Retail Management
Prof. Swagato Chatterjee
Vinod Gupta School of Management
Indian Institute of Technology - Kharagpur

Lecture – 11
Franchising in Retail

Hello everybody, welcome to this NPTEL Swayam course on retail management. This is Dr. Swagato Chatterjee from VGSOM, IIT Kharagpur, who is taking this course for you. We are in week 2. This is lecture 10 and we will be discussing franchising in retail. So, we were discussing about the ownership formats of retail, and under the ownership formats one of them is franchising. So, what is franchising?

Franchising is a kind of retail activity while the owners are giving the brand name and the operational instructions and sometimes the raw materials as well to the retailer who runs the show. And the retailer has his own space. The franchisee has his own space and he or she is also having investing the amount of money to create the infrastructure inside that space and the selling activity and marketing activity in the local places is done by the person who has taken the franchising contract.

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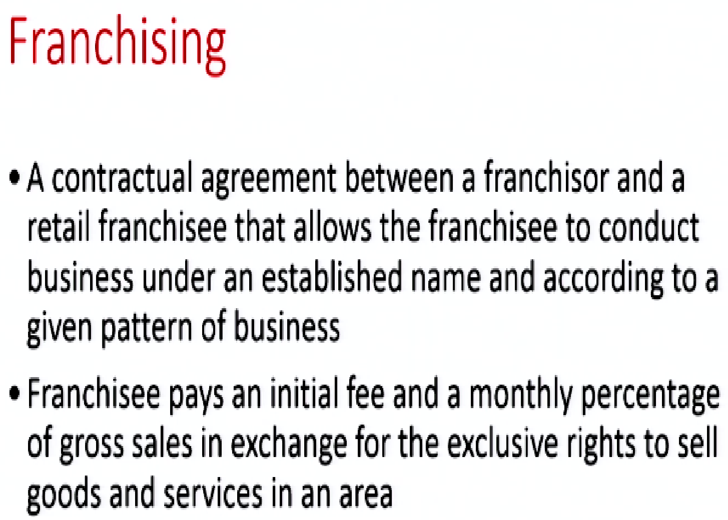

So, this is an activity, a contractual agreement between a franchisor and a retail franchisee that allows the franchisee to conduct business under the established name and according to a given pattern of business. So, the brand name is given and the operational instructions are given that is under which you do the operations. So, the franchisee has everything else. He has to give everything else. The manpower, the resource, the space, the investments, everything will come from the franchisee.

The franchisor will give you the brand name, established brand name and an established operational instructions or type of operation probably. Franchisee pays an initial fee. So, to become a franchisee you have to pay a fee and a monthly percentage of gross sales in exchange of exclusive rights to sell the goods and services in an area. So, you have to pay the franchisee fee because what?

Because the franchisor will guide you how to create the store, what kind of operations has to be done all that training activity to do the business as per the franchisor's requirement or as per the franchisor's set procedures that training activity and consulting activity will require certain initial amount of fee. Also by paying that initial amount of fee, the franchisor are giving you exclusive right to do business in a particular area.

The franchisor is assuring that he or she will not let anybody else to do business in their name in that particular area, so that rights has some price and the consulting activity for how to make the retail store has some fee that is your initial fee that you pay. Then you use the brand name, every day you are using the brand name and selling the product, every day you are using the products of this particular company and selling it, so that is the monthly percentage of the gross sales that you have to pay. The rest is yours as a franchisee, so that is the business.

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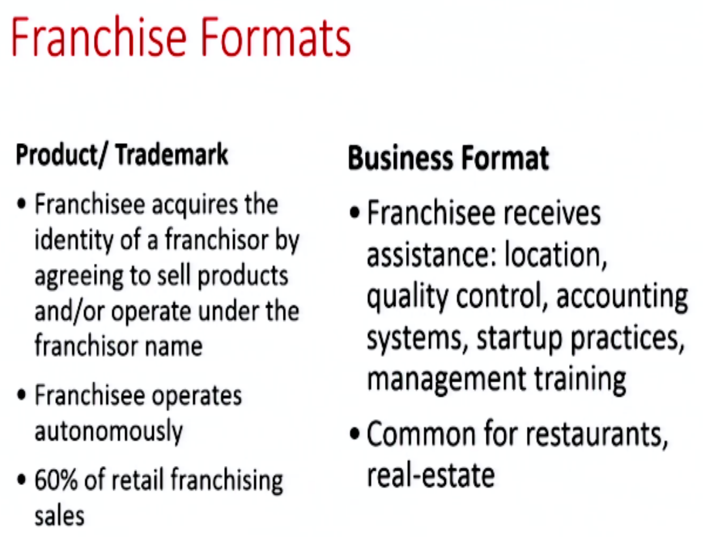

