

MarketLine Case Study

Franchising

Foodservice and hotel companies
grow using franchising

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OVERVIEW

Catalyst

US-based companies have used franchising as a route to expansion for many years. While the business system franchise model is only viable in certain sectors, such as foodservice and lodging, certain leading players in these industries now operate almost exclusively as franchisors, with very limited activities as operators of their own restaurants or hotels. This Case Study explains why the model is so attractive to franchisors, and also explores some of the downsides.

Summary

- Franchisor companies' market capitalization has been outperforming the S&P 500 index for several years.
- Product distribution franchising is similar to a supplier-dealer relationship; business system franchising involves a closer relationship between franchisor and franchisee, and will be the focus of this study
- Franchising is only appropriate for some industries, generally those where uniform products and strong brands are important but capital barriers to entry for franchisees are relatively low. In the US, franchising is very significant in foodservice, hotels, and retail. In these industries, it accounts for a substantial percentage of both the number of business establishments and workforce.
- A value-chain analysis of Burger King shows that the primary activities of Burger King itself are not the same as the primary activities of the whole system. The system is in the business of offering foodservice to consumers, but Burger King as a corporation is mainly involved in the development and deployment of intellectual property: product design, branding and marketing, and business process development and training.
- A SWOT analysis of leading US hotel chains reveals the advantages of multi-brand franchising in defending revenues in a cyclic industry and expanding into developing markets. It also suggests that finding reliable franchisees with good access to credit, and defending intellectual property in certain countries, may be key challenges.

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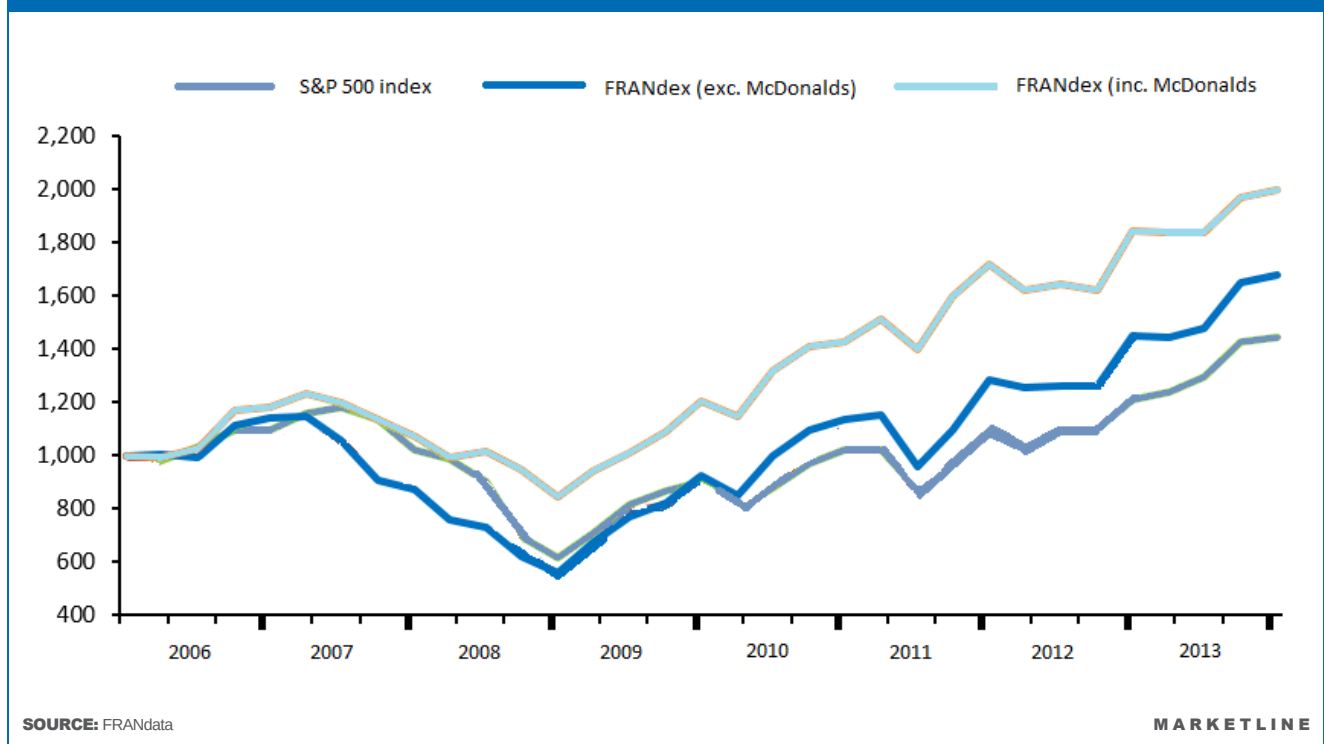
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MAJOR US FRANCHISOR COMPANIES CURRENTLY OUTPERFORMING S&P 500 INDEX

In Q1 2014, franchise research company FRANData published its latest FRANDex results. The FRANDex tracks the market capitalization performance of more than 40 US-based public corporations which use business format franchising as a significant part of their strategy. This showed that since 2010, the FRANDex has outperformed the S&P 500 consistently. In fact, if McDonalds is included, the franchisors have outperformed S&P 500 since at least 2006.

Figure 1: Comparison of franchisor market cap and S&P 500 index, 2006-2013



This Case Study will explain what franchising involves, and why it has led to commercial success for the major franchisors.

