

U.S Franchising in East China

Non-food Companies Landscape



Market Research Report
U.S. Commercial Service Shanghai



U.S Non-Food Franchise Companies Landscape in East China

Market Research Report

Overview: U.S. franchisers remain optimistic despite the increasingly challenging business environment in China. Companies report that rents, wages and cost of capital are on the rise. However, many American companies continue to view China as a great market opportunity with the world's largest consumer market.¹ With a quickly expanding middle class, China is predicted to be the world's largest economy by 2029.² Companies realize that business in China is not a "winner takes all" game. Companies are now looking beyond first-tier cities to grow business in second- and third-tier cities. The service sector is growing, while successful merchandise companies are utilizing "online to offline" strategies to offset rising costs and capitalize on technological trends. Many successful franchises in China report plans to increase the number of franchise units in the coming year. The regulatory environment is evolving in China, allowing for increased transparency and protection. Trends indicate non-Food & Beverage industries will provide increased U.S. franchising opportunities in the years ahead.

Eastern China Opportunities: International companies continue to invest in Shanghai, and are progressively interested in second- and third-tier cities. Apart from Shanghai, the neighboring provinces Jiangsu, Zhejiang and Anhui offer 25 such cities.³ These developing markets offer millions of new customers, with lower labor and real estate costs. In addition, local governments in these cities often encourage partnership, investment and new business creation.⁴



Optimistic Franchise Outlook: The China Chainstore & Franchise Association (CCFA) surveyed a group of "100 Strong China Franchises" in 2015 and discovered that over 90% predicted sales growth and store openings to continue to grow in the coming year.⁵ Of these, 44% were optimistic that the rate of sales growth in 2016 would surpass the 2015 rate. Only 7% of respondents planned to reduce their number of franchise locations.

¹ *The Allure and Challenges of China's Changing Consumer Market*, Accenture, 2014

² *America's Days Are Numbered as the World's Top Economy*, U.S. News & World Report, Andrew Soergel, 28 Dec 2015

³ *Administrative divisions of the People's Republic of China* (中华人民共和国行政区划), http://www.gov.cn/test/2005-06/15/content_18253.htm, retrieved 11 March 2016

⁴ *As China Reduces Local Spending, Cities Woo Private Investors*, The New York Times, Neil Gough and Cao Li, 6 Aug 2015.

⁵ 2014 中国特许连锁 100 强调查报告, China Chain Store & Franchise Association, June 2015

Business Models and Strategies: Franchising is still a relatively new concept in the Chinese business culture. A common strategy for U.S. companies has been to enter one of the major Chinese first-tier cities using wholly owned foreign entity (WFOE) stores. This way the company is familiar with local business customs and culture, becoming better able to assess franchise opportunities in other cities. Recently the “two plus one” rule that required companies to have two direct-operated outlets has relaxed, with the textual interpretation allowing for companies to own the two initial outlets outside of China.⁶ However, successful companies are still opening direct-operated outlets within China prior to franchising with local operators. As successful expansion continues, many companies maintain a small set of direct-operated outlets. A record number of U.S. businesses in China reported that producing and servicing the domestic China market was their priority.⁷

Examples of Successful Non-Food & Beverage Franchises in China	China Sales Revenue	China Franchises	Total China Location
	\$ 149 m	235	240
	\$ 570 m	675	688
	\$ 187 m	745	857
	\$ 246 m	4886	4900

* 2015 China Chain Store & Franchise Association

Growth Industry Trends: Demographics and policy changes in China are shifting the franchise landscape. Traditionally food and beverage (F&B) and retail outlets dominated the international investment scene in China. The CCFA reports that more than 40 percent of all franchisers in China are in these industries. Non-F&B industries are currently in demand and face less market saturation and competition. Current demographic and market trends are creating opportunities in the following industries:

The legacy, and now liberalization, of China’s one-child policy⁸ is creating demand for **baby/child products and educational services**. Parents of single children invest heavily in the child, and now parents are able to have a second child with the policy’s update last year.

China’s population is aging due to a lower mortality rate and decades of the one-child policy. **Elder care and hospitality services** are on the rise. By 2025 nearly one in four Chinese will be over 60.⁹ The Chinese culture places responsibility on the children for the care of parents and grandparents. The 4-2-1 phenomenon (4 grandparents, 2 parents, 1 child) is difficult to bear, and services and companies will be situated to care for the elderly. Changes to the one child policy may take decades to help alleviate the current rate of population aging.

