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***"Franchising is the wave of the future,"***

*U.S. Department of Commerce*

***"Franchising is the single most successful marketing concept ever."***

*John Naisbitt, Megatrends*

# Abstract

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*Franchising is an old phenomenon with beginning dating in the middle Ages. Nowadays, the concept has become so popular that it has becoming to spread in all different countries and industries. This paper aims (1) to reveal the basics of the franchising model, in terms of defining the concept and its principles, (2) to reveal the nature of frontier markets and the reasons behind their increased attractiveness in the in the last years, (3) to explore the opportunities of franchising in a frontier market as well as the (4) the challenges for its development on the Bulgarian market. Bulgaria is classified as a frontier market with all the features that this classification comes with – low liquidity, high growth potential, etc. The paper reveals major figures from the franchising market in Bulgaria and aims to show its development in the recent years.*

*The paper addresses the questions about franchising, especially in the frontier market Bulgaria: existence and development of the concept, franchise versus staring own business, challenges and opportunities in times of crises, main perspectives.*

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## Introduction

Franchising is a popular concept which popularity has risen extremely in the last 15 years. The concept dates from the Middle Ages, but it bloomed extremely in the last century. Companies like Coca Cola, McDonalds and Subway have become symbols of this business model.

The application of the business concept in developed and emerging markets over the last couple of decades helped in deriving main lessons that can be useful for smaller, less liquid markets – the frontier markets.

The Frontier markets are often called the next emerging generation which shows that they are unexplored area of potential. These markets offer numerous of advantages but the obstacles as low liquidity, underdeveloped capital markets and political instability still restrict the business initiatives in these countries.

Franchising has proven successful in developed and emerging markets and its applications are beginning to show in frontier markets more tangible.

The paper shows how this internationally known concept functions and develops in a frontier market, as Bulgaria, showing the main trends and the major obstacles that it meets on this market.

## **Part A**

### **CHAPTER 1 - The Theory of Franchising**

#### **1.1. What is Franchising?**

More than 20 years ago, in 1985, John Naisbitt, the author of Megatrends, famous American author, forecasted that in 2010 franchising will be the most successful concept ever. According to the famous trend researcher the concept will grow and according to IFA, he was completely right.

Worldwide, franchising accounts for almost \$2 trillion revenue every year. Distributing goods and services using the franchising model covers over 75 industries in world perspective. In other words this would mean that every 1 out of twelve businesses function under the rules of the franchising concept. Each hour of a business day, more than 7 new franchised businesses are being opened (Frannet, 2013).

#### **1.2. Franchising Definition**

Franchising is a business concept that is based on contract between two parties, franchisor and franchisee, that determines the responsibilities and obligations of both. The legal binding between the franchisor and the franchisee is the key element of a strong, continuing and cooperative relationship. (Hunt, 1972, p. 33). The Franchisor is a company that possesses already developed product or service. Franchisee acts as an independent contractor in the chain of the franchisor, opening a franchise in his local market, operating under the trade mark of the franchisor and usually profiting from the franchisor's guidance. The franchisee manufactures or markets the licensed products or services and pays a fee to the franchisor.

From management perspective the concept is a hybrid form that lies between two extreme models – vertical interfirm integration and operations between completely



independent companies. The contractors involved operate independently but in a way these operation are similar to the interfirm ones.

From a marketing perspective franchising is a market oriented method for selling goods from independent, usually small companies that might possess certain entry capital but no know how and business experience. Additionally from this perspective the concept can be seen as channel for realization of products and services.

From the perspective of international business, franchising is a market entry strategy. The concept is a contractual entry mode situated a level higher than licensing and a level just before joint ventures (Kotabe & Helsen, 1998).

It is more than clear that franchising is a complicated system for which the theory and the practice have not completely united on unique definition. In some extend this is due to the difference in the way a franchising system is formed on a national and on an international level.

One common and detailed definition (Deutcher Franchise Verband, 2013) allows identifying four main elements of the franchising concept:

- Franchising is a system for organized distribution of products and/or services – the main similarity between franchising and distribution is that both franchisees and distributors are independent tradespeople with exclusive rights over a product (service by franchising as well)
- The franchisor offers to the franchisee a franchising package in return of fee/fees – the franchising package (business format franchising) includes not only the products, but also other features as intellectual property rights (trademarks, logos and symbols), know-how in terms of design, marketing and trade politic, advertising materials, qualification of the personnel, etc.
- The franchisees are independent business units and organizational entities – they possess autonomous financial, investment and administrative politic which is the main difference between them and the subsidiaries. Generally, they set freely the prices of their products and services and receive own incomes. They increase their profit by entering the franchise system which is led and controlled by the franchisor
- The franchisor is responsible for controlling the whole franchising system

### 1.3. Origin of the Franchising Term

Franchise has its roots in the French language originating from the word “franche”. The term was used in France in the middle ages, describing *the release from duties and taxes*. Later, an earlier form of franchise was seen when the salesmen and craftsmen were granted permission to organize fairs and/or markets. In 17<sup>th</sup> the term represented a “description of privileges, which the state assigned to individuals”. (Strehle, et al., 2005, pp. 3-4)

The term was widely spread in USA, France and Great Britain and it was just in the middle of 19<sup>th</sup> century when it found its present meaning: the permission for the commercial use of rights of a third person.

### 1.4. Development of the Franchise Systems

Business relations, close to what we call franchising today, appeared during 16<sup>th</sup> century in Japan. The system Norenkai required that each ex-employee that starts own business should pay percent of its profit to the ex-employer. The licensed trade with alcohol created business relations, similar to the franchising, between the breweries and the pub owners in England and Germany.

Franchising close to what we know today has its roots back at the end of the American Civil War and the company Singer<sup>1</sup>. In 1860, Singer gave permission to its dealers to sell the company's products. The granted rights included the clause “on own calculation and in own name” (Strehle, et al., 2005, p. 5). Later on this distribution system was used by beverage and car manufacturers. Nowadays, this system has developed to “Product distribution franchising” or “Product and trade name franchising”.

The real growth of franchising was first seen at the beginning of 20<sup>th</sup> century. In the early 1900's, Henry Ford franchised dealers for his Model T. The oil companies followed the model development by franchising gas stations. 30 years later, the

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<sup>1</sup> Sewing Machine Company

concept had spread into areas like automobile, soft drink bottling and gasoline industries. In mid of 20<sup>th</sup> century the number of companies offering franchising reached 100. (Herman, 2013).

The new history of the concept begins in the middle of 20<sup>th</sup> century. Raymond Kroc, fifty-two-year-old milk-shake machine salesman, changed the history and created a new stage for one of the most successful business concepts in the world. His vision of sophisticated delivery and operating system in the food industry brought to the world a new level – fast food restaurants. After establishing a profitable and fast growing business, 15 years later, he started franchising and made McDonalds a synonym for both “fast food” and “franchising”. (Gross, 1996, pp. 177-179)

In the 1960s the franchise concept spreads widely in Europe in food and hotel industry (Hilton, Holiday Inn, etc.), clothing and cosmetics, rental cars, etc. Franchising systems became more popular due to the increasing production capacity and the higher intensity of the demand.

Important characteristic of the franchising evolution during the last two decades is its internationalization. In the second half of the 1980 the concept becomes quite widely used as an expansion method to the global markets in different spheres. The rapid economic development of the Middle East and the stabilization of the market relation between Russia and Eastern Europe led to additional push into direction internationalization.

Nowadays companies like Coca Cola, Pepsi, KFC, McDonalds, Burger Kind, Pizza Hut, Rent a Car, etc. are known in almost every country.

Even the franchise experts nowadays cannot say the exact number of the franchise systems in the world at this very moment. One is for sure – the number grows.

## **1.5. Franchise Agreement**

The most common definition of the franchise agreement is as *“a contractual arrangement between two legally independent firms, whereby the franchisee pays the franchisor for the right to sell the franchisor’s product or the right to use his*

trademarks in a given location for a specified time period” (Lafontaine & Shaw, 1999, p. 1).

*“We define a franchise agreement as one lasting for a definite or indefinite period of time in which the owner of a protected trademark grants to another person or firm, for some consideration, the right to operate under this trademark for the purpose of producing or distributing a product or service .... The franchise contract involves a sharing of intangible capital, especially trademarks and goodwill, in dependent firms.”* (Caves & Murphy II, 1976, p. 82)

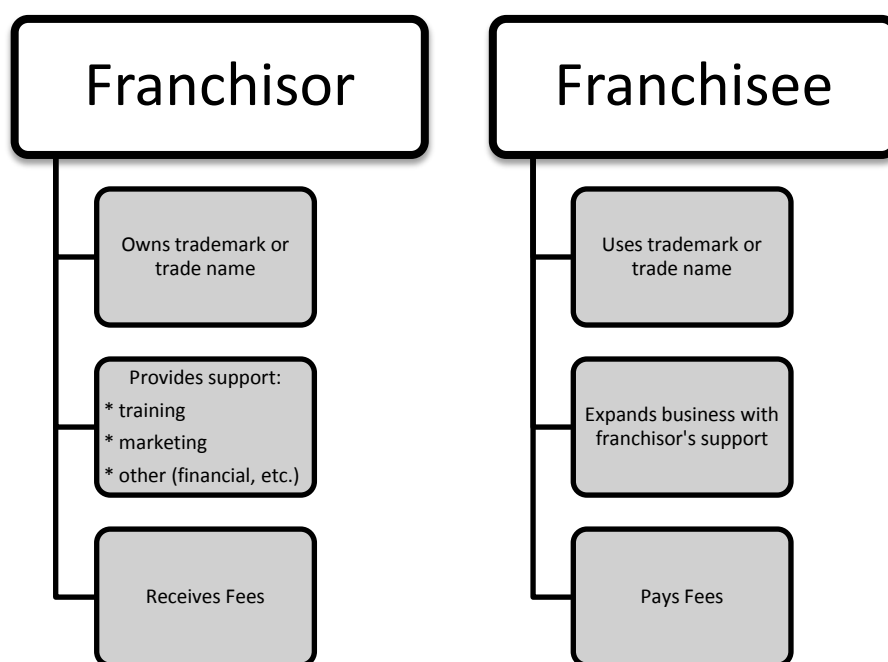


Figure 1: Franchise agreement  
Source: Own representation

In other words, the franchise agreement

- Is the key document of the “franchisee – franchisor” relationship.
- Is the legal base for binding the both parties
- Lays down the rights and obligations of each party
- Has the purpose to assure equally treatment of the participating sides.

There is no standard form of franchise agreement because of the terms, conditions, and the methods of operations of various franchises vary widely depending on the type of business involved.

## 1.6. Types of franchising

Historically, there are two types of franchised relationship: traditional and “business-format” franchise systems (Blair & Lafontaine, 2005, p. 5).

### 1.6.1. *Traditional (product format franchising)*

The basic concept of this form of franchising is that a given company owns a certain product and grants exclusive rights (sales or distribution) to the franchisee.

Traditional format franchising is the oldest form of the modern franchising. At the end of 19<sup>th</sup> century, John Pemberton<sup>2</sup> began applying the franchise concept by offering to many small companies the distribution of one of the most famous drinks nowadays – Coca Cola. The companies were supplied with the main ingredients and received the rights to bottle and distribute the product under the brand name Coca Cola. Companies like General Motors (1898) and Rexall (1902) followed Coca Cola’s example. (Felstead, 1993)

This type of franchising is also known as first generation franchising and to a great extend (content and economic purpose) overlaps the modern distribution system that offers exclusive right for certain region.

This type of franchising offers the least commitment between the two parties – franchisor and franchisee. The closer look into this relationship reveals a combination of rights and obligations typical for the classic licensing and forms of mediation like distribution, commissioning and participation of the sales representative.

Traditional Franchisees *do not pay* running royalties on their sales. Franchisor’s product is sold to its franchisees and the profit for the manufacturer (franchisor) is set by the mark ups earned by the dealers. (Lafontaine & Blair, 2003, p. 385)

Nowadays, this type of franchising is most often found in automobile dealerships (e.g. Ford Motor Company), gas stations (Exxon) and soft-drink bottlers (Pepsi).

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<sup>2</sup> Creator of Coca-Cola

### **1.6.2. Business-format Franchising**

Business format franchising is *“a relationship between the franchisor and the franchisee, where the franchisee uses not only product, service and trademark, but also the complete method to conduct business (including marketing plan and operational manuals).”* (International Franchise Association, 2013)

This is the most common type of franchise. The first true Business-format franchising was created by Martha Matilda Harper. In the early 1890s she developed a network of Beauty Shops, growing it to more than 500 shops in USA, Canada and Europe.

Many companies have been using the system since 1920s, but the real development and spread of the system came after 1950s (McDonalds and Burger King).

