Print ISSN 2093-9582, Online ISSN 2508-4593
http://dx.doi.org/10.21871/KJFM.2016.06.7.1.5.

Essay on the Lessons Learned from Korean Franchisors Going International*

Hark Bae**

Received: May 11, 2016. Revised: May 30, 2016. Accepted: June 15, 2016.

Abstract

Purpose - The purpose of this paper is to find the issues associated with international expansion of Korean franchisors going international and suggest lessons of proposition to reduce the failure risk in international expansion of franchise systems.

Research design, data, and methodology - This is the exploratory study and structured to review (1) background to motivate the expansion of franchisors towards international market, (2) the status of Korean franchisors going international in recent years, (3) issues, (4) lessons learned from the experiences, and (5) summary. Secondary sources were reviewed to get necessary data and statistics.

Results - Master franchising was the most preferred entry mode for Korean franchisors. Franchisors must understand the expenses to be incurred as well as revenues associated with international activities. Brand is the core asset of franchisor as a differentiation strategy.

Conclusions – The paper indicates that even if international franchising is the unique business model for franchisors to use in little or least risk compared with other international entry modes, it needs a set of complex capabilities that much differ from those in domestic and franchisors should take a step approach to the international market with the planned and long term perspective.

Keywords: Franchise, International Franchising, Master Franchising, Success Factors.

JEL Classifications: F10, M30.

1. Introduction

Franchisors are motivated to expand their systems offshore for the diverse reasons. (1) Domestic market saturation: As the domestic market nears saturation, rates of growth and network development in the domestic market decline, while they need to keep the growth dynamic(Aydin & Kacker, 1990a). Furthermore, market saturation intensifies competitions which in turn cause tighter regulatory control, mostly unfavorable to franchisors. (2) Franchisor's desire to take advantage of a foreign market with great potential: Access to new market will provide an opportunity to increase revenue and profits (Hackett, 1976). Going out of the limited domestic market of 50 million populations, franchisors will be able to seek diverse global market opportunities for growth. (3) Response to inquiries of potential foreign franchisees (Walker & Etzel, 1973): Globalization made it quite easy for potential foreign franchisees to seek and approach unique and/or interesting franchise systems everywhere in the world, due to the development of technology in the communication and transportation. (4) Desire to capitalize their proven franchise system and build up the brand reputation: Through the increase of consumer awareness, franchisors will be able to raise their corporate brand value. Success in international arena demonstrates the

* This paper is written on the basis of the material presented at Franchise International Malaysia 2016, National Franchise Conference in Kuala Lumpur, Malaysia on May 7, 2016.

** Ph. D. Candidate, Sejong University, Korea.
Tel: +82-070-7668-5568, E-mail: hbae115@naver.com

strong growth potential, which significantly raises corporate value.

Recent years, Korean franchisors are notably increasing their international activities. A number of Korean franchisors with international presence increased from 56 in 2010 to 138 in 2015, representing 246% growth during the last 5 years.

The purpose of this paper is to see the reasons for the current trends of Korean franchisors actively seeking overseas expansion, to find the issues and to discuss the lessons in order to alleviate the risks with the international franchising.

2. What's Happening to Korean Franchise Industry?

2.1. Industry Overview

Franchise business in Korea began with the entries of global franchisors in 1980's. Especially, 1988 Seoul Summer Olympic Game was the turning point for the introduction and development. Korean government's open economic police provided a favorable environment to the franchise, which induced many global franchise brands to enter retail and service market of Korea. Wendy's set up its first outlet in 1984, Pizza Hut and Baskin Robbins in 1985 and McDonald's and Seven-Eleven in 1989. Subsequently, new entries of global franchisors continued to increase in 1990's. Japanese retail service brands such as FamilyMart, Ministop and Lawson, and American brands of Dunkin'donuts and Starbucks joined during the same period.

At that time when franchising concept was not much developed in Korea, success of these global service companies using unique business model of franchising gave a great impetus to the introduction and benchmarking by many Korean companies, particularly in eating and retail business sector. Consequently, many Korean based franchise brands such as Paris Baguette, Tous-les Jours, Nolboo and Bbq, currently major players in domestic franchise market, have emerged.

During the period of late 1990's - 2000's, Franchise business in Korea enjoyed accelerated growth and the growth continued until around 2010. Two big financial crises - '1997 Asian financial crisis' and '2007 Global financial crisis due to US sub prime mortgage' - made great contributions to this growth: A number of laid-off employees joined the franchise market to become franchisees and lots of new franchisors were also established to meet this abrupt rise of demand.

