Selecting Optimal Expansion Markets in International Franchising

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Abstract:

Using a strategic model of international expansion, this study develops a ranking of 125 countries based on their attractiveness as expansion markets for international franchise companies for 2015. Based on the premise that business companies view international expansion ventures as investments, a country's attractiveness is based on its risk/return profile. Following financial investment theory and practice, the most attractive markets are the ones that offer the best trade-offs between market potential and market risks. Market potential is measured by a weighted average of population size, gross domestic product (GDP), and per capita GDP. Market risks include economic, political, legal, regulatory risks as well as cultural and geographic distances. For US-based franchise firms, the Top 10 most attractive countries for franchise expansion in 2015 were Taiwan, Germany, Canada, Sweden, the United Kingdom, Hong Kong, Singapore, Korea, Australia, and Japan. The Bottom 10 least attractive countries in 2015 were all in Africa except for Syria. This study highlights the fact that the relative attractiveness of a given country as an international franchise expansion market may evolve over time, sometimes dramatically, as in the cases of Taiwan and Sweden. However, the relative attractiveness of various countries over time is remarkably stable for the most part as nine out of the Top 10 countries were the same in 2011 and again in 2015.

Key words:

International franchise expansion, market potential, market risk, country attractiveness index

1. **Introduction**

Franchise companies are increasingly going international. Domestic market saturation, reduction of trade barriers, advances in communication and transportation, growth of foreign economies and improved currency convertibility have spurred franchise companies to expand to foreign markets (Aliouche and Schlentrich, 2011; Justis and Judd, 2003). In 1989 only 34 percent of US-based members of the International Franchise Association (IFA) reported having units overseas. By 2006 this proportion had increased to 52 percent (Schlentrich and Aliouche, 2006). A recent IFA franchisor survey found that 79 percent operated internationally (IFA 2016). Most of the recent growth of many US firms occurred in overseas markets. US fast food giant McDonald's experience is a telling example. Between 2012 and 2014, McDonald's added a net of 1 778 restaurants worldwide. Of those, 1 585 (or 89.1 percent) were located overseas and only 193 (10.9 percent) were added in the United States, the company's home country. By 2014, McDonald's had more restaurants overseas (21 908 or 60.4 percent of total units, up from 57.2 percent in 2010) than in the United States (14 350 or 39.6 percent), and a significant majority (68.5 percent) of the company's revenues was generated overseas (McDonald's 2011, 2015).

Though many franchise firms see international expansion as a strategic imperative, internationalization is not without risks. Examples of failures of franchising companies include Hilton Hotels leaving Iran due to the 1979 revolution and Dunkin Donuts closing their operations in the United Kingdom in 1991 for lack of profitability (Aliouche and Schlentrich, 2011). While it is generally accepted that a strategic approach that takes into account all key success factors is needed to enter new international markets, many company executives still use intuition, personal experience or contacts, or other ad-hoc methods in their internationalization decisions (Han and Dickman, 2001), leading to a likelihood of failure.

For a company that has been successful in its home market, two factors play a key role in the success or failure of its international expansion projects. First and foremost, the location of the expansion project (that is, the country to expand to – or *where*) is a deciding factor in internationalization decisions. Entering the wrong market at the wrong time is a sure recipe for failure. For example, the likelihood of a foreign franchisor thriving in a country characterized by political instability, endemic corruption, no rule of law, and whose population has low and declining incomes is almost nil. Thus selecting the right country where the franchisor has a chance to succeed is one of the most important decisions to make after the company has strategically decided to expand internationally. Another key factor that can enhance a foreign franchisor's likelihood of success is its ability to adapt to local conditions. The franchisor's products and services and way of doing business may have led it to success in its home market. However, these may not necessarily work well in a foreign market. Thus some adaptation to local conditions may be needed to succeed overseas.