Franchisees usually pay initial fee at the beginning. This fee is fixed, in many cases relatively small. Additionally, the franchisees pay running royalties (usually as fixed % of the franchisee's sales revenues) and advertising fees.<sup>3</sup> Most popular franchising opportunities are in the following industries: Fast food, Service, Lodging, Restaurants, Building and construction, Business services, Retail, etc. (Franchise Business for Sale, 2007)

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<sup>3</sup> There are exceptions, as % calculated of total revenue, including payment provisions, increasing and decreasing scales, and royalties as a % of the profit. Less frequently

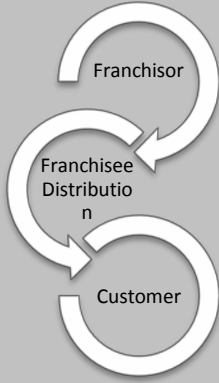
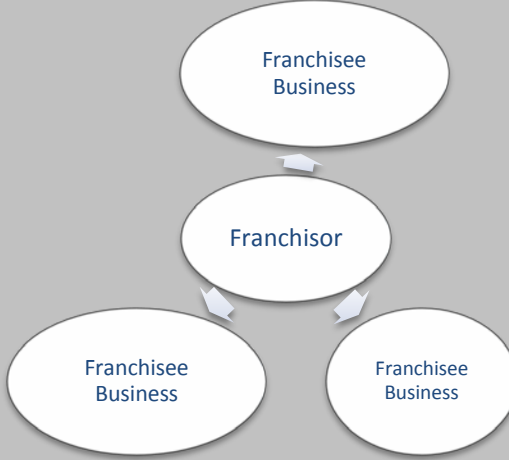
Major differences	Traditional	Business – format
Overview		
Contract	Subject of the contractual relationships is the right to produce and/or distribute products	The contract between the parties predefines certain standards and on this basis the franchisor grants the rights for implementing the whole business format/concept
Product Conceptual Difference	Franchisee typically sells products that are manufactured by their franchisor.	Franchisee obtains complete system for delivering the product or service and for doing business.
Industries where the form finds wide spread	Soft drinks, automobile and accessories, gasoline.	Service-related fields (home repair and remodeling, various maintenance and cleaning services, etc.), business support services (accounting, etc.), environmental services, hair salons, fitness clubs and health services, educational products, etc.

Table 1: Traditional versus Business Format Franchising – major differences

Source: Own representation

### 1.6.3. Master Franchising

Master franchising is a form of a higher level (Goldberg, 2013) where the master franchisee receives exclusive rights over a certain territory. The master franchisee steps into the role of a franchisor for the given region and is responsible for

recruitment and training of franchisee, any ongoing support, etc. The master franchisee and the franchisor usually divide the initial franchising fee and the ongoing royalties (Franchising.bg, 2013).

Master franchising has certain advantages for the franchisor:

- Cutting on costs for setting up an infrastructure – the experience of a master franchisee as a partner in international expansion saves certain amount of expenses and efforts to the franchisor.
- In addition, master franchisees could overcome any problems for the franchisors derived by cultural and language differences
- Master franchisee ease up the process of recruiting local employees as well as dealing with any real estate questions that might rise.

## 1.7. Why do Companies Franchise?

At the beginning the franchisor has been just a company taking a decision to expand. Franchise as an option has not been considered. The company then faces the problem that it needs to wait the first return on investment in order that it can forward its expansion. The company strives for development whereas facing time and capital restrains.

Both time and capital restrains for expansion will be eliminate once the company decides to become a franchisor. The model itself will allow the franchisor to develop a lot faster and with relatively less investments needed.

In addition, the owners of each new business unit will be more motivated. The franchisor can, thus, concentrate more on developing the brand and the product line.

Franchising seems appealing also due to the opportunity for effective minimizing costs of coordination and production costs. In addition, this business concept ensures entrepreneurial discretion and flexibility. The combination of the mentioned above

*Franchising turns corporate managers into profit-sharing owners. (Franchising in FM Markets)*



makes franchising more attractive than vertical integration<sup>4</sup> (Caves & Murphy II, 1976, Carney & Gedajlovic, 1999).

Franchising entry strategy offers easier access to capital due to the fact that franchisees invest usually own capital. Additionally, this model lowers the performance monitoring costs and encourages the extension of the geographical reach.

## **1.8. Advantages of Franchising to Independent Business**

When you use an established business model you will not only minimize the likelihood of repeated failure, but also make use of economies of scale. For example, when purchasing equipment, products or advertising materials their cost can be significantly reduced, as well as the cost of developing new products or services.

Perhaps the most valuable thing the franchisee profits from the franchising relationship is the training. Trainings and seminars that are conducted by the chains increase the competence of the franchisees and allows implementing successful practices used by other participants in the chain.

The franchisor offers support on selecting and training employees, keeping accounts, improving customer service, etc. Centralized marketing of the brand is the second big advantage for the franchisee. By independent business, owning just one store would probably not allow the owner to profit from national advertising and PR campaigns.

There are franchises that are already known to the potential customers and ensure perceived quality, which greatly increases the chances of the business success of the franchisee. Franchisors may provide a whole marketing plan as well.

In addition, franchisees' access to finance is much easier. Due to the lower risk, banks are more willing to finance franchises than own businesses.

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<sup>4</sup> Vertical integration is a method through which the company expands its business into spheres where the units are at different points of the same production path. For example a manufacturer owns its distributor and/or supplier. This method is used by the companies aiming to reduce costs and turnaround time, to improve efficiency by decreasing transportation, etc.

There are companies that provide financing or take part of the initial cost of their franchisees.

Last, but not least, when the franchisee decides to sell out, it would be much easier than if it was own, independent business.

Other advantages for the franchisee:

- The Franchisor has already identified a business niche and the franchisee can benefit from this fact (Cockburn, 2013)
- A franchise system provides an established product or service with a brand name recognition that is already widespread. Thus the franchisee benefits from the brand recognition and customer awareness. Awareness and recognition would take usually years to be established. (Tauber, 1981)
- The start-up process would potentially involve less time and energy (Sorenson & Sorensen, 2001)
- The franchisee will make use of the knowledge, brand recognition, customer awareness, etc. of a company with already established reputation which generally increases the chances of business success (Falbe & Dandridge, 1992)
- Quality and consistency – this advantage might be listed in the common ones that concern the end user as well. Franchise system operate under strict rules of quality and consistency which are mandated by the franchising agreement (Brickley & Dark, 1987)
- Pre-opening and ongoing support – pre-opening in terms of construction, design, financing (in some cases), training, opening program, etc.; ongoing in terms of training, advertising, promotion, operational procedures and assistance, supervision and management support, increased spending power, in some cases access to bulk purchasing (Sherman, 2004)
- Exclusive Rights – for example for one or more unites for certain territory (city, country, whole regions) (Cockburn, 2013)
- Reducing the risk of failure (Tauber, 1981)

## 1.9. Disadvantages of Franchising

Starting a franchise, would mean for the franchisee to comply with the discipline in the chain. In addition, certain sacrifices will be needed: sacrifice part of its independence for the sake of the benefits that will give the imposed order.

The practice has shown that many franchisees decide to buy consequently more than just one franchise. This would mean that the order and the discipline in the chain has definitely has more advantages than disadvantages for the participating parts in it.

The franchisor, while pursuing profit, might face problem with maximizing the returns of his tangible assets. This is the case when the returns are on quasi-rents earned by franchisees in heterogeneous local markets. (Caves & Murphy II, 1976)

Other disadvantages for the franchisees include:

- Business growth is potentially limited by the performance of the entire franchise (Truth in Franchising, n.d.)
- Costs may be higher than if you start your own business from scratch – some franchising systems require relatively high starting fees which might make it (in some markets) impossible to start a franchise. Own business instead would come with less costs and thus would be more attractive.
- Balance restrictions and support with own ability to manage business (British Franchise Association, 2013)
- Damaged image can lead to poor performing, unforeseen or/and financial problems – damaged image might be easily cause by any of the other franchisees in the chain or by the franchisor
- The franchisee has less influence over the termination conditions
- Ongoing royalties and advertising fees (International Franchising Association, 2002)
- Not completely independent, procedures and restrictions (Small Business Development Corporation, 2012)

## 1.10. Popularity of Franchising

Franchising is gaining popularity all over the world. According to a forecast (Franchisopedia, 2012) of the International Franchising Association in 2035 over 50 percent of all products will be sold through franchising operating units. Additionally, 82 % of the franchisee starters still keep active on the market after 5 years from start (Franchising.bg, 2009). In comparison, self-owned businesses reach a quote of up to 20% for the same factor.

Franchising has the ability to gain a large market share (Lancit, n.d.). According to the International Franchising Association, the number of franchise systems in the United States is over 2,500 with over 534,000 franchise units. These numbers represent just about 3% of the US business but account for 35% of the service and retail revenue of the country's economy. (Franchise Direct, 2013)

Interestingly, in the USA only 8% of all service business is operating under franchise concept, but they make about 40% of all service-related revenue. (Modern Franchises, 2013)

*“The Franchising industry and businesses employs 21 million people and generates \$2.3 trillion of economic activity. A new franchise business opens every 8 minutes of every business day.”* (Export.gov, 2013)

Companies that decide to operate in dispersed or distant markets very often choose franchising over other forms of governance. (Sorenson & Sorensen, 2001)

The word “franchising” usually comes quickly into people’s mind with association of big chains as McDonalds, KFC, Subway, etc. All this examples require a high initial investment in order to become part of their franchising chain. The last years, though, showed that franchising is gaining popularity in another sector, namely the low-cost franchises. According to a recent study (Franchise Business Review, 2012) of Franchising Business Review, this franchising sector has become more and more popular in the last couple of years. Fitness and recreational business, travel planners, healthcare providers – they all share the same common feature – their type of business requires smaller offices or retail spaces. Thus, they need smaller amount of capital to start a franchise business.

The low-cost franchise model has proven extremely profitable and popular in the years of economic downturn. Finding the right niche and brand combined with low-cost investment has become attractive and profitable for small but even for investors with large amount of capital. Along with the low initial fees, these franchising models bring relatively low risk.

## CHAPTER 2 - Frontier Markets

### 2.1. What are Frontier Markets

*“Frontier Markets”* is an economic term introduced in 1992 by Farida Khambata (The world bank, 2008). It is used to describe a subset of very small emerging markets. They have lower market capitalization and less liquidity than more developed emerging markets. (Cordiant, 2011)



Figure 2: Map of Frontier Markets  
Source: MCSI and FTSE

*“Frontier markets are those that have not yet reached the size of more established emerging markets and may not be considered investable markets by index providers.”* (Parish, 2011)

There is still no unique definition of the frontier markets and in a way all definitions run the subject path rather than the path of full objectivity. The frontier markets are a subset of small emerging countries mainly gathered together in one category due to factors as their income (low to middle) and the relatively under-developed capital market. Nevertheless, it is necessary to clarify the fact that among the countries that fall under the term “frontier markets” there might be a significant contrast. For example: *wealthy* Middle Eastern Economies compared to the less developed African countries, which, though show rapid growth.

Frontier markets represent 12.2% of the world's population with combined GDP of \$2.955 bn (Bfinance, 2012).

Like mentioned above, there is no perfect definition of what frontier markets are neither there is a full and unique set of features that apply to each one of them exclusively. However, there could be drawn a map of major, common characteristics which apply to some extent to each of these countries leading to their inclusion under this term:

- The frontier markets are considered by the most investors as markets with low liquidity
- High rates of economic growth (Schroder Fund Advisors LLC, 2012) – the economic growth in frontier markets is induced mainly by the following three factors: growing population, natural resources, average real GDP growth<sup>5</sup>, infrastructure investment, domestic consumer spending. (Ernst & Young, n.d.)
- “The Emerging Markets of tomorrow” – large frontier markets<sup>6</sup> are considered to be the next generation of the emerging markets, offering highest potential to upgrade to emerging markets. For the smaller ones, on the other hand, it is almost impossible to reach the category of the emerging markets
- Manufacturing – this characteristic have been considered as one of the main differences between an emerging and a frontier market. Emerging markets over perform the frontiers by rapid development of its manufacturing sector. (Ethiopiainvestor, 2013)
- Political risk due to dictatorship regimes in some of the counties or democracy with a short history in others.
- Low/middle income countries
- Rated high-risk by investors
- Limited private capital flows
- Others (underdeveloped capital markets, etc.)

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<sup>5</sup> In 2008 the average GDP growth in FM markets has been approximately 4.8%, compared to 1.5% in the early 1990s.

<sup>6</sup> Qatar and UAE are awaiting emerging market status upgrade. MSCI's annual review scheduled for June, analysts say there is a possibility that the United Arab Emirates and Qatar will be elevated from the MSCI FM Index to the MSCI EM Index. Source: <http://tribune.com.pk/story/550410/msci-relegates-pso-to-frontier-markets-small-caps-index/>

Behind the label “frontier market” actually stays the presumption that they will become more liquid, less risky and with return characteristics of the emerging markets.

## **2.2. Tracking Frontier Markets**

The International Finance Corporation's (IFC) definition of frontier markets is wider than that of the index providers.

*“Frontier market index providers restrict their index components to countries with functional stock exchanges that are open to foreign investors, but do not meet the volume and liquidity requirements for being included in the emerging markets composite.”* (Cordiant, 2011)

There are a couple of major providers of indices to investment institutions worldwide. For the purposes of this paper, the major two of them have been taken into account: FTSE (Financial Times Stock Exchange Index) and MSCI (Morgan Stanley Composite Index). Examples given from other two providers support the findings in this section.