After then, however, the market got saturated soon due to explosive increase of new market entries coupled with sluggish domestic demand in consumer market. A lot of new entries and new brands joined the domestic market under the unfavorable market condition of lower economic growth.

2.2 Challenges: Increasing number of franchisors and saturated domestic market

According to 'Franchise Information Disclosure System' of Korea Fair Trade Commission (a company that use franchising must register the disclosure document on the system), number of franchisors increased by 1,505 or 62% and number of brands by 1,897 or 64% during the period of last 5 years(<Table 1>). And notable is that Food & Beverage accounts for more than 70% in terms of number of company as well as number of brand registered and most of them would be classified as small and medium sized companies.

In the meantime, number of units posted relatively modest growth of 23% during the corresponding period. This can be attributed to the fact that there remain fewer prime locations for new franchise units. It appears still growing but the rate of the growth has declined significantly.

<Table 1> 5 year statistics of Korean franchise

Year	2011	2012	2013	2014	2015
No of Franchisor	2,405	2,678	2,973	3,482	3,910
No of Brand	2,947	3,311	3,691	4,288	4,844
No of Unit	181,081	188,114	203,349	207,068	223,569

Source: Fair Trade Commission(2016).

Furthermore, the international comparison among selected countries shows that it appears much clear that franchise market in Korea is so much crowded. In particular, number of franchisors and units to the population are quite high, compared with US, Japan and Australia whose franchise industries were matured far earlier.

<Table 2> Comparative status among countries

	Korea	US	Japan	Australia	Malaysia
No of franchisor	3,910	1,400	1,321	1,160	700
No of unit	223,563	769,683	259,124	79,000	6,000
Population(million)	49	317	127	21	31
GDP per capita	27,195	55,805	32,486	50,962	9,557

Source: Fair Trade Commission(2016).

2.3. Opportunities

Going international for growth and/or survival

Franchisors facing with the decline of both sales and profit in network units were driven out to go international seeking new business opportunities. Since 2010, there have been explosive growths in international units. During the period of 2010-2015, international units increased by 4.7 times, from 991 in 2010 to 4,656 in 2015. And most recent period of 2013-2015 shows 45% increase(table 3). And 70% of the franchisors with international presence had launched their international operation since 2010.

<Table 3> Number of Korean franchisor with international presence and their international units.

Year	2010	2012	2013	2014	2015
Franchisor	56	77	95	120	138
Unit	991	1,485	2,717	3,726	4,656

Source: Fair Trade Commission(2016).

<Table 4> Number of international unit of Korean franchisor, by country

Country	China	US	Vietnam	Philippine	Japan	Indonesia
No of unit	1,814	1,444	292	195	142	140

Source: Fair Trade Commission(2016).

About 73% of total international units are operated by 10 big brands. In 2015, 6 big brands increased their international units by 560. Meanwhile, small brands have continued to show significant increases as well in recent years – 370 new units were established by 84 small brands. Majority of units are operated in China and US, currently(<Table 4>). In the meantime, according to the survey, top 5 countries that Korean franchisors plan to enter for next 5 years are Vietnam, Thailand, Hong Kong, Indonesia and Malaysia in the order of priority. Noteworthy is that their main focus has moved from US and China to South East Asian countries.

Global PEF began to invest in Korean franchisors.

In 2011, Morgan Stanley PE acquired Nolboo NBG, one of the largest restaurant chains in Korea, at the amount of 120 billion Won(equiv. US 100 million estimated). It was the first case reportedly that PE invested in franchise business of Korea. And subsequent investments by PE were followed (<Table 5>). This provided the significant impact to the overall development of Korean franchise, motivating franchisor owners to grow further. Before then, there was no way of exit, lucrative and acceptable for franchisor founders/owners(there are fewer franchisors, listed in the Korea Stock Exchange). Some franchisors tried to go IPO but failed. Investors were not positive in investing to franchise companies because service franchise business including food and beverage was regarded as domestic oriented with limitation for expansion and growth. However, growing international activities of Korean franchisors began to present the growth potential in global market and attracted the investors. Once a franchise system is proven successful in the foreign market, corporate as well as brand value could be multiplied. It is known that PEFS's investment in franchising is due to the scalability, quick liqidity generation and less capital expenditure requirement for expansion.

'Franchise Times*** made a 2015 survey to find the ownership structure of US top 500 franchise companies. According to the survey, 'Private Equity Fund's(PEF)' have ownership of 71 out of top 200 franchise companies and they take majority ownership over 201-500 ranked companies.

