Introduction to franchise models in food retail

Retail franchising definition

Franchising	Franchising is a management model based on an **agreement between a franchisor and a franchisee** by which **the latter is authorized to sell products and use trade marks, image and know-how owned by the franchisor**				
Franchisee tasks	**The franchisor cedes the use of proprietary elements** to a third party **in exchange of a remuneration:**			At the same time, **the franchisee is in charge of the management of the stores**	
	Trademark and products	**Know-how**	**Image**	**Point of sales management**	**Business management**
Elements controlled by the franchisor	**The franchisor keeps the control of some key elements of the business model**:				
	Commercial model	**Assortment and product development**	**Marketing and promotions**	**Prices (depending on legislation)**	**Logistics**

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

Main factors to define a franchise model

Ownership	Master franchise	Individual franchise	
Scope	Generalist	Niche	
Model to be franchised	Core company model	Specially designed format	
Management	Agency	Hard	Soft
Remuneration system	Royalties	Margin	Commission

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

Franchisee profile	Investors	Retailers	Self-employment	Specialist/ others
Economic model	Company	Franchise		

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
SPAR	Carrefour, Auchan	Carrefour, Groupe Casino

- 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	
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).	Carrefour, E.Leclerc, Groupe Casino, Auchan, Intermarché, U
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.	Dia, Pam, Edeka, Eroski, Rewe Group

The presence of franchise models is substantially lower in:

Discount	UK	USA
Dia, Netto	Costcutter	Supervalu
Only two important Companies of this segment**: DIA and Netto (Intermarché)** operate franchise models	▪ **Top players operate integrated stores only.** Tesco is starting franchise for small stores in Asia. ▪ Only Costcutter is franchising convenience stores in the Country.	**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:

Reason	Description	Franchise model
Growing without CAPEX	▪ **Growing the network with lower CAPEX and improvement of Company's ROCE.**	**Generalist franchise**
Execution improvements	▪ **Higher involvement of the franchisee** and **better knowledge of the customer and local market.**	
Exploit niches	▪ **Access to market niches where owned stores are not profitable or they are still not present.**	**Niche franchise**
Lack of know-how	▪ Cases when **characteristics of the local market prevent the Company from using its own model** (security, cultural, legal and commercial peculiarities…).	

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

Control of franchisor

\+ ⟷ -

	Agency	Hard franchising	Soft franchising
Model	▪ Franchisees **manage the stores under strict parameters and are paid a commission** on sales. ▪ The Company **controls the locations of the stores and assumes the majority of operating costs and CAPEX.** ▪ **Low investment required for the franchisee.**	▪ The Company has some control (variable depending on the model) in key aspects of the franchise: **location, assortment, pricing, image…** while the franchisee is in charge of operations. ▪ Some models **imply the participation** of the Company in the **CAPEX and operational costs.**	▪ The **Company** acts as a mere **wholesaler and the franchisee has almost full control of operations, assortment, pricing…** ▪ **Normally operating under "umbrella" banners and CAPEX requirements tend to be low.**