Every index aims to measure properly the performance of the market. The difference between the indexes comes from the way they have been built. In other words, the index is based on a certain methodology. The measured assets differ from each other (style, class, etc,) which is the reason of using a different methodology for assessing them.



## 2.3. Frontier Markets – Classification

Standard & Poor's are one of the first agencies establishing frontier index. In 2007, the agency launched Select Frontier Index. In the recent years, other agencies like MSCI, Russell, and FTSE have established their own frontier market indices. For example, MSCI's Frontier Markets Index includes 25 countries (MSCI, 2013), FTSE – 26 (FTSE, 2013) and Russell's index consists of 39 countries (Russell Investments, 2013).

It is still hard to define the frontier markets uniquely. Each of the agencies is using own set of criteria on the basis of which certain countries are flagged as frontier markets. In the table below are shown the major criteria:

<b>MSCI</b>	<b>FTSE</b>	<b>Russell</b>	<b>Standard &amp; Poor's</b>
economic development	market and regulatory environment	market capitalization	macroeconomic conditions
size and liquidity	custody and settlement	risk	political stability
and market accessibility	dealing landscape	liquidity prerequisites but with accessible market data available	legal property rights and procedures
	derivatives		trading and settlement processes and conditions

*Table 2: Country classification criteria*  
Source: MSCI, FTSE, Russell, Standard & Poor's

The purposes of this paper do not require deeper explanation of the methodic of the indexes, the criteria in details or the differences between the indexes from a different provider. The paper aims to shows the challenges and the development of the franchising in one of these frontier markets, Bulgaria. As seen from the table 3, the country is classified as frontier market by both FTSE and MSCI.<sup>7</sup>

<sup>7</sup> The country is classified as frontier market by Russell as well (Source: <http://www.russell.com/indexes/documents/research/frontier-markets-of-europe.pdf> ) and by Standard & Poor's as well (Source: <http://www.prnewswire.com/news-releases/sp-launches-first-investable-index-for-frontier-equity-markets-58788242.html> )

Europe	Middle East	Asia	Africa	Latin America
Bosnia and Herzegovina	Bahrain	Bangladesh	Botswana	Argentina
<b><u>Bulgaria</u></b>	Jordan	Pakistan	Côte d'Ivoire	Trinidad and Tobago
Croatia	Kuwait	Sri Lanka	Ghana	
Cyprus	Lebanon	Vietnam	Kenya	
Estonia	Oman		Mauritius	
Kazakhstan	Qatar		Nigeria	
Lithuania	Saudi Arabia		Tunisia	
Macedonia	United Arab Emirates		Zimbabwe	
Malta				
Romania				
Serbia				
Slovakia				
Slovenia				
Ukraine				

Table 3: Frontier Markets based on FTSE and MSCI data  
Source: FTSE, MSCI

## CHAPTER 3 - Frontier Markets and Franchising

### 3.1. Franchising in Frontier Markets – Expectations

Franchising in frontier markets develops following the example of the concept developing in emerging and developed markets. Due to the additional risk and constraints in this subset of markets, it is crucial to understand the concept itself with its main lessons that can help it develop.

#### ***3.1.1. What makes franchising attractive or do the opportunities can overcome the challenges***

Low disposable income, poor infrastructure and legal framework are just some of the factors that make business in frontier markets harder and riskier. On the other hand, though, these markets present an unexplored territory where franchising as a concept might bloom due to the growth potential, lower costs and economic stimuli. In fact, the key to success is to explore carefully the market and its constraint - especially through the perspective of the differences between the smaller subset in the pool of frontier markets.

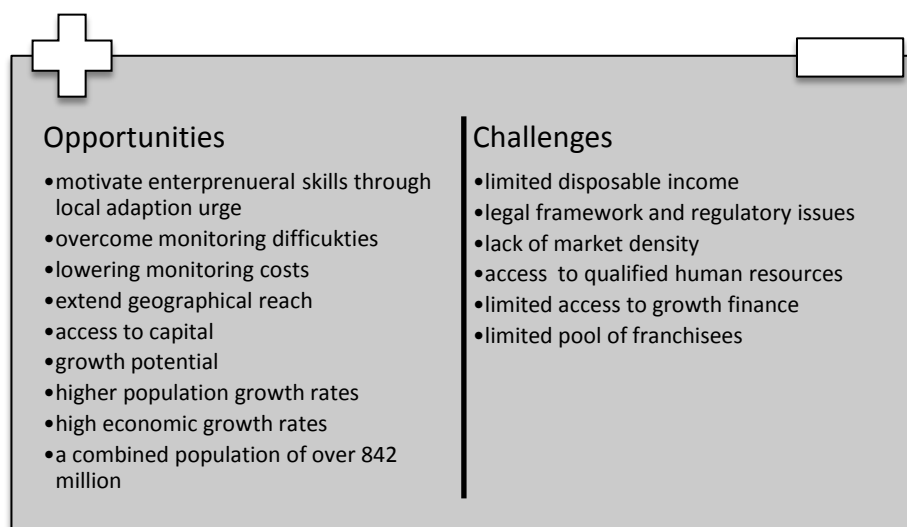


Figure 3: Franchising - challenges versus opportunities  
Source: (Schroder Fund Advisors LLC, 2012)

### ***3.1.2. Franchise as the change of fundamental business model – one of the common mistakes in frontier markets***

The franchising in emerging and developed markets with its many years of history and experience has shown that the growth of a certain franchising chain is preceded by unit profitability. McDonalds was founded in 1940 (McDonald's, 2013) as Bar-B-Q restaurant in San Bernardino, California. Fifteen years later, in 1955, the company opened its first franchise unit in Des Plaines, Illinois. Ten years afterwards the company concept succeeded in a way that allowed its spread to 700 restaurants throughout the United States. This is just one of many examples (Miller & Deelder, 2009) that prove one important manner that can be predicted for franchising chains: there is certain time needed to build a profitable, replicable and sustainable model and just then to launch it to the next level – franchising.

## **3.2. Potential Risks**

Generally, the investors in frontier markets meet all the challenges mentioned in the section above. Additionally, they need to be prepared for some additional risks that are induced by the character of these markets. Investors are used to facing the risks, as a natural feature of each investment. Less developed international markets, though, challenge the investors with additional obstacles due to an insufficient infrastructure and protection that they might have in established markets.

The risks showed below encourage investors to gain more experience in order to be able to succeed on such markets.

<b>Operational risks</b>	Settlement issues Failed trades
<b>Regulatory &amp; Market Risks</b>	Market entry/exit barriers Currency restrictions Maintenance/limitation of foreign ownership
<b>Currency risk</b>	Volatile currencies
<b>Governance risk</b>	Differences in the standards of corporate governance and financial reporting
<b>Geo-Political risk</b>	Geo-political conditions affecting market accessibility Geo-political conditions affecting operational risks Geo-political conditions affecting regulatory risks
<b>Transactional costs</b>	Higher commissions, fees and taxes Wider bid/ask spreads Lower liquidity
<b>Sector and sovereign risk</b>	Few sectors dominate which leads to increased exposure to sovereign risk

*Table 4: Additional risks in frontier markets*  
Source: Northern Trust Corporation, Ernst & Young

## Part B

### CHAPTER 4 – Case Study: Bulgaria



Figure 4: Economic Map of Bulgaria  
Source: Nation Master

#### 4.1 Bulgaria – Country Profile

Bulgaria is a European country lying strategically in the northeastern part of the Balkan Peninsula. The country is European backdoor to Asia and Middle East.

This strategic location allows access to the following markets (Invest Bulgaria Agency, 2011):

- Southeastern Europe – rapidly growing market with over 122 million consumers
- European Union – Bulgaria offers environment of lower costs of living and doing business, as well as duty-free access to 500 million consumers.
- Commonwealth of Independent States, Middle East and North Africa

Bulgaria has grown in the last years as an attractive country for investments due to the balanced combination between political and macroeconomic stability.

Additional factors that strengthen the country's image are its membership in EU, Nato and WTO.

Bulgaria is upper middle-income economy with population of about 7.6 million people with a per capita income of \$6,530<sup>8</sup> (World Bank, 2013).

#### **4.1.1. Political stability**

Bulgaria has been a parliamentary republic for over two decades now. In 1989 the communist system in the country collapsed and a democratic government was elected.

The years of democracy and transition has proven hard for Bulgaria and its population. In March 2012, the government abandoned its plans for building a new nuclear power station at Belene. That was the last drop that caused total loss of support for the Bulgarian executive authority. Less than a year later, thousands of people went on the streets protesting against the monopolists, the high electricity bills and the poor conditions of life in the last years. The government resigned and on 21 February 2013 the parliament accepted it in a 209-5 vote. (Vesti, 2013)

Early parliamentary elections were held on 12 May 2013. Boiko Borisov's party "Citizens for European Development of Bulgaria (GERB)" won ahead of the Socialists with around 4 % of difference. Four parties gathered enough votes for being presented in the parliament. None of them, though, received enough members of the parliament in order to create government on its own.

Turnout in the election was the lowest in post-communist history. The turnout of these early parliamentary elections has been estimated at 51.33%<sup>9</sup> (Mediapool.bg, 2013). The leading party has also been hit with claims of fraud (Dnevnik, 2013).

All these recent events predict rising fear of further instability in the country.

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<sup>8</sup> GNI per capita, 2011

<sup>9</sup> According to official preliminary results by the Central Electoral Commission

### 4.1.2. Economic environment

On 1 January 2007 the former communist country entered the European Union. This step increased the potential opportunities in Bulgaria and its attractiveness for business initiatives.

The real GDP showed stable growth from 2001 to 2008. Averaged more than 6 % annual growth was seen between 2004 and 2008. The growth was driven by factors as higher consumption, banking lending and foreign direct investment inflow.

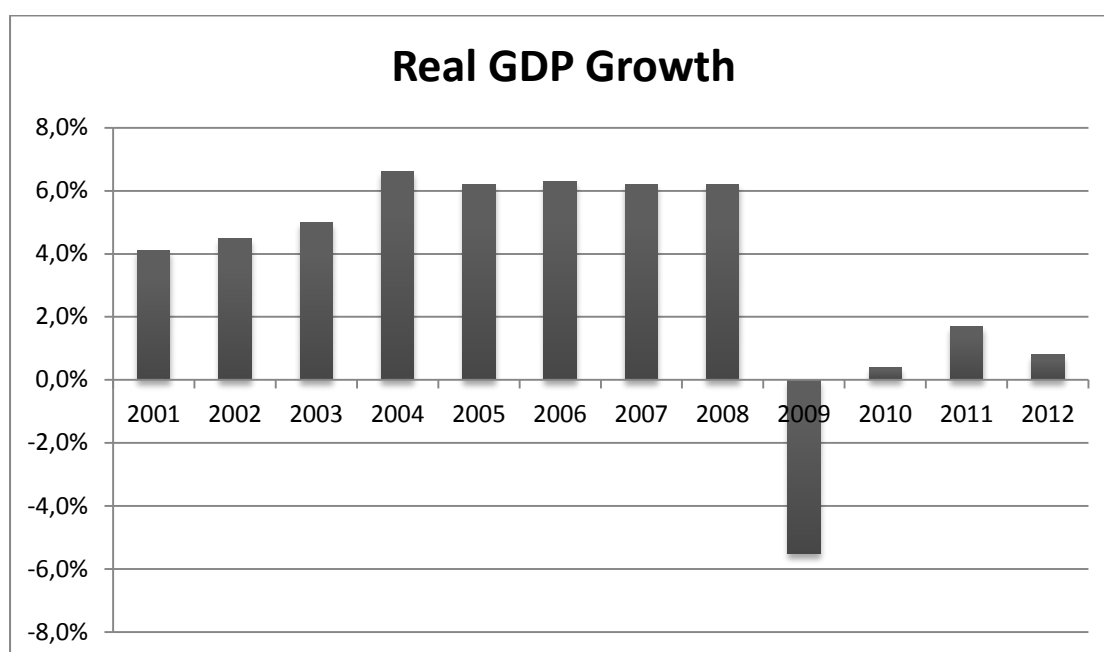


Figure 5: Real GDP Growth from 2001 to 2012 (Bulgaria)  
Source: IMF

Between 2000 and 2010, the income per capita in the country increased rapidly from 28% to 44%<sup>10</sup>. Austerity measures were taken in order to lower the budget deficit to 4.8 % of GDP in 2010 to 2.5 % for 2011<sup>11</sup>. Today Bulgaria remains among the

<sup>10</sup> As a share of the EU average

<sup>11</sup> The plan includes reducing spending by "\$584 million in 2011 by cutting funds to almost all government ministries; a reducing public sector jobs by 10 percent and a freezing wages for up to three years, Austerity Measures in the EU" ( Source: <http://www.europeaninstitute.org/Special-G-20-Issue-on-Financial-Reform/austerity-measures-in-the-eu.html> )



member states with the best austerity<sup>12</sup>. This has been considered as an important achievement in the context of both the global and European economic uncertainty.