<Table 5> Cases of franchisors acquired by Private Equity Fund

Company	Date	PEF	Inv. amount (in Billion Won)
Nolboo NBG (Korean food restaurant)	Nov 2011	MorganStanley	120
BurgerKing Korea	Sep 2012	BoGo Fund	100 (est.)
BHC Chicken	Jun 2013	CVC	100 (est.)
Hollys Coffee	Jun 2013	IMM	40-50(est.)
Krazer Int'l(Hamburger)	Mar. 2014	Nau IB Capital	15
KFC Korea	May 2015	CVC	100
GongCha Korea	Sept 2014	Unison Capital	34
ChangKo 43	Sept 2014	CVC	14

Source: SBI E Trade Securities Co. Ltd. (2016).

PE's investment in franchising has revitalized Korean franchise industry. It provided franchisor founders/owners with attractive opportunities of big fortune and leveled up the management with financial and human resources, and marketing skills for overseas expansion. Founders and owners of franchisors became to recognize the importance of international success. A success in a certain foreign market expedites access to multiple markets, replicating the franchise system with necessary adaptation. They came to know that international growth potential attracts PE's investment to support their further growth and success.

*** 'Franchise Times' is a national publication of US, specialized in franchising business. It annually publishes the Top 200+, a ranking of the 500 largest franchises based on worldwide sales in its October issues).

3. Issues with Going International

3.1. Unprepared entries

Korean brands that achieved a certain level of success in the domestic market are apt to have blind optimism and/or arrogant belief in success. Many of them did not understand that 'going international' needs important capabilities different from what made them successful in domestic market(Shane, 1996). Especially, small brands which were pushed out to go abroad for survival were almost not prepared for overseas expansion. Their preparation just began after receipt of offers from abroad.

"It is increasingly important for franchisors to understand the capabilities needed in the international arena-including the capacity to develop new capabilities(Fladmoe-Lindquist, 1996)."

Two categories of capabilities were suggested in previous researches in international business and franchising. One is administrative efficiency and the other is host country risk management(Huszagh, Huszagh, & McIntyre, 1992; Kedia, Ackerman, Bush, & Justice, 1994; Shane, 1996).

Administrative efficiency includes the distance management capability and the adaptability to the different culture.

- Distance management: Monitoring in franchising is of critical importance. The franchisors need to monitor their franchisees to prevent opportunism by franchisees. Monitoring international units over long distances need complex set of skills and it cannot be easily obtained and does not substitute for experience(Huszagh et al., 1992).
- Cultural adaptability: Host country culture different from that of home country raise diverse issues such as personnel, hiring and franchise format. However, franchisors are apt to act based upon assumptions derived from experience and knowledge in home country. Then, it makes replication of the franchise system difficult(Aydin & Kacker, 1990b)and may result in failure.

Host country risk management

- Host country policy evaluation: Host country policies regarding the franchise right transfer and repatriation of fees and royalties also put significant influence (Kaufmann & Lafontaine, 1994)
- Exchange rate management: Exchange rates fluctuation can increase financial exposure.

As a result of the unprepared entries without necessary capacity and capability, franchisors are exposed to a critical risk. And it was true to some big brand franchisors as well as small & medium.

3.2. Master franchising used as most popular entry mode

Globally, master franchising is increasingly used as an entry mode for franchisors. it is among the fastest methods of international franchisors to expand abroad because this method involves minimum financial risk and a quick go-to-market strategy(Alon, 2006).

"Younger franchising firms are seeking foreign markets to expand their presence, but much of the expansion is in response to inquiries from abroad"(Alon, 2000). The increasing use of master franchising can be explained by these unsolicited offers(Ryans Jr, Lotz, & Krampf, 1999). They try not to lose these unsolicited opportunities, which inevitably made franchisors to choose master franchising as an entry mode just because it is the mode with least risk, commitment and control, compared with other entry mode.

With only some exceptions of big brand, Korean franchisors used the master franchising as their primary international entry mode simply because they were not prepared to have necessary capabilities. It was not strategic but easy decision to avoid unknown risk. Although master franchising is least risk entry mode, overseas expansion for international success is more costly and risky than domestic expansion(Aydin & Kacker, 1990b).