The purpose of this article is to identify and rank the international expansion markets where franchisors have the highest opportunities to succeed, that is, the countries that would be the most attractive to franchisors as expansion markets. This article thus extends the Aliouche and Schlentrich (2011) and Aliouche (2015) studies by updating the rankings using 2015 data and comparing the results with the 2011 findings. The rest of this article is structured as follows. Section 2 identifies the key factors that play a determining role in international franchise expansion. Section 3 introduces the model and the methodology used to rank 125 countries according to their attractiveness as international franchise markets. Section 4 presents the attractiveness rankings results for 2015. Section 5 compares the 2015 rankings to the 2011 rankings. Section 6 discusses the results and offers some important implications. Finally, Section 7 concludes.

2. Franchise internationalization: The *Where* decision

The internationalization process has been studied for decades. Arguably one of the best known internationalization models is the Uppsala model (Johanson and Vahlne, 1977). This model posits that because of the risks inherent in international markets, firms tend to expand first to psychically close countries and initially tend to favor low resource commitment modes of entry into foreign markets (such as exporting and licensing). After gaining experiential knowledge of foreign markets, they then gradually move to more psychically distant countries and to higher resource commitment modes of entry (such as direct foreign investment). Though a major advance in internationalization scholarship at the time of its inception, the Uppsala model focused mostly on psychic distance. Though distance (cultural and geographic) is an important source of risks, it is dwarfed by other key factors (other market risks and market potential) in internationalization decisions (Aliouche and Schlentrich, 2011). Also, the Uppsala model did not address the specific characteristics of franchise firms. In addition, much new knowledge has been gained about the internationalization process since the inception of the Uppsala model several decades ago. Therefore, a more current international expansion model that also takes into account foreign markets potential (in addition to foreign markets risks), and that focuses on franchise firms is needed. Such a model is discussed below.

There are over 200 foreign countries and territories a given franchisor may see as potential international expansion markets. However, these potential markets are not all alike. Some are friendlier than others. Some have greater potential than others. Furthermore, the franchisor does not have unlimited resources – therefore it has to select one (or a few at best depending on its financial and managerial resources) that it should target first. Ideally, the target expansion market selected would be one that maximizes the likelihood of success of the international expansion venture. But first, how are we to define *success* for an international expansion venture? Looking at an international expansion venture as an investment by a business company, and borrowing from financial investment theory and practice, we can postulate that a successful project is one that maximizes returns and minimizes risks (Aliouche, 2015). Thus, from the perspective of the expanding franchisor, countries which offer optimal risk/return trade-offs are the most attractive as international expansion markets.

A number of studies have helped identify the determinants of returns and risks in international franchising. Market potential is a key determinant of the return on investment for the expanding international company. Market potential is based on the size of the market, the growth of the market, and the purchasing power of the consumers in this market (Agarwal and Ramaswani, 1992; Buckley and Casson, 1998; Ekeledo and Sivakumar, 1998; Lafontaine and Leibsohn, 2005; Rothaermel, et al., 2006). Markets that grow faster, that have larger customer bases with higher purchasing power are more attractive to companies looking to enter new markets.

Entering new international markets may increase a franchisor's potential returns; it also, however, increases its risks (Boczko, 2005; Han and Dickmann, 2001). Six categories of risks have been identified in international franchising: economic, political, legal, regulatory, cultural, and geographic (Aliouche and Schlentrich, 2011). Economic and political risks arise when adverse economic and political conditions or changes in a host country may cause losses for the foreign companies operating there. Adverse economic and political conditions or changes may include currency instability, increased tariffs, banking instability, increases in the unemployment rate, government finances, strikes, boycotts, and so on. (Clark and Tunaru, 2003; Cosset and Doutriaux de la Riancerie, 1985; Erevelles, et al., 2005; Hoffer and Haller, 1980; Rothaermel et al., 2006).

