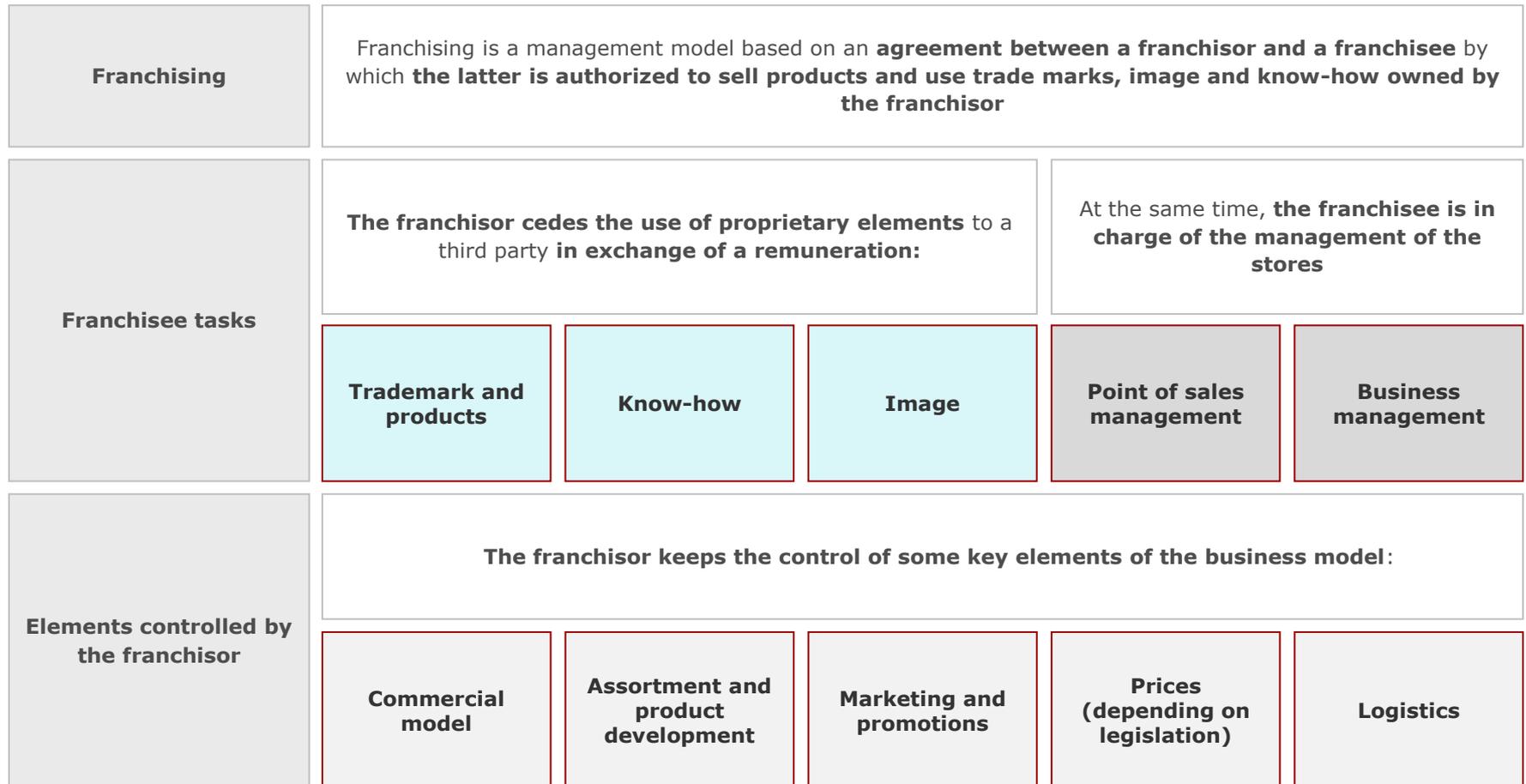


Introduction to franchise models in food retail

Retail franchising definition



Reasons for franchising

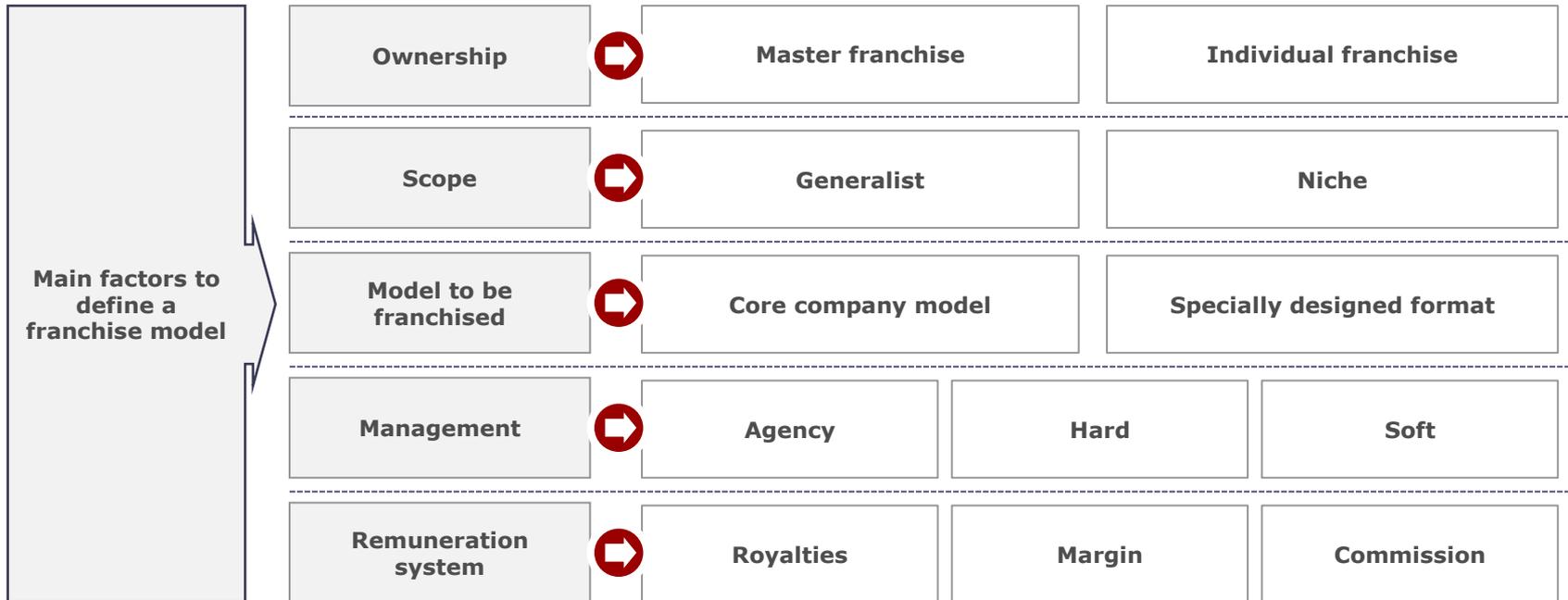
In a franchising agreement, the franchisee will need to share part of its income and lose some control over the business in exchange of commercial advantages

Franchisee	Security	Well-known brands and proven business models would increase the success rate of the franchisee
	Brand and Know-how	Access to brands and products as well as to proprietary knowledge and technology
	Competitiveness	Access to better sourcing conditions and a more complete assortment. Support in advertising and marketing.

Companies have different reasons to franchise depending on their strategy, commercial model and financial

Company	Growing without CAPEX	Accelerate growth with low CAPEX improving the profitability of the Company
	Exploit niches	Access to market niches where owned stores are not profitable
	Execution improvements	Higher orientation to results of the franchise and better knowledge of customers and local markets
	Better results	Improve global Company financial results
	Lack of know-how	Highly difficult to penetrate markets due to cultural, legal or commercial particularities, insecurity, low income per capita...

Franchise business models – main parameters



The combination of the different parameters (not all are possible) will have a relevant impact on:



Franchise ownership model – Master franchise vs. individual (i)

Master franchise

- Under this model the Company grants the rights to use its trademark, know-how and technology to a Company or investor in a specific geographic area (normally in exchange of a royalty and an entry fee).
- The master franchisee has the right to:
 - Expand the network through integrated or sub franchised stores.
 - Manage the whole network (respecting the intellectual rights and the guidelines of the Company).

This model is normally used by:

Pure international franchisors

Companies willing to enter in non-core areas or countries

Retailers looking to integrate small chains with strong regional presence



- For retailers, a master franchise can be an interesting option to **cover areas out of their core business, with low effort and excellent profitability.**
- However, **this is a risky model** if the area granted to the master franchisee can be potentially a good zone for a future expansion. The **breach of the agreement will imply the loss of this area** or strong difficulties to re-start and depending on the size of the master franchisee **can have strong financial implications.**
- Some retailers **start their** expansion in **new countries using Master Franchisees and, once the business is consolidated** and the Companies have acquired **proper knowledge of the local market,** they **buy-back their franchisees** and integrate the stores within their own operated networks.

Franchise ownership model – Master franchise vs. individual (ii)

Individual franchise

- This model is intended for **individuals (investors, entrepreneurs, small retailers...)** being the most common format in food retail.
- The Companies using this model try to **achieve different objectives**, which will determine the franchise **value proposal and the franchisee profile** to whom the franchise is addressed.
- The proper adaptation of the commercial and economic model to the franchisee profile along with the identification of the most suitable market niche are the key premises to succeed.