3.3. Resource shortage

Cash flow trouble

Development of international market transplanting operation needs much longer time. Franchisors, particularly with small brands, are likely to need the immediate cash generation from upfront franchise fees. However, it is difficult to get reasonable level of fees from foreign partners(master franchisees) because their brands are unknown in foreign market and they are unable to provide professional support to the partners. All in all, they were in the lack of understanding that it needs substantial input of host country resources to make the international operation successful, even in case of master franchising: Franchise system localization, supporting organization set-up in home country, supporting first unit establishment in host country, initial marketing activity support, registration of intellectual property right, travel to support the launching of operation, consulting for legal including franchise contract document, accounting, tax and etc., manual and training program for host country employees, and translation/interpretation.

The reasonable level of initial franchise fees should be good enough to cover the expenses for finding and negotiating with potential master franchisees, and other various expenses to make the master franchisee successful. Franchisors with resource constraint were not able to compensate these expenses and became to have cash flow trouble within a few years. Cash outflow surpassed the inflow from the initial master franchise fees soon. Their supporting and monitoring activities which are of critical for the success of master franchisee are shrunk back. And in turn, it began to cause the complaint from master franchisees and conflict between both parties.

Different regulation/culture/language/taste/preference

Franchise companies that do not possess the expertise and resources including human and financial for international expansion, did not understand that all these difference put substantial increase of unexpected expenses. As franchisors are operated basically with a small pool of human resources and financial constraint, compared with other business model, they could not manage to tackle these differences properly.

3.4. Focused on product/service rather than 'brand'

Entry barrier is quite low in service sector. And service franchise system is relatively easy to copy. As brand is the core asset of the franchise company, brand building is critically important to keep competitive advantages. Once the franchise system proves successful, copycats and imitated systems emerge in the host country soon. In addition, since business environment in the host country may not be favorable to foreign brands, failure in brand building may result in giving a way to local copycats and imitated brands.

Korean franchisors have mostly focused just on their products and services appearing unique to foreign customers. In long term perspective, franchise system should build up their brands.

3.5. Failure in partner selection

Foreign partner selection is the most important success factor. Well selected good partner will be able to make up the weakness of franchisor and to generate synergy effects with cooperation. There are many cases that successful franchisors in the international market attribute their success to the right partners in the host country. Small franchisors with the rare occasion of opportunity, could not be patient until finding the right partner fit to their system. Even though the proactive search for finding right partner is desirable, it is quite difficult for the small Korean brands unknown to foreign customers to do so.

Thanks to the favorable market environment particularly in Asian countries due to K-pop and Korean culture wave, lots of offers and inquires were coming into the Korean franchisors in recent years. They were overwhelmed by these unexpected opportunities and in majority cases they decided ‘to go’ without knowing that there can be many problems encountered in the foreign market.

Hackett(1976) suggested such problems as follows ;

l Host government regulation and red tapes
l High import duties and taxes
l Logistics problem inherent in operation of international franchise systems
l Monetary uncertainties and royalty retribution to franchisor
l Control of franchisees
l Location problems and real estate costs
l Patent, trademark and copy right protection
l Language and cultural barriers
l Availability of raw materials for company product
l Foreign ownership limitation
l Competition in foreign market areas
l Adaption of franchise package to local markets

Substantial part of these problems can be solved or mitigated by the help of foreign partner. The local partner will make a important role to much more ease up the foreign market entry.

4. Lessons Learned

4.1. Master franchising is ‘not risk free’.

Master franchising was the most preferred entry mode for Korean franchisors. Their choice of this mode was based primarily on the consideration that it puts lowest risk and no financial burden to franchisor and they can get up front fees from master franchisee and pass most of the responsibilities over to master franchisee through the contract.

- Even if master franchising is the least commitment and control entry mode, it still requires substantial input of home country resource to make master franchisee succeed.
- Quality control is difficult and it may put the overall franchise system in risk.
- Lack of commitment and communication will result in the conflict between franchisor and master franchisee
- Master franchisee that was trained and educated, may become a competitor.

Regardless of the entry mode, monitoring over foreign partners and units, and adequate management control over long distance are significant capabilities for the success of international franchise system.

4.2. Precise cash flow projection on a conservative base is required

Cash flow problem is crucial, especially as to the small enterprises. Many Korean franchisors, small in size, experienced serious cash flow trouble within a few years of their first entry. Expenses associated with international activities can be larger than the profits earned during the initial few years. Franchisors must understand the expenses to be incurred as well as revenues associated with international activities.

