Franchising in Frontier Markets

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

Dalberg

Foreword

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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.