Apart from pure franchisors, the individual franchise model is used by a vast majority of integrated retailers in continental Europe (while in the USA and UK is uncommon):

French retailers

French retailers are strongly focused on franchising including not only their **core formats, but also a wide variety of niche franchises** to cover all market niches (also operating at international level).



Europe (except UK)

A good number of retailers in Western Europe, Spain, Germany, Italy..., and in Central Eastern Europe (Poland,..) use franchise models for their development.



The presence of franchise models is substantially lower in:

Discount



Only two important Companies of this segment: **DIA and Netto (Intermarché)** operate franchise models

UK



- **Top players operate integrated stores only.** Tesco is starting franchise for small stores in Asia.
- Only Costcutter is franchising convenience stores in the Country.

USA



While franchising is used in a vast variety of business there are very few integrated Companies franchising in food retail since the sector is occupied by large formats which are less adequate to be franchised.

Franchise scope – Generalist and Niche

There are two different franchise formats depending on the scope and similarity to the core model operated by the Company:

Generalist

- The **franchise format is similar to integrated stores** and can cover the same area as the core business of the Company.
- The format is used by “pure” franchisor companies and by integrated players where **Company Owned – Company Operated (COCO) and franchised stores coexist**.
- **The model selection criteria (own/franchise)** in mix companies is based on **opportunity** (existence of the right franchisee many times contributing with own premises) with a slight tendency of **protecting the “core” network operating it directly**.
- **There are companies such as DIA (and Simply to a lesser extent)** that have **evolved from a niche model to a generalist one** (some owned stores even becoming franchised), keeping franchises for the original niche markets as well.

100%
franchised

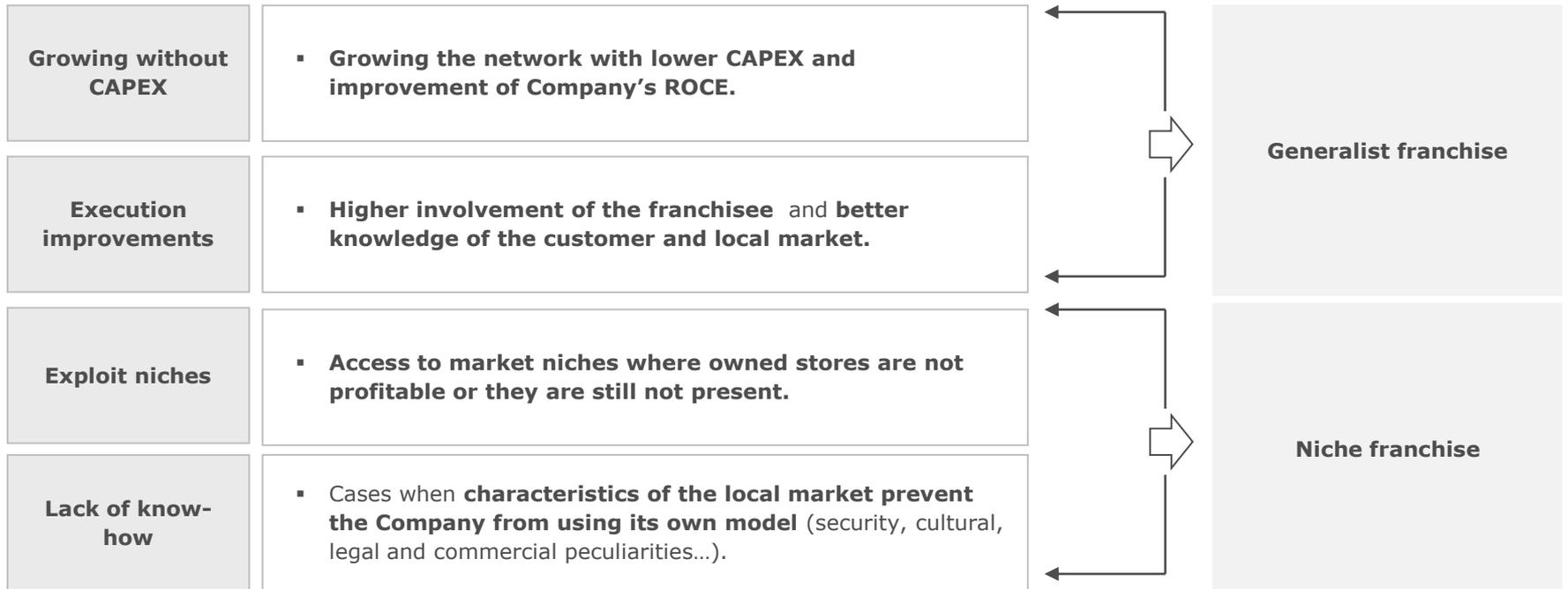
Mix

Niche franchise

- Franchised stores are intended to cover different market niches than COCO stores, increasing the scope and potential growth.
- **Main niches** where franchised models operate:
 - **Low potential areas where COCO stores are not profitable:**
 - Rural areas
 - Low socioeconomic status (SES) areas
 - Touristic, seasonal or other special zones
 - **Different format from the core business of the Company:**
 - Convenience
 - Specialized stores: perishables, etc.