Bulgarian governments committed to policy of supporting conservative fiscal measures, responsible fiscal planning and structural reforms. Additionally, the Bulgarian currency (Lev) was pegged to the euro in 1999. The commitment to economic reforms and responsible fiscal behavior, though, was not enough to overcome the consequences of global downturn, namely decrease in industrial production and domestic demand, as well as reduced exports, and capital inflows. GDP growth changed dramatically in 2009, contracting by 5.5%. Despite the recovery in exports during the next year, the GDP increased just slightly. The last two years, 2011 and 2012, the growth could not reach the levels it had before 2008 but started to increase slowly (Central Intelligence Agency, 2013).

The country offers flat, low incorporate income taxes which favor the investments.

Nevertheless, Bulgaria still faces significant challenges. For years the country fights unsuccessfully with corruption in public administration. Weak judiciary and certain rate of organized crime damage the investment climate and economic opportunities.

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<sup>12</sup> "According to the European Union's Maastricht criteria, EU member states may not have a budget deficit that exceeds three percent of their Gross Domestic Product (GDP) or a national debt that exceeds of sixty percent of the GDP. Listed below are the EU states' 2009 government budget deficits as percentages of GDP, their official predicted future government budget deficit as a percent of GDP. Also listed is the national debt as a percentage of GDP for 2009",

<http://www.europeaninstitute.org/Special-G-20-Issue-on-Financial-Reform/austerity-measures-in-the-eu.html>

<b>Bulgaria - Summary Statistics</b>	
<b>Population</b>	7.4 million
<b>Labor force</b>	4.6 million
<b>Urban Population:</b>	73%
<b>Capital</b>	Sofia
<b>Total area:</b>	110 879 sq. km
<b>Languages:</b>	Bulgarian (official) 85.2% Turkish 9.1% Roma 4.2% English, German, Russian, French: widely spoken
<b>Religions:</b>	Christian Orthodox 76% Muslim 10% Other 14%
<b>Currency</b>	Lev (BGN)
<b>Fixed exchange rate</b>	€1 = BGN 1.95583
<b>Corporate income tax</b>	10%
<b>Personal income tax</b>	10%
<b>VAT (standard)</b>	20%
<b>Government type</b>	Parliamentary Democracy
<b>Executive state body</b>	Council of Ministers, head: Prime Minister
<b>Important Memberships</b>	EU member since 2007 NATO member since 2004 WTO member since 1996

Table 5: Bulgaria – Summary Statistics

Source: Bulgarian National Bank, National Statistical Institute

#### 4.1.3. Legal environment<sup>13</sup>

The legal framework in Bulgaria creates favorable conditions for the franchising business.

Franchising business has been actively presented in Bulgaria for over a decade (first forms appeared earlier, but the last 15 years it has started to bloom). However, the Bulgarian legal system seems to lag in its performance and thus there is still no clear

<sup>13</sup> Interview with Svetoslav Biliarski from [franchising.bg](http://franchising.bg) (2013), (Светослав Билярски: Франчайзинг бизнесът още не е регулиран у нас“), [http://www.b2bmagazine.bg/index.php?option=com\\_content&view=article&id=89:..](http://www.b2bmagazine.bg/index.php?option=com_content&view=article&id=89:..)

basis in the legislation for this business concept (Biliarksi, 2013). In fact, only a short definition of franchising is mentioned in the Corporate Income Taxation Act<sup>14</sup>.

*„10. "Франчайз" е съвкупност от права на индустриална или интелектуална собственост, отнасящи се до търговски марки, търговски имена, фирмени знаци, изработени модели, дизайни, авторско право, ноу-хау или патенти, предоставени срещу възнаграждение, за да се използват за продажба на стоки и/или за предоставяне на услуги.“<sup>15</sup>*

On the one hand, loose legal framework is one of the major problems in this subset of markets and Bulgaria is just one example that proves it. The stable legal environment is a prerequisite for each type of business. In frontier markets there is even stronger need for established regulation and clear set of the business postulates. This would ensure a clearer basis for settling any conflicts that might appear between the partners and for building transparent relationships between the franchisor and the franchisee.

For example, in a legal regulated market as USA, franchisors are not allowed to promise investment return and profits. This would probably bring the franchising business closer to a financial pyramid. Some franchisors even might refuse to revise franchisee's business plan since this may mean promising any profits or successful insights.

On the other hand, the legal environment accommodates the franchising business:

- There are no specific registration needed, franchisors must comply with the regulations of Bulgarian Commerce Law.
- No restrictions on capital royalties and interest
- Franchisors from USA are protected by the US-Bulgarian Bilateral Investment Treaty<sup>16</sup> from 1994
- Established infrastructure for providing effective and adequate protection of intellectual property – the law in this area is harmonized with EU legislation

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<sup>14</sup> „Закон за корпоративното подоходно облагане”, <http://www.nap.bg/page?id=34>

<sup>15</sup> "Franchise" is an aggregation of rights of industrial or intellectual property right, related to trademarks, trade names, logos, models, designs, copyrights, know-how or patents granted for remuneration to be used for sale of goods and / or provision of services. "

<sup>16</sup> Treaty concerning the encouragement and reciprocal protection of investment, [http://tcc.export.gov/Trade\\_Agreements/All\\_Trade\\_Agreements/exp\\_002792.asp](http://tcc.export.gov/Trade_Agreements/All_Trade_Agreements/exp_002792.asp)

and Agreement on Trade-Related Aspects of Intellectual Property Rights. The country is a member of the World Intellectual Property Organization

#### **4.1.4. Market potential**

Foreign (especially western European and US) goods and services are well accepted from the Bulgarian buyers. Opening the borders allowed the population to travel more and to develop a cosmopolitan taste. In addition, more and more tourists come to the country each year and this increases the exposure to foreign goods. The factors mentioned above increased the awareness and trust in a high level of awareness and trust in foreign brands. Increased financial independency combined with higher awareness and acceptance contributes to creating a favorable market environment for foreign franchising brands.

Growth in disposable income is another factor that influences the commercial climate. Between 2000 and 2010 Bulgaria's per capita income <sup>17</sup> increased dramatically from 28 % to 44 %.

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<sup>17</sup> As a share of the EU average

# CHAPTER 5 - Challenges and Opportunities of Franchising in Bulgaria

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*I would like to thank Veselin Dimitrov (Partner at Franchisopedia ,Sales manager at Kiberman, Sales Manager at Franchising.bg) for his support and for granting permission to use the survey reports about franchising in Bulgaria (2009, 2010, 2012). Mr Dimitrov knowledge and experience has proven essential for the existing of this paper.*

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## 4.1 Background

Business model of franchising is becoming more and more attractive in Bulgaria for the people that are looking for new opportunities and ways to start own business. Franchising is believed to be less risky and independent initiative due to:

- Starting new business supported by a proven trademark
- Immediate access to resources and infrastructure
- No need of establishing any new brands

The first forms<sup>18</sup> of franchising in Bulgaria began operating on the market in the 70ies of 20<sup>th</sup> century. Known as first franchise contractors are Sheraton, Hertz, and Novotel. In fact, first in the mid 90ies the industry started to develop more intensively.

Nowadays, companies offering franchise or big chains operating by the rules of the franchising model exist in many sectors of the economy. Nevertheless, relatively small part of the business active population is really aware of what franchising is, how it operates, its advantages, disadvantages and applications. The lack of information is believed to be the reason behind that fact.

The year 2007 is important for Bulgaria in many directions, as well as in direction development of franchising. Since that year Bulgaria is a member of the European Union which has made the country extremely attractive for foreign investors bringing

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<sup>18</sup> All sources found state first forms without further information on concrete examples

more investment into franchising as well. The last years showed that world-known companies and trademarks started developing own channels on the territory of the country.

The franchising systems in the country are two types: such brought from abroad and such created in Bulgaria. The invasion of the world known brands is strongly presented in the last three years and all the reports from 2007 till now show the rising interest of foreign chains for operating on the Bulgarian market. The expenses for elaboration of a franchise start from 12 000<sup>19</sup> and can include: all needed documentation, training and education, administrative expenses, software provision, hiring and training of a franchising manager, marketing, advertisement, etc.

#### ***4.1.1. Profile of the franchisor – or who is looking for franchising opportunity***

In United States, the profile of the typical franchising candidate is an employed person that is seeking for an opportunity to be his own boss. The other big group that seeks franchising opportunities are investors that tend to buy regional and master franchisees for whole regions or/and countries.

In Bulgaria these two groups still seem to be not so widely spread (Franchising.bg, 2012). Instead, four main groups have being developing in the last four years:

- Businesspeople that are relatively experienced in managing own business. They possess certain capital for investment and strong desire to start new business. This group is considered as serious franchising candidates. The percentage of successful franchising business among this group is relatively high
- Entrepreneurs willing to start an additional business whereas they are trying to avoid spending time, efforts and money in developing own business model
- Candidates with no business experience. They rely on the strength of an already known and used trademark as well as on developed know-how.

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<sup>19</sup> Data from 2012

- In 2007 Bulgaria became full EU-member which cause forming of one more group – candidates seeking euro financing for starring new business. This niche is mainly occupied by low-budget franchises that can quickly turn into national chains.

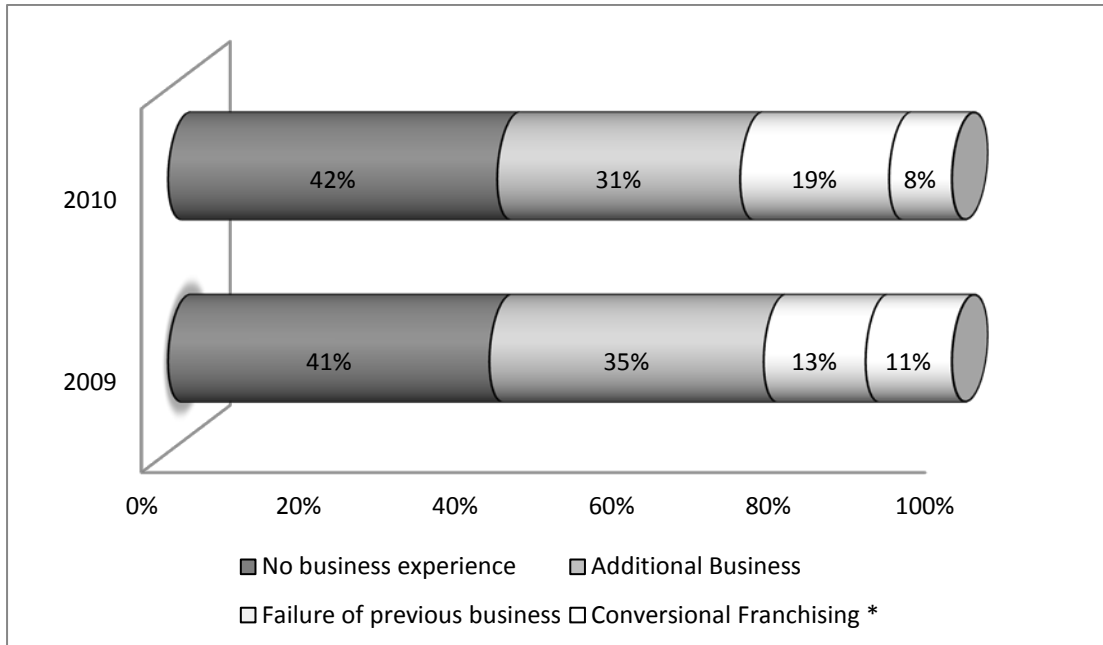
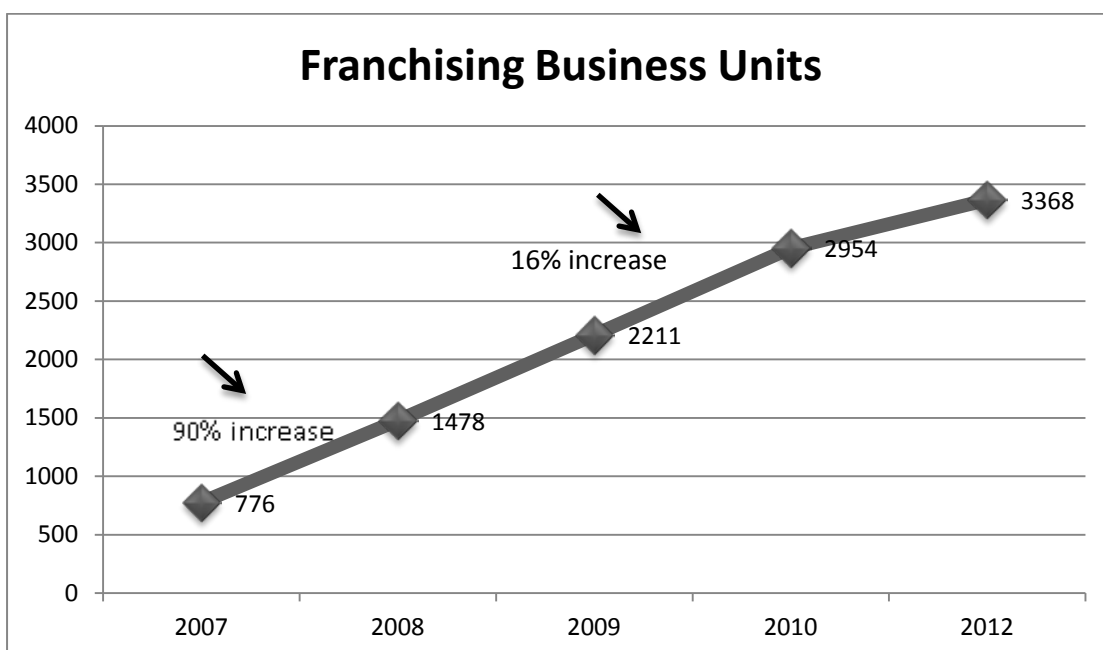


Figure 6: Who is looking for franchising  
Source: Franchising.bg

Comparing the percentage of increase is clearly seen that franchising units keep growing. The perceptual increase in the crisis years is not as high as in 2008, but nevertheless the trend is definitely in the same direction.