Legal and regulatory risks arise when unfamiliar and/or changes in the laws and regulations of the host country may hurt foreign companies operating there: non-enforcement of legal contracts and intellectual property protection laws, restrictions on the ownership and control of corporate property, barriers to repatriation of profits, and discriminatory pricing and tax policies (Boczko, 2005; Fladmoe-Lindquist, 1996; Lafontaine and Leibsohn, 2005; Shane, 1996).

Companies operating in foreign markets face additional risks arising from a different culture than what they are used to and from physical (geographic) distance. Operational business practices, contract negotiations and human resources management practices are all influenced by a country's culture (Alon and McKee, 2006; Eroglu, 1992; Fladmoe-Lindquist, 1996). As the geographic distance of the foreign market from the company's headquarters increases, monitoring costs and difficulties in providing logistical support to foreign franchisees also increase (Baena and Cervino, 2011; Rubin, 1978).

Successful international expansion thus creates a potential for higher revenues, profits, and shareholder value while minimizing the many risks that are inherent in international markets. It then behooves the franchise company seeking to expand internationally to identify the countries with the best risk/return characteristics – these would be their most attractive potential markets as this is where expansion could be most successful.

3. Selection of Optimal Franchise Expansion Markets: Methodology

Aliouche and Schlentrich (2011) and Aliouche (2015) have developed a model that allows one to identify the most attractive expansion markets for franchisors seeking to expand internationally. This model is applied here to US-based franchisors using data from 2015. As shown in Aliouche et al. (2012), a comparative study of US and Australian franchisors, this approach can be adapted and applied to franchise companies from other countries as well.

Based on standard indexing methodology, the model used here ranks countries according to their attractiveness as international expansion markets for foreign franchise firms. The model takes into account key determinants of international franchise expansion identified through the international franchising literature (see Section 2), and input from franchise executives. As the analysis of the *where* to expand decision is conducted mainly at the macro level, the key determinants are market potential as measured by market size, market growth, and purchasing power; and market risks as measured by economic, political, legal, and regulatory risks, and cultural and geographic distances. Many of these variables are not directly observable. Therefore, the use of proxies is necessary in order to operationalize them. A country's market potential is proxied by the weighted average of its population size (representing the number of potential customers), its real GDP growth over the most recent five years (to capture market growth), and its per capita GDP (representing its nationals' purchasing power). These measures are obtained from the International Monetary Fund's World Economic Outlook (IMF, 2015).

Economic and political risks are proxied by the Euromoney's Country Risk Index, an index that is widely used to capture a country's economic and political risks (Cosset and Roy, 1991). This index is a consensus survey of expert opinion of country risk covering 186 countries (Euromoney, 2015).

Legal and regulatory risks are proxied by the World Bank's Ease of Doing Business Index, an index that captures the key factors that determine the legal and regulatory risks that may face a company operating a business in a foreign country (World Bank, 2015). This is a highly accepted index as more than 675 academic publications have used it or referred to it (Aliouche and Schlentrich 2011).

Geographic distance is computed by taking the simple average of the target country ranking in terms of distance in miles from the franchisor host country and its ranking in terms of travel time to reach it from the host country. Cultural distance is quantified by computing an index based on the differences in Hofstede's four cultural dimensions: uncertainty avoidance, individualism, masculinity, and power distance (Hofstede, 2007; Hofstede and Hofstede, 2005). Kogut and Singh (1988) proposed a formula that allows the quantification of the cultural distance between a host country and any other country:

$$CD_j = \Sigma_{i=1}^{4} \{(I_{ij} - I_{iu})^2/V_i\}/4,$$

where I_{ij} stands for the index for the i^{th} cultural dimension and j^{th} country, V_i is the variance of the index of the i^{th} dimension, u indicates the host country, and CD_j is cultural distance of the j^{th} country from the host country. Countries are ranked from smallest cultural distance from the host country to the largest cultural distance. A distance index is computed as the simple average of each country's geographic distance ranking and its cultural distance ranking.