Reasons to franchise depending on scope

The strategy of a Company influences the decision on the type of franchise model to be implemented:



Commercial model of a franchise

Companies use a variety of franchise models. The decision on the format to be franchised depends on the reasons or goals of the Company and the niches to be covered by the model

Same model as
COCO stores



- This is the obvious model since it implies the Company is taking **full advantage of its know-how, brand awareness and can deploy full synergies** with COCO stores.
- Franchisees use **the same standards as COCO stores while bringing some flexibility to the franchise** (especially when stores are used for those areas where COCO stores are not present)

Adapted model



- Companies **adapt their core formats to be used in niches:**
 - Adapting the assortment
 - Changing certain elements of the standard commercial model (equipment, lay-out, price,...)
- Some companies create **different banners to operate these stores** to avoid confusing consumers and prevent direct comparisons with the core banner.

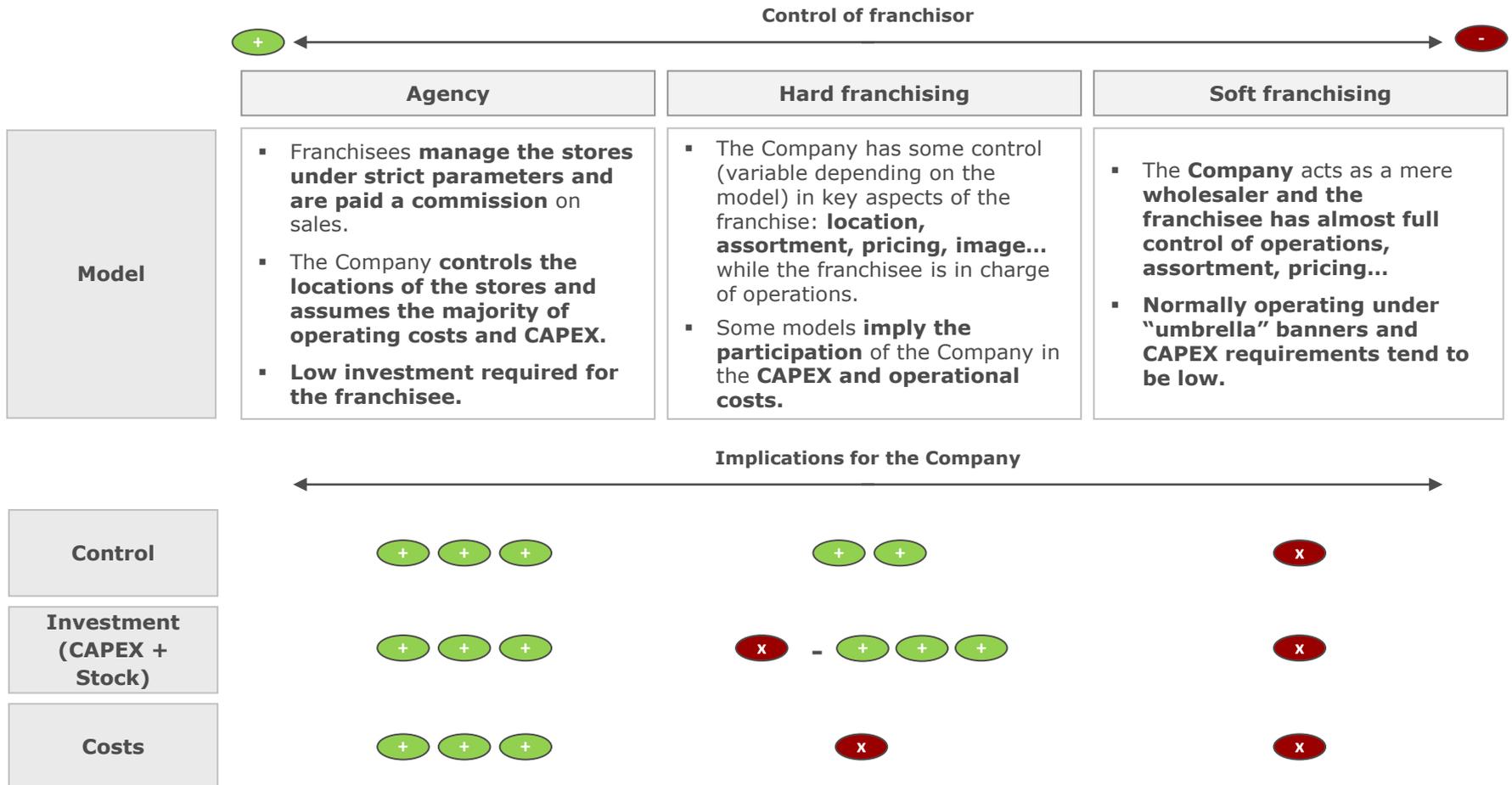
Different value
proposal



Companies create specific business models to operate different value proposals (convenience, fresh, specialization in some categories of the assortment,...)

