Steve Beck, with Wouter Deelder and Robin Miller

Franchising in Frontier Markets
What's Working, What's Not, and Why

If you happen to need a cab in Bangalore, call SPOT City Taxis. SPOT (Self-employment Program for Organized Transport) is now the largest taxi operator in the capital city of India's "Silicon Valley," having grown organically from 18 cars in 1999 to the more than 300 operating today, 24/7.

SPOT was started to promote employment, enable asset ownership, and build credit history among low-income households. Unlike other taxi operators in the city, SPOT's fleet is driven by owners, who operate franchise businesses linked by a common brand, a computerized radio dispatch system, and standards for service, processes, and values. Typical of franchise businesses the world over, SPOT combines the management and financial strengths of an established corporate entity with the entrepreneurial vigor and aligned incentives that come with business ownership.

SPOT drivers purchase the cars on installment over a three- to four-year period, with vehicle leases arranged on favorable terms by the franchisor. In addition to arranging financing, SPOT offers an established network of pooled customer demand, fleet-management services, and a dispatch center that channels customer

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Steve Beck is a senior fellow at the John Templeton Foundation and co-Founder of SpringHill Equity Partners, a private equity fund manager providing growth capital and support to small, growing businesses in Africa. Wouter Deelder and Robin Miller are consultants with Dalberg Global Development Advisors.

This essay provides a brief summary of the findings of a six-month survey conducted by Dalberg Global Development Advisors, with funding from the John Templeton Foundation and support from the International Finance Corporation of the World Bank. The primary purpose of the study was to explore the potential of franchise business models to stimulate economic growth, create jobs, and develop entrepreneurial skills in frontier economies. The report won the 2009 Arthur Karp Annual Franchising Research Award from the International Franchise Association for best applied research in franchising. A full copy of the research findings can be downloaded from the websites of the John Templeton Foundation (www.templeton.org), the International Franchise Association (www.franchise.org), and from the News/Recent Publications section of Dalberg's website (www.dalberg.com).

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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,

Table 1. Comparison between traditional and "business-format" franchise models.

requests directly to the drivers. The business is profitable for franchisee and franchisor alike. After paying for fuel, maintenance, finance charges, and royalties, franchisees net more than three times the average income in India, build a credit history, and own a valuable asset. Meanwhile, the franchisor—SPOT—has a profit margin that exceeds 20 percent.

In the last few years, researchers and the international development community have begun to promote franchising as the potential "next big thing" in development. As in developed economies, franchise businesses in frontier markets are designed for replication, require less experienced entrepreneurial talent to manage a proven business format, and provide business-learning opportunities within a defined support structure. But is this promise being realized? Before addressing this question, we need to take a step back, define our terms, and review salient lessons from the history of franchising in developed markets.

FRANCHISING DEFINED

Franchising is commonly understood as a "contractual agreement between two legally independent firms in which one firm, the franchisee, pays the other firm, the 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."[1] Franchise formats range from the right to sell and/or service a product acquired from the franchisor—as with Avon cosmetics, automobile dealerships, and gas stations—to a more complex agreement that includes a license to an entire business model—as with many well-known restaurant and hotel chains. The former, simpler model is commonly referred to as "traditional or product format franchising," whereby the franchisee resells the franchisor's product. The latter,

more complex model is known as “business-format franchising,” whereby the franchisee pays a license fee and royalty or commission on revenues to the franchisor (See Table 1.)

Terms like “micro-franchising” and “social franchising” have entered the development lexicon in recent years and are often confused with each other. To clarify, micro-franchising refers to businesses in which the franchisee is very small—even a single person—and the required investment and infrastructure is minimal.[2] Social franchising refers to franchises whose primary objective is the effective delivery of public goods and services such as health care and education, which are often supported by some kind of philanthropic subsidy.