The different determinants in franchise internationalization decisions do not all have the same relative importance. To ascertain their respective weights, a survey of franchise executives was undertaken. These executives represented 104 US franchise companies with 115 415 units located in the United States and 165 559 units globally. The survey results showed that 62 percent of the respondents with international franchise experience assigned an equal importance to market potential and market risks, while 78 percent of them assigned equal weights to each of the categories of market risk (economic, political, legal, regulatory, distance) (Aliouche and Schlentrich, 2011).

Following standard indexing methodology, international attractiveness scores are generated by computing the weighted average of all components: market size (16.7 percent); market growth (16.7 percent), and purchasing power (16.7 percent) (for a total market potential weight of 50 percent); and economic and political risks (20 percent), legal and regulatory risks (20 percent), and cultural and geographic distances (10 percent) – for a total market risk weight of 50 percent). Attractiveness scores are computed for 125 countries that had populations of at least one million people and that had publicly available data. These scores are then ordered from lowest (most attractive: #1) to highest (least attractive: #125) to obtain a country attractiveness index.

4. Selection of Optimal Franchise Expansion Markets: Results

Table 4.1 and Table 4.2 show, respectively, the Top 20 most attractive countries for international franchise expansion and the Top 20 least attractive ones for 2015. Appendix A displays the complete list of the 125 countries included in this study. Countries with low index scores are the most attractive (with a score of 1.00 being the perfect score), while those with high index scores being the least attractive (with a score of 125.00 being the worst). These rankings also show that there is no one perfect expansion country (that is, the best in every dimension taken into account, which would have an attractiveness score of 1.00). Conversely, there is no absolutely worst expansion country (that is, the worst index score in every dimension). Index scores range from 26.43 for Taiwan (making it the most attractive country for US-based franchise companies in 2015) to 106.58 for Swaziland (making it the least attractive country among the 125 included in this study).

These rankings show the importance of taking into account market risks when considering foreign expansion markets. Some countries with very large market potential such as China are ranked lower than some smaller countries such as Sweden because China is much riskier than Sweden. Though China ranks very favorably in terms of population size (#1) and GDP growth (#2), it ranks very poorly in terms of legal and regulatory risks (#73) and cultural and geographic distances (#56). On the other hand, Taiwan ranks favorably on several dimensions: per capita GDP (#11), GDP growth (#25), economic/political risks (#15), and legal/regulatory risks (#17). A company seeking to expand internationally and searching for a balanced risk/opportunity profile – as this current index shows – would find Taiwan the most attractive country to expand to. The next nine most attractive countries, in this order, are Germany, Canada, Sweden, United Kingdom, Hong Kong, Singapore, South Korea, Australia, and Japan.

Some countries that are attractive from a market potential perspective, such as China, Argentina, India, Brazil, and Peru, are not highly ranked overall, as they have high market risks. These countries would not be the first choices of US international franchise firms that endeavored to balance the risks and returns of their international expansion ventures.

At the other end of the spectrum, Swaziland, with a very small population size (#125), low GDP growth (#122), and high economic and political risks (#122) is the least attractive for US-based franchise companies in 2015. The next nine least attractive countries, in this order, are Benin, Togo, Mauretania, Gambia, Sudan, Lesotho, Syria, Madagascar, and Chad. Note that nine out of the ten least attractive countries are located in Africa, with the only non-African country in the bottom 10 (Syria) being a country that has been mired in a vicious civil war recently. Companies espousing the business format franchising model would shy away from these countries. However, organizations that use social franchising to provide goods and services to bottom of the pyramid (BoP) populations and other underprivileged populations may be attracted to these countries. While a typical (commercial) franchise company's main objective is to maximize profits and shareholder value, a social franchisor's primary objective is to maximize social benefits with profit being a secondary objective (Aliouche and Schlentrich, 2015; Aliouche and Bonet, 2015).

