PROCEEDINGS

Enabling SME Growth through Franchising

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Executive Summary

With their proven business models, management expertise and established brands, franchises represent important opportunities to increase the number of SMEs in Africa. As the economies in the Africa region continue to grow, a significant number of franchises are now operating in many more African countries. Moreover, since franchising represents a lower business risk, the number of franchises in Africa is expected to grow.

The franchising business also faces numerous challenges, ranging from the limited amount of working capital to slow returns on investment. Also, the lack of intellectual property rights protection in Africa has raised concerns from international franchises. In the future, to accelerate the development of franchising, banks should be more forward-thinking, and franchises should be more mindful of their relationship management with financial institutions and intellectual property protection.

The Basics of Franchising

- The franchise industry market is saturated in Western economies. As a result, there is a real effort to expand these systems internationally.
- As the economies in the Africa region continue to grow, and many countries become more stable, foreign investment is increasing. Also, with the rise of middle classes with disposable incomes, international franchisors are increasingly interested in entering regional markets. In this regard, the middle class is larger in Africa than in India, which has a larger population. As such, growing number of franchises now operate in an increasing number of African countries.
- Ninety percent of businesses in Africa are SMEs. As such, the expansion of franchising

could have an enormous impact on SME growth, foreign direct investment and general growth in the economy.

- The franchise industry has many positive development impacts in terms of job creation and contribution to gross domestic product (GDP) growth. In South Africa alone, the franchise sector employs approximately 400,000 people through 757 franchise systems and their 35,111 franchise outlets. The sector contributes 13.3 percent to South Africa's overall GDP. The franchise industry's turnover was estimated at South African Rand 587 billion (US$ 41 billion equivalent) in 2017, compared to R465 billion (US$ 32 billion equivalent) in 2014. This is a testament to the positive growth rates that the sector has experienced in recent years.
- Franchising often entails lower business risks. Research shows that average business failure rates can be as high as 85 percent, whereas in the case of franchising it drops as low as 15 percent. This significantly reduces the risks associated with starting a business, as well as the financial attractiveness of such ventures to financial institutions.
- It is important to understand the various characteristics and categories of franchising. The three M's represent the basic characters of franchising: Mark (license), Money and Marketing. As such, it is important for merchants to consider the franchise laws under every jurisdiction. In addition, different types of franchising exist. For example, a single-unit franchise, although not common in international franchising, gives one individual the license to operate one particular unit. The master franchise provides an entity or an individual with the rights to an entire country or region. They in turn can provide sub-licenses, acting as a franchise organization within their own country. Also, there are many types of franchises beyond the food industry. For example, they may involve educational tutoring, the automotive industry, childcare and professional services.
- There are a number of franchise associations that provide information and assistance for franchising opportunities in Africa, including the Egyptian Franchise Association, the Nigerian Franchise Association, the South African Franchise Association, and the Pan-African Franchise Association.

Franchising Challenges

- There are three major challenges for the franchise system, including access to finance, access to supply chains, and enforcement of intellectual property.
- Supply chains can be problematic in Africa, often involving hundreds of suppliers to run a small franchise, overwhelming the owner with administrative tasks.
- Intellectual property protections may be absent in some African countries.
- From the financial perspective, franchisees often lack the level of working capital required by banks. Due to the traditional thinking of some banks, franchises can find it difficult to secure appropriate financing unless they can provide collateral. In addition, franchises are mainly concentrated in urban areas, creating a misleading image of being expensive. This discourages most of the population in Africa from contributing to the business. Moreover, in Kenya, for example, people in urban areas only account for 20-25 percent of the total population. Efforts to establish copycat businesses can also cut into franchise profits.
- In managing these challenges, banks should be more forward-thinking, and should train their relationship management teams. Relationships between bankers and franchises should be fostered to help bankers to appreciate the difference between traditional businesses and franchises.
- Franchises face difficulties in securing finance because of the relatively slow rate of return on investment, compared to other opportunities such as real estate speculation. For example, in a restaurant franchise that is doing well, you might earn a 20% return on your investment, and get your money back in five years. Continuing in the same business for another five years, after a modest renovation, would then yield an excellent subsequent return, potentially as high as 300 or 400% per year, but only after the first five-year break even. Banks that are unaware of the business model are reluctant to provide financial

support to franchises because they do not have enough experience.
- Sometimes franchises may find the terms of finance unrealistic. For example, a restaurant under ideal running conditions can earn a net profit of 20 percent, whereas the rate at which banks are normally comfortable lending to SMEs is also 20 percent. Therefore, franchises are only able to pay interest, without being able to pay off the principal.
- Franchising, targeted to the bottom of the pyramid, where there is an exploding consumer base, is probably the biggest opportunity in Africa, and that is where FinTech and innovative banks can really make a difference. FinTech, in particular, has the ability to assess risk in a totally different way.

Financial and Regulatory Challenges for the Development of Franchising in Africa

- It is important for franchises to understand the local conditions and accommodate local tastes. For example, when Kentucky Fried Chicken (KFC) was looking to expand its business in South Africa, it could not find sufficient poultry of good quantity and quality. KFC currently sells about 10 percent of the commercially available poultry in the country, which is an enormous proportion for a single business to consume. Thus, franchisors should be comfortable in accommodating local conditions and supply chains.
- Despite the absence of franchise-specific laws across the African continent, there are many laws that can impact franchising. These laws vary greatly from one country to another. For example, there are transfer technology laws in Ghana and Nigeria to govern the transfer of know-how to the local population. Mozambique’s laws are based on the Portuguese legal framework, and look at franchising as an agent. Therefore, it is necessary for franchises to fully understand the legal environment in which they may be operating in the event of takeover or shutdown attempts against their businesses.
- The lack of intellectual property rights protection has raised concerns from international franchises. A basic understanding of any franchise arrangement is that the intellectual property of the franchisor is licensed to franchisees for a limited time and under certain terms and conditions. The “rule of law” is critical to maintaining any franchise agreement and protecting property. Without the franchisor’s ownership of its intellectual property, the franchisor would have no interest in teaching a potential competitor its proven trade secrets. Concerns over the weak protection of intellectual property in Africa have been expressed by several brands, such as McDonald’s and Starbucks. Moreover, examples of recent court decisions underscore the fact that intellectual property expertise varies within Africa.

SME Growth Opportunities in Franchising

- There is great potential for African countries to develop more local franchises. Out of approximately 10,000 different franchise concepts in the world, only 3-4 percent originate in Africa, and 98 percent of them are concentrated in Egypt, Morocco, and South Africa. Thus, there is tremendous opportunity for a unified franchise industry umbrella organization to be established, especially one that addresses local concerns. In addition, efforts should be made to develop indigenous brands/franchises, allowing the industry to grow at a faster pace.