CHINA: Franchising Industry

Access Dynamic and Emerging Markets

JLJ
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INTRODUCTION

The objective of this report is to provide an overview of the Chinese franchise market[1] with focus on four sectors: food & beverage, apparel, education, and fitness, beyond the already established cities of *Shanghai*, *Beijing*, and *Guangzhou*.

EXECUTIVE SUMMARY

Market overview. There are an estimated 2,600 brands with some 200,000 franchised retail stores in over 80 sectors. Franchising has also experienced significant growth in the last few years due to rising disposable incomes and an increasing number of Chinese entrepreneurs willing to adopt franchising models.

Regulatory environment. China's first franchise law was enacted in 1997, but there were several uncertainties and "grey" areas, particularly for foreign franchisors. More regulations were issued in 2005 and in March 2007, which further clarified the law; for example cross-border franchising[2], which was previously in a grey area, is now permitted. This opens up opportunities for mid-sized US franchisors that do not necessarily want to or have the resources to set up a legal presence in China.

Key sectors. The franchising model has been used to different degrees in the four sectors analyzed in this report. The F&B sector was one of the first to use franchising in China, but majority of franchisors are domestic; many international F&B brands have few franchised stores in China. In the apparel sector, franchising is mainly used to expand in Tier 2 or Tier 3 cities, while stores in Tier 1 markets are usually kept as direct-owned outlets. There is a large presence of foreign companies in both the education and fitness sectors. In education, the use of franchising is limited by regulations. In the fitness sector, franchising is still a common strategy for expansion, although several large gym chains are moving away from it and using Joint Ventures or direct-owned stores instead.

Key emerging markets. Key Tier 2 emerging markets for franchisors are still concentrated on the East Coast, e.g. *Qingdao* and *Nanjing*. Inland Tier 2 cities – such as *Xian* and *Chongqing* – offer potential in the longer term since disposable incomes there are still relatively low. It is generally difficult to find good potential partners in Tier 2 cities, and many strong hospitality groups are large domestic or Hong Kong companies with a national presence.

Key opportunities and challenges. There are good opportunities in all four sectors for US franchisors, especially for mid-market or high-end brands. However, there are several key challenges to adopting the franchising model, including the difficulty of finding good partners or franchisees, lack of control over store quality, need for localization, etc. Companies need to be prepared to invest a significant amount of time, commitment, and resources to manage China operations.

Market access. Foreign franchisors can enter via either cross-border franchising or establishing a local legal entity (WOFE/JV[3]). If the local legal entity is to be a franchisor, it must operate two direct-owned stores for at least one year, before it can have franchisees. However, more time is still needed to observe how the new franchising law is implemented. Although a higher capital investment is needed to set up a direct presence in China, it offers the foreign company greater monitoring/control over Chinese franchisees.

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[1]Franchising refers to the practice where the franchisor grants the franchisee the right to use a developed concept (including trademarks and brand names, production, service and marketing methods and the entire business operation model) for a fee. Franchisees supply the capital and staff.
[2] Where the foreign franchisor signs a franchise contract with a master franchisee in China, without establishing a legal presence in China
[3] Wholly-owned Foreign Enterprise or Joint Venture

INDUSTRY OVERVIEW

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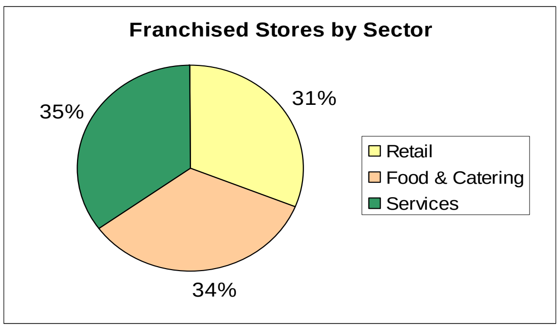
Market overview. China has 2,600 franchise networks[4] operating in the first quarter of 2007 and over 200,000 franchised outlets. However, many of these franchises are domestic brands and small in scale, with an average of 73 outlets per franchise brand[5], compared to over 540 in the US. The limited use of franchised stores also reflects the key challenges to adopt this model, for example, regional differences and quality of local franchisees/partners.

Market growth. Growth in sales from franchised stores has averaged 35-40% in the last few years. In 2006, sales from franchised outlets grew by 40%, compared to 10% for retail outlets in general. Currently, franchising in China only accounts for 3% of total retail sales – compared to 40% in the US and about 10% on average in Europe. Thus, there is still significant growth potential in franchising.

Drivers of growth. On the demand side, growth is driven by an expanding consumer market, a developing urban middle class, rising disposable incomes, and changing customer attitudes. On the supply side, an increasing number of Chinese companies are using the franchising model to expand. Also, more Chinese entrepreneurs are willing to be franchisees for foreign brands, and have the financial resources to do so. In addition, the Chinese market has become more attractive to foreign franchisors since the regulations newly introduced in March 2007 address many previous issues that were unclear in the previous regulations. *[see section on Regulatory Environment for more details.]*

Key sectors. The franchising model is adopted in over 80 sectors. In 2005, 34% of franchised stores were in *food and catering*, 31% in *retailing*, and 35% in the *service (includes laundry, property agents, copy-shops, etc.)* sector. Companies with existing chain stores[6] have used franchising to expand – 69% of chains adopted the franchising model at the start of 2007. In particular, fast food chains rely heavily on franchising – 95% have used franchising to expand.