FRANCHISING LESSONS LEARNED

Franchising can be viewed as a centuries-old phenomenon. One of the oldest franchise models can be traced back centuries, to the practice of European royalty granting land rights to individuals in the Middle Ages. These land franchisees (the noblemen) were required to protect the franchisor’s (the monarch’s) territory by establishing an army. In turn they were free to charge tolls and to establish and collect taxes, a portion of which was remitted to the monarch.[3] In modern times, Coca-Cola has been franchising its bottling processes to extend its geographic reach for over 100 years. McDonald’s and Subway are symbols of 21st-century franchising. The International Franchise Association was established 50 years ago to represent and serve this growing sector of the economy.

Much has been learned over the decades that helps inform franchise growth strategies in frontier markets. Three factors are particularly relevant.

Why Franchise?

Businesses choose a franchise growth strategy over other forms of expansion primarily to extend their geographic reach, access capital (as franchisees typically invest their own capital), lower the costs of performance monitoring (agency costs), and harness entrepreneurial incentives. In effect, franchising turns corporate managers into profit-sharing owners.

Unit Profitability Comes First, Growth Second.

Successful franchised chains grow in a predictable manner. Most spend several years developing, refining, and proving a profitable, replicable business model at the unit level before franchising. McDonald’s opened its first franchised restaurant in 1955, 15 years after the company’s founding. Subway waited nine years before opening its first franchise outlet, and Holiday Inn waited five. It takes a good deal of time to test the profitability and sustainability of a business model and to prepare the processes, products, and procedures for reliable replication.

One of the most common mistakes we observed in our research on franchises in frontier markets is the attempt to franchise before achieving profitability at the unit level, and doing so with the belief that the franchising will change the funda-

mental business economics. Growth increases profitability primarily through economies of scale; franchising per se has only a small positive effect on profitability.[4] One large, well-established fast-food franchisor disclosed that the cost levels of their franchisees are just 0.5 percent to 1 percent lower than those of company-owned outlets. We could not find a single example of a chain that started with a loss-making outlet and franchised its way to chain-wide profitability."

Franchises Are Not Necessarily Lower Risk.

Owning and operating a franchise business is often promoted as being "low-risk" by franchise organizations, franchisors, and industry forums. On the surface, it seems logical that running a tried-and-tested business model with support from the franchisor is less risky than starting and managing an independent business. However, the conventional wisdom is not supported by data published in 2005, which shows that 35 percent of franchised businesses fail over a five-year period, a slightly higher percentage than independent businesses.[5] As ever, the reality is even more complex and nuanced. For the franchisee, the risks of franchising are higher than for independent entrepreneurship when the chains are smaller and newer, and lower when the chains are larger and more mature. 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 that that the franchisor might bankrupt the entire chain.

FRONTIER MARKET CHALLENGES

When we researched low-income markets, we found relatively few large-scale international franchises operating in these challenging markets. For example, KFC has only three outlets and Subway just seven in sub-Saharan Africa, a multi-country market of 800 million consumers.[6]

These multinational chains face the same constraint every business faces in sub-Saharan Africa: a population with limited disposable income. Our study identified two additional barriers that compound the challenge of establishing franchise businesses in frontier markets: limited access to growth finance, and the lack of legal frameworks to manage franchise relationships and assets.

Limited Disposable Income.

The average worker in Nairobi labors for 90 minutes to purchase a Big Mac, compared to just 13 minutes in New York City.[7] While sub-Saharan Africa represents a huge potential market, it currently cannot sustain a sufficient number of outlets to encourage investment by the large multinational chains. Only four of the top ten international franchise chains have ventured out of South Africa into other sub-Saharan markets, with a total of 30 outlets between them.[8] As we noted above, franchising requires, rather than generates, a profitable business model. Basic economics, therefore, will limit the international expansion of large chains to larger,

more affluent emerging markets such as Brazil, China, and Russia, at least for the time being. This creates a great opportunity for local and regional chains whose economics are better adapted to lower income markets.

Limited Access to Finance.

