

## FRANCHISING AS A TYPE OF EFFECTIVE BUSINESS DEVELOPMENT

*In the article there is presented a comparative data on the franchising development in Ukraine and in Poland. At the beginning there is a summarized information about franchising around the world and advantages and disadvantages of it for both sides of the agreement are shown. Later in the article Lviv entrepreneur Mark Zarhin is described, who started "Pizza Chelentano" and "Potato House" and spread it in all parts of Ukraine and even abroad due to the franchising system. After that there are mentioned troubles, which restrict fast franchising development in Ukraine. The purpose of this article is to draw attention to the franchising system as a way out for many problems of Ukrainian small business development.*

12 years of living is a rather long period of time for a human being, but not for a state and that's why economic development is extremely needed by Ukraine and all other countries with transition economies. First of all, they need to make up for the lost decades. Secondly, there is a growing number of young people who are searching for work and a lack of vacancies leads to a high unemployment rate and immigration.

All around the world a sick layer of middle class claims for a high social security. It usually consists of white collars, which work in the medical, science, educational institutions and also to a large extent those, who own their small or middle business. Nowadays more and more companies are being started and risk is one of the greatest challenges the entrepreneur meets. Franchising all over the world is known as a least risky type of business development. It provides ready business, after it has gone through all the initial troubles about being acknowledged by the customers, struggling for the market share, etc. Ready brand name and steady financial position are two main factors, which reduce the probability of bankruptcy. Advantages of franchising development for the economy are the same as of small and middle businesses: increase of country budget (taxes and other payments), unemployment decrease, social security, contribution to the enlargement of middle class, etc. All these factors help our country and any other country with transitional economy to reach the level of Western European countries.

Small and middle business provides 40-70 % of GNP in European countries with highly-developed market economy. Franchising is one of the least risky and the most effective ways for running a business. It is a type of business, when a goods or service producer (franchisor) gives the exclusive right to an independent owner (franchisee) to distribute his production/service on a determined territory. As part of the franchise agreement the fran-

chisee pays an initial sum of money, a franchise fee or front end fee, to the franchisor and agrees to pay a royalty or management services fee for continuing advice and assistance, which is usually calculated as a percentage of annual turnover. The franchisee may also pay an advertising fee to contribute to the franchisor's annual advertising and marketing costs. The franchisee also has to find the necessary capital to open the business.

As any type of a business franchising has its advantages and disadvantages [1]. Advantages of franchising for a franchisor:

- it costs franchisor much less money to distribute goods and services by using franchises than by operating company-owned units;
- franchisor gets extra money from licensing trademarks and trade name and from other services he provides to the franchisee;
- risk diversification: franchisor almost doesn't spend money for business expend and that's why he risks less.

Disadvantages of franchising for a franchisor:

- very often franchisor has to credit franchisee, which decreases his possibility to save and reinvest money;
- franchisee may spoil a good reputation of a franchisor;
- franchisor has to spend a lot of money on trainings, control after right use of the "know how", instructions on running a business.

Advantages of franchising for a franchisee:

- franchisee can reap the benefits of the franchisor's knowledge and experience;
- franchisee doesn't need years to establish a reputation for quality goods and services, because the franchisor has already provided him with a proven, recognized product;
- advertising and promotion costs are minimized;
- possibility to get a credit from a franchisor.

Disadvantages of franchising for a franchisee:

- limited independence and initiative: franchisor sets the rules, and franchisee must follow standardized procedures;
- the royalty fees are based on a percentage of monthly gross sale, not profits (even if a franchisee loses money, he still has to pay it);
- the franchise agreement may be only for a period of years, after that a franchisee may not be able to continue his business.

The fact that franchising combines advantages of small and middle business adds to its popularity [3]. For Ukraine, where small and middle business is only in the process of its development, introduction of this type of business is becoming a relevant positive impulse for the economy growth. The franchising development in Ukraine contributes to solving the following problems:

- stimulation of appearance of new competing goods with well-known trademarks, widely advertised in the country and abroad, that will contribute to the expansion of new goods sale markets;
- enlargement of financial and material investments into franchising business on the part of franchisors - residents and non-residents, and also on the part of Ukrainian and Western banks under the guarantee of a franchisor;
- essential enlargement of work places on the labour market;
- further economy development of Ukraine due to the income increase into the country budget.