So, what are the various formats? Either you can give the product or the trademark or the business format itself. So in the first one franchisee acquires the identity of the franchisor by agreeing to sell products or operate under the franchisor's name. So the brand name is something that is given. But franchisee operates autonomously. There is autonomy there. Sso how you will sell is up to you.

So 60% of retail frachising sales happens like this. For example you will see there are lots of pharmacies who are business doing like this, lots of diagnostic centers do business like this. So let us say you have taken a franchisee diagnostic center, the diagnostic activity, etc., happens in a centralized lab, but you are basically a collection agent. So the persons whom you will basically hire or employ will depend on you.

The franchisor will give you certain instructions like let us say Apollo Diagnostic or or let us say various other diagnostic centers are there. So, they will give you certain instructions, but the franchisee will ultimately run the show. How much price will be charged? What kind of services will be given? Home delivery at up to how much distance from delivery will be given or home collections will be given, etc.

In what speed the emails will be sent, all these things, all the other decisions, how much is the space, how many people will I employ as the collection agents these are all decisions of probably the franchises. But they are using the franchisor which is in this case the Apollo Diagnostic or Appollo Clinic their name. But in some other cases the business format, everything how to run the business you get assistance from the franchisor.

So, franchisee receives assistance based on the location, the quality control, the accounting system, the startup practices, the management training, so every step of the management will be governed or probably will be supported, will be at least assisted by the franchisor. It happens in case of Domino's, it happens in case of Pizza Hut. So, it is a vertical marketing system, but the retailing contracts are like that. It is a franchisee contract and common for restaurants and real estate as I just told you.

So, these are the two different formats. One format is you are only using the brand name and rest is majorly yours, here you are using the brand name and the operations as. Now, how will be the distance, means how much involvement of the franchisor is in the business activity?

How much involvement or assistance is required from the franchisor in the business activity leads to different kinds of relationship between the franchisor and the franchisee.

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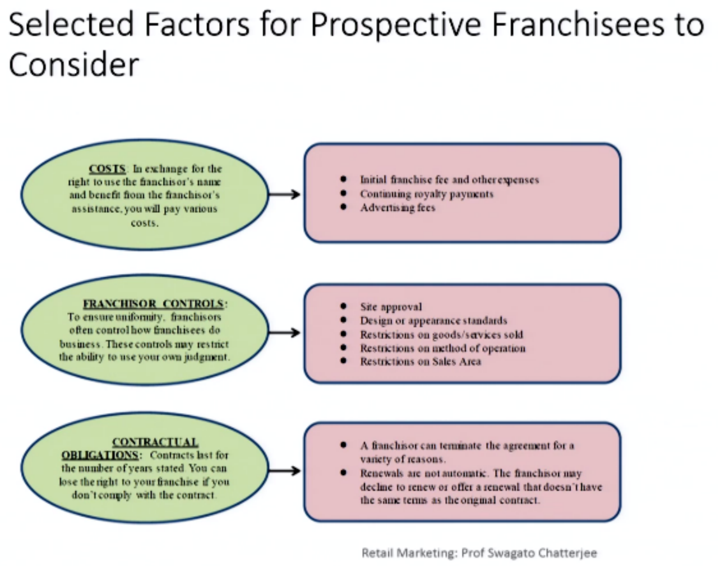

What are the selected factors for prospective franchisee to consider? If I want to be a franchisee what should I consider? The first thing that I should consider is the costs. In essence for the right of use the franchisor's name and benefit from the franchisor's assistance you will pay various costs. What kind of cost? The initial price franchisee fee as I told, continuing royalty payments which is a percentage of the sales that is second and the advertising fees.