4.3. Long-term success comes from 'Brand Building'

Brand is the core asset of franchisor as a differentiation strategy. Franchisor should pay adequate attention to care for the brand on top of the product/service. Successful operation in host country induces many imitators. However, it will not be a much threat when brand is well established with high consumer awareness and recognition. Brand management is important to keep competitive advantage for long term growth and success.

4.4. Step approach reduces the failure risk

To avoid the costly mistakes, franchisor should not attempt simultaneous entries to multiple countries and should proceed step by step getting learning benefit from the experiences through trial and errors.

4.5. Be patient until finding appropriate partner

Waiting cost for right partner is far less than the trouble and/or failure cost due to wrong partner selection. Failure in right partner selection will make it difficult to achieve planned expansion. Brand image will be damaged and professional knowledge and expertise deprived.

4.6. Be prepared for the support function to foreign partner

Franchising is continuing relationship. 'Without valuable support' is primary reason for the conflict and failure. Franchising is not one way street. It is relationship business. Good relationship in franchise business comes primarily with franchisor's leadership and support.

5. Summary

Great success in manufacturing sector of Korea has helped to open the foreign market opportunities to service sector, as well. Korean franchise companies started international expansion aggressively in recent years but most of them have failed and withdrawn within a few years. Some were seriously damaged by the continuing losses from their foreign activities.

A specific set of capabilities much different from that in domestic is required for success. It is difficult for franchisors to get profits from the export sales of supplies and their revenues and profits come mostly from the continuous inflow of fees and royalties from franchisee. In case of master franchising contract, the fees shared with local partner become much smaller than equity investment mode.

As their success comes from the continuing growth of international units, franchisors have to get longer perspective than other international entry method. Due to the very short history of international expansion, many mistakes and errors were made in the course of international market penetration. It is well known in the industry many franchise companies- both big and small- have experienced serious financial losses and damages.

This paper is the exploratory. And literature review was limited. To discuss the issues and lessons more theoretically, it is hoped that more research study including empirical research be followed.

References

Alon, I. (2000). The organizational determinants of master international franchising. *Journal of Business and Entrepreneurship,* 12(2), 1-18.

Alon, I. (2006). Market conditions favoring master international franchising. *Multinational Business Review,* 14(2), 67-82.

Aydin, N., & Kacker, M. (1990a). International outlook of US-based franchisers. *International Marketing Review,* 7(2). http://dx.doi.org/10.1108/02651339010143381

Aydin, N., & Kacker, M. (1990b). International Outlook of US-based Franchisers. *International Marketing Review,* 7(2). doi:10.1108/02651339010143381

SBI E Trade Securities Co. Ltd. (2016). *Cases of franchisors acquired by Private Equity Fund.* Tokyu, Japan: SBI E Trade Securities Co. Ltd. Retrieved May 22, 2016, from http://bicswift.org/SBI-E-Trade-Securities-CO/ETRSJPJ1

Fair Trade Commission (2016). *2015 Franchise information service system of Fair Trade Commission.* Retrieved May 22, 2016, from http://www.jftc.go.jp/en/

Fladmoe-Lindquist, K. (1996). International franchising: Capabilities and development. *Journal of Business Venturing,* 11(5), 419-438.

Hackett, D. W. (1976). The international expansion of US franchise systems: Status and strategies. *Journal of International Business Studies,* 7(1), 65-75.

Huszagh, S. M., Huszagh, F. W., & McIntyre, F. S. (1992). International Franchising in the Context of Competitive Strategy and the Theory of the Firm. *International Marketing Review,* 9(5), 5-18

Kaufmann, P. J., & Lafontaine, F. (1994). Costs of control: The source of economic rents for McDonald's franchisees. *Journal of law and Economics*, 417-453.

Kedia, B. L., Ackerman, D. J. Bush, D. E., & Justice, R. T. (1994). Study note: Determinants of internationalization of franchise operations by US franchisors. *International Marketing Review,* 11(4), 56-68.

Ryans Jr, J. K. Lotz, S., & Krampf, R. (1999). Do master franchisors drive global franchising? *Marketing Management,* 8(2), 32-37.

Shane, S. A. (1996). Hybrid organizational arrangements and their implications for firm growth and survival: A study of new franchisors. *Academy of Management Journal,* 39(1), 216-234.

Shane, S. A. (1996). Why franchise companies expand overseas. *Journal of Business Venturing,*11(2), 73-88.

Walker, B. J., & Etzel, M. J. (1973). The Internationalization of U.S. Franchise Systems: Progress and Procedures. *Journal of Marketing,* 37(2), 38-46.