Companies with famous brands from the USA, Canada, France, Germany, Japan, Great Britain, Australia spread their businesses owing to the franchising system. Each eight minutes one franchisee appears in the world because the effectiveness in such companies is twice higher than in ordinary enterprises. Great Britain statistical data testifies that each invested pound of sterling brings six pounds of profit in eight years (whereas the usual enterprise brings only three).

German franchising association forecasts stable yearly 10-15 % increase of franchisee objects during the first ten years of the current century. The fact that during the last five years only 8 % of enterprises turned out to be insolvent confirms the economic viability of the franchising system.

One of the main reasons for franchising fast spread and success is the combination of profound knowledge, rich experience and strong financial position of the franchisor — a business organizer, and the franchisee - an energetic businessman, whose enterprise functions as a part of one complex, united by the franchisor [4].

Ukrainian economists regard the franchising agreement (agreement of commercial concession)

to be the most perspective and effective method of business transaction in comparison with all other types of contractual relations, which are based on transmission of exclusive rights on the objects of intellectual property.

According to the data of the Ministry of Economics, over eighty franchising contracts were signed in Ukraine, the quarter of which was signed by fast food companies. The largest franchising companies are: "McDonalds", "Buskin & Robins", "TNK-Ukraine", "LUKOYIL-Ukraine", "Alliance", "Shvydko", "Rostiks", "XXI age", "1C: franchising", "American Clearens International", "Uno momento", "Coca-Cola", "Adidas", "Pepsi-Cola", "Fuji-Film", "Dewoo-Motors". Experts and operators report that Ukrainian fast food facilities currently operate with up to 25 % profitability.

Here arises a question: if franchising has so many advantages what restrains its rapid development in Ukraine? Today mainly western companies (as it was said above) play the role of a franchisor promoting their business and name in Ukraine. This happens, first of all, because the concept "franchising" is still hardly known by Ukrainian owners, secondly, franchising can be effective only in the business, which brand, success and stability is well-examined through the time. There are not very many companies like that in Ukraine yet.

But there are a few leaders who have already been using the franchising system. The example of successful franchising application on the very Ukrainian market is "Potato House" and "Pizza Chelentano", founded by Lviv entrepreneur Mark Zarhin. The company has created a nationwide chain of "make-your-own" pizza and potato restaurants, having penetrated even into small Ukrainian towns. The number of company franchisees in Ukraine, Russia and Poland has grown to 42. Each month approximately 5 new fast-food establishments appear. An average restaurant creates 25 new working places. Mark Zarhin's success recipe is the following: first of all, the restaurant must be well technically planned from the interior's design and the service system to the severe control of the product quality, its range. Secondly, among all fast food systems he accumulated the best pizza filling, taking into consideration the local consumer's culinary mentality. In each restaurant the food is cooked in the its own kitchen. Because of this fact "Potato House" and "Pizza Chelentano" have much lower profits, than McDonald's does, whose semi-finished ingredients are produced in the transnational universal fabrics. But the food at Mark Zarhin's restaurants pleases the client as much as the food cooked at home. The company also currently promotes a new brand for coffeehouses, "Lavazza Point", and plans to open 100 outlets.

An interesting fact is that while selling his business as a franchise, at first, Mark Zarhin didn't know that he was using the franchising system. On the one hand, this fact proves that franchising isn't very popular in Ukraine yet, and on the other hand, it shows how creative and enterprising Ukrainian businessmen are.

Another problem is adjustment of contractual relations between franchisor and franchisee, franchisor's defense from not conscientious competition of franchisee, and on the contrary, franchisee's defense from possible not quite correct franchisor's actions. That's why the law is required, moreover it should be similar to the common law, accepted by European Union, which has a character of recommendations and is accepted by legislation of different European countries.