Source: Ministry of Commerce

Regulatory Environment

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Regulatory developments. China's first franchise law was enacted in 1997 by the *Ministry of Domestic Trade*, which did not make clear provisions for foreign companies. In 2005, the *Ministry of Commerce (MOFCOM)* released hastily – due to WTO commitments – drafted measures applicable specifically to foreign franchisors. This document confirmed that foreign companies must establish a legal entity in China before they can engage in franchising; however many other issues were still unclear, including the legality of cross-border franchising. In March 2007, further updates ("*The Regulations*", "*The Record Filing Measures*" and "*The Information Disclosure Measures*") to the existing regulations were announced, which addressed many of the grey areas. These new amendments form the new regulatory framework for franchising. The following are the most important aspects of the updated regulation. It must be noted that these May 2007 regulations are still relatively new, and more time is needed to see the actual implementation.

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[4] Refers to a system of franchisees under the same network. A franchise brand may have more than one franchise network, e.g. it has a few regional master franchisees, which in turn further sub-franchise.

[5] Includes China's large franchise brands, with thousands of outlets, as well as the multitude of small brands, with only a few outlets each.

[6] While franchises are always chain stores, the opposite does not hold true.

Cross-border franchising. Cross-border franchising, whereby foreign franchisors engage a master franchisee in China without setting up a local legal entity, was previously in a "grey" area - old regulations mandated franchisors to set up a legal presence and operate at least two stores in China before franchising; however, some foreign companies still entered via cross-border franchising. With the newly updated law, this practice is now fully legal. The franchisor still needs to have at least two successful stores, but these do not have to be in China. According to *MOFCOM,* several franchisors have already entered using this method since May 2007[7].

Operating in China. Although cross-border franchising is allowed, for companies which choose to set up a legal entity in China, they are still subject to the relevant company laws. Thus the Chinese legal entity has to operate two successful stores for at least one year, before it can be a franchisor *[more details in section on Market Access]*

Key Franchise Sectors & Competitive Landscape

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The following sections of the report focus on four sectors: 1) Food & Beverage; 2) Apparel; 3) Education and 4) Fitness. Franchising is adopted in all four sectors, but the presence of foreign franchises differs depending on sector. Table 1 compares foreign to domestic franchises for these sectors.

Domestic vs. foreign brands. In general, domestic franchise brands outnumber foreign brands. However, many domestic outlets suffer from poor standardization and consistency across their outlets. Foreign brands are well-accepted, but have the widest presence in Tier 1 cities, where a large brand can have dozens of outlets per city, compared to about 1-4 outlets for each Tier 2 city.

Franchising among foreign brands. Many brands which franchise internationally choose to operate through direct ownership and JVs with local partners in China. Among the ones that do franchise, 60% are using master franchisees[8] over individual ones[9]. One reason franchising has not been pursued on a large scale by these brands are concerns about potential damage to brand image and product quality due to franchisees or partners not being able to operate at the desired standard levels. As a matter of fact, many foreign brands also find it difficult to find good franchisees. At the same time, with a large and rapidly growing market, many companies choose direct-owned stores due to the potentially higher returns. *[more details in section on Key Opportunities & Challenges]*

Table 1 – Differences between foreign and domestic brands across key sectors.

<table>
<tr><th></th><th>Foreign</th><th>Domestic</th></tr>
<tr><td>Overall</td><td>- Stronger presence in Tier 1 than 2
- Small proportion of the total franchise market
- Generally good consistency across stores</td><td>- Larger percentage of competition in Tier 2
- Dominate in terms of number of franchise chains
- Usually less brand consistency across stores</td></tr>
<tr><td>F&B</td><td>- Many foreign brands, but often not franchised, thus low share of foreign brands among F&B franchises
- Strong presence in Tier 1, fast expansion in Tier 2
- Int'l brands common in fast food/casual dining
- US chains prevalent among foreign ones</td><td>- Large presence in Tier 1 and Tier 2
- A few major brands franchise on a large scale (with hundreds of stores)
- Mainly Chinese/East Asian cuisine
- Some companies moving away from franchising due quality concerns (e.g. Chongqing Dezhuang)</td></tr>
<tr><td rowspan="2">Apparel</td><td colspan="2">- Franchising increasingly popular in casual wear, sportswear, children's wear and underwear
- Large brands, e.g. Li-Ning and Esprit, are already found in Tier 3.</td></tr>
<tr><td>- Good presence of foreign franchisors
- Tier 1 often direct-run/JV. Tier 2 has relatively higher degree of franchises
- European brands are prevalent (e.g. Vero Moda, Etam)</td><td>- Franchising very common; mainly in Tier 1 and 2
- Strong in low-end of market due to low prices, largely absent from the high-end market
- Quality of management rapidly improving among larger brands (e.g. Metersbonwe)</td></tr>
<tr><td>Education</td><td>- Presence in Tier 1 and Tier 2
- Few foreign franchisors but the existing ones have relatively high market share (e.g. Aptech)
- In franchised language education only one US company (WEB International English, via JV)</td><td>- Presence in Tier 1 and Tier 2
- Only a few large brand names
- The largest player does not franchise (New Oriental)</td></tr>
<tr><td>Fitness</td><td>- High share of foreign franchisors
- Large presence in Tier 1, expanding via mid-end clubs in Tier 2
- US chains prevalent among foreign gyms</td><td>- Apart from the larger brands, the market is served by a plethora of local ones
- Same high-quality equipment as foreign chains
- Generally less management/training expertise</td></tr>
</table>

Source: JLJ analysis

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[7] Company names not available

[8] The franchisor grants the master franchisee the authority to act as franchisor in a specific region, e.g. city, province or country.

[9] The franchisor grants an individual the right to act as a franchisee; there is no intermediary, as there is in master franchising.