Small and medium-sized enterprises are poorly served by local banks in frontier markets, leaving a large gap in financing options between microfinance and traditional corporate debt. This gap, known as "the missing middle," encompasses capital needs between $10,000 and $2 million. The financing needs of most franchisees in frontier markets fall within this range. Therefore, just as franchising typically shifts the financing burden from the franchisor to the franchisee in developed markets, the franchisee in frontier markets struggles to access the needed capital on viable terms. This fact further constrains an already very limited available pool of talented, qualified franchisees.

Loose Legal Frameworks.

Business format franchising flourishes in an environment that includes the legal and regulatory frameworks and the technical and legal advisory services it needs to prosper. These factors benefit franchisor and franchisee alike. However, where they are absent, the risks and costs of franchising increase significantly. A franchise-friendly environment is largely absent in sub-Saharan Africa and South Asia, although we observed significant differences between national markets.

In most frontier markets, policy reforms that help small and medium-sized enterprises (SMEs) must be established before any franchise-specific initiatives will yield results. Priority should be given to reforms that (a) increase the ease and speed of opening new businesses by reducing red tape and restrictive registration, licensing, and permit laws; (b) strengthen contract frameworks and enforcement; and (c) expand access to finance for SMEs through credit facilities and loan guarantees. Once progress is made on these reforms, strengthening intellectual property protection and enacting franchise-specific laws related to registration, purchase, and sale will help accelerate the growth of franchise businesses.

PROMISING MODELS

Having noted these formidable challenges, our research identified several promising franchise models, like SPOT, that have adapted and are thriving despite less than ideal conditions.

Homegrown chains are better positioned than Western chains.

Homegrown chains' tailored products, pricing, cost structure, and better alignment with the local enabling (or disabling) environment helps them succeed. Nando's is a good example of an indigenous franchise fast-food business that is thriving in frontier markets that have not been penetrated by better known Western chains. Founded in South Africa in 1987, Nando's has since expanded to

31 countries on five continents. The company currently operates in 14 frontier markets across sub-Saharan Africa and South Asia, and it continues to expand into new territories, often through master franchise agreements. As if to prove the point, Nando's most recent market entry is through a master franchise with Bantu Investment Holdings in Kinshasa, Democratic Republic of Congo.[9]

Traditional format (product distribution) franchising is better suited to frontier markets than business format franchising.

Simpler is better in frontier markets. Traditional format franchisors simply outsource the distribution of their products to their franchisees. As such, they experience fewer franchisor/franchisee conflicts, require less capital, and are less dependent on favorable legal and policy environments. Kegg Farms (India), Natura (Brazil), Coca-Cola's Manual Distribution Centers (Africa), and Fan Milk (Ghana) are all good examples of successful traditional format franchise businesses in frontier markets.

Founded in the early 1960s, Fan Milk Ltd. is a publicly listed company in Ghana and the country's leading producer of ice cream and yogurt. Fan Milk distributes its products primarily via franchised street vendors on bicycles. The franchisor has 350 employees who serve the more than 8,000 micro-franchisees selling dairy products on bikes.

The initial capital required of a Fan Milk franchisee is $55 to purchase an appropriately fitted bicycle. Fan Milk provides free equipment repair services to all vendors and rewards top sellers. Twice a year, vendors receive training on product handling and hygiene; some qualify for health insurance. Franchisees' average profit is one-third more than the average national income of Ghana. Fan Milk requires franchisees to save 10 percent of their profits, which is paid directly into a bank account the company establishes for them. After an average tenure of eight years with Fan Milk, many franchisees invest their savings in a larger enterprise.[10]

Successful franchises have innovated to overcome frontier market challenges.

Innovative franchisors address the challenge of accessing capital in a number of ways:

Underwriting the capital requirement of franchisees. SPOT City Taxi borrowed to finance the purchase of vehicles, which in turn were purchased by the franchisee drivers on installment, with financing costs included in their monthly franchise fee. In this way, SPOT transferred the assets to the franchisee over a three- to four-year period.