Management model

According to the degree of control of the franchised network by the franchisor and the involvement in the CAPEX and operational costs of the stores, there are 3 major "individual" franchising models

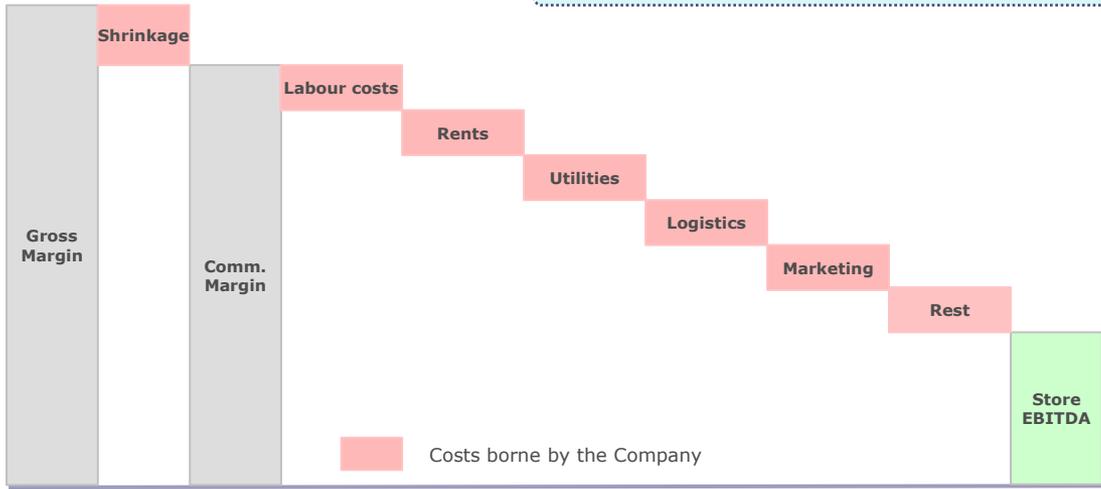


Management model – advantages and disadvantages

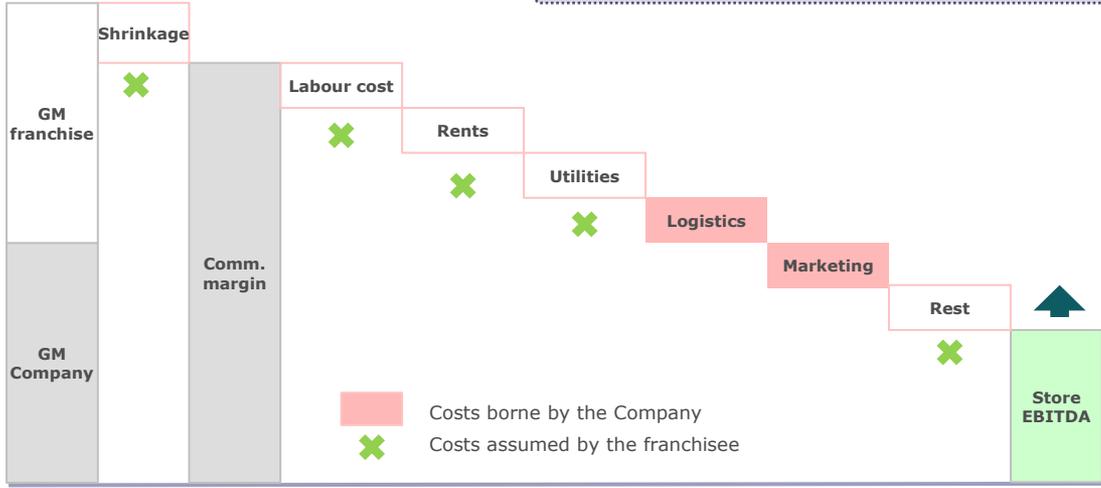
	Agency	Hard franchising	Soft franchising
Advantages 	Strong control over the network and the commercial model	Good control over the commercial model	Low entry barriers for franchisees
	Big incentives for the franchisees to increase sales	Low or zero investment: improve Company ROCE	No investment and easy to manage
	Higher profitability: the franchisee manages labour costs	Lower risks (zero or very low in FOFO models)	Good system to reconvert existing retailers
Disadvantages 	Company funds all CAPEX and the majority of the costs	High initial capital needed: limited number of candidates	Low competitiveness of the model compared to harder ones
	Implementation difficulties: systems, training, control	Need to adjust the economic and commercial models of the franchisee	Low commitment and profitability for the Company
	Weak commitment by the franchisee (low investment)	Reputational risk	Uncertain sustainability on the long term: lack of competitive advantages for the franchisee