KEY INDUSTRY 1: FRANCHISING IN FOOD & BEVERAGE

Summary: Franchising in F&B sector

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Franchising is frequently adopted especially in the *fast food* and *casual dining* segments. The most common franchises are domestic and *Taiwanese* brands, serving mainly Chinese/Asian food. Many international and *Hong Kong* brands choose direct-ownership over franchising, due in part to concerns over brand/quality control. Large players like *KFC* already have a strong presence in Tier 2 and even some Tier 3 cities (e.g. *Kunshan*), but largely through self-owned stores. *KFC*, for example, has 2000 stores in China, but only 2% are franchised. In contrast, more recent entrants rely heavily on the franchising model to close the gap between them and established market leaders – e.g. 90% of *Papa John's* shops are franchised.

Market Overview

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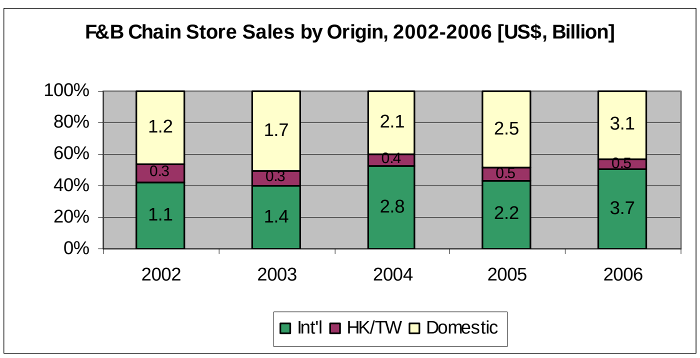
F&B market. Eating is a fundamental component of the Chinese culture – about one-third of total household expenditure is spent on food and about 20% on dining out. Annual revenue generated by the F&B industry[10] has increased at about 19% CAGR from 2003 to 2006 to reach $137 billion. In particular, sales revenue from F&B chain stores grew at almost 40% CAGR in the same period to reach $7.3 billion in 2006.

Chain stores. Domestic companies represent the majority of chains (2006: 73% of chain stores, 250+ brands), followed by foreign (20%, ~70 brands), and Hong Kong/Taiwan chains (7%, ~26 brands). However, although there are less foreign-invested companies, they generate sales near equivalent to that of Chinese companies, as shown in the chart below.



Source: National Bureau of Statistics.

Franchising. By the end of 2006, 95% of fast food chains were using the franchising model on some scale. Sales from franchised F&B stores increased 43% CAGR from 2003 to 2006 to reach $2.54 billion. The relatively low sales of franchised stores compared to total F&B chain store sales (which is $7.3 billion) can be attributed to the relatively limited number of franchised stores among international chains, which usually generate higher total sales than Chinese chains. To compare two similar-sized brands in terms of total number of China stores: *Dicos Fried Chicken* (majority franchised stores) generated $0.2 billion in retail sales while *McDonald's* (very few franchised stores) was about $0.4 billion (2006).

Market segments. *Fast food* is the fastest growing segment in the F&B sector. Sales grew at 157% CAGR between 2003 and 2006 to reach $2.9 billion. 42% of fast food chains are international brands, about 45% are Chinese chains, and the rest are Taiwan/Hong Kong chains. The number of Chinese fast food chains also increased faster than international ones - 21% CAGR for Chinese compared to 11% for international. Another key segment, especially for foreign franchisors, is *casual dining.* The casual dining market was valued at about $3.3 billion in 2006. Of the casual dining market, *pizza* is the largest segment, accounting for about 45% of all casual diners. Other segments include coffee shops, local food chains, and restaurants.

[10] This includes chain stores and stand-alone stores that employ a minimum of 20 people including restaurants, fast food shops, coffee shop, ice cream shop, etc.

Key trends. Growth is mainly driven by rising disposable incomes; rapid urbanization and busy lifestyles also create an increasing demand for eating out and for fast, convenient meals. The Golden Week holidays in China are also key time periods for spending and eating out. Annual per-capita spending on dining-out is expected to increase by about 15% to reach $120 in 2007. For Chinese consumers, atmosphere, cleanliness, and hygiene are becoming increasingly important, besides price.

Competitive Landscape

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Foreign vs. domestic. In terms of number of stores, foreign chains generally lag behind Chinese and Hong Kong/Taiwan-invested ones. Domestic brands have stronger market penetration (especially in Tier 2 or 3 cities) as they are generally more affordable. Large foreign chains that entered China early, e.g. *KFC,* are usually present in Tier 1 and 2, and some Tier 3 cities. Relatively newer entrants are still predominantly located in Tier 1 cities, e.g. out of *Papa John's* 51 shops, only about 9 are in Tier 2.

Investment model. Although large foreign brands have a well-established presence, most retain direct ownership through a WOFE or JV with a local partner. For example, successful international franchise brands like *Pizza Hut* or *McDonalds* have none or very few franchised stores in China. Three key reasons for this: 1) difficulty in finding good franchisees, 2) protection of brand image/product quality, 3) higher revenue/profits from direct-ownership of stores. On the other hand, relatively new entrants, such as *Papa John's* and *Burger King*, have either adopted or plans to adopt the franchising model to expand quickly (see table below).

