iš franšizės gavėjo pusės. Šio darbo tikslas yra apžvelgti franšizių vietą verslo pasaulyje. Taip pat išanalizuoti situaciją Lietuvoje ir išsiaiškinti veiksnius, dėl kurių franšizės verslas atsilieka. Franšizavimas tapo populiarus pasaulyje kaip paskirstymo metodas dėl verslo įvairumo. Yra numatoma, jog lėtesnis populiacijos augimas, populiacijos persikėlimas į didmiesčių sritis ir naujų technologijų atsiradimas suteiks franšizėms naujų galimybių ir užtikrins, jog franšizių verslas bus toli nuo sustojimo taško.

Reikšminiai žodžiai: verslo modelis, ekonomikos augimas, franšizė, franšizės gavėjas, franšizės teikėjas, sėkmės reitingas.