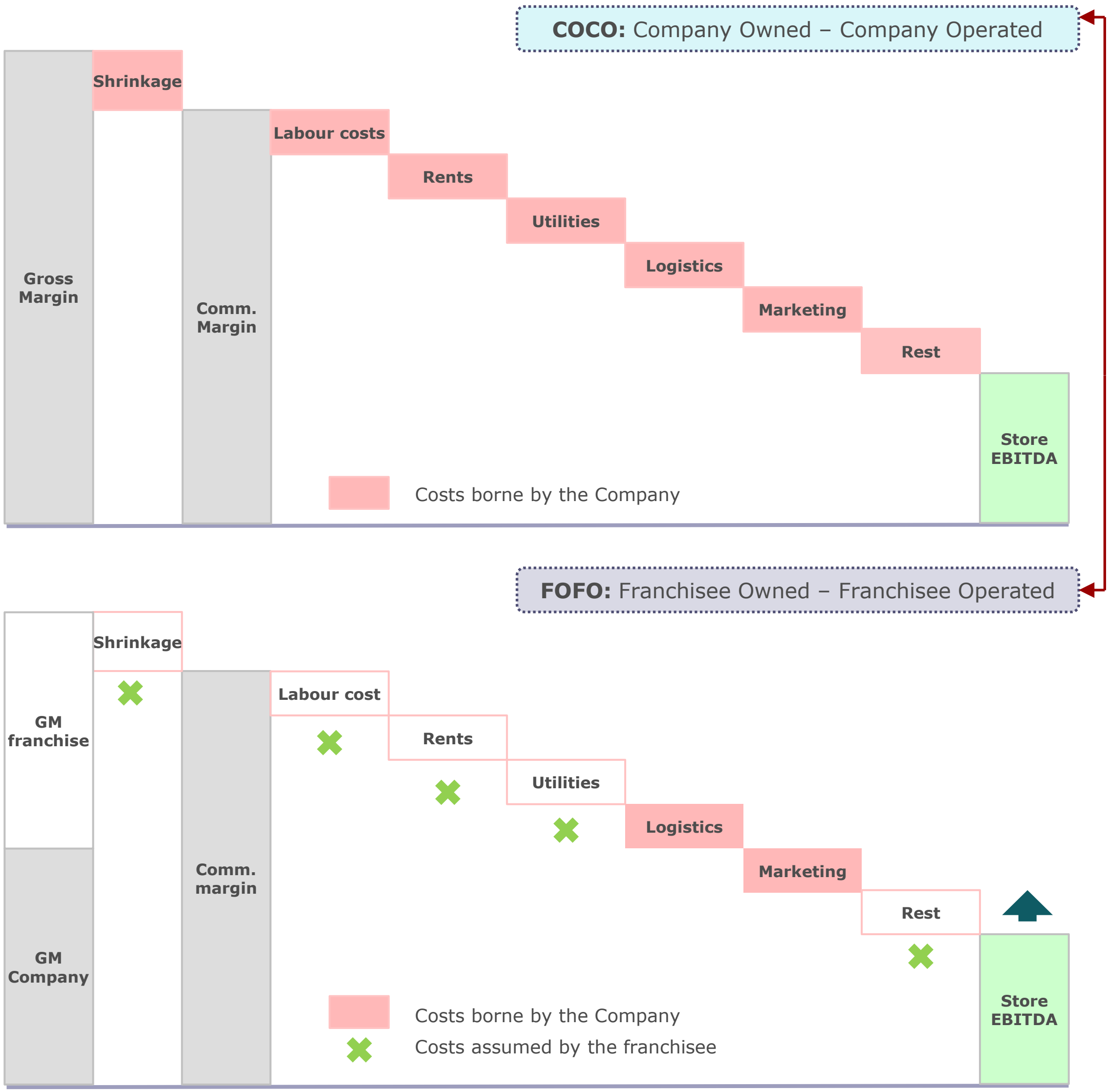
Implications for the Company

	Agency	Hard franchising	Soft franchising
Control	+ + +	+ +	x
Investment (CAPEX + Stock)	+ + +	x - + + +	x
Costs	+ + +	x	x

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 fro 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 committment and profityability 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'



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

Commission on sales	▪ 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.

Participation on Gross Margin	▪ The Gross margin is divided between the Company and the franchisee:
	  ▪ 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).**

Royalties	▪ **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

Network Control (+ ⟷ -)

	Integrated store	Agency	Hard Franchise	Soft Franchise
Ownership of the store	Company	Company	Franchisee	Franchisee
Ownership of the stock	Company	C / F	Franchisee	Franchisee
CAPEX	Company	Company	C / F	Franchisee
Store image	Company	Company	Company	C / F
Systems, IT…	Company	Company	C / F	C / F
In-store operational costs	Company	C / F	Franchisee	Franchisee
Assortment, pricing and lay-out control	Company	C / F	C / F	Franchisee
Remuneration	Company	C / F	C / F	Franchisee
Initial costs for the franchisee		Very Low	High (except COFO)	Medium-Low