Product distribution franchising is similar to a supplier-dealer relationship

One approach is for the franchisor to allow a company to distribute its products. For example, a car manufacturer will usually have a network of dealerships offering its vehicles to the end-user, rather than operating its own chain of showrooms around the country.

At first sight, this may appear to be no different to a manufacturer of, say, household products distributing them via retailers, rather than trying to run stores of its own. In fact, the manufacturer-franchised distributor relationship is considerably closer than this. It may involve exclusivity, so that a dealer selling one manufacturer's cars would not be able to sell its competitors' cars. The Coca-Cola Company's 275 franchisees are responsible for taking the syrups that Coca-Cola itself manufactures, and then creating the finished beverages by adding carbonated water, bottling them, and distributing to retailers and foodservice outlets within a geographical area. Some may offer products from other manufacturers, but Coca-Cola brands will be highly important to their operation, most of them have the phrase "Coca-Cola" in their company names, and The Coca-Cola Company may hold equity in the bottling company. However, it is generally assumed that the franchisees already know how to run their business.

Business system franchising replicates an operational model in many locations

Business system franchising is the alternative model. Here, the franchisor goes beyond licensing a franchisee to offer its products, it provides an entire operational system. The franchisee is given detailed training on the layout of premises, visual design and branding, what equipment to install, marketing, recruitment of staff, product preparation, and so on.

This mode of franchising is common in the fast food and hospitality industries. The franchisor first develops a highly successful way of operating; this tried-and-tested system is then replicated at multiple geographical locations by franchisees rather than by the company itself. The franchisor obtains revenue from the one-off start-up fee paid by the franchisee and from royalties paid as a percentage of revenue. The remaining revenue is retained by the franchisee, who is responsible for all the costs.

The remainder of this study will focus on business system franchising.

Franchising is significant in several industry sectors in the US

The International Franchising Association reported in Q1 2014 that franchised businesses account for 3.5% of US GDP. More than 770,000 business establishments (physical locations) are franchise operations. They employ more than 8.5 million people, or 6% of the US employed population.

Franchises are particularly common in certain industry sectors. The following table shows franchised establishments and their employee numbers as a percentage of the total number of establishments and workforce in these sectors.

Table 1: US industry sectors with substantial incidence of franchising, 2011

Sector	Establishments	Employment
Accommodation	42%	39%
Food services and drinking places	33%	45%
Real estate	26%	16%
Retail trade	15%	7%

SOURCE: US CENSUS, INTERNATIONAL FRANCHISING ASSOCIATION

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It is common for a particular company in sectors such as these to have a balance of company-operated and franchised establishments. Thus, in FY 2013 global hotel chain Wyndhams had two hotel properties that it owned and operated, 58 which it managed directly on behalf of other owners, and 7,425 franchised hotels. McDonalds on the other hand favored a more even balance, with 81% of its system quick service restaurants under some form of franchise, compared to 19% that it owned and operated itself. Maintaining at least a few locations under its direct control enables the franchisor to test out new products, services, design, and so on before rolling out to the entire system.

FRANCHISING WORKS BEST WITH UNIFORMITY, STRONG BRANDS, LOW CAPITAL INTENSITY, AND PHYSICAL OUTLETS

Not all businesses are best expanded through franchising. Some criteria are as follows:

The company has a very uniform product range

A typical franchisor wants to offer identical products at all its locations. Customers going to McDonalds expect the burgers to be the same size, same taste, and cooked in the same way wherever they buy them; if one branch of Starbucks offered coffee much stronger or weaker than its neighbor, customers would be taken aback. As the franchisor company has learned from its experience in the market what its customers want to consume, it is important that franchisees do not deviate from this.

Conversely, a company that offers highly customized products or services to its customers would be a poor candidate for expansion via franchising. Law firms and advertising agencies need to assess the requirements of each client individually and provide bespoke advice. It would be difficult to develop a system franchise package that could be offered to a franchisee with no experience of those markets.

Brand strength is an important asset

Franchising allows expansion by the rapid deployment of new outlets. However, if this is to translate into rapid sales growth, customers must recognize (and like) the brand. If they do not, then a new outlet would be in the same position as any independent start-up in that market.

Figure 2: Instantly recognizable? Burger King's logo supports its brand



SOURCE: Burger King

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In some industries, the intellectual property of brand strength is less important, and R&D-led intellectual property is more significant. For example, when healthcare providers decide what drugs to purchase, they are unlikely to ask whether one company has a better brand identity than its competitor, but will look at the results of clinical trials to determine which offers the more effective therapy. Business system franchising would be a non-starter in the pharmaceutical industry. However, something akin to product distribution franchising can occur. A company might license another pharma player to produce one of its patented drugs, perhaps to access a particular country's market.

The industry is labor intensive, with a predominantly low-skilled work force

Franchising is common in the foodservice, retail, and hospitality industries, which tend to be labor intensive. Attempts to replace staff with technology have yielded mixed results. For example, the "Automat", a form of automated restaurant, was launched in the US in the early 20th century, but fast food outlets ultimately took over from them. Self-service checkouts in supermarkets are becoming more common, but other functions such as shelf replenishment in stores, or cleaning in hotels, are still very much the domain of human workers. Furthermore, the majority of the workforce is relatively low-skilled. This means that it is usually simple to recruit suitable employees, rather than needing complex assessments of what a potential new hire could add to the company.

