Reducing the risk for Franchisors and Brands in International Expansion Settings

Address to the Capital Area Franchise Association
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By means of introduction to this topic, I would ask you to participate in a short exercise. Using an imaginative paper and pen, please jot off the top of your minds, what international cities you think your brand could hit a home run in? Now, let's discuss why did you pick that city.

Did anyone say Cairo? Why not? Indeed, what we see in the press today suggests a great deal of personal and legal risk to doing business in Cairo. Is however, our perception of personal risk, jading our perception of the business' true operating and financial risk? Today, there is US Federal grant money from $50K to $4M for projects that create jobs in Egypt, and a franchise business could tap such funds, because franchises are viewed as excellent job creators and gender equality enablers by the international donor community. A franchise rollout in Egypt now costs substantially less than dozens of other international markets today. Is Egypt now worthy of a second look?

Let's consider another location. Did anyone say Jeddah? Most people do not know where Jeddah is, let along what kind of market opportunity it represents. Consider that 3 of the top 50 restaurant franchises in the world have their highest grossing units in the second most populous city of Saudi Arabia. Consumer spending on leisure and entertainment in Saudi Arabia is among the highest in the world, and the youth have an intense affinity for American-style entertainment.

Was Jeddah off our opportunity horizon because of some conscious calculation, or did we simply not know anything about this marketplace?

Cairo, Jeddah - too risky? Too exotic? Yes, exactly – international expansion should be a question of risk. But for every location that was mentioned as potential "winners" for your brand's international expansion – London, Sydney, Toronto – I would argue that there are risks – as thorny and complex as the ones in Cairo and Jeddah today.

Opening in Moscow sounds alluring, as does opening in Johannesburg, Singapore, or perhaps even Jeddah. Clearly, there are excellent opportunities for franchisors in all of these locations, but beyond having a nice visit, the question an executive team needs to ponder is if an international expansion really represents a mainstream strategic growth for your company?

Issue 1: What is your plan for strategic growth?

The reality is that most franchisors expand internationally on a whim, and I am realistic in thinking there is little I can say that would convince most management teams to turn away from a what appears to be a "great opportunity". Seven out of ten franchise businesses expand because of an immediate opportunity, not because they are following a plan. An offer to "buy the rights" feels so much better than "spending money" to develop a defendable expansion plan, conducting studies, country visits, etc. I understand the desire to say "yes, let's do it" and plan later. However….

There is no international franchise expansion I know of – and its been 18 years - that has ever hit its forward looking revenue and cost projections within 10%. In most instances I encountered, they were grossly underestimating the potential revenue while at the same time grossly underestimating the actual start-up costs and operating expense ratios. In short, the franchisor's guessed, and I would argue that its never good business to guess when one is signing any venture agreement like a master franchise agreement.

Issue 2: What can save you millions and make you millions at the same time?

What would you think about hiring a non-English speaking deaf person to work in a franchise unit?

How about a team of non-English speaking deaf people to operate a unit?

How about granting a master license in a foreign country to the "Union of Deaf Persons" where the plan was to employ hundreds of deaf people, with very few "hearing" people in the organization?

What if I then told you that in this country, deaf people have a 5x lower turnover rate? (less than 7% versus 35%) such that training costs could be cut to a fraction of what they are in the US. That a business that partnered with this Union would receive preferential state funding and other state and municipal concessions like prime central locations? What if it was known that deaf workers were far more apt to follow operating rules than any other segment of the working population? This is the case of a major international food franchise's rollout in one high growth marketplace.

The point is, with the right information a franchise is able to make the right strategic and economic choices; thus making / saving millions.

(Advanced topic: Consider, could your training materials handle such a situation? Adapting training materials to suit a deaf recruit is quite similar to adapting training materials to suit a foreign language speaker who cannot understand or read a word of English. Consider: What if you recruits were functionally illiterate? In more than half the world, a lack of literacy is a significant impediment to operating controls and consistency in quality).