Property ownership is increasingly popular with the liberalization of home ownership in China, with the need for more **real estate services**. It is expected that the government will combat potential slow home sales growth with further interest rate cuts, lower down-payment rates, tax

⁶ *Looking forward by looking back: China’s Franchise Regulations after eight years*, Tao Xu, DLA Piper, 17 July 2015

⁷ *2015 China Business Report*, The American Chamber of Commerce in Shanghai, 2015

⁸ 中共全会公报允许普遍二胎政策, 网易新闻, 29 Oct 2015

⁹ *The Kin and I*, The Economist, 29 Aug 2015

rebates and more liberal housing registration procedures.¹⁰ As China's economic growth rate decreases, real estate is still regarded as a pillar industry.

University/language preparation training is a growing industry for franchises. China is reported to have more citizens studying English than the entire population of the United States.¹¹ Foreign universities, online education and test preparation services are increasingly popular.

Chinese consumers with improved financial means now spend more money on **beauty, leisure, health and cleaning services**. China is the world's largest luxury goods market;¹² consumers are spending more capital on high-end services and products. While Chinese consumers remain price conscious, they still perceive increased value in branded products and services with foreign names and origins.

The market for **Economy Hotels** in China is fast growing, with opportunities outside the primary first-tier cities. Domestic tourism is booming, and China is set to be the largest budget hotel room market in the world. China has multiple week-long holidays that encourage citizens to get out and travel the country.

Industries the Chinese Recommend: The China Council for the Promotion of International Trade (CCPIT) monitors international investment industries and recommended the following franchise industries currently:

- Air / Water purification
- Baby products
- Early education
- Home care for the elderly

Franchise Trends in China

O2O Growth and Integration: Successful companies are identifying Online to Offline (O2O) opportunities. These methods utilize the Internet and social media to drive the company brand and lead to interactions with customers offline. Effective franchises within China are developing their O2O best practices to cut costs and attract new customers.

Service Industry is growing: Service industries, especially those that are integrated with O2O, are growing quickly. Correspondingly, Chinese discretionary income has risen for several

Second- and Third-tier Cities	
<u>Jiangsu</u> (13)	<u>Zhejiang</u> (10)
Changzhou	Hangzhou
Huaiyin	Huzhou
Lianyungang	Jiaxing
Nanjing	Jinhua
Nantong	Ningbo
Suqian	Quzhou
Suzhou	Shaoxing
Taizhou	Taizhou
Wuxi	Wenzhou
Xuzhou	Zhoushan
Yancheng	<u>Anhui</u> (2)
Yangzhou	Hefei
Zhenjiang	Wuhu

¹⁰ 5 Predictions for China's Housing Market in 2016, The Wall Street Journal, 23 Dec 2015

¹¹ The Statistics of English in China, Rining Wei and Jinzhi Su, 2012, English Today, 28, pp 10-14

¹² China world's biggest luxury consumer, Lyu Chang, China Daily, 21 Feb 2014

decades¹³, with the Chinese consumer increasingly more willing to spend money on companies that serve them.

Second- and Third-tier franchising is growing: Franchise companies are increasing more rapidly in second- and third-tier cities than in first tier cities. Companies face less international competition in lower tier cities. These cities are highly populated, and provide less expensive labor and rent costs.

Success Factors and Tips from Companies with China Experience

Expect strong competition, counterfeits and copies: Brands in China report that both strong competition and intellectual property (IP) theft is common. Several successful companies reportedly are accepting this reality, and operating with the assumption that other businesses will imitate company IP. While China refines IP protection policy for this “Shan Zhai” copycat culture, companies must weigh the risk of IP theft against the opportunity costs of waiting for additional legal reform and protections. Consumers in China are sensitive to brand quality, and are better able to spot original brands against their copied counterparts. In some cases, it was reported that the presence of copied IP indicated increased quality for the original brand.

Register the brand within China in advance: Register the company name in Chinese characters with English equivalent sounds. If unable to register the English name, register the brand name as an “image” that contains the English name. Find a lawyer to register your trademark before you sell into China. The CCFA reports that trademark approval process can take 18 months.

Be selective with franchisees: Work with franchisees that will protect the quality, safety and property of the company. A franchisor’s main priority is to protect the brand reputation and use. Locate and work with franchisees that support your goals in this regard. Be prepared to refuse potential franchisees that do not meet your criteria. Very Successful U.S. franchisors report that they are rejecting dozens of franchise applications a year in order to select good partnerships. Better to reject upfront, than to close stores later.

Adjust marketing and promotion strategies to the Chinese market. Utilize locals to vet ideas and tastes. Remain flexible to change products and services as needed. Several U.S. companies have reported to have even changed key company icons, characters and logos to conform to Chinese market appeal.

Minimize franchising and product fees to expand more rapidly and achieve more momentum.