Economic model – COCO vs. FOFO store – P&L 'ceteris paribus'

COCO: Company Owned – Company Operated



FOFO: Franchisee Owned – Franchisee Operated



The **economic model of a franchise is based on two main aspects:**

The Company must remunerate the franchisee, which translates into a **lower margin**

The franchisee takes on some part (variable depending on the model) **of the store operating costs**

The impact on store EBITDA will depend on:

Trade-off between cost borne by the franchisee and margin granted by the franchisor

If the franchisee is able to increase revenue over comparable owned stores

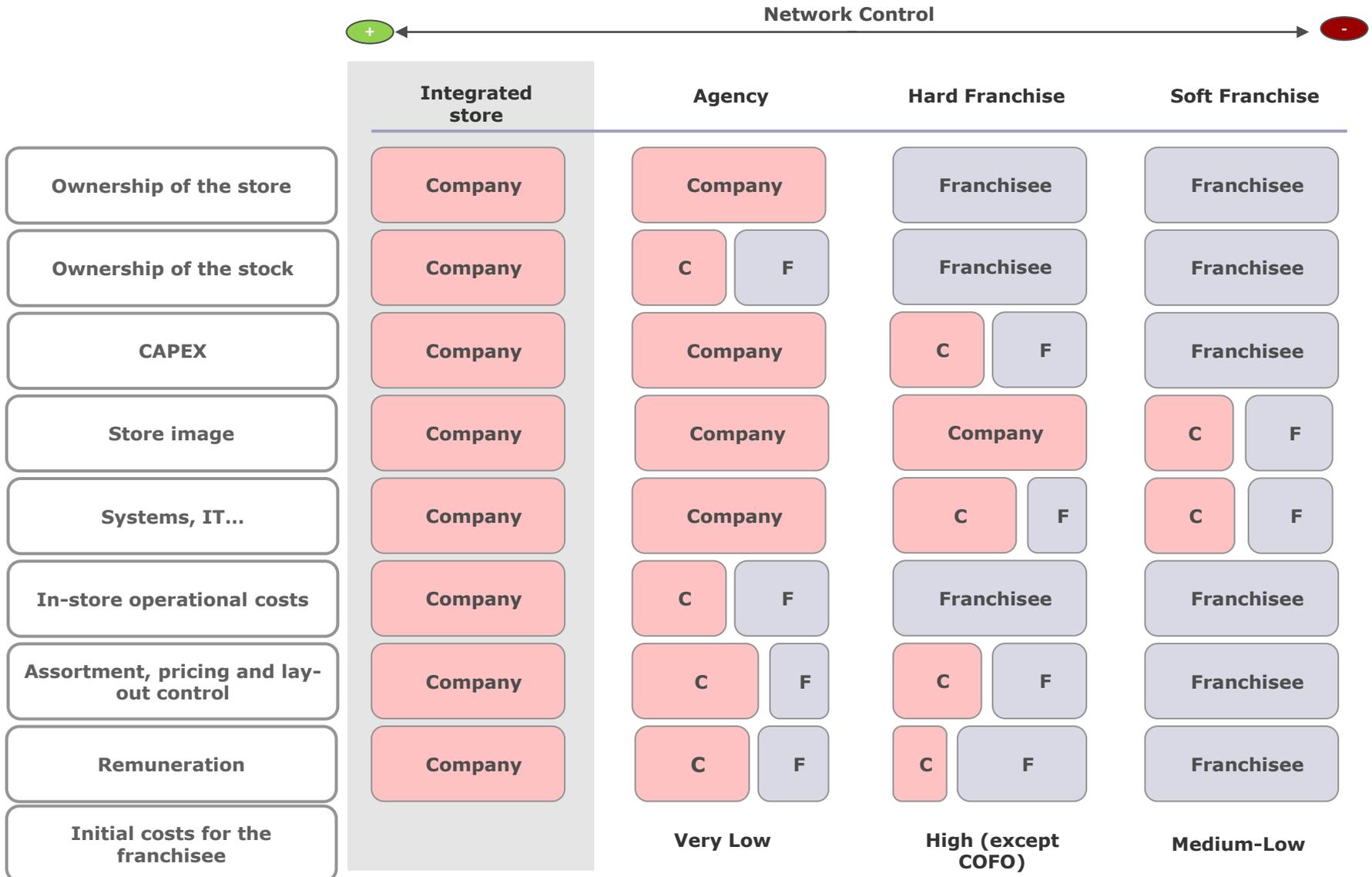
If higher margins can be charged (via price) in market niches with lower competition

Remuneration

The remuneration models are key to design the right economic model for both the franchisee and the Company