There is an opinion, that, besides a lack of law about franchising, Ukrainian franchisors and franchisees also suffer from a shortage of powerful infrastructure. Indeed, abroad there are a lot of services around the franchise sale process itself - consulting, business plan preparations for future enterprise, crediting, leasing of new equipment, insurance against bankruptcy of franchise, insurance of loans for purchasing a franchise, etc. Ukrainian franchisees also have a problem with finding collateral. European banks, which specialize on franchising crediting, do not require collateral, as a rule. The collateral can be the equipment, which is purchased for the new franchise, or already available assets plus positive credit history. Expensive banking loans, an undeveloped leasing system, and obscure legislation are additional factors detracting from the franchising fast development in Ukraine.

According to the State Committee for Statistics, the total number of small businesses in Ukraine in 2001 was 233,607. Thus the number of small business per 1,000 people is estimated at 4.5-4.8. There is a yearly 15 % increase of the small business objects, and such dynamics is considered to be positive for the transitional period. However, from the point of view of economic aspects, tempos of small business development are completely insufficient. The table 1 summarizes the differences in small enterprises sector's characteristics across countries [5].

An obvious conclusion is that small enterprises are much more numerous in developed countries than in Ukraine. Consequently they play much more significant role in Western economies. They account for at least 49 % of jobs and produce more than half of total GDP [3].

Today small business is in a complicated situation in Ukraine: most of the companies lack cash; tax pressure is too strong; state maintenance is not significant enough; bankruptcy risk is rather high. In such conditions small business won't execute one of its major functions - capital accumulation and social base expansion of the market economy. Due to the franchising many problems of small business can be solved, especially investment increasing for permanent moderniza-

tion and equipment renewal, which are necessary for high-quality goods production and services providing. In the countries, where franchising is popular, small business is supported by special governmental commercial organizations, by credit institutions. For example, in Poland such governmental support of franchising exists. So far Ukrainian banks are not well motivated to support small business, and because of that franchising system is not spreading fast enough.

In Poland franchising still does not have such an important role in the economy as in America or Western Europe, where franchising chains can be responsible for generating up to 15 % of GDP. At present, franchising systems in Poland are the source of around 3.2 % of GDP. However it may not be very long before this country catches up with other highly developed markets [2].

In 2002 the number of franchising systems operating in Poland exceeded 120 (see table 2). In terms of numbers, there are slightly more distribution franchises (retail) (50.8 %) than service franchises (48.8 %). On highly developed franchising markets this proportion is inverted; service franchises are more numerous. Indeed, numbers of service franchising systems have risen recently, which would suggest that the Polish market is gradually maturing.

Despite the market development, the niche for so called "white collar franchising" is still not developed in Poland. It includes services for business like tax consulting companies, office materials suppliers or cleaning services companies.

Also in 2002, the number of people directly employed in the franchising sector rose above 100,000, which is equivalent to around 2.5 % of all those employed in the enterprise sector (see table 3). Franchising now has a wider role on the labour market than simply self-employment for jobseekers. Franchisees now employ nearly 70,000 people, or on average of nearly seven people per franchising outfit. The largest numbers of people employed by franchisees work in food retailing (47.6 %), at petrol stations (12.6 %) and in the horeca sector (9.5 %).

There are 33,8 thousand people employed in the headquarters of franchising systems and in the outlets owned by them. This means that more than 270 persons are employed by one franchiser. The most people are employed by the franchisors at petrol stations (30.2 %) and in catering, trade and hotels (28.8 %).

Distribution systems dominate by volume of revenues generated - 91.6 % of the income on the whole franchising market (see table 4). This is natural, since retail chains have lower margins but high turnover. Revenues of service systems accounted for 8 %, and those of manufacturing chains 0.4 %. Within the retail chain section petrol stations (47.1 %) and food chains (24.8 %) generated the highest proportions of revenues.

The first franchising systems in Poland were foreign (Yves Rocher, Adidas, Aral, McDonald's). In 2002 for the first time the number of Polish systems (55.7 %) overtook the number of foreign systems (44.3 %) (see table 5). This indicates that the Polish market is maturing and that local franchises are gradually taking hold. More and more Polish businesses are seeing franchising as a way to expand.