However, industries that are capital- rather than labor-intensive are another matter. Suppose an aluminum manufacturer such as Alcoa wants to expand its capacity. Perhaps it could offer a large number of franchisees a back-yard micro-smelter kit that can be built for a \$10,000 investment, plugs into the household electricity supply, and produces a small amount of aluminum each year? This, of course, is not going to happen. The fixed-to-variable cost ratio of aluminum smelting is such that it is only realistic to carry it out in a small number of huge facilities so that scale economies come into play. This requires a correspondingly huge capital expenditure, beyond the reach of the individuals and SMEs that might consider buying a fast food franchise.

Online transactions are not a significant threat in the industry

Business system franchising is fundamentally about adding more physical outlets to the system network in order to access more customers. If online transactions can replace sales in physical locations, there may be limited benefit to increasing the bricks-and-mortar network, at least in the long term.

For example, CD and DVD stores are under pressure from iTunes and other online retailers of digital downloads. Since music and video can be digitized with little or no loss of quality, and media player hardware is ubiquitous, many consumers will see little benefit in scanning through racks of CDs in a traditional store. It is irrelevant to the online buyer whether the downloaded file comes from a server in the same city or on a different continent.

However, foodservice does require physical proximity. Even if food is ordered online, the restaurant must be near enough to deliver within a few minutes, and there is currently no way of converting food to a digital format and then back again. Likewise, personal services such as hairdressing or dry cleaning cannot be carried out remotely and are candidates for franchising. Companies such as Dryclean USA, Comet Cleaners, and Toni&Guy are examples of personal service franchisors.

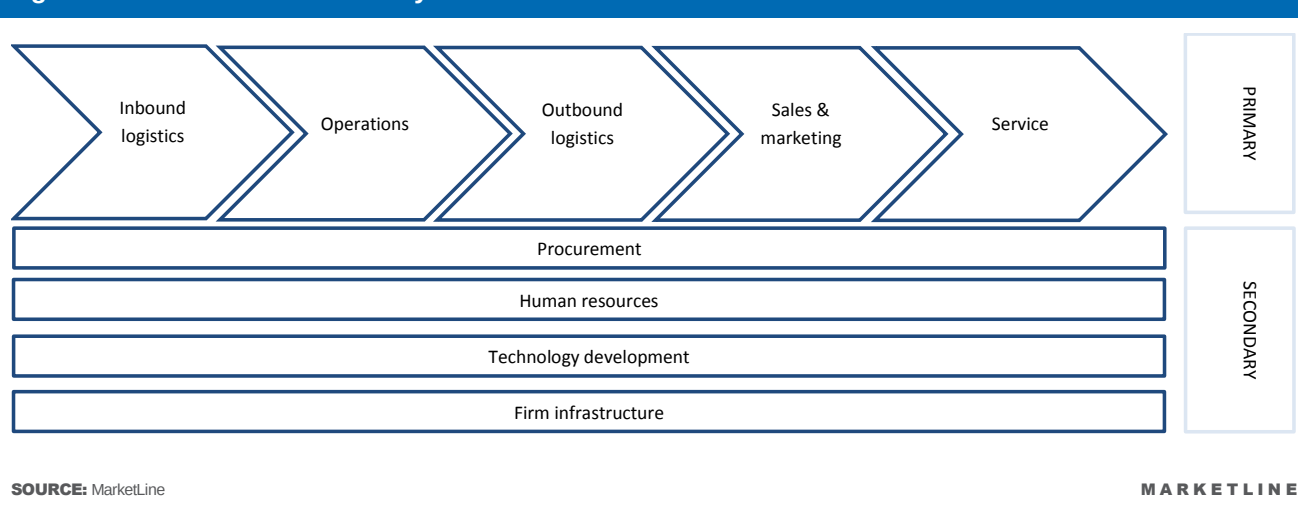
Centralized back-office functions offer a significant economy of scale

One benefit of business system franchising is that certain common functions can be centralized, because each franchise is a replica of the same basic business operation. These functions include advertising and marketing, product development, training, and so on. Without the need to duplicate these functions at every outlet, franchisees save their own time and resources, and there are the expected scale economies arising from centralization.

VALUE-CHAIN ANALYSIS OF BURGER KING HELPS EXPLAIN ITS FRANCHISING STRATEGY

Value-chain analysis examines the primary and secondary activities of a company, to determine how it can improve competitiveness by focusing on low cost or differentiation. Many such analyses of quick service restaurant companies are available. However, they tend to look at the system (franchisor plus franchisees) as a whole. What is revealed by looking how the system divides activities between franchisor and franchisee?

Figure 3: The classic value-chain analytical framework



As an example, we can look at Burger King. Worldwide, it has 13,667 restaurants, of which 13,615 (99.6%) were franchised as of FY2013. It continues to own and operate 52 outlets in Miami, Florida, but the remaining 7,103 US restaurants, and all its non-US locations are franchised. The years 2011-2013 saw a significant number of company-operated restaurants within and outside the US being converted to franchises.

The company uses two forms of franchising. In one, the company works directly with the owner of each restaurant, who pays a one-off fee at the beginning of their tenure and at each renewal (occurring at 20-year intervals), and then 4.5% royalties on revenues. In the other, a master franchisee has exclusive responsibility for all operations in a geographical area. The master franchisee is generally a company with a strong supply of capital, and depending on the terms of the partnership may be able to offer sub-franchises to other owner-operators.

