FRANCHISING INDUSTRY IN CHINA – OVERVIEW AND ASSESSMENT OF DYNAMIC AND EMERGING MARKETS

EXECUTIVE SUMMARY

SOVEREIGN

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ABOUT US

With offices in Shanghai and Beijing, Sovereign China was created by the merger of Sovereign's existing China operations and the JLJ Group in 2013. The JLJ Group was established in 2003 to accelerate international clients' ability to understand and operate in the China market and has successfully assisted more than 500 companies from over 50 countries with their China market entry.

Sovereign China provides a suite of services designed to lead foreign investors through the market entry process and stay with them to develop long-term success in China. From assisting with understanding the market, developing a market entry strategy to establishing their operations and finally providing back office and compliance support services, we are with our clients from planning to execution.

Sovereign's Consulting services include, but are not limited to, market research & assessment, consumer and competitor research, and market entry/growth strategy development. Our team is a balanced mix of Chinese and Western professionals with many years of industry and consulting experience in China, the U.S., and Europe. Our professionals have gained experience at top international consulting firms and have extensive business networks both in and outside China. Sovereign's skilled consultants are experienced at identifying and vetting clients' potential partners in the China market, such as VC/PE firms, distributors, franchisees, and licensee's etc.

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Sovereign China's consulting services can assist you with your China market needs in a number of ways, which include:

- Market research and assessment
- Market forecasting and business intelligence
- Competitive intelligence
- Customer satisfaction surveys
- Growth strategy
- Other areas including, accounting, location analysis, identifying acquisition targets, etc.

For more information on how Sovereign can assist you, please contact us at info@jljgroup.com

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INTRODUCTION

The objective of this report is to provide an overview of China's franchise market[1], analyzing key trends and market dynamics. The report also focuses on five key sectors, which are: food & beverage, retail, education, beauty, health & fitness, and hospitality, and also provides an analysis of select Tier 2 and 3 cities, which are emerging markets outside the Tier 1 markets, which are Shanghai, Beijing, and Guangzhou.

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Market overview. China is now the largest franchise market in the world in terms of the total number of franchised outlets – there are over 4,500 franchise systems[2] with some 400,000 franchised outlets in over 70 industries. Franchising has grown significantly in the last five years, with an increasing number of Chinese entrepreneurs willing to adopt a franchising model.

Regulatory environment. China's first franchise law was enacted in 1997, but the law was incomplete and there were several uncertainties and "grey" areas, particularly for foreign franchisors. Additional regulations were issued in 2005 and 2007, which amended and clarified the 1997 law; for example cross-border franchising[3], which was previously a grey area, was fully permitted beginning in 2007. More amendments were also issued in 2011 and 2012, which opened up opportunities for foreign companies that do not have the desire or resources to set up a legal presence in China to have franchises.

Key sectors. This report focuses on five key sectors, which are: 1) food & beverage; 2) retail; 3) education; 4) beauty, health & fitness; and 5) hospitality. The franchising model has been used to different degrees in these five sectors. The F&B sector was one of the first sectors to use franchising in China, but the majority of franchisors are domestic. In the retail sector, franchising is mainly used to expand into lower Tier cities (e.g. Tier 3 or Tier 4 cities), while stores in Tier 1 and Tier 2 markets are usually direct-owned/self-operated outlets. There is a large presence of foreign companies in the education sector and the use of franchising is common in lower-tier markets. Franchising is more commonly adopted in the health and beauty segment, but is less popular in the fitness segment due to the high initial investment; most fitness players form partnerships or JVs to open chains instead of franchised outlets. Within hospitality, franchising is widely adopted in the budget hotel segment to support the rapid expansion across China, especially in lower-tier cities; some mid-range and high-end hotel groups choose to franchise a limited number of their hotels.

Key emerging markets. Key Tier 2 cities, which are emerging markets for franchisors are still concentrated on China's East Coast and include cities such as Qingdao, Wuxi, Xiamen, Suzhou, and Ningbo. Inland Tier 2 cities, such as Chengdu and Wuhan, offer potential in the long run as the economies are growing and disposable incomes are increasing. However, it is generally difficult to find good potential partners in Tier 2 and 3 cities, as many potential partners/franchisees lack the necessary management experience to successfully operate a brand. To maintain the consistent service quality in direct-owned/self-operated and franchised outlets, it usually takes significant time and human resources of franchisors for training.