Partnering with microfinance institutions (MFIs). MFIs are often in a good position to aid in franchisee selection and provide capital for franchisees to get started and/or to expand their franchise businesses. As franchisors seek to access bottom-of-the-pyramid markets, MFIs will become increasingly important sources of capital for their franchisees. We are skeptical, however, of MFIs becoming a distribution channel for non-financial products and services. Financial institutions have tried this the world over, without success.

Supplying on consignment. Under this model, traditional product franchisors supply initial stock and whatever else is needed on consignment to overcome the franchisee's inability to access the capital required to purchase stock. The franchisee purchases the stock after it is sold, with financing cost typically included in the repayment.

International franchisors have employed master contracts to simplify the management task and entrust franchisee management to a national entity better equipped to manage the local environment. Successful franchisors also have used technology to compensate for loose contractual, legal, and regulatory frameworks. SPOT, for example, uses the radio dispatch system and (eventually) GPS to provide low-cost monitoring and to exclude "rogue drivers" from receiving franchise benefits.

FRANCHISING OF PUBLIC GOODS AND SERVICES: PROMISE AND PROBLEMS

Some of the most interesting franchise models we studied were designed to deliver such public goods and services as health care and education in low-income markets. Socially motivated development entrepreneurs have started creative franchises in these sectors in the last decade. The best known examples are The Healthstore Foundation's (HSF) chain of 85 micro-clinics in Kenya and Rwanda; VisionSpring's network of trained "vision entrepreneurs" who sell eyeglasses to low-income consumers in rural India; and Living Goods's Avon-style distribution of health and consumer products to peri-urban markets in Uganda through community health promoters. These chains were all started with grant capital, thereafter seeking to rapidly replicate a standardized service with diminishing grant subsidies and, in some cases, to achieve economic self-sustainability.

While franchising may be more efficient than the current publicly or foreign-aid funded delivery of health care and education services in these markets, no one has yet created a proven, self-sustaining model that can meet these needs on a large scale. Sector economics in health and education in low-income markets are espe-

cially problematic. For example, VisionSpring lost $641,000 on $150,000 of sales in 2007. Having sold 100,000 pairs of eyeglasses in its first seven years of operation, VisionSpring has calculated its break-even point at 80 million glasses sold per annum.[11] Its business model clearly is a very long way from being able to generate enough cash to fuel its own growth.

Driven by acute local needs and a passion to meet them, all of the social franchises we studied pursued franchised expansion before establishing financial sustainability at the unit level. In so doing, they neglected a key lesson from franchise history and triggered (at least) three problems:

- An insatiable demand for grant financing, focusing top resources on fundraising rather than on serving customers effectively
- Increased conflict between franchisees and franchisor, especially with regard to how to grow, improve, and expand the business
- Subsidized competition against new entrants who might otherwise be able to serve the market profitably

With these social franchises, the "good" has become the enemy of the "great." While it may be *good* to continue with a grant-subsidized delivery model if quality services are delivered more cost effectively than by public or aid-funded models, the grant subsidy impedes the creative and urgent search for a profitable *great* business model that can fuel its own growth to provide services at a large scale.

The fact that HSF recently decided to restructure from a grant-fueled to a for-profit business model is telling. HSF was established as a charity in 1997 with a mission to address the acute need for essential drugs and medicines in low-income countries at the quality standard necessary to provide effective treatment. In the 10 years that followed, HSF established 82 franchised medical clinics and medicine shops under the brand Child and Family Wellness (CFW) in rural, peri-urban, and urban-slum Kenya, plus three in Rwanda. CFW franchisees paid an initial fee to acquire a franchise, and HSF lent the balance needed to open a clinic. Care was taken to ensure that franchisees were self-sustaining, but little effort was made to ensure that HSF's franchisor in Kenya was self-sustaining. In practice, the franchisor subsidized the franchisees by providing training, marketing support, and central services free of charge. No royalties or advertising and marketing fees were charged to the franchisees. Meanwhile, the franchisor sought to plug ever-growing losses with grant funding.