Issue 3: The frequency and impact of poor estimating (financial, organization, market, and commercial)

While working for the new master developer of a top 5 sit-down restaurant franchises, I was challenged to negotiate the valuation process for a "corporate buy-back" clause. Key to the valuation calculation was the number of table turns that needed to be fixed in the agreement. I forecast 12 table turns a day, while the franchisor insisted on a max of 7. When I left, less than 1 year into operation, we were approaching 17. Some franchisor might say: Great, as the franchisor I can exercise the buy back clause and capture the business back super cheap. Problem then the franchisor faced is that they then needed to run the operation – locally, in the ex-franchisee's home court – and that franchisee was angry, really angry – and the franchisor was the interloping foreigner, claiming "it was in the contract." These situations only end badly.

I would include weak due diligence in poor estimating. Global franchise feeling competitive pressures to lock in central location sites that were being bought up by a competitor's corporate arm faster than they could move. Sold the rights quickly, little due diligence and 5 years later, had to abandon the master franchisee because the criminal acts that would have seriously impacted the share price in the US had they come to light. What should have tipped them off? Paid in cash, several different currencies bound in rubber bands, the $400K installment on the rights?

(Advanced topic: Who in your organization would be best able to forecast revenues and expenses in international market settings? Most franchisors allow their franchise sales executives to lead this effort, but invariably, these are not the individuals who are able to recast operating financials. An important consideration is who specifically would you add to the international franchise sales effort in order to better understand the revenues and costs involved?)

Issue 4: Failing to understand the competition and competitor's options for impacting one's business performance

The competitive landscape in international settings is somewhat different than the North American home market. It many be a surprise to some, that competition in many international settings is often more saturated with substitutes, more price driven, and more aggressive than in North America. Consider the competitive landscape:

Locals – they know and read the market better than we do. It is not uncommon for local franchise businesses to achieve growth rates of double and triple what international franchisor's can do. (Malaysia, Bulgaria, Russia). They do this by leveraging their knowledge and relationship capital for creating results.

Globals – they know and read the market better than we do. Globals who do not franchise in the US, might be large franchisor's overseas. They always have a plan – and are rarely, if ever, swayed by "golden opportunities." Consider: the copy center franchise to beat in Russia is "Xerox Document Centers." In the US, Xerox does not operate such centers, but in Russia, given the lack and weaknesses in business machine sales channels, the establishment of their own chain of product sales stores with retailing made the most sense.

Your friends – friends at home may be your most aggressive, most nasty competitors in international markets. It is a reality that one could face the situation where two franchise brands owed by one parent, fought each other tooth and nail, to secure the same flagship locations.

Competitive options – in countries where there are ruling / royal families, signing up with a prince is a good thing or bad thing? Take a vote. Could you really say "no" to a royal that walked in your door in New York with offer to buy the rights at full price, for cash today? How about a princess? Princes and princesses have options to suppress competition (and franchisor rights) that you cannot even imagine. How one structures the terms & conditions in the development agreement, and how a franchisor actively participates and protects their interest in the operation, in the financial investment, and in the brand in such settings is critical.

Beyond the types of competitors, it is important to understand the volume and intensity of competition. Where is the highest concentration of brands in the world? Not London, not New York, but Dubai and by an impressive factor far above all others. In terms of aggressiveness, intensity and breadth of substitutes, it is fair to consider that most franchises will face a great deal more competition in international markets than they do in their home market.

Issue 5: Who wants to run Europe? You don't want Europe, how about China?

Consider the recent experience of senior colleague of mine. A blue-chip hotel franchise wanted to hire an international researcher to gather the data to help write the plan for 600 new units in a key international market over the next 10 years, but grew frustrated when they could not find the candidate who fit the corporate mold they wanted filled. Ultimately, this SVP of strategy decided to hire a person with blue-chip US domestic experience and let them grow into the international aspect job – expecting than any smart American could learn Germany, as easily as they could learn India, or China, or Russia.