Table 2 – Key Chain and Franchised stores in F&B sector

Brand	Year of entry	Total outlets	Franchised outlets	Location	Notes
International franchisors without franchised outlets in China					
Pizza Hut	1990	250+	0	National	- Very popular casual dining brand - Limited localization
Yoshinoya	1992	110	0	East China	- Beef and rice diner. - Low prices and localized offerings.
Häagen-Dazs	1996	50	0	East China	- Rather successful - Premium positioning
Burger King	2005	9	0	East China	- 3 franchisees in Beijing currently being finalized - Plans aggressive franchising: 1000 franchisees in the next 10 years.
International franchisors with franchised outlets in China					
KFC	1987	1800+	37	National	- Largest and most popular fast food chain - Low prices and localized menu
McDonald's	1990	750	1	National	- Menu largely similar to US; price comparable to KFC - 4 more franchisees to be added by end-2007
Subway	1995	61	61	East China & Sichuan	- Product offering not localized, but local condiments offered
Papa John's	2003	51	46	East China	- Pursuing localization - Rapid franchising to close gap with rivals
Hong Kong & Taiwan franchisors					
UBC Coffee (TW)	1997	1000	850+	Shanghai and South China	- Largest franchise chain in China - Experiencing issues with franchisee quality
Dicos Fried Chicken (TW)	1989	600+	512	National	- Third largest fast food brand in China - Low price targeted to young masses
Chinese franchisors					
Chongqing Dezhuang	1999	408	370	Mid- & West China	- Casual diner with good reputation - Traditional Chongqing-style hotpot
Malan noodle	1995	381+	300	Northeast China	- Popular Chinese fast food noodle chain - Targeted to mass market.
Inner Mongolia Xiaofeiyang	1999	326	249	National	- Casual dining, Mongolian cuisine - Targets families

Note: Data for Mainland China, no. of outlets estimated; national presence refers to stores in almost all provincial capitals and other cities, East China refers to cities along the East coast, spreading from *Guangdong* in the south to *Liaoning* in the north; Mid China includes *Sichuan*, *Chongqing*, *Wuhan*, *Shaanxi*, etc;. Source: Company websites, phone interviews, news articles, and JLJ analysis.

Key Opportunities

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With changing consumer preferences and rising requirements on store/food quality, there are good opportunities for US franchisors, especially in areas where domestic companies are weaker.

1. ***Casual dining*** – There are currently limited number of foreign casual diners in Tier 2 cities, representing good opportunities for US franchisors. Consistent quality, marketing, and brand experience is increasingly appreciated. Currently many domestic chains are hampered by a lack of clear standards and identity across outlets. For example, *Tujia Bakery* is marked by differences in ingredients and preparation methods across stores.

2. ***Innovative products*** – An increasing number of consumers are interested in new experiences, and domestic chains often cannot deliver these as they lack R&D / product innovation. Foreign chains are significantly stronger in this area. For example, *Starbucks* frequently experiments with new localized items, such as *Red Bean Frappucinos* and *sweet mooncakes*.

3. ***Organic ingredients*** – *Burger King* has begun introducing organics into several international markets while in the US, *Chipotle* and *O'Naturals* represents a new type of organic fast food brand. Several food scares and a growing environmental awareness among China's middle class are driving up demand for organic ingredients, offering long term opportunities in this segment. *Papa John's* is already focusing its marketing on fresh ingredients to gain an edge over *Pizza Hut*.

Key Challenges

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Despite opportunities and strong management skills of foreign (and US) chains, there are several key challenges that must be overcome:

1. ***Finding good partners and franchisees*** - Chinese companies may not have a good understanding of franchising and lack modern management practices. For example, Chinese chain *Xiaofeiyang* is closing franchised stores that do not meet its quality standards. On the other hand, many new foreign entrants often have unrealistic expectations of local partners or franchisees. Companies need to be prepared to spend more time to train franchisees in China compared to US.

2. ***Localization*** – The Chinese palate differs greatly from the US one; there is also great regional variety, e.g. Southeastern food is bland while *Sichuan* food is very spicy. *KFC* appeals to local tastes by offerings such as *spicy chicken burgers* and *mushroom chicken congee*. Conducting consumer research (e.g. focus groups) is usually needed for testing menus.

3. ***Strong competition*** – Competition is intense, with many large and medium-sized international chains already present in China and offering similar menus, (e.g. *Hard Rock Café, TGI Fridays)*. Many of the most successful international chains engage in aggressive marketing and advertising campaigns. *KFC,* for example, is known for its creative commercials which are updated frequently.

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Burger King – A relatively late entrant to the Chinese market, the company opened its first store in *Shanghai* in 2005, where the brand was well received. *Burger King* has developed a loyal following among local teens, white collars, and expatriates. Before their official entry, *Burger King* ran a small pilot restaurant in a hidden location, where it analyzed local tastes and adapted products to the local market. The company is in the process of finalizing 3 franchisees in *Beijing.* More are expected to follow as the company has announced an aggressive franchising strategy to catch up with other more established fast food established brands.

Papa John's – Has been expanding rapidly since its entry. At first, stores were run by a master franchisee, *Shanghai RCS Group Co. Ltd.* After establishing a good store network and brand image, *Papa John's* allowed *RCS* to engage in sub-franchising in 2006. In the next decade, *Papa John's* plans to add about 200 direct-owned and franchised outlets outside its base in *Shanghai*. To support this expansion, web conferencing is used for all meetings with international staff and to review store layouts. This has significantly decreased traveling costs of staff.

KEY INDUSTRY 2: FRANCHISING IN APPAREL

Summary: Franchising in the apparel sector

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Franchising is popular in the *casual wear* and *sportswear* segments. Foreign franchisors – among which most are European brands – have a competitive advantage in areas such as supply chain management, branding, service, and quality. *Hong Kong* brands (such as *Giordano, Esprit*) are also successful because of a combination of international management skills and a better understanding of the Mainland market. However, domestic franchisors are increasingly competitive, and are increasingly able to offer apparel with fashionable design at competitive prices.

Market Overview

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Apparel sector & chains. Total retail sales for the apparel industry reached $96 billion in 2006[11], a 15% growth over 2005. In 2006, there were about 5,400 apparel chain stores with total retail sales of about $0.7 billion[12]. Expansion of apparel chains into Tier 2 and Tier 3 cities is a key trend. In March 2007 *Li-Ning* announced new stores would be located mainly in Tier 2 and Tier 3 cities while *Esprit* already operates in Tier 3 cities such as *Guiyang* and *Changzhou*.