Primary activities are those in which value is created directly

A company creates value by transforming inputs such as raw materials and labor into outputs, goods and services that can be sold to customers for a higher price than the inputs cost. In value-chain analysis, activities that are directly involved in this wealth creation are termed primary activities.

Typically, these include:

- inbound logistics - raw materials and other inputs are received and warehoused
- operations - the raw materials are transformed into marketable products
- outbound logistics - processing customer orders and dispatching them
- service - maintaining assets such as equipment
- marketing and sales - setting prices, communication and advertising, developing distribution channels

As explained below, Burger King has some involvement in procurement by authorizing suppliers of food, equipment, and so on. But as a franchisor, it is not responsible for the details of either receiving raw materials, storing them, processing them, or delivering finished products to restaurants or final customers.

The company will need to maintain its company-owned restaurants, and of course its own office buildings, IT infrastructure, and so on, like any large company. But franchisees are responsible for the upkeep of their premises.

As of FY2013 Burger King owned and leased back 1,845 properties to franchisees in North America, and normally uses "triple-net" contracts in which "the franchisee is obligated to pay all costs and expenses, including all real property taxes and assessments, repairs and maintenance, and insurance".

Burger King is more closely involved in marketing and sales activities. It has central control of the product lines offered by restaurants, and their retail prices. Trademarks and branding are important intellectual property assets for the franchisor. In its FY2013 annual report, Burger King stated "We depend in large part on our brand, which represents 39% of the total assets on our balance sheet as of December 31, 2013, and we believe that our brand is very important to our success and our competitive position. We rely on a combination of trademarks, copyrights, service marks, trade secrets, patents and other intellectual property rights to protect our brand and branded products."

Furthermore Burger King is able to establish a fairly uniform visual design to its franchised restaurants. For example, by 2015 it aims to have 40% of its US restaurants re-imaged in its new "20/20" design, which has an industrial esthetic. To do so, it is offering finance to its franchisees to help cover the typical cost of around \$300,000-350,000 per restaurant. The remodeled restaurants are said to gain 10-15% annual sales enhancement, and the mean annual revenue for a franchised restaurant in 2013 was \$1.2m, so the investment should pay for itself in three years or so.

In a highly competitive consumer market such as fast food, advertising is very important. Franchisees are obliged to pay 4-5% of their revenues into advertising funds, which are managed by Burger King in the US and some other countries, and by master franchisees elsewhere. Burger King maintains quite stringent control of advertising and other aspects of marketing. In the US, and other countries where it manages the advertising fund, it controls budgets, media spend allocation, and so on centrally. Its global marketing division offers guidance to franchisees in countries with local control of the fund, so that a global brand message is maintained.

Secondary activities support the company's primary activities

Secondary activities do not directly add value, but are important in providing the organizational framework in which the primary activities can occur. Typical of secondary activities are:

- procurement - purchasing of raw materials and consumables, and capital items such as equipment
- human resource management - recruitment, promotion, staff development, and related functions
- technology development - developing expertise, processes, and technology needed across the business
- firm infrastructure - general management, planning, accounting, compliance, and similar

In the US and Canada, Burger King purchases equipment, food, beverages (other than soft drinks), and other supplies via an agent, Restaurant Services, Inc. (RSI), a not-for-profit purchasing cooperative. RSI is also authorized to act as an agent for franchised restaurants in the US, and as of 2013 it represented 91% of these. Burger King is tied into long-term agreements with The Coca-Cola Company and Dr Pepper/Seven Up, under which its system restaurants are committed to buying certain minimum volumes of soft drinks from these companies. Outside North America, Burger King authorizes suppliers for its franchised restaurants, using the same criteria it uses for the US and Canada, but is not directly involved in purchasing.

As with inbound and outbound logistics, Burger King has essentially outsourced the day-to-day processes of purchasing, invoicing, and so on to its franchisees, while maintaining centralized control on standards and specifications.

Burger King had 2,420 employees in FY2013, staffing its company-operated restaurants, support centers, and field operations.

A workforce of this size places Burger King squarely in the category of large corporations, rather than SMEs, and its HR function will reflect this. However, according to Statista, the average number of employees in a US quick service restaurant in 2013 was 15.7. Thus, globally, Burger King's 13,667 restaurants employ perhaps 215,000 people in some capacity. If the franchise owners themselves are included, since operationally they have a similar role to middle- or senior management employees, and Burger King's own workforce, the total system-wide number rises to nearer 231,000. This is considerably more than General Motors, for example.

Without franchising, the costs of HR management would rise to those of a company nearly a hundred times larger in terms of workforce numbers.

Hidden under the category of Technology Development is perhaps the most important aspect of Burger King's business: the development and refinement of the franchisor's business system that it provides to franchisees. As the company describes it, a franchise arrangement gives the franchisee the right to operate restaurants "using Burger King trademarks, trade dress and other intellectual property, uniform operating, procedures, consistent quality of products and services and standard procedures for inventory control and management."

To ensure that all outlets are operated in a consistent manner, Burger King requires franchisees and restaurant managers to undergo initial and ongoing training, both in the classroom and on the job. It has invested in its BK GURU digital training and communication system to support this. It also has in-house "Sales, Profits and Operations Coaches", who work with franchisees to improve the customer experience and therefore sales. The result is that customers receive a uniform experience in Burger King restaurants around the world, in terms of the menu offered, the taste and quality of the food, pricing, restaurant design, and standards of customer service.