So franchisor does the advertising. How will they take up the advertisement? Centralized advertisement that is done by the franchisor which is the TV ad. In the TV ad you do not go see ads of Domino's of a particular store. For example I am from Kharagpur, I do not see Domino's Kharagpur's ad in TV. So Domino's ad that comes in the TV will be centralized. But the leaflet that I get with the morning newspaper in my local area will be probably done by the local franchisee.

So that advertisement fee is taken care of by the franchisee, but TV ad which is centralized which is basically benefiting everybody how will that price will be shared? Who will incur that cost? So that cost these franchisor will take certain cuts from the franchisee. So this is where the potential conflicts also comes up, we will talk about that in some time. That one franchisee may feel that I do not require the TV ad, why are you doing TV ad?

These people are anyway students, they are anyway socialize to somebody who has opened up a retail store inside a university campus. They know that the students are hungry. There are not much options available, students will anyway come, I do not require that ad. And these students do not watch TV. You are giving TV ads, they are all in Netflix and other OTT platforms, they do not watch TV anymore.

TVs are seen by people who are senior or probably who do not have internet access right now. So why would I bother about that? So you may start feeling that. So if that kind of feeling comes up, then the potential conflict comes up that I have to pay advertising fees because everybody is paying, but I am not reaping benefit out of it. Franchisor controls that is another factor.

The control means to ensure uniformity, franchisors often control how franchisee do business. These controls may restrict the ability to use your own judgment. So, basically how much I would say independence you are getting as a franchisee also is an important factor. So site approval, design approval, restrictions of goods and services sold, restrictions of method of operations, restrictions on the sales area; all these things will sometime create problem.

So, that is also some of the things that the franchisee has to consider before they go for franchising contract. And what are the obligations of the contract? For example, contracts last four numbers of us stated, you can lose the right to your franchise if you do not comply with the contract. So, then what are the contracts that are there? What are the obligations that are there? The franchisor can terminate the agreement for a variety of reasons and renewals are not automatic.

The franchisor may decline to renew or offer renewal that does not have the same terms as the original contract. So, if the year let us say after 4 years, 5 years contract, the franchisor found out that okay this franchisee is not working properly or the overall brand image of the franchisor getting affected for some reason I do not know. So if they think like that, they might not renew it or they might agree to renew it with certain other terms and conditions and other costs involved then that might lead to a breaking of the relationship.

So, if that brigades broke and that relationship gets broken, then there is a potential problem. Then what is the exit clause? If the agreement gets broken, what kind of losses I will face or gains I will make as a franchisee. So, costs, restrictions and exit clause these are the three major things that a franchisee should consider when they go further contractual agreement and these are not very uncommon.

For example, I have seen there is a very well known Bengali restaurant if I can give that particular name, who had a store in Bhubaneswar, who had a franchise in Bhubaneswar. So it was based out of Calcutta and they opened a franchisee in Bhubaneshwar. It ran properly. There was quite a bit of inflow of people there and then there were some contractual problems.

It might be related to I would say the people who are managing there how or the quality of services that were giving, so it was getting affected. Slowly, the image was getting affected and the franchisor decided that okay we will move out from this particular location. So they did not renew the contract and once they did not renew the contract, the Bengali restaurant is still going on in Bhubaneshwar, but it is not in the same label anymore.

Now, the franchisee might feel that okay there are two kinds of outcomes that the franchisee can feel. One is that I have invested so much and I have invested in my employees, I have trained my employees and now all of a sudden the franchisor goes away, so what will I do with this trained employees? They are trained to make Bengali dishes, they are trained to deal with Bengali customers, what would I do here?

So, one way of dealing with this situation is that you continue the business with a new name. The advantage is that that you do not have to pay any franchisee any cost to somebody else, all the profit is yours, but the disadvantage is that you do not have the pool. Now, if you have already created local level of associations, if local people know about this particular brand, irrespective of the overall brand in the franchisor brand then some of the people may come here.

So, you can rely on that benefit and even create your own brand image over time as well, so that is what this retail store, this restaurant is trying to do. So that is another outcome of the exit of contractual agreement.