After a decade of operation, HSF's founder, Scott Hillstrom, realized that the mission was unattainable with the current model. HSF could not meet the need for essential drugs and medicines on a large scale with a grant-subsidized model. In 2008-2009, the organization embarked on an ambitious restructuring plan designed to yield a profitable—and therefore scalable—franchise business model. HSF has slashed overhead in the Kenyan franchisor organization; is positioning new CFW clinics in more densely populated areas, screening potential franchisees for their business acumen and entrepreneurial drive, in addition to their clinical qualifications; and outsourcing procurement, storage, and distribution functions

to a high-quality drug distributor. HSF projects that it will break even at 225 outlets by 2015, with increasing profitability in following years.

HealthStore's primary goal is not to make money off the health care needs of the poor in Africa but to finance its own growth and achieve the desired health care benefits on a large scale. Whether this is achievable remains to be seen, but it is certainly worth the effort. We believe that local or national third-party payors (e.g., private or state-funded insurance or voucher schemes) will ultimately prove more effective and sustainable than foreign grant subsidies. In any case, the franchising of public goods and services in frontier markets warrants further empirical research and creative, intelligent entrepreneurial effort.

SUMMARY

Franchising, and its younger cousins micro-franchising and social franchising, are not the next big thing in development. Indeed, we should be suspicious of anything purporting to be the "next big thing."

Nevertheless, it is encouraging to see a wide variety of franchises innovating and thriving in very challenging markets. SPOT Taxis's innovations have overcome capital constraints and enable them to monitor franchisee performance. SPOT thereby generates employment, enables asset ownership, and builds credit history among hundreds of low-income households in Bangalore. Fan Milk has employed traditional format franchising to become Ghana's leading supplier of dairy desserts. The company provides experience in business ownership for thousands of first-time entrepreneurs, many of whom move on to start other businesses. Nando's has established an enviable footprint across 14 frontier markets and is now challenging more mature fast-food chains in their home markets. And Healthstore has embarked on a quest for a truly great business model, one in which profits fuel the needed growth of a large-scale franchise chain that supplies high-quality essential medicines and health care to low-income consumers in East Africa.

Franchising in its various forms can accelerate the entrepreneurial growth of small and medium-sized businesses in frontier markets. The examples we studied point to the potential for success when the lessons of franchise history are observed and business models are creatively adapted to frontier market conditions. That is promising news for entrepreneurs, investors, and students of development alike.

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1. Francine Lafontaine and Roger D. Blair, *Economics of Franchising* (Cambridge, England: Cambridge University Press, 2005).
2. We are grateful for the pioneering work on micro-franchising by Jason Fairbourne and BYU's Marriott School of Business. According to Fairbourne, "The overall objective of micro-franchising 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 micro-franchises will be minimal." See Jason Fairbourne, Stephen W. Gibson, and W. Gibb Dyer, *Microfranchising: Creating Wealth at the Bottom of the Pyramid* (Northampton, MA: Edward Elgar,

2007).

3. For a compelling history of franchising, we recommend the article "Where it all began. . . the evolution of franchising" by Michael Seid at http://www.whichfranchise.com/us/article.cfm?articleID=255. We have borrowed one of his early examples here.
4. James W. Bronson and Cyril P. Morgan, "The Role of Scale in Franchise Success: Evidence from the Travel Industry," *Journal of Small Business Management* 36 (1998).
5. Lafontaine and Blair, *Economics of Franchising*.
6. Entrepreneur.com 2008 rankings; company websites.
7. "UBS Prices and Earnings," 2006 Edition, available at http://www.ubs.com/1/e/wealthmanagement/wealth_management_research.html Methodology: Local price of the product divided by the weighted hourly wage in 14 professions.
8. Entrepreneur.com; company websites.
9. "Nando's Seeks to Spread Its Wings in Congo's Heartland," *Business Day*, February 10, 2010.
10. Fan Milk's story has been well documented over the years by Jason Fairbourne at BYU's Marriott School of Business.
11. "VisionSpring 2008 Growth Capital Offering: 5-Year Prospectus," 2008.