Burger King has little involvement in the primary activities of the system

The entire Burger King system, like any foodservice organization, creates value by sourcing food and beverages, cooking them, and serving them to customers in restaurants.

However, value-chain analysis of Burger King itself, in comparison to the system as a whole, shows that the franchisor has made strategic decisions about which parts of the business to assign to franchisees, and which to retain in-house. Key differentiators from competitors, such as brand, marketing, and menu, are strictly controlled from the center. Scale economies are exploited for the system as a whole, for example using Restaurant Services to negotiate with suppliers exploits the bulk buying power of the system, thereby reducing costs. On the other hand, the franchisees are responsible for those aspects of the business in which there is no benefit to centralized operation such as recruiting serving staff, buying, cooking, and selling the food, and maintaining the restaurant premises.

Its own primary activities are focused on intellectual property

What are the primary activities of the Burger King company itself? Essentially, it develops and sells (or more accurately rents out) intellectual property. Development of product recipes, business processes and training, brands, and marketing services are at the heart of its business model and constitute its primary activities. Its own tiny roster of restaurants although significant to its revenues, are less so to its profits, and could ultimately be re-franchised. Their main role at present is to act as a test bed for innovation.

Moving restaurants from company-owned to franchised has been accompanied by rising profits

Since 2011, Burger King has adopted a strategy of refranchising virtually all its company-owned restaurants, leaving just the 52 Miami-based outlets under its direct control. The financial results are summarized in Table 2.

Table 2: Financial results of Burger King refranchising strategy

Indicator	2011	2012	2013
Company restaurant revenues, \$m	1,638.7	1,169.0	222.7
Franchise and property revenues, \$m	701.2	801.9	923.6
Total Company restaurant expenses, \$m	1,447.4	1,037.2	195.3
Franchise and property expenses, \$m	100.2	115.1	152.4
Company restaurant revenues - expenses, \$m	191.3	131.8	27.4
Franchised restaurant revenues - expenses, \$m	601.0	686.8	771.2
Selling, general and administrative expenses, \$m	418.5	347.6	242.4
Net income, \$m	88.1	117.7	233.7
Number of company-owned restaurants	1,295	418	52
Number of franchised restaurants	11,217	12,579	13,615
BK revenue per company restaurant, \$	1,265,405	2,796,651	4,282,692
BK revenue per franchised restaurant, \$	62,512	63,749	67,837
BK expenses per company restaurant, \$	1,117,683	2,481,340	3,755,769
BK expenses per franchised restaurant, \$	8,933	9,150	11,194
BK revenue - expenses, company restaurant, \$	147,722	315,311	526,923
BK revenue - expenses, franchise restaurant, \$	53,579	54,599	56,643

SOURCE: Company filings, MarketLine calculations

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The first point to note is that as Burger King relinquished direct control of more than 1,200 restaurants, its annual per-outlet revenue from company-owned restaurants increased from \$1.3m to \$4.3m. In comparison, franchised restaurants had total sales revenue of \$16,078m in FY2013, equating to an average of \$1.18m. This suggests that it has retained control of some of the most strongly-performing restaurants in the system. Even though per-outlet costs increased for these restaurants, their profitability, as measured by revenue - expenses, rose.

The average revenue Burger King obtained from each franchised restaurant also increased slightly.

More importantly for the franchisor's bottom line, the contribution each made to company profit increased from \$53,579 to \$56,643. It is clear that company-owned restaurants are contributing a lot more on a per-restaurant basis, but given their revenues, this is likely to be because they are unusually strong performers within the total system.

In 2011, company-owned restaurants contributed \$191.3m to Burger King profits (restaurant revenues - expenses), while franchised restaurants contributed around three times as much. By 2013, company-owned restaurants contributed \$27.2m to profits while franchised restaurants contributed almost 30 times this amount.

At the same time, selling, general and administrative, costs decreased from \$418.5m to \$242.4m. Although Burger King does not specify exactly what is included here, these are likely to be primarily those costs incurred by the central administrative functions of the corporation, rather than those incurred by its individual restaurants; the latter are broken down into cost of goods sold, payroll, and occupancy costs. It is possible that by refranchising so many restaurants, the central costs of management also decreased.

Burger King uses franchising to expand internationally

Burger King was established in the US in 1954, and its first international location was Puerto Rico, which it entered in 1963. By 1986, about 8% of its 4,743 restaurants were located outside the US. Continued expansion meant that by 2013, the company had 13,667 restaurants in its system, of which 47% were based outside the US. In the 2011-2013 period, Burger King set up master franchise agreements for strategic international markets such as Russia, South Africa, France, India, and Brazil.

One reason for Burger King's drive to operate as a near-100% franchisor company is that franchising is a well-established mode of international expansion.

Opening a single quick service restaurant does not require prohibitively high levels of capital. About Money reports that capital requirements for a Burger King restaurant range from \$300,000 to \$2.8 million, and the franchisee must have a net worth of at least \$1.5 million. This is affordable for many private individuals or small companies. Master franchise companies are frequently investment houses, which have access to higher levels of capital. From the perspective of a franchisor, the ability to "outsource" the obtaining of start-up capital to its franchisees greatly reduces the barriers to rapid entry and expansion in a new geographical market.

As a bonus, the franchisee will generally have better knowledge of the market, and is well-placed to research suitable locations for restaurants.