*Figure 7: Franchising Business Units*  
*Source: Franchising.bg*

Traditionally, the food sector dominates with 15 % franchise companies in 2009, reaching 32% in 2010. In 2010, though, 14 new sectors started offering franchising business models (Franchising.bg, 2010).

#### **4.1.2. Return on investment – time perspective**

Franchising spreads in different companies and different sectors. Thus there cannot be a unique answer that would apply to all industries and businesses. The return on investment is highly dependable on abilities, desire and the efforts of each franchisee. The period varies from 2 months to 5 years depending on the factors stated above.

In the period 2007 to 2009 the average period for return on investment is about 15 months from the beginning of the franchising (Franchising.bg, 2009). Due to the economic circumstances, in 2010 this period increased to 26 months (Franchising.bg, 2010).

In two cases, the period of return on investment is relatively short (especially compared to other examples):

- Low-budget franchising businesses in the service sector, which are not bound to expenses for rent, salaries, reconstruction
- Entrepreneurs that possess managerial and trade experience



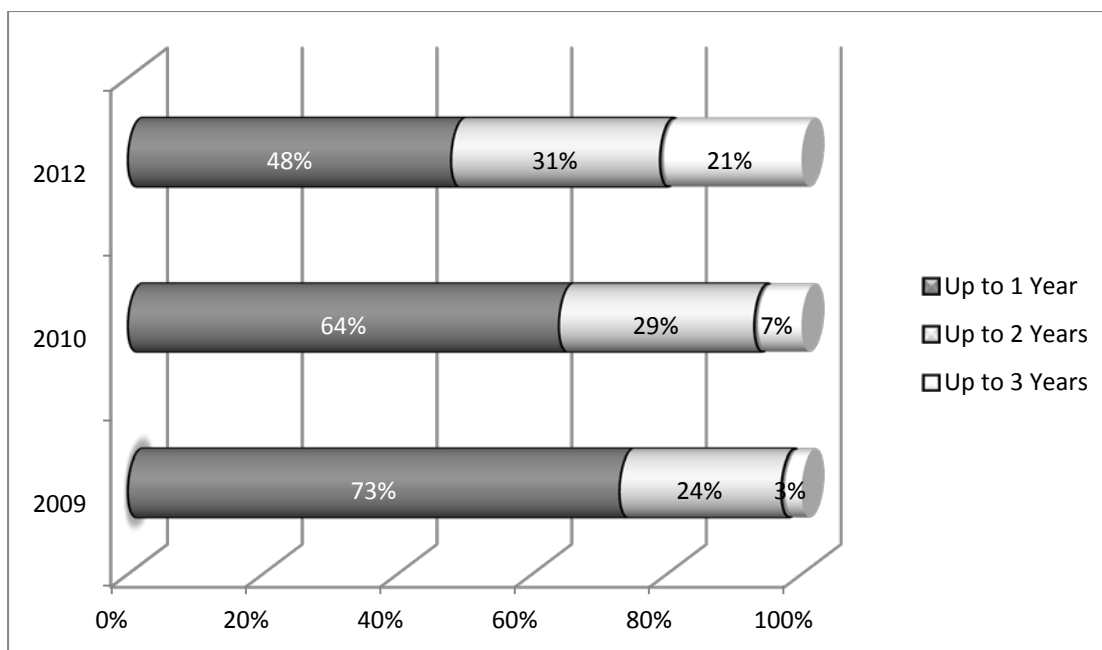


Figure 8: Periods of return on investment  
Source: Franchising.bg

The data comparison above shows that in the last four years the return on investment extends longer and longer and the percentage of businesses that manage to return their investment in up to one year has decreased dramatically.

#### 4.1.3. Profile of the average franchising

The average franchising can be described by the following features:

- Initial franchise fee – this is a single payment made at the start of a new franchise unit and includes staff training, specialized training of the manager of the unit. In some cases the fee covers equipment, marketing, etc. In 2009 the average franchise fee reached 5900 lv<sup>20</sup> (Franchising.bg, 2009). Just a year later the same feature was measured to be 4200 lv (Franchising.bg, 2010). Experts explain the decrease by the desire of the franchisors to create a wider franchising net. At the end of 2012 the starting average fee is already a lot higher, 17 825 lv (Franchising.bg, 2012), which, though, is still couple of times less than such fee in USA (\$40 000) and Western Europe.

<sup>20</sup> Lev/euro = 1.95583, fixed exchange rate)

- Franchise royalty payments – each franchisor develops own system and strategy for its monthly deductions from the turnover of the franchisee. Basically, we can distinguish four major directions: as a percentage of the turnover, fix payment, percentage plus fixed minimal payment or no monthly royalties. In fact, when the last method is chosen the franchisor does not requires any monthly payments but instead make a special agreement with the franchisee that the offered production will be purchased from the franchisor. In 2009 the numbers showed that the average franchise royalty payments were 4,9%, decreasing to 4.7% in 2010, and rising up to 6,2% at the end of 2012 (Franchising.bg, 2012).
  
- Contributions to a national advertising fund - it is not rare that the franchisors might require such a payment from the franchisees. When such contribution has been agreed, it is usually between 2 and 4 % depending on the business branches. In 2012, the average rate of this indicator was 3.5%. This is basically with 0.3% less than the value in 2010, and respectively 0.7% less than 2009.
  
- Investment for starting a franchise – in the last couple of years the average starting investment has slightly increased, from 29 500 lv in 2009, till 38 454 lv in 2012. The reports made in 2012 show that most of the people, willing to start a franchise business, would agree to spend no more than 10 000 lv. The financial crisis on the markets in the last years, as well as the economic situation in Bulgaria complete explains this number. What is a bit surprising, though, is the higher percentage of people willing to invest in relatively more expensive franchise business in comparison to the one of people willing to spend over 50 000 lv but no more than 100 000.

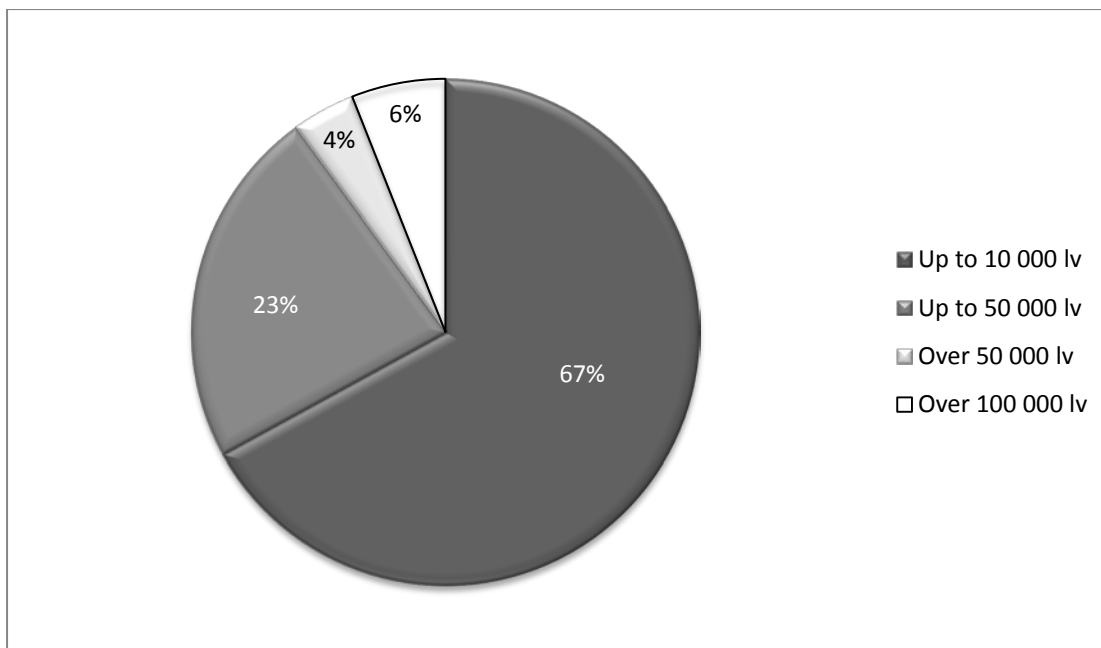


Figure 9: Investment for starting a franchise  
Source: Franchising.bg

- Number of franchise units – the units in 2012 is more than twice more than the ones in 2009. The reason for that are the large chains that the franchisee have started to build in the last two years.

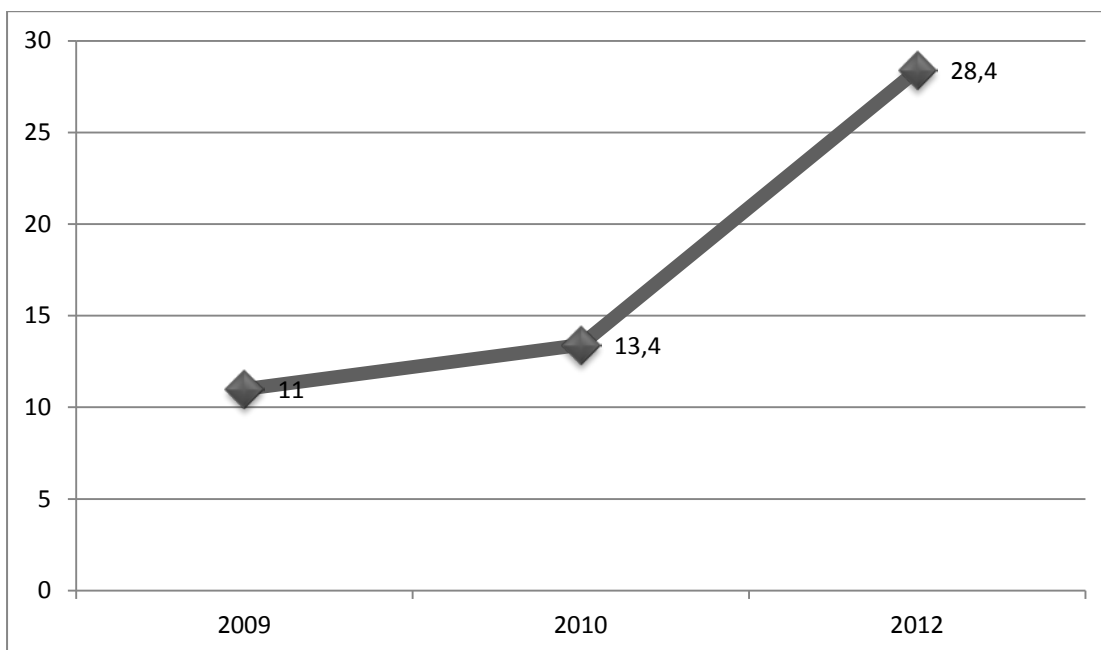


Figure 10: Number of franchising business units  
Source: Franchising.bg

- Average length of the contract – the average length is about 5 years (2009), reaching 4.5 years in 2012.

- Profit expectations – along with the other advantages of the franchising, the expected profits are the next major factor influencing the boom in the franchising in Bulgaria in the last years. In 2012, 68 % of the franchisees share the opinion that the made profit is higher than the household expenses.

In the last couple of years, there are two main tendencies that are spotted in this area and aimed to improve the relationship between the two sides of the business model:

- In 2009, 76% of the franchisors share the opinion that they need to be more precise in franchisees selection and to follow if the franchise procedures are strictly followed. This has led to developing a testing system and additional requirements for financial stability.
- More and more franchisors recognize the need of finding the right business partner. The last years brought them to experience that the chain is as weak as its weakest link. Thus, the franchisors have started to understand that finding a wrong partner can lead to negative influence on the whole franchising chain and to ruin the image of the trademark.

## 4.2. Franchising in Bulgaria – Trends and Opportunities<sup>21</sup>

### 4.2.1. Franchising chains show steadily increase 5 years in a row

Over the last five years franchising in Bulgaria is really starting to develop really fast and to spread wider. According to the current statistics (Franchising.bg, 2012) the companies offering franchising in the country have tripled from 2007 to 2009. Nevertheless, the number of franchises in 2008 is only 60. These 60 companies account for 1478 franchising business units (Invest Bulgaria Agency, 2011). The trend shows that the growth has really speeded up: in the first half of 2009 20 new companies started operating on the market. 62% of these companies are Bulgarian companies whereas about 68% of them have been working for over five years at that moment.