The majority of foreign chains are expanded by a Polish branch of the mother company. The role of Polish master franchisors in the launch of foreign systems is increasing (such firms have been responsible for the rollout of 15.6 % of the system). These are Polish businesses with a license for expanding a foreign system within Poland and to grant sub-licenses to individual Polish franchisors.

Currently 68.7 % of the franchisees work in domestic franchising systems (see table 6). On the other hand, 31.3 % of the franchisees have bought license of the foreign systems.

It is highly likely that once Poland joins the European Union many systems will decide to set up in Poland. Already 57.4 % of the foreign systems presented here are based in the EU. The largest number of franchises from any single country are based in France, the US and Germany (see table 7). Countries with a highly developed franchising sector that have only a limited presence in Poland are Italy, Spain and Britain. This suggests that these countries have not yet discovered the Polish market. The example of Spain and Portugal gives room for optimism: the number of franchising systems in these countries doubled only shortly after their accession to the EU.

Another indication of the growth trend in Polish franchising is the fact that over the next few months more than ten new systems are planning to sign their first franchising agreements and many existing ones have plans for further dynamic growth. Many franchisors, with positive experience of the franchising business model, are planning to open more franchises or purchase licenses to other systems. Franchising is also an opportunity for Poland's increasingly wealthy middle class. In seeking economic expansion this sector is beginning to appreciate the stability and predictability of activity within the framework of a

franchising chain and the support offered by the franchisee. It is only a matter of time before financial institutions recognize the franchising sector to be a credible partner supplying reliable, solid clients.

### Conclusions and suggestions

Comparing the development of franchising system in Poland and Ukraine is rather relative. First of all, because the first franchise agreement was signed much earlier in Poland (1989) than in Ukraine (1997). By 1997, there had already been 45 franchising systems in Poland. Nowadays there are approximately 122 franchising systems and 10 213 franchising outlets. Secondly, because of smaller franchising experience in Ukraine than in Poland there is very little information and statistics about franchising system itself. The common trend for both countries is that fast food businesses and petrol stations mostly use the franchising system.

The Ukrainian market offers many opportunities for international franchising. However, as an entrepreneurial activity, franchising encounters the same general barriers, as the establishment of small and medium businesses do. These include the whole complex of taxes, high credit rates, crisis of nonpayment, unstable legislation, and very strict control under the subjects of entrepreneur activity by the state. The investment climate remains the major obstacle for franchises in Ukraine.

In order to accelerate the franchising development on the very Ukrainian market, I regard such steps should be made:

- 1) to ratify a law "About franchising", where the rights of franchisor and franchisee would be protected;
- 2) to enhance activities of consulting and business centers for business plan preparation, management advice;
- 3) to develop banking crediting and leasing system for franchisee under the guarantee of franchisor (a franchisor could also give a credit to a franchisee on favourable terms);
- 4) to pay more attention in the institutions, universities, colleges at franchising technology and to investigate franchising experience on real life cases.

### APPENDIX

Table 1. Differences in small enterprises' characteristics across countries

Country	Number of small enterprises (thousands)	Number of small enterprises (per thousand population)	Employed in small enterprises sector (millions)	Share of small enterprises in total number of jobs (%)	Small enterprises' share in GDP (%)
UK	2.630	46	13.6	49	50-53
Italy	3.920	68	16.8	73	57-60
France	1.980	35	15.2	54	55-62
EU countries (overall)	15.770	45	68	72	63-67
USA	19.300	74.2	70.2	54	50-52
Russia	890	6.1	6.5	10	10-11
Ukraine	233	4.8	1.72	8	10

Source: Small and medium enterprise survey. Summary report.

**Table 2. Distribution of franchising systems by sector in Poland**

Sector	Franchising systems	
	№	%
Distribution	62	50.8
food	16	13.1
clothing and footwear	22	18.0
petrol stations	4	3.3
luxury goods	3	2.5
other retail	17	13.9
Services	59	48.4
cafes, bars, restaurants and hotels	19	15.6
cosmetics and hairdressing	13	10.7
education and training	6	4.9
other services	21	17.2
Production	1	0.8
Total	122	100.0

Source: PROFIT System [2].