SWOT ANALYSIS REVEALS ADVANTAGES AND DISADVANTAGES OF FRANCHISING IN HOTEL INDUSTRY

All companies have internal strengths and weaknesses, and must deal with the external opportunities and threats offered by the market in which they operate. Franchisors have an additional set of external factors to deal with: the franchisees themselves. The following generic SWOT analysis relates to a typical hospitality company, such as Wyndham or Choice Hotels, that operates primarily via franchising. While it does not describe any company in particular, it highlights some of the franchise-dependent risk factors that such franchisors describe in their regulatory filings.

Strengths: strong brands, diverse geographies, established franchise model, technology

The largest companies in this industry tend to offer several hotel brands. Thus, Wyndham has 14 brands including Dream, Travelodge, Super8, and Tryp by Wyndham; Choice Hotels offers 11 brands such as Comfort Inn, Rodeway Inn, and Clarion. These will be targeted at different chain scale segments (luxury, upper upscale, upscale, upper midscale, midscale, economy). At least until the development of online review websites, guests travelling to an unfamiliar location would have few ways of knowing in advance what quality of accommodation and service would be provided by a hotel. In this situation, a clear brand identity acts as a kind of guarantee or promise of what is being offered. It is therefore a good differentiator and a competitive strength.

Figure 4: Wyndham's brands, 2014



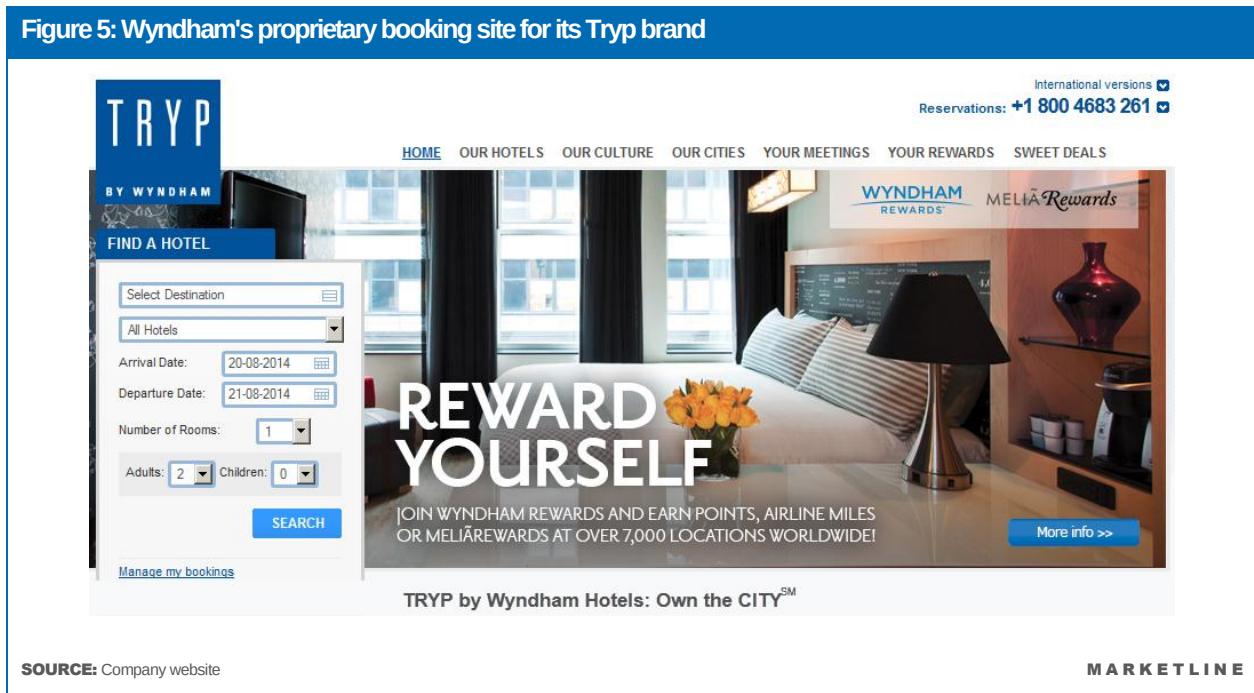
Geographical diversity is also common. Wyndham and Choice are rather focused on the US, generating respectively 25% and 8% from outside their domestic market. IHG, on the other hand, has 52% of revenue generated outside the US, and 12% from Greater China alone. In an industry that is sensitive to economic downturns, a mixture of developed and emerging markets promises more stable revenues.

US-based hotel companies of this scale almost always have a well-developed brand franchise system in place. By far the largest number of hotels in their system are franchised, with smaller numbers managed by the companies on behalf of third parties, and still fewer owned (or leased) and operated directly by the companies themselves. For example, the figures for IHG in 2013 were 3,977 franchised, 711 managed, and only nine owned/leased. With mature business systems established, these companies are strongly positioned to generate revenue from their franchisees, and to grow their business, much as Burger King is.

One aspect of the hotel franchising model that is not so important in foodservice franchising is the franchisors' online technology.