Franchising. Franchising is popular in *sportswear* and *casual wear*, e.g. *Nike* and *Vero Moda,* where growth in the number of franchised stores is faster than that of direct-owned stores. While less popular in the *children's wear* and *underwear* segments, the number of franchised stores is still increasing at faster rates than direct-owned stores.

Drivers of growth. Growth is driven by the growing middle class, especially young office-working women, who are a key customer group. Growth in the children's wear segment is partly fuelled by the one-child policy, which results in extended families focusing significant spending on one child, commonly known as the "little emperor" phenomenon.

Market Segments

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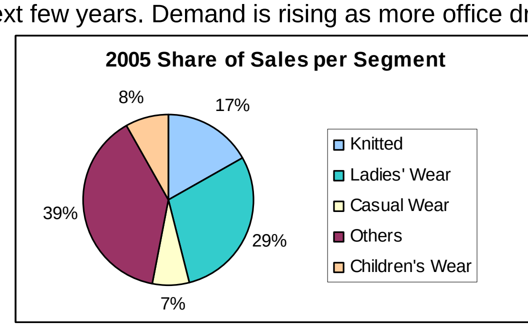
Ladies' wear. Sales have been growing ~20% annually. Foreign brands (*Etam, Esprit, Only*) dominated the top 3 in 2005 through quick response to needs and localized designs. However, the top 10 brands have only a 20% market share. *Knitted underwear,* of which ladies' underwear has the largest potential, is expected to grow at rates of 20% annually in the next decade. Foreign brands are limited to the premium segment. In 2005 the top 10 underwear brands accounted for about two-thirds of the market.

Children's wear. One of the fastest growing segments with about 8% annual growth, and expected to reach ~17% from 2010 onwards due to an expected baby boom from 2007 - 2012. Foreign brands captured a 50% market share, while the top 10 brands held a combined market share of 30% in 2005.

Casual wear. Casual wear sales only accounts for 7.5% of total apparel sales; however growth rates of 10% are expected in the next few years. Demand is rising as more office dress codes are less strict.



Source: China National Commercial Information Center

[11] Includes all outlets (e.g. department story, specialty store, chain store, etc.) irrespective of the number of employees.
[12] Retail sales from chain stores are low compared to total apparel retail sales, as the main apparel sales channels are individual shops/stands (low-end, unbranded apparel) and department stores (mid-high end)

Sportswear. Experiencing double-digit growth since 2000 and expected to reach $6.2 billion by 2008. Popularity is fuelled by greater health awareness, changing lifestyles, and the Olympics. The segment is dominated by *Nike*, *Adidas*, *Li-Ning*, *Anta,* and *Reebok*, with a combined 40% market share in 2006.

Competitive Landscape

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Geographic distribution. Domestic, *Hong Kong* and foreign brands are found throughout Tier 1 and 2 cities. The largest brands, such as *Li-Ning* and *Esprit*, are also present in Tier 3 cities. Products sold in Tier 1 cities are differentiated and targeted towards specific customer groups (e.g. young people into alternative fashion) while products in Tier 2 and 3 markets are still more generic. However, product differentiation in Tier 2 cities is expected to increase rapidly.

Investment model. Domestic brands predominantly rely on the franchising model to expand. On the other hand, there is no dominant investment model for foreign brands – *Etam* has both direct-owned outlets and JVs, *Vero Moda* franchises in secondary markets, and *Esprit* uses franchising in primary and secondary markets. Among foreign franchises, the majority are European companies; major American fashion brands, like *Gap*[13], are not yet in China.

Table 3 – Key franchised chains in apparel sector

Brand	Year of entry	Total outlets	Franchised outlets	Location	Comments
Foreign Franchisors					
Nike	1980	3174	2700+	National	- Targets young segment - Prices similar to US and Europe
Jeanswest	1993	1300	950+	National	- Targets young segment, mid-end & premium
Esprit	1992	300+	270	National	- Targets the 25-40 age group. - Plans to enlarge to 600 in the coming years
Vero Moda	2001				- Targets young females, mid-range pricing
Jack & Jones	1999	700[14]	300	East China	- Men's fashion with focus on jeans, mid-range
Only	1996				- For young women, mid-range pricing
Hong Kong Franchisors					
Baleno (HK)	1996	3700	3327	National	- Casual wear for the average consumer - Low prices
Giordano (HK)	1992	728	644	East China	- Casual wear, mid range
Bossini (HK)	1993	449	150+	East & Mid	- Casual wear, low-mid range
Domestic Franchisors					
Li-Ning	1990	4297	3860	National	- #1 domestic sports brand. - Perceived as equal to Nike, but lower price - Entered the European market April 2007.
Metersbonwe	1995	1800	1450	National	- Casual wear, targeted at young age group - Mid-range
Youngor	1979	1500	1200	National	- Casual wear and costumes.
SeptWolves	1990	1200	1000	East & Mid	- Casual menswear.
Baoxiniao	2001	600	551	National	- High-quality suits.

Note: Data for Mainland China, no. of outlets estimated; national presence refers to stores in almost all provincial capitals and other cities, East China refers to cities along the East coast, spreading from *Guangdong* in the south to *Liaoning* in the north; Mid China includes *Sichuan*, *Chongqing*, *Wuhan*, *Shaanxi*, etc;. Source: Company websites, phone interviews, news articles, and JLJ analysis.

Key trends. As consumers become more sophisticated, the market structure is shifting from one with few varieties, high volumes, and long product life cycles to one with more variety, small volumes and short product life cycles. This is partly led by the successful entry of fast fashion brands like *Zara* and *H&M* in Tier 1 markets in the past 1-2 years. In coastal cities, strong brands, design, and quality are increasingly valued over low prices. Other segments which are increasingly popular include casual wear and apparel made of natural fibers, especially cotton.