As someone who had worked in 58 countries, I can assure you that this is a decidedly stupid presumption. International markets are foreign markets. It is a fallacy to think that someone with strong US domestic experience and no meaningful international work background could adapt to any country in the world, could effectively lead a start-up and then thrive during the high-growth phase in any of the dynamic markets of Asia, China, Brazil, and sub-Sahara Africa.

A true internationalist can speak with the same ease about any major international marketplace as you could speak about your brand. The competency of a genuine internationalist will be obvious, and will sound completely foreign to someone who has principally worked in the US domestic market. (If they don't seem "really foreign" you probably have the wrong person). My recommendation is to be sure you have at least one such person on your team.

Issue 6: It is extremely unlikely that the business you are in now is the business you will be in 5 years from now if you go international.

Consider the McDonald's experience in Russia – Image this – a row of 80 cash registers, all manned, all turning over order in under a minute, 10 seconds for hours upon hours. Tverskya Metro McDonalds in Moscow averaged over 2,000 guest checks per hour in its 5th year of operation.

How did they get there? They studied the situation (4 times actually, with 4 different research-consulting firms), and understood one fundamental point: there were no reliable, quality suppliers in Russia at the time, and that trucking supplies 1,500 miles from Europe was financially risky and unsustainable. To solve this problem, McDonalds decided to attempt to source 100% locally (they came close – about 97%). But the point is that they spent 2 years and $150M US creating a local supply chain – McFactory - before opening this first unit.

When the Russian Financial Crisis occurred in 1997, McDonalds was the only international franchise not to take a multi-million dollar financial (currency hedging) hit. Several of the biggest and best known names we forced in a matter of days, to close national operations because of the loss of their foreign supply lines. It then took them years and tens of millions to recover.

The point: Foreign markets – and especially emerging markets – lack the infrastructure we are used to in the US. To launch, grow and protect the operation and the brand, it is often necessary to vertically integrate into one's supply chain. A failure to do this leaves the business exposed to long international supply chain risks that could literally topple the business in a matter of days if an unfortunate "force majeure" event occurs.

Issue 7: Who are you getting in bed with?

Though this type of activity is uncommon in the US, I can share with you – with absolute certainty – that there are low cost services where the court records and other negative data on potential partners can be buried.

If the franchisee appears to have everything perfect, chances are they have told this story before. If they own other brands, insist on talking to those brands. If they have the perfect management team, find out how many brands this team is actually running. One such group I worked with had amassed 42 master brand / franchise development agreements covering 16 countries over 10 years. They had lost track of what development obligations they had, and could not forecast working capital needs. As a consequence, during the 2008 financial crisis, they saw more than half of their brand operations collapse when the franchisors tightened the payment terms on their product shipments. Three years later and the bailout is still not complete.

(Advanced topic: Fast-moving food and service franchise businesses are viewed by many as one of the most efficient means of money laundering. How is your operation prepared to catch and deal with such an issue?)

Concluding Remarks: The Upside

As much as I have sounded negative, there is an upside: One goes international because that is where the money is. The markets of the Middle East, South America and parts of Asia are growing at a rate of between 5% and 7% per annum today. In many, many countries there are government funds and government support available to franchises that deliver jobs or deliver services that they themselves have been unable to deliver. It is important statistic to note, that among all of those franchises and brands who have built a meaningful international side to their business, that over 80% of them have found that their highest grossing units are all outside of the US.

These issues and many other risks require serious consideration and dedicated attention. If you don't have the talent internally, I would urge you to hire it – full time, part-time, Board-member or a consultant. How do you know you have found the right person? They will be able to talk about the top international markets around the globe as easily as you talk about your brand. Can't find this talent? Consider acquiring a local brand, building on that foundation and using that knowledge to expand - both the acquired brand and your own.

I sincerely hope that these thoughts have stimulated your thinking, expanded your horizons, or perhaps convinced you to not pursue an international route just yet. If you are still interested in expanded abroad, I do hope we run into each other in the international departure lounge in the very near future. Thank you.