<INSERT TABLE 4.1 ABOUT HERE>

<INSERT TABLE 4.2 ABOUT HERE>

5. Comparison between 2015 Rankings and 2011 Rankings

Given the dynamic nature of most countries' economic, political, and institutional environments, it would not be surprising that the relative attractiveness of various countries would change over time. Table 5.1 and Table 5.2 display country attractiveness scores and rankings for 2011 and 2015, respectively, for the Top 10 countries. In 2015, the ten most attractive foreign expansion markets for US-based franchise firms were Taiwan, Germany, Canada, Sweden, the United Kingdom, Hong Kong, Singapore, Korea, Australia, and Japan. In 2011, the Top 10 were Canada, Germany, the United Kingdom, Australia, Hong Kong, Singapore, Taiwan, France, Korea, and Japan.

Taiwan edged up to the top spot, moving from #7 in 2011 to #1 in 2015. Taiwan made significant gains, as it meaningfully improved its market growth ranking and its legal and regulatory risks ranking. Sweden also made substantial gains as it leaped from #13 to #4, having improved its position in almost every category (market growth, purchasing power, economic/political risks, and legal/regulatory risks). Though not as dramatic as the gains by Sweden and Taiwan, Korea made some gains, mainly as Australia, the United Kingdom, and, to a lesser extent, France and Canada lost ground, with France dropping to #11 in 2015. It is noteworthy that four out of the ten most attractive markets for US-based franchise firms are newly industrialized Asian economies (Hong Kong, Singapore, Taiwan, and Korea) in both 2011 and 2015, providing more evidence of the economic emergence and significance of these countries.

Three important observations can be made. First, the relative attractiveness of various countries for foreign franchisors evolves over time. Second, though for most countries this evolution is not large (in fact four countries – Germany, Hong Kong, Singapore, and Japan – had the exact same rankings in 2011 and 2015), some can move significantly in the rankings. Cases in point are Taiwan as discussed above, and Sweden moving from #13 in 2011 to #4 in 2015 as a result of improvements in its economic growth, per capita GDP, and political, economic, legal, and regulatory risks. Third, the relative attractiveness of various countries over time is remarkably stable for the most part as nine out the Top 10 countries were the same in 2011 and again in 2015 – with four countries' relative rankings being exactly the same in both years.

<INSERT TABLE 5.1 ABOUT HERE>

<INSERT TABLE 5.2 ABOUT HERE>

6. Discussion and Implications

The success of a franchise company's international expansion initiatives is determined to a large extent by the choice of the markets they expand to (*where*). It seems clear that a commercial (as opposed to a social) franchise company moving into Swaziland has almost no chance of success (that is, maximizing its profits and shareholder value as defined above) given that country's very small population, low growth and high risks. On the other hand, a franchise company entering Taiwan has a real chance of generating profits and increasing its shareholder value as Taiwan offers it a very propitious economic and institutional environment where it can thrive: high growth and high purchasing power with low economic, political, legal and regulatory risks. In order for a franchise company to maximize the likelihood of generating profits and shareholder value in its foreign markets, it needs to start by selecting the foreign expansion markets that are best suited to its corporate culture and resources.

The rankings reported in this study reflect the preferences of US franchisors whose corporate cultures and resources favor, on average, a balance between risk and market potential (equal weights for risks (50 percent) and market potential (50 percent). However, franchisors with different corporate cultures and resources would rank their target expansion countries in a different order. Risk-averse franchisors with limited resources would stay away from risky countries even if they had high market potential. For example, these franchisors would stay away from countries such as China, India, Brazil, and Russia despite their high market potentials. In fact, for these risk-averse franchisors, Taiwan would not be their top expansion market target. Countries such as Canada, the United Kingdom, Switzerland, and Norway would be preferable as they are much less risky while they still have meaningful market potential.

On the other hand, risk-taking franchisors with significant financial and managerial resources would most likely go where the risk-averse franchisors would not – when the market potential is high enough. Despite the higher risks, these risk-taking franchisors would prefer countries such as China, India, Argentina, and Indonesia – countries with higher risks, but with significant market potential. The model used in this study can easily be adapted by individual franchisors to take into account their own risk preferences and generate country rankings specific to them. They would do this by assigning the appropriate weights to each of the risks and market potential components.