[1] Franchising refers to the practice where the franchisor grants the franchisee the right to use a developed concept (including trademarks and brand names, production, service and marketing methods and the entire business operation model) for a fee. Franchisees supply the capital and staff.
[2] This refers to a system of franchisees under the same network. A franchise brand may have more than one franchise network, e.g. it has a few regional master franchisees, which in turn further sub-franchise.
[3] Where the foreign franchisor signs a franchise contract with a master franchisee in China, without establishing a legal presence in China.

Key opportunities and challenges. There are potential opportunities in the five sectors covered in this report for foreign franchisors, especially for mid-range brands, as the mid-range brand market is still far from being saturated, especially in lower tier markets – domestic brands lack brand recognition while foreign brands generally have a positive perception among Chinese consumers; many mid-range international brands have yet to enter the lower-tier markets. Moreover, the consumption power of the Chinese middle class[4] is expected to continue to grow in the coming decade. However, there are several key challenges to adopting the franchising model in China, including fierce competition, need for localization, the difficulty of finding good partners or franchisees, and possible intellectual property infringement. Franchisors seeking to enter or increase penetration in the China market need to be prepared to invest a significant amount of time and resources to manage China operations.

Market access. Foreign franchisors can enter via either cross-border franchising[5] or establishing a local legal entity (WFOE/JV[6]). If the local legal entity is to be a franchisor, it must operate two direct-owned stores for at least one year, before it can have franchisees. Although a higher capital investment is needed to set up a direct presence in China, a direct presence may offer foreign companies greater monitoring/control over Chinese franchisees.

INDUSTRY OVERVIEW

Market overview. China is now the largest franchise market in the world in terms of the total number of franchised outlets. By the end of 2012, there were nearly 2,000 recorded franchisors[7] and more than 4,500 franchise systems, which cover over 70 industries. The total number of franchised stores at the end of 2012 was nearly double the figure in 2007, having increased from over 200,000 to over 400,000. This significant growth has been driven by the rising disposable incomes and the increasing number of Chinese entrepreneurs willing to adopt the franchising model. However, many of these franchises are domestic brands and still small in scale, with an average of ~90 outlets per franchise system[8], compared to several hundreds of outlets per franchise system on average in highly developed franchise countries such as the US and UK.

Market growth. The total number of franchised stores increased at a 15% CAGR[9] from 2007 to 2012. Five key sectors (includes F&B, Retail, Education, Beauty, Health and Fitness, and Hospitality) experienced strong growth in terms of market value. As of 2012, the top 120 franchisors[10] in China, including Lianhua, QuanJude, KFC, Home Inn, and Chlitina, reached a total of over 130,000 chain outlets, among which 84% are franchised outlets.

From 2008 to 2011, total sales of the top 120 franchisors rose from USD 51 billion (RMB 311 billion) to about USD 61 billion (RMB 371 billion); however, sales in 2012 fell below USD 61 billion (RMB 371 billion) and the number of franchised outlets among the top 120 franchisors decreased. This slow in sales was especially noticeable in the retail sector. Challenges were encountered because of the fast expansion of franchised outlets, rising labour costs, and poor management of some franchised stores.

[4] It refers to people who earn between USD 7,250 (RMB 50,000) and USD 62,500 (RMB 420,000), according to National Bureau of Statistics in 2005.
[5] It refers to the operating mode that foreign franchisors engage a master franchisee in China without setting up a local legal entity.
[6] Wholly Foreign Owned Enterprise or Joint Venture.
[7] Source: Sovereign Analysis on multiple sources including Ministry of Commerce, the figure includes over 1,590 cross-province franchisors and around 380 inter-province ones. The recorded franchisors might account for around 90% of the total number of franchisors in China.
[8] This includes China's large franchise systems, with thousands of outlets, as well as the multitude of small systems, with only a few outlets each.
[9] CAGR = Compound annual growth rate.
[10] The top 120 franchisors were rated and selected by the China Chain Store & Franchise Association (CCFA) based on key criteria including 1) tracking record (above 3 years), 2) the rate of franchised stores out of the total number of chain stores (above 50%), 3) total number of stores (above 100), sales revenue (above RMB 50 million), or leading representative enterprise of the industry, etc.