<p>Commission on sales</p>	<ul style="list-style-type: none"> ▪ This system (used in Agency models) implies that the Company pays a commission over total sales. In order to adapt to different GM levels, different commissions are implemented depending on the product categories. ▪ It is possible to receive additional bonuses depending on execution indicators or other parameters.
<p>Participation on Gross Margin</p>	<ul style="list-style-type: none"> ▪ The Gross margin is divided between the Company and the franchisee: <ul style="list-style-type: none"> ▪ Products have a discount over the recommended retail prices. ▪ Margins can be segmented depending on the product. ▪ A variation of this system (generally used in soft franchises) is selling at a wholesaler price with discounts or bonuses depending on the volume. ▪ Some international models used a system based on the ex-post margin: Franchisee's remuneration is calculated as a percentage of the total Gross Margin of a given period of time (normally a month).
<p>Royalties</p>	<ul style="list-style-type: none"> ▪ The franchisee buys goods from the Company at a cost price and keeps the total Gross Margin. Some discounts can be made depending on sales. ▪ Franchisee pays a royalty to the Company. ▪ The Company can charge additional fees: marketing, logistics, rights for the use of IT systems.. ▪ Sometimes, the price does not include supplier bonuses or other marketing income, which are also Company's income.

Franchising models according to the overall network control



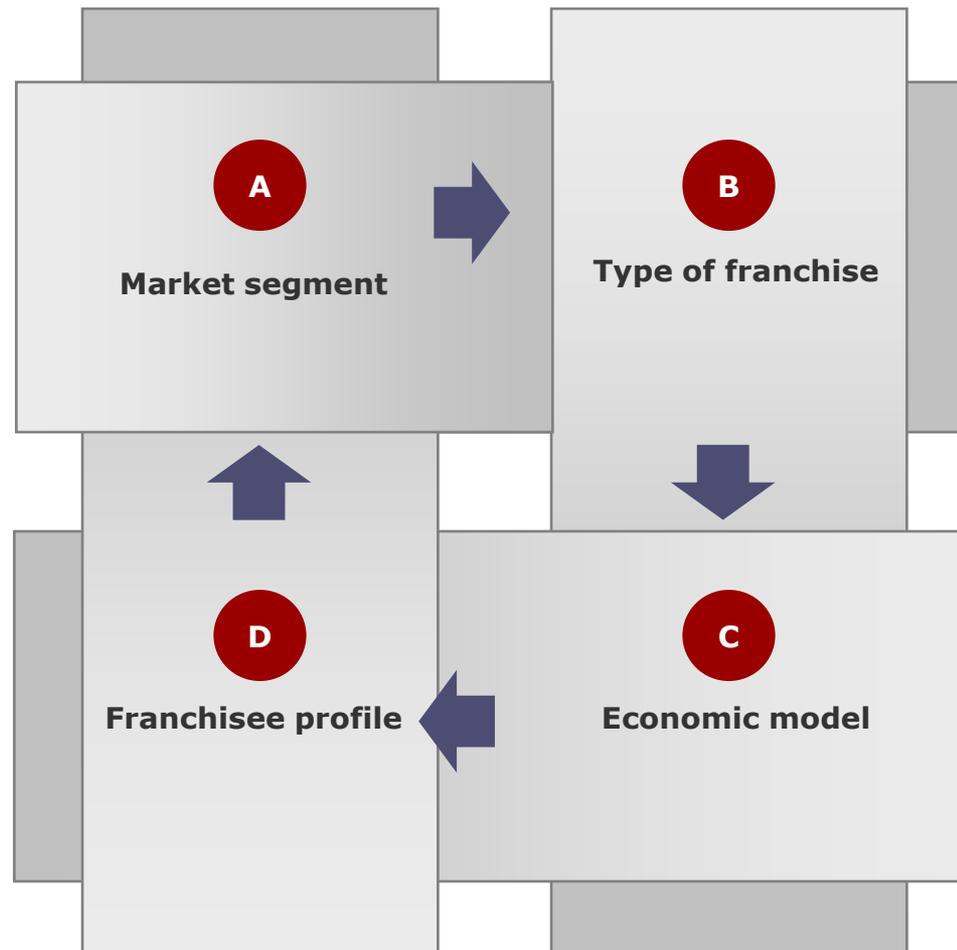
Different profiles for different franchise models