**Table 3. Employment in the franchising systems by sector in Poland**

Sector	Number of people employed directly by franchisers		Number of people employed directly by franchisees	
	(000)	%	(000)	%
Distribution	20.7	61.2	55.2	78.8
food	2.7	8.1	33.3	47.6
clothing and footwear	2.2	6.5	5.6	8.0
petrol stations	10.2	30.2	8.8	12.6
luxury goods	0.4	1.1	0.3	0.4
other retail	5.2	15.3	7.2	10.2
Services	13.1	38.8	13.8	19.8
cafes, bars, restaurants and hotels	9.7	28.8	6.7	9.5
cosmetics and hairdressing	0.3	0.8	0.7	1.1
education and training	0.4	1.1	0.9	1.3
other services	2.7	8.1	5.5	7.9
Production	0.0	0.0	1.0	1.4
Total	33.8	100.0	70.0	100.0

Source: PROFIT System.

**Table 4. Polish franchising systems in 2001 -volume of revenues by sector**

Sector	Revenues in 2001	
	PLNm	%
Distribution	21.361	91.6
food	5.771	24.8
clothing and footwear	1.017	4.4
petrol stations	10.970	47.1
luxury goods	420	1.8
other retail	3.182	13.6
Services	1.855	8.0
cafes, bars, restaurants and hotels	903	3.9
cosmetics and hairdressing	143	0.6
education and training	66	0.3
other services	743	3.2
Production	96	0.4
Total	23.312	100.0

Source: PROFIT System.

**Table 5. Polish and foreign franchising systems**

Systems	№	%
Polish	68	55.7
Foreign developed by a master franchisor	19	15.6
Foreign developed directly	35	28.7
Total	122	100.0

Source: PROFIT System.

**Table 6. Franchise outlets in domestic and foreign systems**

Systems	Franchise outlets	
	Number	%
Polish	7015	68.70
Foreign developed by master franchisee	643	6.30
Foreign developed directly	2555	25.00
Total	10213	100.00

Source: PROFIT System.

**Table 7. Countries of origin of foreign franchise systems**

Countries	Number of systems	%	Countries	Number of systems	%
France	11	20,4	Great Britain	1	1,9
USA	9	16,7	Italy	1	1,9
Germany	8	14,8	Canada	1	1,9
Sweden	4	7,4	Israel	1	1,9
Switzerland	4	7,4	Norway	1	1,9
Spain	2	3,7	Korea	1	1,9
Japan	2	3,7	Holland	1	1,9
Australia	2	3,7	Greece	1	1,9
Austria	2	3,7	Total	54	100,0
Hungary	2	3,7			

Source: PROFIT System.

1. The American Bar Association Legal Guide For Small Business-N. Y.: Three Rivers Press, 2000.

2. www.franchising.info.pl.

3. www.dkrp.gov.ua.

4. www.lp-ua.info.

5. www.eerc.kiev.ua/research/matheses/2003/pdfvavryshchuk.pdf.

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## **ФРАНЧАЙЗИНГ ЯК УСПІШНА ФОРМА РОЗВИТКУ БІЗНЕСУ**

*У статті наведено порівняльні дані з розвитку франчайзингу в Україні й Польщі. Спершу підсумовано інформацію про розвиток франчайзингу у світі і переваги та недоліки цієї форми розвитку бізнесу для обох сторін франчайзингової угоди. На прикладі діяльності львівського підприємця Марка Зархіна, який, використовуючи договір франчайзингу, започаткував «Піцу Челентано» та «Картопляну Хату» і розповсюдив ці ресторани у всіх регіонах України і навіть за кордоном, описуються перешкоди, що стримують швидкий розвиток франчайзингу в Україні. Мета статті – привернути увагу до системи франчайзингу як однієї з можливостей подолати труднощі на шляху розвитку українського малого бізнесу.*