King-sized appetite

Is franchising in China too dangerous? A number of restaurant chains are taking the plunge to find out

-------By Daniel Inman

Burger King has big plans for China. Fresh off a lucrative initial public offering in the US in 2006, the fast food chain announced last month that it would make an aggressive push in China, now fully adjusted to burgers and fries after nearly two decades of McDonald's and KFC, which have over 800 and 1,400 branches nationwide, respectively. By comparison, there are just a handful of Burger Kings in the country - all of them in Shanghai - but, undeterred, the company says it will have around 300 locations in China by 2012, and as many 1,000 by 2015.

Just how does Burger King think it can expand that fast that quickly? Its answer: franchising. "Unlike McDonald's, which owns all its own outlets in China, we are partnering with franchisees across the country except company-owned stores in Shanghai," said Burger King chief executive John Chidsey, known among his subordinates as "the Chief Whopper Flipper" after the chain's signature sandwich. That may seem like an obvious strategy to those familiar with fast-food chains' strategies in markets in the West. Allowing third parties to own and manage branded stores is a tried and true method for saturating a market as quickly as possible, and in China, with its billion-plus stomachs, there is plenty of room for expansion, goes one argument.

Indeed, some firms have made it work, if on a smaller scale. Subway, the American sandwich chain, has 60 outlets in China, all of them licensed franchisees, and expects to open up to another 20 stores in Shanghai alone by the end of 2008. It is also an integral part of the expansion plans of Papa John's Pizza, which expects to have 200 restaurants in China by 2013, half of which will be franchised. Outside of the food service world there is real estate giant Century 21 and office supplies retailer Office 1.

But there is a reason the big boys have preferred to run their China restaurants through corporate. Franchising is still a relatively new concept here, and there are plenty of nightmares for every success story. It can be a struggle to maintain quality when you give up control to a franchisee. Some local franchisees have been known to drop designated suppliers for cheaper substitutes. Some, after being fired for failing to meet standards, have gone renegade and continued to trade under the brand that has been taken from them: Little Sheep, a popular Inner Mongolia-based hot-pot chain that franchises some two-thirds of its 719 outlets, has suffered from copycat outfits trading on its name, as has Shanghai chain Melrose Pizza. Others have bought franchises in Beijing only to move to Canada while a relative runs the show.

Partnering up

The regulatory regime governing franchising in China is still in its early stages. In 2005 the Ministry of Commerce issued rules covering commercial franchising measures in order to meet WTO commitments.

Under the old law foreign companies were unable to jump straight into franchising agreements with Chinese companies, even if they had mature business models back home. They were first required to make an initial investment in China to show that the proposed model would work, due to a clause requiring the franchisor to have had at least two outlets open within China for at least one year.

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A new law came into effect on May 1st of this year. Though it is not yet clear how it will be carried out, one of the biggest changes is that the "in China" clause has been removed. Tim Lamb, vice-chair of the European Chamber's Trade and Distribution Working Group, says he is "cautiously optimistic" that this will allow for the possibility of cross-border franchising, the freedom to enter into franchising arrangements with Chinese companies without first having to set up a legal entity in the mainland.

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But even though it is no longer strictly required, Lamb says he thinks it still makes sense to set up one shop in China for a while to "make sure that you're bringing in a model that is actually going to work". For this reason, it is essential to find good franchisees. Subway in Shanghai, for example, looks for people who have an awareness of Western business practices, and have the resources to open between three and five outlets.

Have it your way

Smaller chains are also drawn franchising their business model. Dragonfly a health retreat chain, has spas in Shanghai, Beijing and Norway. Of its 15 locations, eight are franchised. Having franchisees run a spa is in some ways better than opening an outlet and sticking a manager in it, he adds. Franchise owners, who have a financial stake in an outlet, have a much greater incentive to succeed than regular managers. Many of Dragonfly's franchisees are satisfied customers who want to be part of a business they enjoy, which makes them enthusiastic managers.

Will the home of the Whopper learn from its franchising forebears? So far, Chidsey is at least making the right noises. "We are looking for more committed people as franchisees who understand the local community. ... Our partners should have a passion for running our brand, be financially stable and great operators but not try to squeeze as much money as possible out of the brand." That is certainly the right outlook, but choosing the right partners is easier said than done, especially on a scale of hundreds rather than dozens.

McDonald's, for its part, is granting more licences to franchisees, but it is wading in slowly rather than diving in: There will only be four more by the end of the year. Ensuring that restaurants that fly the golden arches meet company standards is a top priority - McDonald's is giving its franchisees 18 months' training.