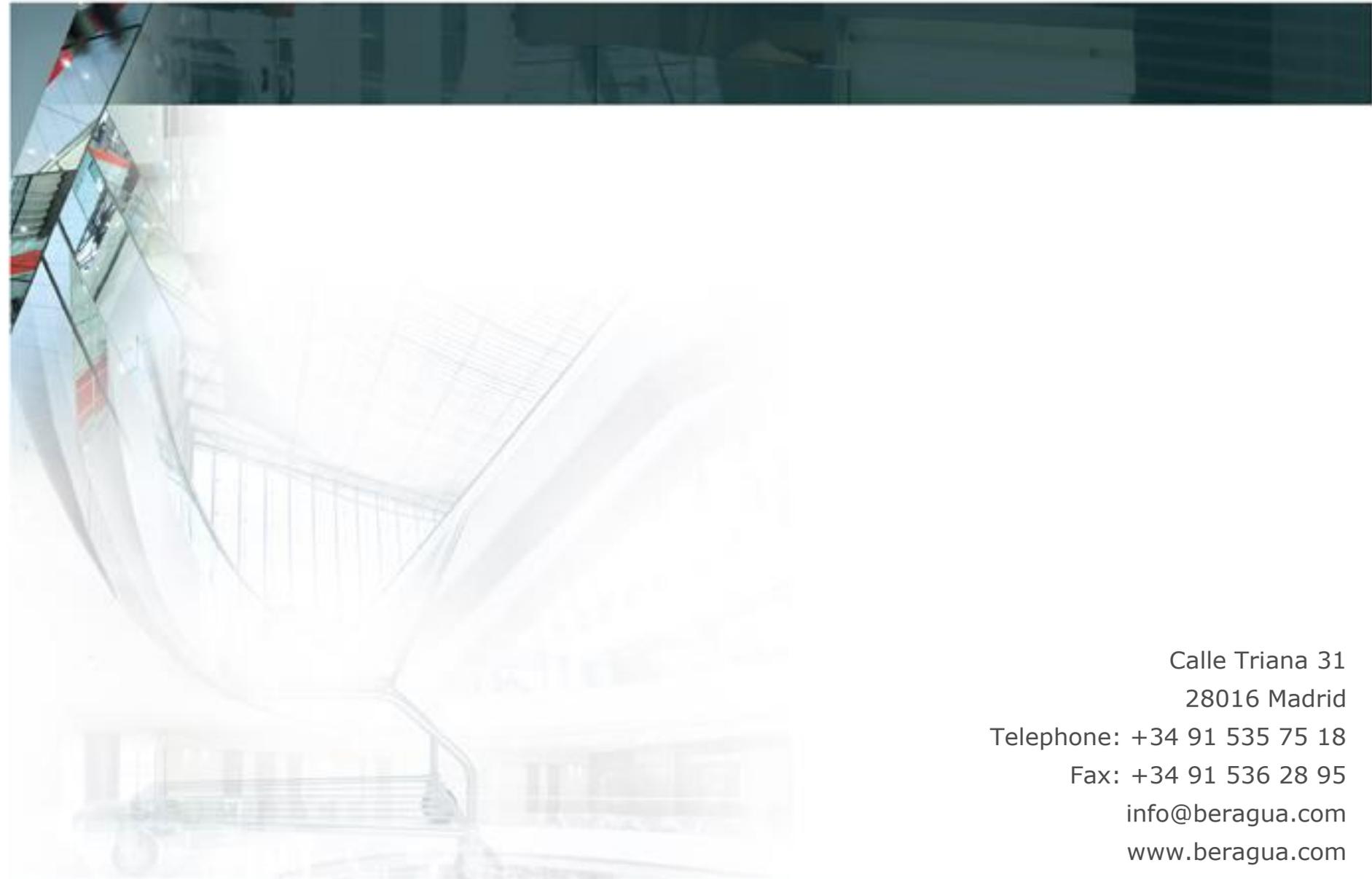
When designing the franchise model it is necessary to assess the availability and characteristics of the franchisee profiles we intend to address

	Franchise model					Key issues
	High investment	Family run	Low sales potential	Large formats	Hard models	
Independent Retailers	✗	✓	✓✓	✓	✗	<ul style="list-style-type: none"> Flexibility to allow current stores to be adapted to the new model with a reasonable CAPEX. System needs to bring some competitive advantages vs. peers.
Large investors	✓✓	✗✗	✗✗	✓✓	✓✓	<p>Hard franchise model (they do not have experience in managing retail business) the model must yield an appropriate return for the investor</p>
Entrepreneurs	✓	✗	✓	✓	✓	<ul style="list-style-type: none"> Mixed profile with a variety of situations depending on the availability of cash Normally it will require hard models: to bring necessary know-how to manage the business.
Self-employment	✗✗	✓✓	✓✓	✗	✓✓	<p>They look to get a higher salary than as regular employees. Profitability is measured in terms of revenues not ROCE. Some of them may lack enough resources to start the business.</p>
Specialists	✗	✓	✓	✗	✗	<p>Part of the assortment can be left under its direct management and use the rest to complement its original offer and bring additional traffic.</p>

Franchise model needs to be consistent in its key parameters

All key parameters of the model need to be consistent and aligned with the main goals of the project





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