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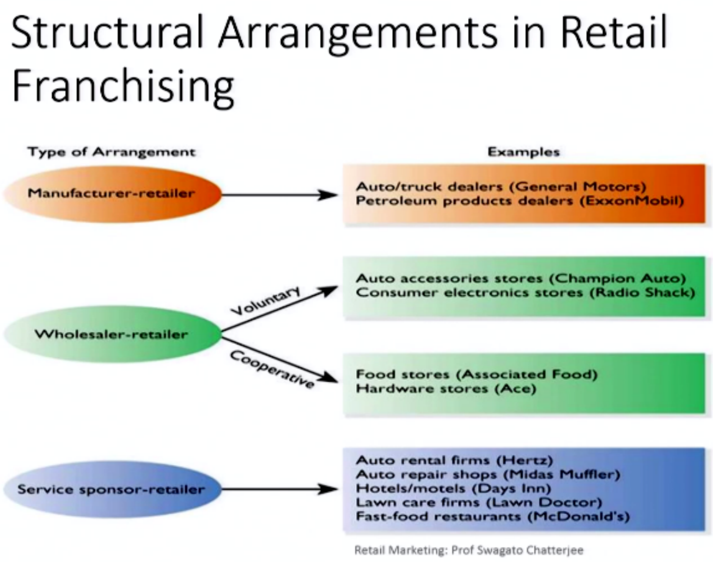

And then there are structural arrangements in the retail franchising as well. So, what are the different kinds of contracts, who comes in the contract? The manufacturer and retailer can come in the contract which is most common like auto or truck dealers or petroleum product dealers are basically where the manufacturer the retailer comes, like all your petrol pumps if you see.

So, the manufacturer will basically give the petrol or diesel to this particular place and the petrol pumps will sell it to you, so that is a manufacturer to retailer relationship. Then there are contractual agreements between the wholesaler and retailer. For example, certain times wholesaer and retailer comes in a voluntary agreement or certain times they come in the corporate agreement.

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Wholesaler-Retailer Structural Franchising Arrangements

- **Voluntary:** A wholesaler sets up a franchise system and grants franchises to individual retailers
- **Cooperative:** A group of retailers sets up a franchise system and shares the ownership and operations of a wholesaling organization

So, voluntary agreement is a wholesaler sets up a franchisee system and grants franchisee to individual retailers. On the other hand in a cooperative system a group of retailers sets up a franchisee system and shares the ownership and operations of a wholesaling organization. So, I chose 10-15 retailers comes together, they own the wholesaling and they then from that wholesaling which is owned by 15 retailers the products come to the retailers individually.

So, example of voluntary one was auto accessory stores like Champion Auto or Radio Shack is a very good example consumer electronics stores. And cooperative are food stores or hardware stores like Associated Food or Ace. You will get similar examples in India as well. The third one is service sponsor and retailer. So, the first two are product oriented, they are not service oriented. The third one is service sponsor, the person who gives the service and the retailer.

For example, McDonald's or Pizza Hut where I am basically the service provider. I am not selling burgers in McDonald's, I am selling that food retailing basically, the experience is what I'm selling. So, I am basically service sponsor and you are the retailer and we come together in a contract. So, how hotels or motels or auto repair shops like Midas Muffler and auto rental firms like Hertz are these kind of examples. So, these examples are there all over India at various places.

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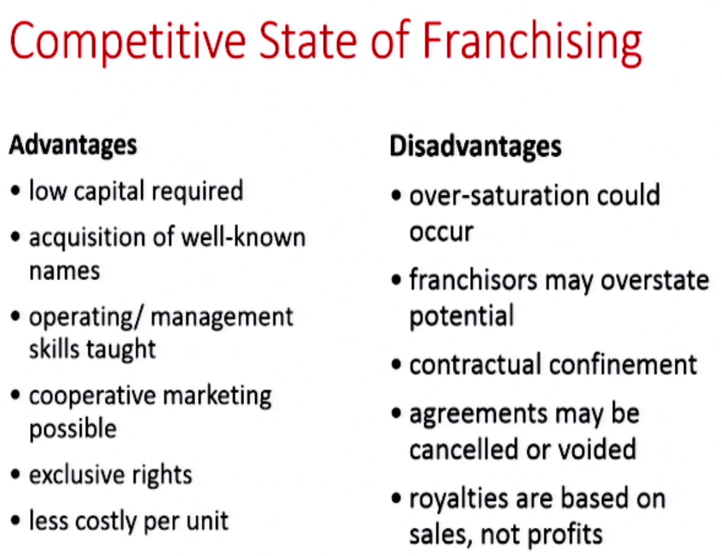