Once it has selected the optimal expansion market that reflects its risk/return preferences, the international franchisor can further enhance its chances of success (maximize profits and shareholder value) by judiciously adapting to local conditions. A big advantage of franchising over other modes of international entry is that international franchising is typically developed in partnership with a local business partner (usually as a master franchisee). As the local franchisee is highly motivated to help the franchise system succeed (as his/her own success depends on the success of the whole system), this local franchisee can provide valuable advice on local market conditions, customs, and so on, and recommend necessary product, service, and managerial adaptations. Thus choosing the right local partner is also a key ingredient to success in international markets.

While international franchisors can improve the likelihood of success of their international expansion ventures by selecting the optimal country to enter, partnering with a capable local partner, and adapting to local market conditions, countries that desire to attract foreign franchise companies can also improve their relative attractiveness. As Tables 5.1 and 5.2 show, many countries have significantly improved their attractiveness rankings from 2011 to 2015. While local policymakers do not have much influence over cultural and geographic distances (at least in the short run), they can significantly improve the institutional environment in their countries by passing laws and regulations that reduce the risks faced by foreign franchisors, and by enacting business-friendly economic and political policies that encourage foreign investment in their country. Furthermore, while local policymakers may not have much influence over the size of their population in the short-run, they may be able to develop policies and programs that promote faster economic growth, thus also increasing the purchasing power of their population and the market potential of their country - thus making their countries more attractive as international franchise expansion markets.

7. Conclusions

Based on an optimal trade-off between market potential and market risks, this study found that in 2015 the Top 10 most attractive countries for US-based international franchise companies were, in this order, Taiwan, Germany, Canada, Sweden, the United Kingdom, Hong Kong, Singapore, Korea, Australia, and Japan. Though relative country attractiveness may evolve over time, it is for the most part remarkably stable as nine out of the Top 10 countries were the same in 2011 and again in 2015.

This study highlights the importance of a strategic approach to international franchise expansion decisions that explicitly takes into account market potential as well as market risks. Some high potential countries such as China, India and Brazil were not ranked very prominently due to their high market risks. However, these countries may still be very attractive for franchise companies that have the financial and managerial resources to be high risk-takers.

Depending on what types of market risks are prevalent, franchising may not always be the optimal mode of entry into a given country. Franchising is generally not the preferred mode of entry into a foreign market with high legal risks where intellectual property is not protected and where the law is not enforced. This is one reason why McDonald’s waited over a decade after its entry into China to start franchising there. On the other hand, where economic and/or political risks are high, entry modes requiring low resource commitment – such as franchising – may be more optimal. A valuable extension of this study is to empirically analyze the relationship between types of market risks and modes of entry into foreign markets to validate the generalizability of these hypotheses.

The model presented in this study can be used as an analytical tool in international expansion decisions. Not only it can help identify the most attractive countries for franchise expansion, it can also serve as a risk assessment tool to study the impacts of different internationalization scenarios.

This study is not without limitations. An evident limitation is that it focuses only on US-based franchise firms. However, this study can readily be replicated in other countries by using data from those countries (cultural and geographic distances, weighting schemes, etc.). A natural extension of this research is to apply the model and the methodology described here to other countries to develop international markets’ attractiveness indices for franchisors based in different countries.

Another important limitation is that the model used in this study incorporated mostly macro variables. Though this helps quickly and cheaply narrow the number of potential target countries to consider, a micro-environmental assessment may be needed to confirm the profitability of these countries. Micro-level factors such as local competition, target country market saturation levels, local wages, local workforce availability, etc. may be important. Thus, a valuable extension of this study is to conduct industry-level and firm-level analyses in the identified target countries to quantify their profitability and share value creation.

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