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International Franchising: Structuring the Relationship

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Approaches to Structuring International Franchise Relationships

Outside of the United States, franchisors use several different approaches to expand their systems. Commonly used methods include: (1) granting franchises directly to franchisees in the target country, (2) setting up a branch or subsidiary of the franchisor in the target country and having that entity grant franchises, (3) creating a separate legal entity with a "partner" in the target country and having that entity grant franchises and (4) granting master franchise or development rights to franchisees in the target country. Before selecting an expansion method, the franchisor should confirm that the laws of the target country permit the structure that the franchisor intends to use. Often, the franchisor will use different approaches in different countries.

Direct Franchising

In this scenario, the franchisor grants a franchise directly to the franchisee in the target country. Franchisors most frequently use this method where the target country is geographically close to the United States, where the target country has customs, languages and legal systems that are similar to those in the United States and where training and ongoing supervision and assistance can be furnished on a cost-effective basis in the United States, in a country geographically close to the target country or in the target country.

Potential Advantages

- The franchisor does not form a legal entity in the target country, thereby reducing costs.
- The revenues collected by the franchisor are higher because the initial and ongoing fees are not shared with a third party.
- The franchisor maintains greater control over the appearance and operation of outlets in the target country.

Potential Disadvantages

- The franchisor might experience problems providing timely and adequate service and support.
- Slower system growth in the target country.

- It may be difficult to ensure a supply of proprietary items to franchisees in the target country.
- The addition of outlets in a foreign market may strain the franchisor's resources.
- Government approval and/or registration may be required for each franchise agreement. This process can be time consuming and costly.

Branch or Subsidiary

If a franchisor establishes a branch or subsidiary in the target country, the branch or subsidiary acts as the franchisor in the target country and is responsible for granting franchise rights to franchisees in that country. A franchisor should use this technique only if it has adequate capital and management resources to dedicate to the branch or subsidiary in the target country. The franchisor should bear in mind that the branch or subsidiary will be responsible for franchise services in the target country, including recruiting, training, site selection and site development, marketing and other administrative functions. Qualified management personnel must reside in the target country to manage the administrative offices and implement the franchise system.

Potential Advantages

- The franchisor will have greater control over franchising activity, including the use of trademarks, proprietary information and other intellectual property.
- The franchisor will collect higher revenues because the initial and ongoing fees are not shared with a third party.
- The office and other facilities in the target country will create a stronger presence.
- If the target country has limitations on currency conversion, the presence of franchisor-owned facilities in the target country can facilitate currency conversion.

Potential Disadvantages

- The franchisor must commit significant financial and management resources to set up an office and other facilities in the target country.
- The franchisor must ensure compliance with laws, customs and business practices of the target country.

Joint Venture

In a joint venture arrangement, the franchisor and a "partner" will form a separate legal entity. That legal entity will grant franchises to franchisees in the target country. Typically, the partner is an individual or business entity located in the target country. Franchisors commonly use joint ventures if the business is relatively unknown or if the market for the products or services is uncertain. In terms of the contributions of each party to the joint venture, generally, the franchisor contributes the franchise system, the proprietary information and intellectual property; the partner contributes money, expertise in operating a business in the target market and knowledge of the laws and customs of the target country.

Potential Advantages

- Since costs are shared between the franchisor and the partner, the parties share the risk of loss.
- The partner has local market expertise, including knowledge of local customs and tastes and valuable business and political contacts.
- By having an ownership interest, even though shared, the franchisor has greater control over the development of the franchise system in the target country and the use of its trademarks.

Potential Disadvantages

- The franchisor and the partner share the initial and ongoing fees, profits and other benefits.
- There is a risk of ineffective management by the partner, disagreements with the partner and diffusion of authority.
- The creation of a joint venture requires a large investment that may be vulnerable to currency conversion limitations and political instability.

Master Franchise/Development Rights
Franchisors utilize master franchise agreements and development agreements to establish a number of franchise outlets, simultaneously or successively, within a substantial geographic area during a defined period of time. When the parties enter a development agreement, the franchisor grants to the developer in the target country the right to establish and operate multiple franchised outlets. The developer will directly own the franchised outlets that are established. If the parties enter a master franchise agreement, in addition to granting the master franchisee the right to establish and open franchised outlets, the franchisor also grants to the master franchisee the right to grant subfranchises to third parties to establish and operate franchised outlets within the designated geographic area.

A master franchise agreement enables the franchisee to expand more rapidly than a development agreement. In a master franchise relationship, however, the franchisor's control over its franchise system, including its trademark, may be diminished. In addition, the franchisor may experience practical difficulties dealing with subfranchisees upon termination of the master franchise agreement. Since a developer will develop the target country itself, a franchisor choosing this approach must find a franchisee with adequate capital and management resources to satisfy the development obligations.

Potential Advantages

- The franchisor commits fewer financial and management resources.
- The technique permits rapid market penetration and system growth.
- Generally, more sophisticated investors will be attracted by these arrangements.
- The costs to enter the market are significantly less even if the language, culture, customs and laws are different.

Potential Disadvantages

- If the franchise is relatively unknown in the target country, if the goods or services offered are not well-developed in the target country or if the franchised business will face significant competition in the target country, the developer or the master franchisee may have difficulty meeting the development schedule.
- If a master franchise relationship is used, the franchisor will receive less revenue because most fees will be split between the master franchisee and the franchisor.
- The franchisor's control over the franchised system in the target country will be diminished.
- There is a risk of "breakaway" franchisees in the target country.

For more information about international franchising and development, please contact Franchise Group Chair Bob Smith at 202.719.4481.

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