What are the advantages and disadvantages? So, first of all for the franchisor at least the capital requirement is low, sorry this is for franchisee that a low capital required because you do not have to create the brand, you do not have to create the whole setup, sometimes you have to only invest on the infrastructure that is there for your retail store and you get benefits of the brand name, of the offset, operations, etc.

Acquisition of well known names, operations and managements are taught to you, cooperative marketing is possible, the one that I just told that the advertisements might not be benefitted for you. In some cases advertisements, TV ads or print ads or digital ads which are clubbed for various retail stores together sometimes it is beneficial for you and if it is beneficial for you then that is an advantage.

You have an exclusive right of a catchment area that is also an advantage. Less costly per unit, so, per unit production will be less costly because this will be shared by various people. But the disadvantage is sometimes there can be oversaturation, too many franchises are there you did not know or you did not basically guess because before you go for the contract, it will be very difficult for you to know that whether I should go into contract because you might not know the underlined figures.

So oversaturation could occur. Franchises may overstate the potential. So basically franchises are selling this particular business opportunity to you. So when they are selling before the contractual activity is a sales activity by the franchisor to potential franchisee, so they might oversell. They might say that this is a very lucrative job offer, why do not you come and blah blah blah and then when you came and invested your money and came into the franchisee you found that it is not so lucrative.

So, that might create a problem. There can be contractual conflict as I told. Agreements will be canceled and voided at certain point of time. Royalties are based on sales, not profits. So, you might have hired because you have to run the show, how much cost you incurr to run the show is on you. So, the manufacturer or the person who is letting you use the brand name might say that I will not give you money based on the profit that you generate, but based on the sales that you generate.

The sales is where I will take a margin because profit will ultimately depend on your operational efficiency and if you do not have the right cannot do anything. So, that is another disadvantage that the franchisees face.

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From the franchisor's perspective, what are the issues? Obviously, the benefits are that you grow, the first benefit is you grow. You have a national or global presence possible. Your qualifications for franchisee or operations are set and enforced, so you decide the terms, you decide how it will be done, etc. Money obtained at delivery.

The moment your product whether the product is sold or not sometimes or how the product is sold, how much costs are incurred to sell the products do not bother about that, you take a cut of the sales and royalty represent revenue stream. So, whatever is the revenue stream corresponding royalty you get. So, you do not have to bother a lot, you set your standards and you have a global presence. These are advantages.

But obviously, there are certain disadvantages for the franchisor as well. So, for let us say Domino's as a company, it also has certain disadvantages to go with this this kind of business. So, like departmental store, leased departmental stores the same thing here if one franchisee he had certain problem that impacts the whole brand, so that is one. Lack of uniformity may affect customer loyalty.

So, if I am a loyal customer of let us say Domino's I might want the similar kind of service standard in every Domino's store. The taste of the Domino's products should be similar. If I do not get that that impacts my loyalty, I might feel that how will I rely on this brand name, here I get something, there I get something else, so that should not be there, there has to be uniformity. Lack of uniformity which comes from lack of control effects customer loyalty. Ineffective franchisees may damage resale value or profitability.

So, if some of the franchises are not effective, they are not working properly that might impact profitability. And potential limits to franchisor rules, so you cannot do lots of control, there will be certain place you have to let it go and that let it go might create a problem and this is a very key challenge that how much as I told you the lease department also here also how much to keep in my hand and how much to let go is something that is an important decision for franchisor.