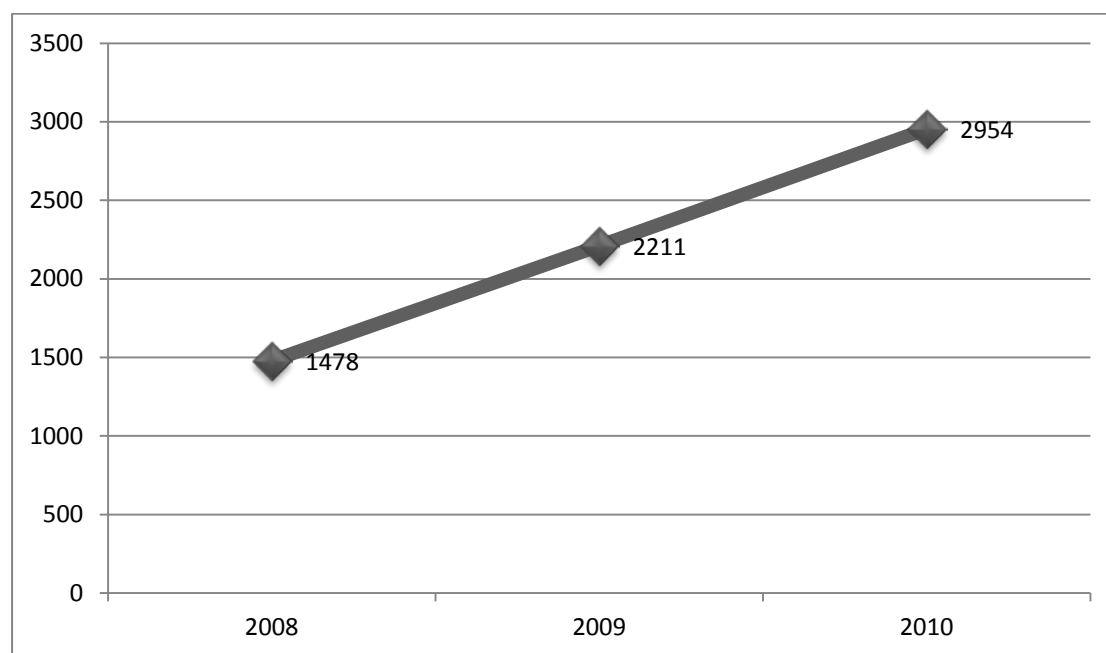


Figure 11: Number of franchising business units  
Source: Franchising.bg

In 2010, 198 companies offered franchising which was far over the forecast<sup>22</sup> from 2009.<sup>23</sup>

<sup>21</sup> The statistics in this section were kindly provided by the Franchising.bg. The data was summarized based on surveys from 2009, 2010 and 2012.

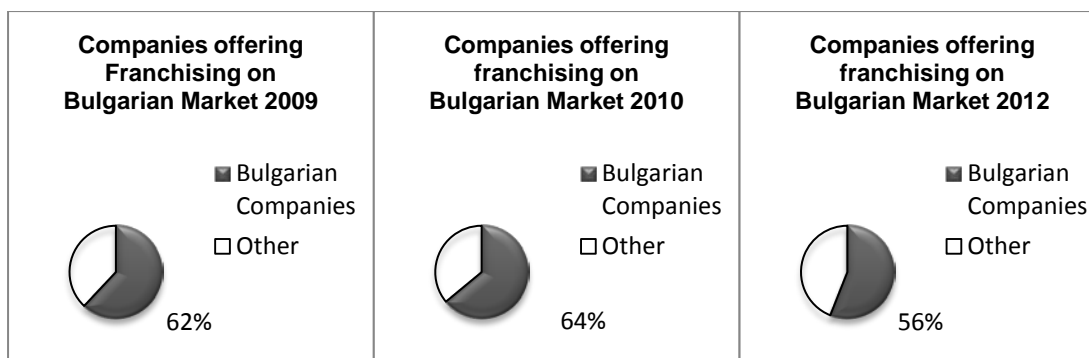


Figure 12: Companies Offering Franchising  
Source: Franchising.bg

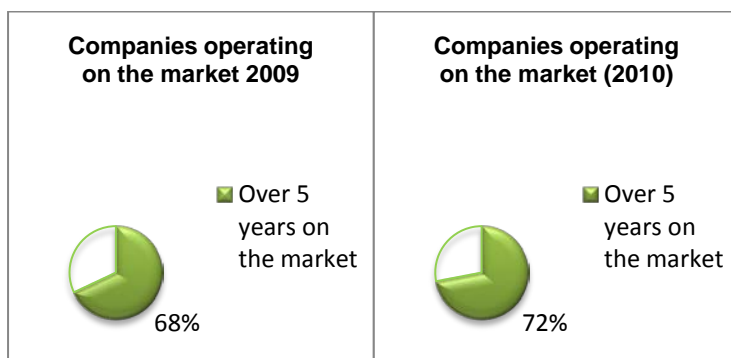


Figure 13: Franchise companies operating on Bulgarian market  
Source: Franchising.bg

Franchising offers a chance to everyone to start its business using the advantages of already profitable business and known brand, as well as the franchisor's requirements and company principals are followed correctly.

Among the most popular international brands on Bulgaria's Market are Subway, KFC, McDonalds, Coca Cola, IKEA, etc. Well known Bulgarian companies that offer franchising are Happy, Еврофутбол, Second Hand Mania, Дон Домат, Неделя, Econt, etc.<sup>24</sup>

<sup>22</sup> Based on the development seen from 2007 to 2009, at the end of 2009 the Franchising.bg forecasted 138 companies

<sup>23</sup> In the surveys conducted in 2009 and 2010 are included all franchising companies. In the numbers presented in 2012 are taken into account, though, just the franchise companies with actively operating franchise chains.

<sup>24</sup> Еврофутбол (Eurofootball), Дон Домат (Don Tomato), Неделя (Sunday)

### **4.2.2. Franchising instead of starting own business – reasons behind the decision**

Two are the major reasons for the wide spread of franchising around the world, as well as in Bulgaria: on the one hand, operating a business under a strong and well-known brand, and on the other hand, the proved know-how and business practices. Additionally, the franchisor offers support in terms training, documentation, choosing of location, marketing and advertising campaign, etc. The data from 2012 proves the importance of the factors stated above:

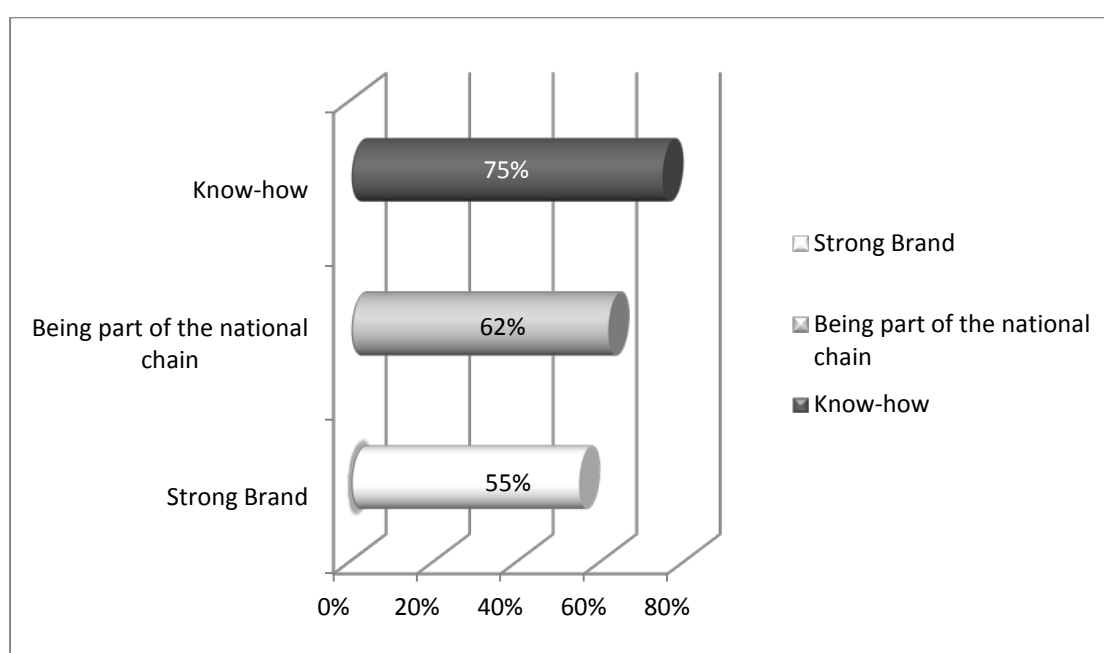


Figure 14: Why did you decide to buy a franchise?  
Source: Franchising.bg


### **4.2.3. Franchising creates job places**

Until the end of 2007 the number of franchising units was 776. Just for one year, the business blooms with about 90% increase. In other words the franchising units in 2008 reach 1478. In 2010, despite the economic crisis, the number of units increases to 2954 (Franchising.bg, 2009). In two years' time, the franchising business proves to be a winning strategy and thus brought an increase of 16 % and units of 3368 in 2012 (Franchising.bg, 2012).

Franchising system contributes to creation of job places which is especially appreciated in times of economic crisis. In 2008 franchising business accounted for 2370 new jobs, and just for one year, in 2009, reached almost 4 times increase, reaching 8000 job places. In 2010, the number reached slowly, but steadily 9500 (Franchising.bg, 2010).



#### 4.2.4. Successful franchising examples in Bulgaria

Fornetti – Mini Bites	
Initial Fee	none
Royalty Fee	none
Additional Investment	5 000 lv ( 2500 Euro)
Contract Duration	Indefinite
Industry	Food

The company Fornetti originates from Hungary dating back in 1997. Currently it has over 6500 business units all over Europe. The company works on the basis of master franchise working with partners from Germany, Poland, Romania, etc. (Fornetti, 2013). Couple of years ago the company, its brand and products were completely unknown on Bulgarian market. The situation changed quickly in 2007 when Angel Dimitrov opens the first franchising unit in Varna. Soon afterwards the brand gained popularity and its franchising model became attractive for many entrepreneurs (Franchising.bg, 2013).

Fornetti remains the producer of its frozen bakery products and sells its production to its franchising partners. They, on the other hand, profit from the difference in the delivery and the end price<sup>25</sup>.

Dimitrov opens three business units at the beginning. Soon after that the number rises to 7 with 18 employees. The initial interest in the products allowed the quick increase in the unit numbers.

Nowadays, Dimitrov possesses only 3 of the units with 6 employees (Капитал, 2010). The reason behind that decision was the market saturation and the high competition. Dimitrov says that the lack of advertisement is one of the big minuses for the company (Капитал, 2010).

Nowadays the company has over 350 units in Bulgaria, offering quick return, safe and long-term earnings, no without initial and monthly fees. The basic requirement remains that the franchisee has own outlet.

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<sup>25</sup> Fixed for all participants in the change



„Пикадили” is a Bulgarian supermarket chain with over 15 years on the market. Its stores operate under international quality standards and high service. The supermarkets are stands for specific atmosphere and European quality of the goods and services provided.

In July 2011, the Bulgarian chain was bought by Delta Maxi Group<sup>26</sup> and thus became a member of Delhaize Group<sup>27</sup> (Delhaize Group, 2013).

At present, Picadilly has 24 supermarkets<sup>28</sup> and 23 stores<sup>29</sup> (Piccadilly.bg, 2013).

On 26<sup>th</sup> March 2011 the chain opened its 26<sup>th</sup> supermarket in Bulgaria. The date remains important in the company’s history due to the fact that this was also the first franchise unit<sup>30</sup>. The franchise unit offered 49 job places. The franchisee, “Демарк Габрово” ООД<sup>31</sup>, is responsible for the management of the unit and the franchisor, Picadilly – for the delivery of goods and the determination of their range. Promotions are also determined by the franchisor.

The franchisees in the Picadilly chain cannot choose their providers but can profit from setting the end price. The partners of the chain share the opinion that they benefit from the established and known brand, the possibility to negotiate higher goods quantities, which, of course, means better prices and better profit perspectives.

<sup>26</sup> Delta Maxi Group is “the largest sub-part of Delta Holding and manages business operations in agriculture, food processing, retail, wholesale distribution, automobiles, real estate development, financial brokerage and financial services”

(Source: <http://www.deltaholding.rs/code/navigate.php?Id=28>)

<sup>27</sup> Belgian international food retailer


<sup>28</sup> 7 in Varna, 11 in Sofia, 1 in each of the cities: Plovdiv, Burgas, Veliko Tarnovo, Lovech, Vidin, Gabrovo

<sup>29</sup> 19 in Sofia and 3 in Varna

<sup>30</sup> With total area of 1500 sq. m, the supermarket was open in “Мон Габрово”, offering over 15 000 products – food and non-food

<sup>31</sup> Represented by Jordan Uzunov

The interest towards the franchising opportunities offered by the chain is enormous. The company, though, chooses carefully its franchise partners – such with top location and applying to the high standards of Picadilly (Expert.bg, 2009).