[13] Gap is currently present in Japan, Singapore, Indonesia, Malaysia and India. It only recently entered South Korea; the company has not announced specific plans for China.
[14] *Vero Moda*, *Jack & Jones* and *Only* are owned by *Bestseller*; each store usually carries all three brands

Key Opportunities

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China's middle class and young consumers are increasingly drawn to branded apparel that can express their individual lifestyle and tastes. This gives US brands chances in areas where local brands are weaker.

1. ***Well-known brands*** **–** While foreign brands cannot compete on price, they generally have strong international brand image. This enables foreign companies to sometimes position their products as more high-end than they are in their home market. *Etam,* for example, used this strategy when it entered the Chinese market.

2. ***Fast fashion*** **–** Chinese brands invest only less than 0.2% of sales revenue in supply chain management and R&D. Thus, they generally have slow turnaround times from design to production, and are unable to constantly introduce new products, unlike international fast fashion brands like *Zara* or *H&M*.

3. ***Fashion accessories*** **–** Fashion accessories are an untapped market in China, where market penetration is less than 5%. Rates for Japan (98.2%), Thailand (68%), Hong Kong (54%), Singapore (48%), and Malaysia (47%) indicate strong growth potential. Current growth rates for accessories is about 19% annually. *H&M* and *C&A*, for example, both offer accessories in addition to clothing.

Key Challenges

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Foreign brand apparel is generally readily accepted in China, although there are still some regional differences.

1. ***Marketing*** **–** Aggressive marketing is crucial to success for apparels, and shopping habits also differ from the West. Major shopping occasions are Labor Day, National Day, and Chinese New Year; marketing and advertising need to be adjusted accordingly. Both *Zara* and *H&M* also launched aggressive marketing campaigns when the first stores opened in China to create brand awareness

2. ***Regional diversity*** **–** Fashion preferences differ between regions, and are influenced by level of development, climate, customs, etc. For example, designs from *Wuhan* have sharp colors, *Hangzhou* is known for its elegant clothes, while *Shenzhen* and *Guangzhou* closely follows trends in *Hong Kong*.

Case Studies

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Esprit **–** A *Hong Kong* company that first set up a number of direct-owned stores in *Shanghai*. After these outlets established a brand image, franchising was used to expand in other cities. *Esprit* believes franchisees can increase efficiency in local markets through local relationships and familiarity with local regulations, e.g. obtaining tax breaks for creating employment. Thus, the company places a high importance on maintaining good relationships with franchisees. The strategy has paid off as the brand is now one of the top foreign brands in China.

Dunhill **–** One of very few luxury brands using the franchising model, *Dunhill* approached China by starting out with regional franchises and then transitioning to directly run operations. In March 2006 *Dunhill* established a JV company to control its most profitable / valuable outlets while regional franchisees remained responsible for the other stores. Since then, *Dunhill* has stopped opening franchised stores because quality standards varied considerably between stores, and some stores fell significantly short of Dunhill's luxury brand image.

KEY INDUSTRY 3: FRANCHISING IN EDUCATION[15]

Note: this section will provide a brief snapshot of the education sector, with focus on a relatively more developed segment, language training. More detailed information for other segments and regulations may be found in the **Education & Training** *report, which is also part of the USCS-JLJ series on China.*

Summary: Franchising in China's Education Market

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The education and training market has grown at average of about 20% annually in the last few years. Franchising is common in all of the three large segments: *language training*, *IT training*, and *children's education*. However, foreign players are still a small part of the *language training* and *children's education* segments due to restrictive regulations. Indian companies dominate the IT segment.

Market Overview

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Education & training market. Currently, there are about 93,200 domestic and international private education institutions in total. *Language training* (about 11% annual growth), *IT training* (~ 20% growth) and *children's education* (~30% growth) are the three top segments. Demand for such services comes from both individual consumers and companies. Increased attention to education is also evident in the rising proportion of income spent on education. The value doubled between 1999 and 2004 and reached US$ 1,547 per capita in 2006.

Franchising. Most consumers perceive large "branded" chains to be more reliable. Thus, franchising is popular as it is seen as a fast method of increasing the number of stores, and consequently increasing brand recognition. Not all large brands franchise, however – notably *New Oriental* and *Wall Street English*. In some cases, this is partly the result of restrictive regulations, especially for children's education *(more details can be found in the Education & Training Report)*. Finally, the IT segment is dominated by global Indian companies - *Aptech* and *NIIT* – which both franchise in China. This segment is thus more competitive and offers relatively less room for new smaller entrants.

Drivers of growth. Demand for training is increasing due to shortage of qualified personnel that can meet international standards, especially managers. Corporate training courses are also used as a retention tool by large MNCs. Demand is also driven by individuals – young Chinese professionals are willing to spend an average of 10% of their salaries on ongoing training. In the children's segment, growth is driven partly as a result of the one-child policy and fierce competition to get into the best schools.

Competitive Landscape – Language

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Tier 1 vs. Tier 2. There are more than 50,000 English language institutes throughout the country; only a few key players have national coverage, e.g. *English First* and *New Oriental*. However, the majority of outlets for these companies are still located in the economically developed East coast. Tier 2 cities offer good prospects as demand exceeds supply, especially since learning English has become a trend among the younger generation and is seen as a key skill to have for significantly enhancing one's career prospects.

Foreign vs. Domestic. Foreign companies are not preferred to domestic ones, as both can hire native speakers as teachers. The franchising model is used by *English First* and *Web International* (table 4) while others engage in JVs or partnerships with universities. 80% of domestic institutes use franchising, but many are small local companies.