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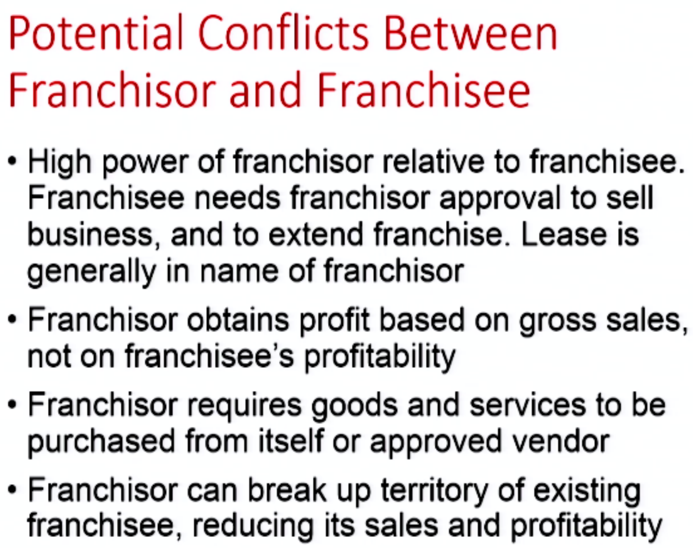

and what are the potential conflicts? I told about this thing that some of the potential conflicts that can come up, what are they? For example, the power distance, who is controlling it, whether the franchisor is poking his nose at every point or not poking his nose at every point. Franchisee needs franchisor's approval to sell business and to extend franchisee. Lease is generally in the name of the franchisor.

So, who has the control on the show is something that may create a conflict. Franchisor obtains profit based on gross sales, but franchisee does not get, so this is a problem. So, whether I make money or not franchisor will make money from the sales so that creates a problem between the franchisee and the franchisor. Franchisor requires goods and services to be purchased from itself or approved vendor, so that is also sometimes franchisot.

So, let us say certain products you do not want to buy from, so you as a franchisee think that product quality of vendor A and vendor B are better and vendor B is getting better price, but vendor A is approved by my franchisor. So though the quality is same, I can make better profit from him, but just because this guy has not approved the vendor B, I cannot buy it from vendor. So this might one want first time, second time, people might say that you do not come to the contract.

It is not that easy because you come to the contract, but after coming to the contract you might feel differently about the contract. And because the franchisor does not have always the control on the franchisee, the franchisee might become motivated to do a little bit some of the operations outside the contract, it is very difficult to control that. But at the end of the day if something happens that will damage the brand.

You can sue the franchisee if the brand is damaged, but there is a limit up to which you can take the money out of the franchisee. Other things you have to incur on your own. So, then there is a potential conflict that there can be chances of monetary losses if the franchisee does not work properly as per my rule and franchisee may feel that though he agreed while signing, these rules are unethical or not profitable for him and he can do something else.

If that is done, that is the route that the franchisee takes then the franchisor has a problem. There is a potential of conflict that may come from there. Franchisor can break up territory of existing franchisees, reducing its sales and profitability, this is another thing. So you have given me the exclusive rights initially for the initial 5 years let us say, and when you are renewing it, you came up with new kinds of rules and in that new rules probably have broken the territory. So if you have broken the territory, then I face a problem.

Let us say before the contract is gone, you send me a notice that this territory will be broken, sign your approval, why face a problem as a frachisee. As as a franchisee I face a problem because either I have to go out of this contract, I have already invested money, I have to go out of this contract or I have to basically agree with this new system. Now, if both is not profitable for me, I will go to the civil court, civil court the judicial system.

If that takes longer period of time, then that is a loss in the business. So if the final justice that we will get from the judicial system is more than the potential cost, expected justice is lower than the expected I would say cost or expected losses, then I would probably not go for the expected justice, I will not go through the justice. So, I will agree off on whatever contract these guys are giving me.

So an expectation comes from what is expected justice. Expected justice is basically probability that you will get justice multiplied by the amount of money that you will get when justice prevailed that is your expected justice, right. Now, the probability and the amount these two is not so much strong in certain judicial systems in certain countries. Now, if that is the case then that there is a problem and it might get elongated.

It might take a long period of time, you might lose your patience to fight a long legal battle with your franchisor who is potentially more stronger than you. So if that is the case, you might not go for civil lawsuit against them. So these kinds of conflicts becomes an important factor which a franchisor and the franchisee has to think before they come into a contractual agreement. So that is where I will stop here. Thank you very much for being with me. I will see you in the next week.