„Неделя“	
Initial Fee	Around 50 000 lv
Royalty Fee	7 %
Additional Investment	none
Contract Duration	5 years
Industry	Restaurant

„Неделя“<sup>32</sup> is the biggest confectionary chain (Franchising.bg, 2009) opening its first unit in 1993. The company is owned by Radoslava and Georgi Minchevi and it started only with 3 employees.

Nowadays, “Неделя” is a known confectionary chain with 25 units in the capital. The company provides job for 450 employees (Nedelya, 2013).

The first franchise unit the confectionary opens in 1999. Nowadays, the company has 25 Units, 18 of which are franchises (Minchev, 2012).

In the center of the chain is a production unit as well as a small marketing department. All partners in the chain have equal rights. The franchisor (“Неделя”) produces the cakes and for the rest of the products are delivered by providers determined by the company as well.

The company owner and head of the chain, Georgi Minchev, says that franchising is a profitable concept especially in years of crisis. He adds that in hard times it is even harder to survive alone (Minchev, 2012).

“Неделя” is the first Bulgarian franchising with only Bulgarian know-how leading to prosperity of the chain and its business.

<sup>32</sup> The names comes from the square “Баба Неделя” where the first confectionary of the chain was opened

## 4.3 Franchising in Bulgaria – Challenges

### ***4.3.1. Franchise awareness among the business active population***

In the last years the franchising concept has gain more and more popularity. This has pushed further the interest in the business active population to learn more about this business model and to explore the opportunities deeper. According to the franchisors about 27% of the franchise candidates are aware of the principles of this business model and do not need consultation. Additionally, they add that around  $\frac{1}{4}$  of the information request received are made by competent entrepreneurs and the rest  $\frac{3}{4}$  ask mainly about the basics of concept (Franchising.bg, 2012).

### ***4.3.2. Drop out of a franchisee from the franchising systems***

The strong world economic crisis in the last years has not left Bulgaria untouched. Depending on the industry the turn outs have fallen with average 10% to 30%. And even though franchising has been blooming in these hard times, still around one tenth of the franchisee cannot perform effectively in the franchising system and need to drop out. In other words, this leads to 7.6%<sup>33</sup> drop out rate. The rate is relatively low having in mind the economic atmosphere during the last couple of years. What is interesting, though, is to recognize the reasons behind. In 2009, 63% of the respondents in the survey claimed that the main factor for their failure were the high rentals (Franchising.bg, 2009). Just a year later, the highest percentage of answers, 68 %, points to the decreased purchasing power of the population (Franchising.bg, 2010).

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<sup>33</sup> Last known data is from 2010. In the 2012 survey this question was not closely discussed.

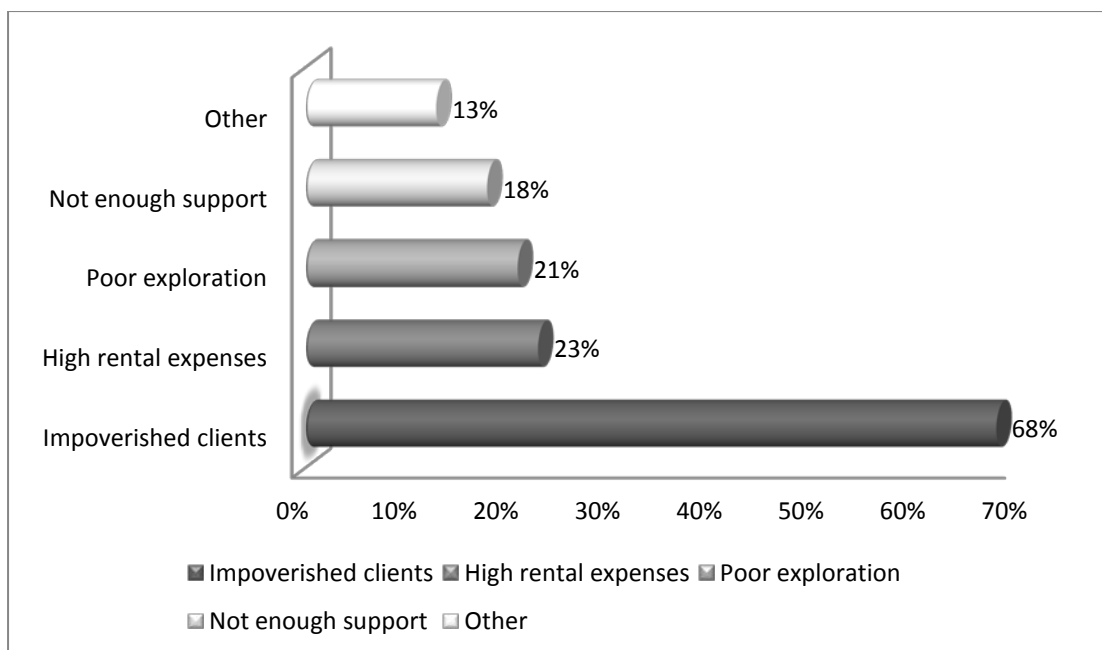


Figure 15: Drop out reasons  
Source: Franchising.bg

Another main reason for drop outs can be derived from the right choice of a brand. In Bulgaria there are just about couple of Bulgarian franchising companies in the food sector and there are far more international ones. Some of the franchisees forget, though, that many of the brands might be internationally known but they are still completely new for the Bulgarian consumer. The lack of awareness would mean additional measures for popularizing the brand whereas in other countries the well-known brand among the consumers is advertisement on its own. In other words, when choosing a strong brand unknown on the national market the franchise model equals the starting of own business (at least in short term period).

It is important to outline here the fact that franchising is very often promoted as “low-risk” business model. In reality this statement does not prove true for all the cases. In fact, a study (Bates, 1995) showed that around 35 % of the franchised businesses fail within a five-year period. The last years show that:

- when the chain is smaller and relatively new, the risk of franchising might be higher than the one for independent entrepreneurship
- the risk is relatively lower when the franchising chain is big and well-known

In addition, there is a risk of failure not of only the own franchise unit but of bankrupt of the whole chain of the franchisor.

#### ***4.2.3. Conflicts between franchisor and franchisees***

In fact, most of the franchisors state that the conflicts are rather rare. The major conflicts are due to insufficient precision in compliance with the performance standards in franchise systems (22% of the franchisors state this fact in 2010). In 2012, around 15% of the franchisors admit that the conflicts with the franchisees are due to the fact that the franchisees fail to comply with contractual clauses and mainly their financial part (Franchising.bg, 2012). The franchisors add that another conflict provocateur are the violations in terms of changing the goods provider or decreased quality of the product or the services offered by the franchisee.

#### ***4.2.4. Franchise education & training***

Choosing the best location and a strong brand are really important factors for the success of the franchise. But the proper training and education, combined with management potential are what can really turn a franchise in a profitable business.

Bulgaria is relatively small market and existing of companies, specializing in education and training in the field of franchising, is still not economically justified. In other words, the franchisors need to take care of the education, training and all other steps, i.e. choosing location, architectural projects, technology, etc. In most of the cases this would mean reducing the capacity of trained franchisees per year (Minchev, 2012).

#### 4.4. Franchising in Bulgaria - Comparison with Other European Countries

Bulgaria is among the countries with still few companies offering franchise. 198 companies offer franchising opportunity on Bulgarian market in 2010. The survey from 2012, though, includes companies (92) that possess active franchising system. Thus from this number have been excluded companies with no franchising units yet.

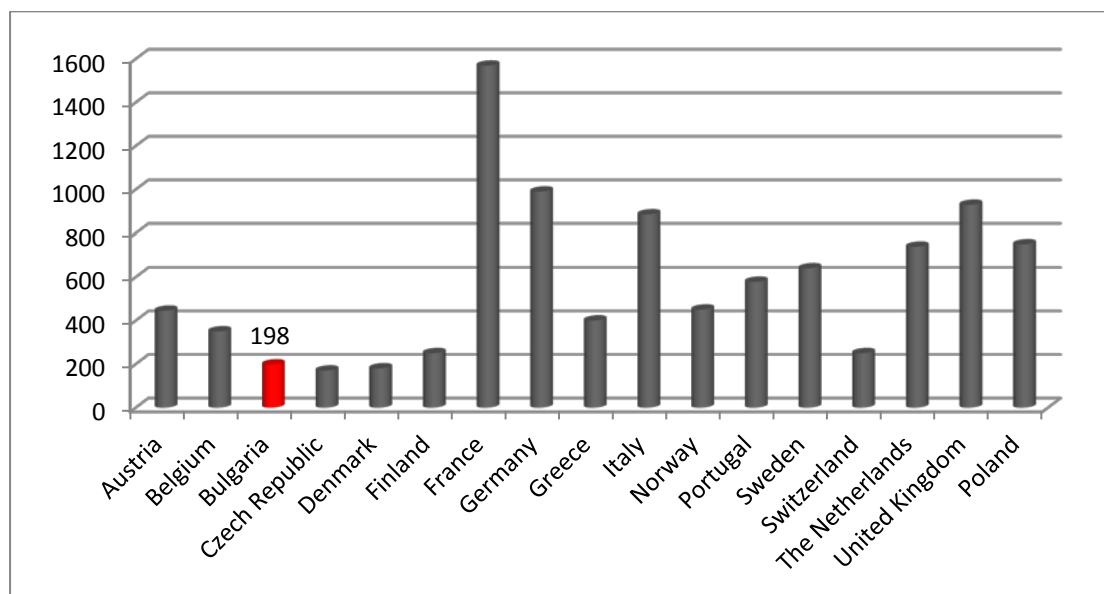


Figure 16: Number of franchises in European countries  
Source: (Franchising.bg, 2012), (Eurofranchise lawyers, 2013)

The country shows, though, a steady increase in percentage in the last couple of years, with an average of around 20%. Compared to the rest of the European countries (Figure 17), Bulgaria ranks 6<sup>th</sup> among 13 countries.

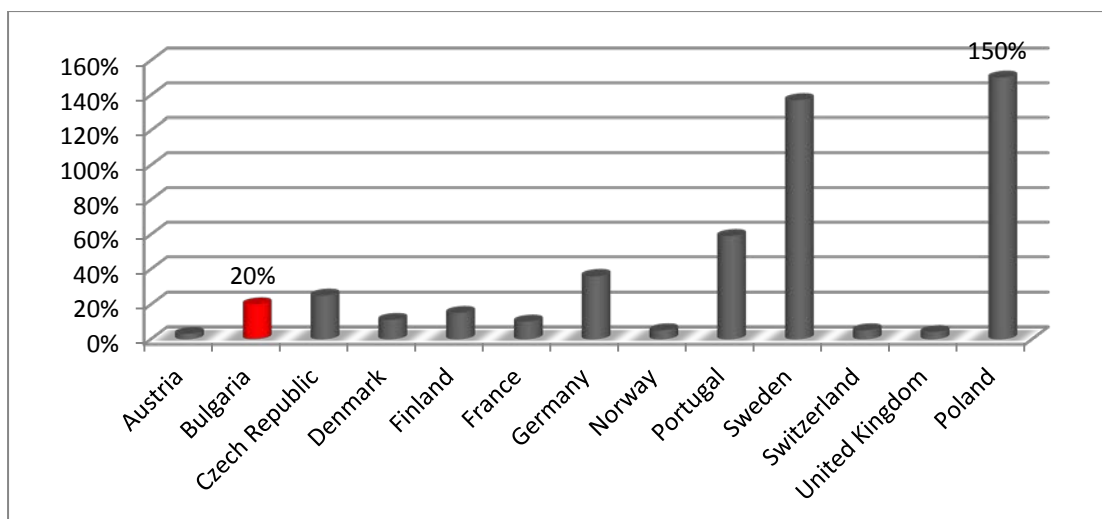


Figure 17: Franchise increase per year (in percentage in last 10 years)

Source: (Franchising.bg, 2012), (Eurofranchise lawyers, 2013)

Legally, most of the countries participated in Eurofranchise Lawyers Survey (2013) do not possess of specific law regulation concerning the franchising concept. Bulgaria is also one of the countries, where no specific law regulation for franchising exists.

Country	EU Regulation	Franchising Regulation on National Level
Austria	EC 330/2010	Antitrust legal framework harmonized with the EU Regulations
Belgium	-	No
Bulgaria	No information on harmonization procedures	No
Czech Republic	-	No
Denmark	EC 330/2010	No
Finland	EC 330/2010	No
France	EC 330/2010	Law related to full disclosure of pre-contractual information
Germany	EC 330/2010	No
Greece	-	No, just a draft is being prepared
Italy	-	Law and Decree of the Ministry
Norway	-	No
Portugal	-	No
Sweden	EC 330/2010	Disclosure Law from 2006
Switzerland	-	No
The Netherlands	EC 330/2010	No
United Kingdom	-	No
Poland	EC 330/2010	No

Table 6: Law Regulation in European Countries

Source: Own representation



Each franchisor develops own system of on-going royalties and the percentage varies depending on country, industry and company. Nevertheless, average figures can be derived that could be helpful for further comparison.