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[15] This section excludes the non-profit education sector

Table 4 – Key franchised chains in language education

Brand	Year of entry	Total outlets	Franchised outlets	Location	Comments
International language training that do not franchise					
Wall Street English	2000	27	0	East China	- Targets business people and mature students.
International language training franchisors					
EF Foundation	1994	80	50	National	- Targets corporate, students and children. - Relatively high price. - Plans 200 franchised outlets by 2008. - Children's education division is not franchised
WEB International English	1998	60	40	East	- Targets business people and mature students. - Business English and oral English
Domestic language training franchisors					
Beijing Global IELTS School	1997	56	40-50	National	- Caters to diverse groups. - Strong collaboration with government and universities.
Liyang Crazy English	2003	49	39	National	- For young school-age learners. - Relatively low price.
Yanghualianpian	1999	37	30	National	- For all ages. - Focus on oral English.

Note: Data for Mainland China, no. of outlets approximate; National presence refers to stores in almost all provincial capitals and other cities, East China refers to cities along the East coast, spreading from *Guangdong* in the south to *Liaoning* in the north. Source: Company websites, phone interviews, news articles, and JLJ analysis.

Key Opportunities – Language

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The maturity of the education market in the US gives US franchisors the experience and know-how to meet new customer demands in the Chinese market, more specifically:

1. ***Oral English, English for young children, and professional writing* –** the top three most popular segments in Language education
2. ***Other languages* –** in particular French, German, and Korean. Next to English, French has the largest market share due to significant French investments in China and Chinese investments in Africa. Currently, some schools focused on English offer French on the side, e.g. *Beijing Global IELTS School*.
3. ***Different teaching methods* –** There is demand for greater variety of classes and teaching methods, ranging from web-based teaching to short, intensive "crash courses". For example, *English First* offers Internet learning through its *Englishtown* brand for busy adults

Key Challenges – Language

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While there is a clear demand for language education in China, there are several key obstacles for foreign franchisors.

1. ***Returns on investment* –** Returns are generally slow. *English First* had franchised all but four of its 68 schools by April 2006, due to cost pressures and strict approval processes; *Wall Street English*, regarded as a success story among foreign institutes, took 5 years to become profitable.
2. ***Identifying regional needs* –** Regional needs differ greatly. For example, *Beijing* is largely a postgraduate market while *Qingdao* is focused on high school education.
3. ***Regulations* –** Due to stringent regulations, the education sector requires a greater commitment on the part of the franchisor than other sectors. *[More details in the Education & Training report]*

Case Study – Language

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English First – Only uses direct-own outlets in Tier 1 but relies on franchising to expand in Tier 2. At first, franchisees were actively pursued. Now, most new franchisees come via referral or expansion of existing franchisees. Through a dedicated franchise department, franchisees are thoroughly trained before being allowed to operate under the brand. Frequent quality audits are performed to ensure compliance.

KEY INDUSTRY 4: FRANCHISING IN FITNESS

Summary: Franchising in the Fitness Sector

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China's fitness sector is still in early stages. Currently growth is limited by a general lack of awareness of healthy lifestyle and high costs of gym memberships. Nevertheless, numerous domestic and international clubs, e.g. *Bally Total Fitness* and *Powerhouse*, already operate mid-end and high-end clubs in Tier 1 and Tier 2 cities. The franchising model is popular and several US players already dominate among foreign brands.

Market Overview

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Fitness market. The top 10 global national fitness markets account for 83% of worldwide industry revenue, with Japan being the only Asian country in the top 10. China's fitness sector is in its infancy and is marked by a large number of local operators, similar to the US in the 1970s. There are several large brand names present, but the largest one has only about 60 stores (*Weider-Tera*).

Franchising. Franchising is extremely popular in the fitness sector. The majority of gyms use the franchising model to expand as new clubs require a substantial amount of investment. Gym membership fees are relatively high, at about $25 to $35 per month, compared to an average of $55 in the US.

Drivers of growth. Only about 0.1% of the adult population frequents the 1,200 or so medium and large gyms in China, compared to 5%[16] in Europe, and 20% in the US. There is thus good potential as even an increase to 1% of gym-going population will result in a huge demand for gyms. The 2008 Olympics are expected to enhance people's passion for sports and exercise, and to convey the benefits of a healthy lifestyle to a wider group of people. In parallel, the government launched the *Nationwide Physical Fitness Program*, which aims to increase health awareness and get 40% of the population to exercise regularly by 2010. Also, the growing middle and upper class population are increasingly concerned with well-being and image, and have enough disposable income to sign up for gym memberships.

Key trends. The key customer group for gyms is no longer only high-income young professionals but include people of various ages with wider range of income[17]; frequency of gym visits has also increased. Currently both men and women go to gyms, while in the past it was predominantly women. The gym is still regarded as a place to socialize, with group classes being more popular in China than in the US. Most gyms offer a wide variety of classes, ranging from *hot yoga* and *spinning* to *belly dancing*.

Competitive Landscape

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Geographic distribution. The market is split between "branded" gym chains, small independent outlets, and hotel gyms. Current demand in Tier 1 cities is met by middle to high-end chains, some of which have already expanded into Tier 2 cities. However chains have a highly regional focus, and there are still no gyms with national coverage. For example, while *Bally Total Fitness* is concentrated in the North, *Total Fitness* is mainly in the South.

Tier 2 markets. The fitness market in Tier 2 cities is only just starting to develop. Outside of the key Tier 1 markets, the number of gyms for any brand in a Tier 2 city is usually only 1 or 2. For example, *Bally Total Fitness,* has 8 locations in Beijing and only 1 to 2 locations in other cities where it is present – such as *Dalian* and *Changsha*. The table below shows the key fitness clubs in China and their presence.