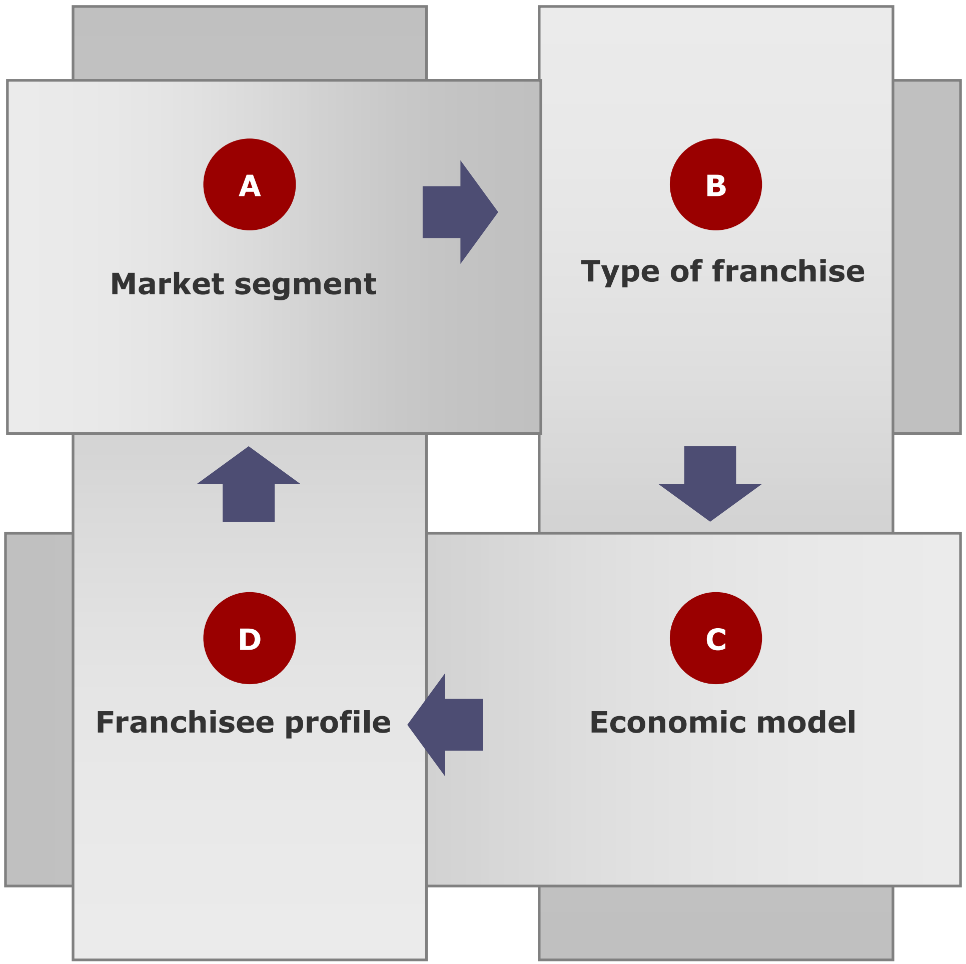
Different profiles for different franchise models

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

	Franchise model					
	High investment	**Family run**	**Low sales potential**	**Large formats**	**Hard models**	**Key issues**
Independent Retailers	✗	✓	✓✓	✓	✗	▪ **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	✓✓	✗✗	✗✗	✓✓	✓✓	**Hard franchise model** (they do not have experience in managing retail business) the model must yield an **appropriate return for the investor**
Entrepreneurs	✓	✗	✓	✓	✓	▪ 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	✗✗	✓✓	✓✓	✗	✓✓	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.**
Specialists	✗	✓	✓	✗	✗	**Part of the assortment can be left under its direct management** and use the rest to complement its original offer and bring additional traffic.

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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