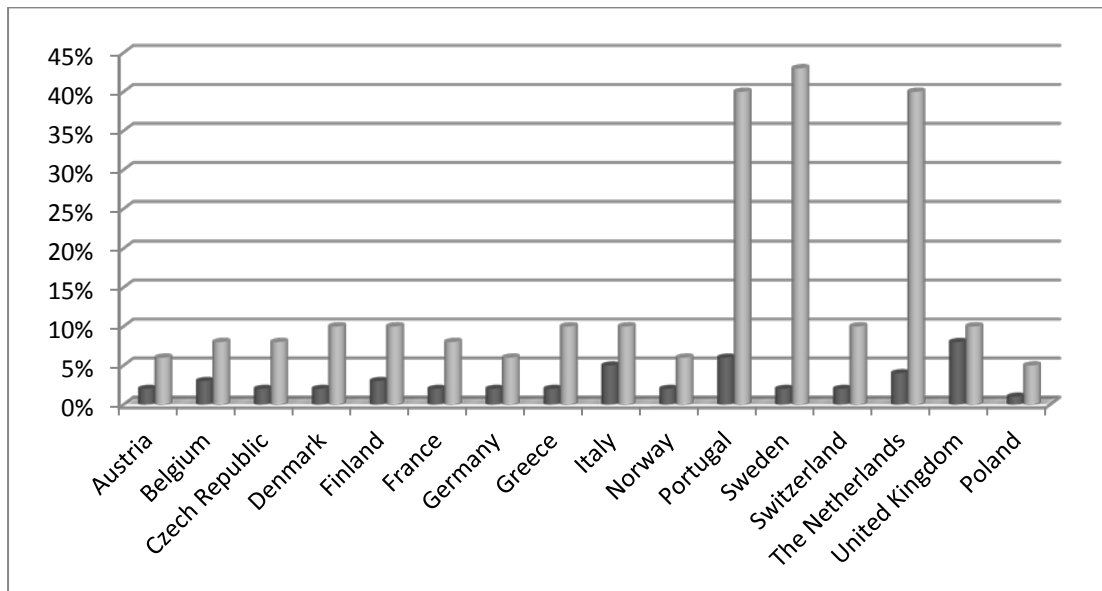


Figure 18: Minimal and Maximal Ongoing Royalties  
Source: (Eurofranchise lawyers, 2013)

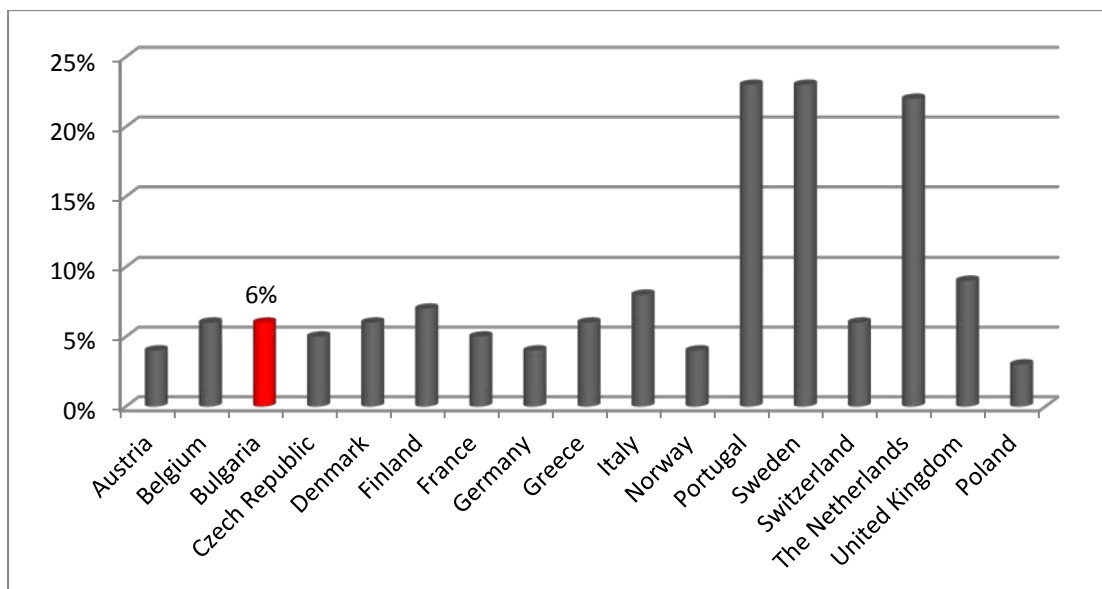


Figure 19: Average Ongoing Royalties  
Source: (Franchising.bg, 2012), (Eurofranchise lawyers, 2013)

## Conclusion

In 2012, 85 % of the franchisors saw the little knowledge of model as the major problem for the more rapid and wide spread of the franchise in Bulgaria. In fact, compared to 2007, the active business population is better informed of the concept. But still, not as well as in developed western European countries or USA. Franchise awareness is one of the main obstacles for successful implementation of the concept in the frontier market. Accepting that fact, Bulgarian organizations, like Franchise.bg, have made strong to educate and inform the business active population in terms of what franchising is, how it functions and what can be expected.

In the last five years the number of franchising chains in Bulgaria has been increasing with about temp of 20 %. 300 entrepreneurs each month are willing to start a franchise business which will give additional push of the concept spread.

According to the specialists, franchising is one of the fewest sectors in the Bulgarian economy which shows positive results in the last years. The big potential is seen in service franchises with low initial investment where no office and retail spaces, less expenses for personnel and maintenance.

The fact that more and more international chains have spotted Bulgaria as a profitable market is a factor that can lead to wider spread knowledge of the franchising system and its applications.

In fact, franchising gained its popularity not in the years of economic prosperity. Its business concept has become an alternative of the own business in years of crisis. The economic situation forces people that have or had own business to search for additional niches to develop further. As a frontier market, Bulgaria is among the countries with middle income and low liquidity. These two factors are one of the obstacles which explain why franchising is preferred in the last years and reveals the potential of the concept in such market.

Franchising is typically widely spread in the food sector. So the stable increase in this sphere is not a surprise. The recent surveys show, though, that other sectors in the Bulgarian economy awake interest among the entrepreneurs. There are whole

industry sectors in Bulgaria where franchising opportunities are still unexplored. These areas possess high potential for building national franchising chains: optics, children's houses, transport services, dry cleaning services; technology sphere and the healthcare industry as fitness, diet programs and healthy nutrition, beauty salons, photo epilation, etc.

In the last five years, more and more Bulgarian companies decide to expand through franchising. The specialists <sup>34</sup> explain that they have helped creating franchising concepts for restaurants and pastries, shops, pharmacies, educational centers, etc. This variety is another good sign showing that the principles function and there is further potential for development of the business strategy. The world franchising picture shows that there are still unexplored niches in Bulgaria, such as optics, hospices, flower shops, travel agencies, etc.

Franchisors in the country are very often interested especially in questions of controlling and monitoring of the franchisees. In the recent years many methods have helped franchisors in this area and these methods has started to gain popularity in Bulgaria as well. Among the commonly used are video monitoring, specially developed software, mystery shopping, contract clauses, etc.

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<sup>34</sup> *Franchising.bg offers consulting and is the most developed platform for information, consulting and analysis concerning franchising in Bulgaria*

# Appendices

## Abstract (English)

Franchising is an old phenomenon with beginning dating in the middle Ages. Nowadays, the concept has become so popular that it has becoming to spread in all different countries and industries. This paper aims (1) to reveal the basics of the franchising model, in terms of defining the concept and its principles, (2) to reveal the nature of frontier markets and the reasons behind their increased attractiveness in the in the last years, (3) to explore the opportunities of franchising in a frontier market as well as the (4) the challenges for its development on the Bulgarian market. Bulgaria is classified as a frontier market with all the features that this classification comes with – low liquidity, high growth potential, etc. The paper reveals major figures from the franchising market in Bulgaria and aims to show its development in the recent years.

The paper addresses the questions about franchising, especially in the frontier market Bulgaria: existence and development of the concept, franchise versus starting own business, challenges and opportunities in times of crises, main perspectives.

## **Abstract (Deutsch)**

Franchising ist ein altes Phänomen, dessen Ursprung bis in das Mittelalter zurückverfolgt werden kann. Heutzutage wird der Bekanntheitsgrad dieses Konzepts in den verschiedenen Ländern und Wirtschaftszweigen immer breiter. Diese wissenschaftliche Arbeit (1) beschreibt näher die Grundlagen des Franchise-Modells, in Bezug auf Definition dieses Konzepts und dessen Prinzipien, (2) enthüllt die Natur der Frontier-Märkte und die Hintergründe der erhöhten Attraktivität dieses Konzepts in den letzten Jahren, (3) erforscht die Chancen des Franchisings in einem Frontier-Markt sowie auch (4) zeigt die Herausforderungen für dessen Entwicklung auf dem bulgarischen Markt. Bulgarien lässt sich als "frontier market" aufgrund folgender Merkmale - niedrige Liquidität und ein hohes Wachstumspotential, klassifizieren. Diese wissenschaftliche Arbeit offenbart die Grunddaten des Franchise-Markts in Bulgarien und versucht die jeweiligen Entwicklungen aufzuzeigen.

Die Arbeit befasst sich mit den Fragen über Franchising und insbesondere auf dem Frontier-Market Bulgarien: Entwicklung des Konzepts, Franchise im Vergleich mit der Entwicklung eines eigenen Unternehmens, Herausforderungen und Chancen in Zeiten der Wirtschaftskrise und den Hauptperspektiven.

## EU Statistics in terms of Deficit and National Debt

	Government Budget Deficit as Percentage of GDP for 2009	Predicted Government Budget Deficit as Percentage of GDP	National Debt as Percentage of GDP for 2009
Austria	3.5%	2011- 3%	66.5%
Belgium	6%		96.7%
<b>Bulgaria</b>	<b>4.7%</b>	<b>2011- 2.5%</b>	<b>14.8%</b>
Cyprus	6%		56.2%
Czech Republic	5.8%	2011- 4.6% 2012- 3.5% 2013- 2.9%	35.3%
Denmark	2.7%		41.6%
Estonia	1.7%		7.2%
Finland	2.5%		44.0%
France	7.5%	2011- 6% 2013- 3%	77.6%

		2014- 2%	
Germany	3%		73.2%
Greece	13.6	2010- 7.8% 2011- 7%	115.1%
Hungary	4.4%	2011- 3.8%	78.3%
Ireland	14.4%	2014- 3% 2015- 2.9%	64.0%
Italy	5.3%	2012- 2.7%	115.8%
Latvia	10.2%	2011- 6%	36.1%
Lithuania	9.2%		29.3%
Luxemburg	0.7%		14.5%
Malta	3.8%		69.1%
Netherlands	5.4%		60.9%
Poland	7.2%		51.0%
Portugal	9.3%	2010- 7.3% 2011- 4.6%	76.8%
Romania	8.6%		23.7%

Slovakia	7.9%	2011- 4.9% 2013- 3%	35.7%
Slovenia	5.8%		35.9%
Spain	11.1%	2011- 6%	53.2%
Sweden	0.9%		43.2%
United Kingdom	11.4%	2015- 1%	68.1%

*Table 7: Austerity Measures in the EU*  
Source: The European Institute<sup>35</sup>

<sup>35</sup> Retrieved 2013, May 26 <http://www.europeaninstitute.org/Special-G-20-Issue-on-Financial-Reform/austerity-measures-in-the-eu.html>



## Frontier Markets Classification

Country	FTSE	MSCI
Argentina	X	X
Bahrain	X	X
Bangladesh	X	
Bosnia and Herzegovina		X
Botswana	X	X
Bulgaria	X	X
Côte d'Ivoire	X	
Croatia	X	X
Cyprus	X	
Estonia	X	X
Ghana		X
Jordan	X	X
Kazakhstan		X
Kenya	X	X
Kuwait		X
Lebanon		X
Lithuania	X	X
Macedonia	X	
Malta	X	
Mauritius	X	X
Nigeria	X	X
Oman	X	X
Qatar	X	X
Pakistan		X
Romania	X	X
Saudi Arabia		X
Serbia	X	X
Slovakia	X	
Slovenia	X	X
Sri Lanka	X	X
Trinidad and Tobago		X

Tunisia	X	X
Vietnam	X	X
Ukraine		X
United Arab Emirates		X
Zimbabwe		X

*Table 8: Frontier Markets – classification*

*Source: FTSE, MSCI*

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Dec 2000 – Dec 2010	Infoplast OOD <i>Operational accountant</i>
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### EDUCATION

Feb 2007 - June 2013	<b>Master of International Business Administration</b> <b>Austria</b> University of Vienna, Centre for Business Studies <i>Focus on International Marketing</i> <i>Conducted marketing research studies for T-Mobile and L'Oreal</i>
Oct 2000 – Oct 2005	<b>BA in Macroeconomics</b> <b>Bulgaria</b> University of National and World Economy

LANGUAGES

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Oct 2005 – June 2007	Participation in Master Courses of European Integration, University of National and World Economy
June 2002 – Oct 2002	<i>Work and Travel Program in Spain</i>

June 2003 – Oct 2003

*Work and Travel* Program in USA

June 2004 – Oct 2004

*Work and Travel* Program in Spain

June 2005 – Oct 2005

*Work and Travel* Program in USA

**PERSONAL INTERESTS**

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