Companies in this sector often invest in their own online booking systems, such as the SkyTouch Technology developed by Choice Hotels, or the proprietary, brand-specific systems offered by players like Wyndham. While guests can also book through third-party sites such as booking.com, the company-operated sites allow much more control over marketing by presenting users with special offers, additional information on facilities, and so on. (Note that the importance of online booking systems does not contradict what was said earlier about the risk of online transactions to franchised businesses: the transaction ultimately requires a stay in an actual, physical hotel, so the service itself cannot be delivered online.) As seen with the foodservice industry, intellectual property developed by the franchisor and controlled centrally, and made available to franchisees, is a common feature of franchised businesses.

Figure 5: Wyndham's proprietary booking site for its Tryp brand



SOURCE: Company website

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As Wyndham states in its 2013 annual report: " Since the royalty fees are a recurring revenue stream and the cost structure is relatively low, the franchise model yields high margins and steady, predictable cash flows".

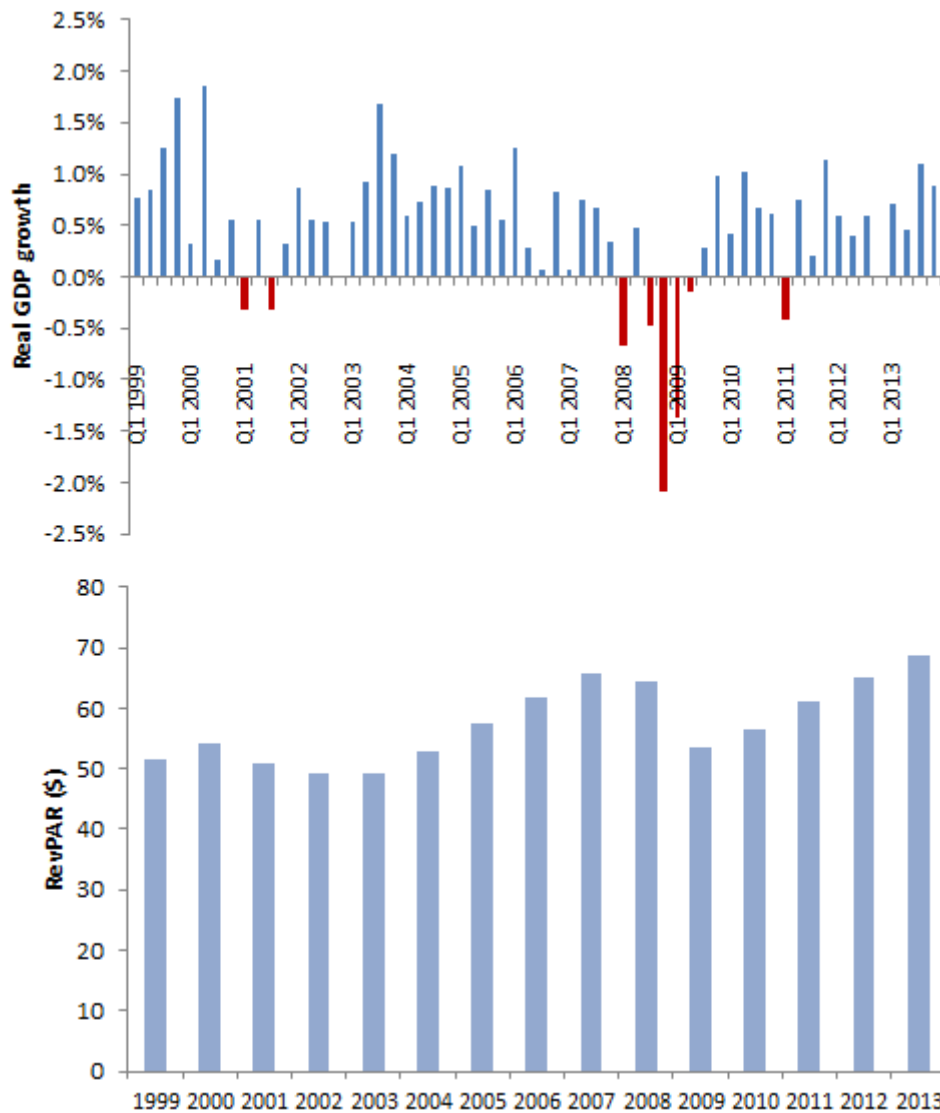
Weaknesses: often company-specific

In this generic analysis, it is difficult to point to weaknesses common to several players. MarketLine's Company Profiles mention certain weak points. For example, Wyndham is rather exposed to US market conditions compared to its more diversified competitors. IHG and Starwood Hotels had relatively high levels of debt in FY2013. These are not necessarily related to the franchising business model.

Opportunities: emerging markets

The hotel industry is cyclic. In an economic downturn, consumers may decide that leisure travel is a luxury they cannot afford, and companies may restrict business travel budgets. Choice Hotels, in its 2013 annual report, quotes data from Smith Travel Research and the US Department of Labor for the US hotel industry 1999-2013. This shows that indicators such as average room occupancy rates and revenues per available room (RevPAR) fell in 2001 compared to 2000, and in 2008 compared to 2007, in response to the recessions of 2001 and 2007-2009. As the chart shows, recovery after recession was fairly slow.

Figure 6: Real quarterly GDP growth and average hotel RevPAR, US, 1999-2013



SOURCE: Choice Hotels Annual Report 2013, Multipl

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By establishing a presence in emerging markets where economic growth remains robust, the major hotel chains can weather domestic economic storms more successfully. For example, MarketLine's Hotels & Motels industry profiles indicate that the Chinese market had total revenues of \$70b in 2013, having grown with a compound annual growth rate of 14.9% during the 2009-2013 period. The US market was more than twice the size, at \$160b, but its annualized growth was only 4.5% during this period.