¹³ *Meet the Chinese Consumer of 2020*, McKinsey Quarterly, Yuval Atsmon & Max Magni, March 2012

Proactively **manage government relations**. Maintain government contacts and keep up-to-date on the latest government regulations.

Hire a good **franchising law firm** with international experience. Experience in China is necessary. Chinese law is evolving, and each province has different laws to comply with. Companies are reportedly encountering vague and inconsistent regulations and rules.

Enforceable agreements: Confirm that your agreements are enforceable. This is particularly true when dealing with intangible assets.

Try to **hedge against currency fluctuations**. Use a letter of credit for royalties fixed to a certain exchange rate. Another method is to pick a set day to calculate the royalty payments.

Develop at least a **5 year plan**, similar to how the Chinese government plans. Successful companies expanding in China can describe their goals for years ahead.

Challenges for Franchising

Franchising Companies report that the greatest challenge businesses currently face in China are rising costs. A second important challenge is the difficulty in hiring and retaining top talent to work the business. In many cases, companies report that both of these problems together create the greatest challenge they currently face.¹⁴

Other challenges reported include: hiring efficient managers, the policy environment, intellectual property protection, securing good physical locations, and decreased profitability.



¹⁴ 2014 中国特许连锁 100 强调查报告, China Chain Store & Franchise Association, June 2015

Franchise regulation in China

Over the last decade China's government agencies and courts have acted pragmatically to encourage company franchising, and the regulatory framework governing franchising in China has become more well-defined and clear. In 1997 the Ministry of Internal Trade established the first Chinese franchise law, setting initial guidelines on trademarks, copyrights and intellectual property protection. Following China's accession to the WTO, the Ministry of Commerce (MOFCOM) issued the 2004 measures that began defining disclosure and filing measures. These were updated in 2007, and most recently in 2012. Though the policy reforms are more defined, they may ultimately provide more protections for U.S. intellectual property and operations. Companies should be aware that the Chinese in their 12th Five-Year Plan are increasingly more focused on growing domestic consumption and development.

Agency	Date	Franchising Measure	Internet Link
State Council (国务院)	May 01, 2007	2007 Regulations on the Administration of Commercial Franchises 商业特许经营管理条例	http://www.gov.cn/jzwqk/2007-02/14/content_527207.htm
MOFCOM (商务部)	April 01, 2012	Administrative Measures for the Information Disclosure of Commercial Franchises 商业特许经营信息披露管理办法	http://www.gov.cn/jfjg/2012-03/06/content_2084101.htm
MOFCOM (商务部)	Feb. 1, 2012	Administrative Measures for Archival Filing of Commercial Franchises 商业特许经营备案管理办法	http://www.gov.cn/jfjg/2011-12/21/content_2025612.htm

Conclusion

Despite the challenges of rising costs and the ability to retain top talent, franchise companies report optimism for growth and profits in the year ahead. The Chinese consumer class is expanding fast, and wields more disposable income than ever before. Western brands remain in high regard by the Chinese. While intellectual property protection is a risk, successful companies report moving forward while the IP policies evolve. Second- and third-tier cities are opening new markets for franchise companies, and nimble organizations are gaining market share. Non-Food and Beverage franchise companies are reporting plans to continue expansion in China, and continue to view the growing market without a "winner takes all" strategy. Examples of successful and early franchise pioneers outside of food and beverage industries indicate that the opportunities are far from saturated, even in the first-tier cities. Indeed, the demographic and economic trends even to some fourth-tier cities reveal that much of China is now open for international franchise opportunities across many industries in the years ahead.

Additional Resources

U.S. Commercial Service China

<http://export.gov/china/>

International Franchise Association

www.franchise.org

China Chain Store and Franchise Association

www.ccfa.org.cn

International Franchise Expo

www.ifeinfo.com

American Chamber of Commerce in Shanghai

<http://www.amcham-shanghai.org/AmchamPortal/portaldefault.aspx>

The US-China Business Council

www.uschina.org

US Commercial Service Franchise Team in China

U.S. Embassy, Beijing

Mr. Shen Yan, Commercial Specialist

(86 10) 8531-3554

yan.shen@trade.gov

U.S. Consulate, Shanghai

Ms. Janet Li, Commercial Specialist

(86 21) 6279-8775

janet.li@trade.gov

U.S. Consulate, Guangzhou

Roya Xie, Commercial Specialist

(86-20) 020 3814 5807

roya.xie@trade.gov

U.S. Consulate, Chengdu

Ms. Fan Li, Commercial Specialist

(86 28) 8598-6939

li.fan@trade.gov

U.S. Consulate in Shenyang

Liu Yang, Commercial Specialist

(86 24) 2322-1198

yang.liu@trade.gov