The hotel chains' established franchising models are highly supportive of this strategy, conferring the ability to expand rapidly into new markets with lower capital requirements for the franchisor than would be necessary for expansion as an owner-operator.

Threats: franchisees must be managed, may have difficulty accessing credit, weak intellectual property protection

While the franchisors have created strong business systems, it is in the nature of this model that they cannot micro-manage franchisees. The day-to-day delivery of services to guests is not in the control of franchisors, except in the hotels that they own or manage themselves. This means that any poor performance by franchisees will impact the brand, but franchisors will have less ability to put this right than if their own employees were underperforming. In fact, it may be difficult to find suitable franchisees in some markets, especially where the concept is unfamiliar. As franchise contracts are generally of many years' duration, mistakes made at the outset could leave the franchisor with long-term problems. This places a lot of pressure on the franchisor's vetting due diligence processes.

Choice Hotels points out in its 2013 annual report that franchisors must compete with other hotel chains for franchisees. A competitive market means that the terms of franchises may not always be as favorable to the franchisor as they would like. A related issue here is that expansion requires that franchisees have access to finance. If banks become less willing to lend, as can happen in times of economic uncertainty, or if interest rates rise and dissuade potential franchisees from taking on debt, expansion will become more difficult for the franchisors to achieve.

As described above, intellectual property is central to a franchisor's business. This can be problematic in some of the very countries that offer promising rates of market growth. For example, China Business Review describes how Starbucks had to take legal action in 2006 against a Chinese company that had all but replicated its name and trademarks. In 2008, a Shanghai court found in favor of the Ritz Hotel Ltd and against Shanghai Huangpu Lichi Leisure and Fitness Co., as the latter had infringed the hotel's RITZ trademark. While these cases are unlikely to have caused substantial damage to the complainants' brands, they do point out the need for vigilance in order to defend intellectual property.

CONCLUSIONS

Franchising is a good business model in specific circumstances

The business system franchising model has been established for several decades in the US, and recent years have seen the market capitalization of leading franchisors outperform the overall stock market as measured by the S&P 500 index. Franchises account for a significant proportion of US business establishments and workforce in sectors such as foodservice, lodging, and retail.

Business system franchising is particularly appropriate in sectors where uniform products are sold in high volumes, where strong brands confer competitive advantages, where capital barriers to entry for franchisees are not prohibitive, and where labor intensity is fairly high. Conversely, businesses that specialize in providing bespoke services to clients, and those where large capital expenditures on productive assets are needed in order to win scale economies, are poor candidates for franchising. Also, businesses where value-added transactions can be completed online, and which therefore do not benefit from a multiplicity of physical locations, are not suited to franchises.

In 2011, Burger King began re-franchising virtually all its company-owned quick service restaurants, and by the end of 2013, 99.6% of its system restaurants were in the hands of franchisees. The company saw a strong increase in net income during this period, which can be attributed to pushing out many of the centralized costs of running restaurants to its franchisees. The model has also provided a low-capital path to international expansion. Value-chain analysis reveals that Burger King itself, like all companies that act almost purely as franchisors, is primarily concerned with the development of intellectual property. This includes recipe development, brand building, marketing, and of course the design and promotion of its business system to franchisees. What might be thought of as the traditional primary activities of a foodservice player are actually conducted by the franchisees.

SWOT analysis of typical major US hotel chains such as Wyndham or IHG has shown that key strengths include building a portfolio of strong brands to target different customer groups, reducing dependence on the large but mature US market, and developing an effective business system franchise. Just as Burger King owns few restaurants, these companies own few hotels themselves, but have large numbers of franchisees. This allows them to benefit from the opportunities offered by emerging markets such as China: again, the ability to expand the physical network rapidly and with low capital requirements, is a major advantage of a franchise model. However, there are some threats as well. Compared to company employees, franchisees are much more free to run their hotels as they see fit, and if they deviate from the business model, this could impact on brand value. Furthermore, expansion depends on potential franchisees being able to obtain finance, and this is out of the control of the franchisor.

Franchising may be seen as an example of a wider business trend, in which a company focuses on intellectual property, (broadly defined) while leaving other companies to convert this into actual goods and services. For example, Apple and Nike develop designs for sportswear and consumer electronics, but do not have factories: contract manufacturers, often in lower-wage economies, convert the designs into physical products. Apple and Nike sell these, using highly effective marketing and brand-building - more intellectual property - to do so. ARM designs the advanced, low-power microprocessors found in smartphones and tablet computers. It then licenses their fabrication to microelectronics companies, relying almost entirely on license fees and royalties for all its revenues. For companies like Nike, reducing wage costs may be a driver: clothing manufacturing is fairly low-tech, and labor intensive, so outsourcing to countries where wages are low is economically rational. Microchip manufacturing is capital intensive, since fabrication facilities are expensive to build, so it may be ARM's strategy to let the manufacturers spend this money while benefiting from a steady stream of revenue from royalties and fees.

All these companies are operating in highly competitive markets, so it is vital that they keep up the momentum on innovation, and ensure strong defense of their IP assets, if they are to remain successful.

APPENDIX

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MarketLine | John Carpenter House, John Carpenter Street |
London, United Kingdom, EC4Y 0AN
T: +44(0)203 377 3042
E: reachus@marketline.com

MarketLine