[16] The average percentage for 16 European countries. In decreasing order these are: UK (10.13%), Sweden, Switzerland, Spain, Greece, Austria, Germany, Netherlands, Italy, France, Belgium, Denmark, Portugal, Slovenia, Croatia, and Poland (1.13%).
[17] Note that with annual fees ranging into the thousands of RMB (~US$ 300 onwards), memberships are still a big-ticket item for many people.

Investment model. There is no clear customer preference for either foreign or domestic clubs as both have access to top-end equipment and facilities. The franchising model has been popular in this sector for both domestic and foreign companies, as can be seen in table 6. However, many companies, notably *Weider-Tera* and *Megafit,* have started to limit their franchised operations because of quality concerns. Currently, the strategy for these companies is to form local partnerships, as opposed to using franchisees.

Table 6 – Key franchised chains in fitness sector

Brand	Year of entry	Total outlets	Franchised outlets	Location	Comments
International fitness franchisors					
Weider-Tera	2000	63	3-5	Mostly East China	- Global chain focused on quality - Reclaimed many franchises; in future only using direct-run and JVs, to retain management control
CSI-Bally Total Fitness	2002	30	25	East & Mid China	- Plans 100 centers in 5 years. - JV between BTF and domestic CSI.
Powerhouse	2004	28	13	East China	- Plans to have 100 centers by 2008
California Fitness: Yao Ming Sport Club[18]	2006	3	0[19]	Beijing Shanghai	- New to China, one of largest globally - Plans widespread franchising, 3 to 5 per city - Hired NBA star Yao Ming as ambassador.
Hong Kong franchisors					
Megafit	2000	10	1-2	Shanghai, Shenzen. Wuhan, Xi'an, Chengdu	- Greatly reduced the number of franchises to maintain quality. - Now has high requirements for franchisees
Domestic franchisors					
Hosa Sports	1999	50+	30	Mostly East	- Largest domestic chain
Impulse	1991	43	22	NE China Mid-China	- Emphasizes quality - Focus on personal coaching
Total Fitness Club	2001	17	16	Shanghai Guangdong	- Plans to have 3 to 5 centers per city - Lower price than international centers
Nirvana Fitness & Spa Club	2000	14	12	Beijing East China	- High-end club emphasizing quality

Note: Data for Mainland China, no. of outlets approximate; National presence refers to stores in almost all provincial capitals and other cities, East China refers to cities along the East coast, spreading from *Guangdong* in the south to *Liaoning* in the north; Mid China includes *Sichuan*, *Chongqing*, *Wuhan*, *Shaanxi*, etc;. Source: Company websites, phone interviews, news articles, and JLJ analysis.

Key Opportunities

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The fitness market is just taking off and is still predominantly concentrated in Tier 1 cities. There are thus opportunities for US gyms especially in Tier 2 markets. More specifically opportunities are in:

1. ***High-end clubs in Tier 2 markets –*** Majority of gyms in Tier 2 cities are small, independent stores that are of low quality. Several large chains have expanded into Tier 2 cities, but most are in the mid-end market, representing opportunities for relatively more high-end gyms.

2. ***Personal trainers –*** As most gym members are first-time members, they are generally unfamiliar with the use of gym equipment. Having qualified trainers and good training programs can be a significant competitive advantage, especially considering many Chinese fitness clubs are well-fitted in terms of "hardware"; differentiation thus lie in "soft" factors like service and training quality.

Key Challenges

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Franchisors will find that challenges are not from lack of capital, but rather from a lack of experience and human resources. Companies need to devote more time and effort to train new franchisees or partners in China than they normally do in the US.

[18] Subsidiary of global chain *24 Hour Fitness*.

[19] Despite being new to the Chinese market and not franchising yet, this brand has considerable potential as it is associated with Yao Ming. Popular sportswear brand *Li Ning*, perceived by Chinese as equal to *Nike*, also greatly benefited from the fame of its namesake.

1. ***Qualified personnel* –** Since the fitness industry is still in its infancy, there is a lack of people who consider it a place for a long-term career. Up until 2002, there were very few or no certified personal trainers. Currently some 80% of certified fitness trainers received their credentials from the *Asian Academy for Sports and Fitness Professionals*, a *Hong Kong* institution that operates according to international standards.

2. ***High investment requirements* –** Significant start-up capital is required for gyms due to high costs of renting / buying a location as well as equipment. It may be difficult for franchisors to find well-qualified franchisees that have the financial resources to invest. Many franchisors thus look to partner with real estate companies to offer gyms in condominium / residential complex.

3. ***Demand still yet to take off* –** The pool of potential members is growing, but still limited as gym memberships are still an expensive item. Nevertheless, all major international gyms are already in China, and competition to sign up members is intense, especially in Tier 1 cities.

Case Study

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***Weider-Tera* –** Tested the franchising model but has reclaimed many franchised gyms and has no plans to open franchised stores in the coming years. Franchisees' lack of management, poor knowledge of fitness, and inferior equipment purchases led to the change in strategy. Now *Weider-Tera* expands via JVs, where they provide part of the start-up capital and assistance in other areas – e.g. location search, equipment import, and setting up daily operations. To maintain service quality, management control is within *Weider-Tera*.

***CSI–Bally Total Fitness* –** In 2002, *BTF* formed a JV with the *China Sports Industry Group* (*CSI*). Combining *CSI's* market knowledge with *BTF's* experience in fitness and management, the company entered *Beijing*. It opened two direct-run outlets in Beijing and had opened its 10th China franchise by August 2004. It is now the second-largest foreign gym chain in China after *Weider-Tera*.

SNAPSHOT OF SELECTED TIER 2 CITIES

Overview

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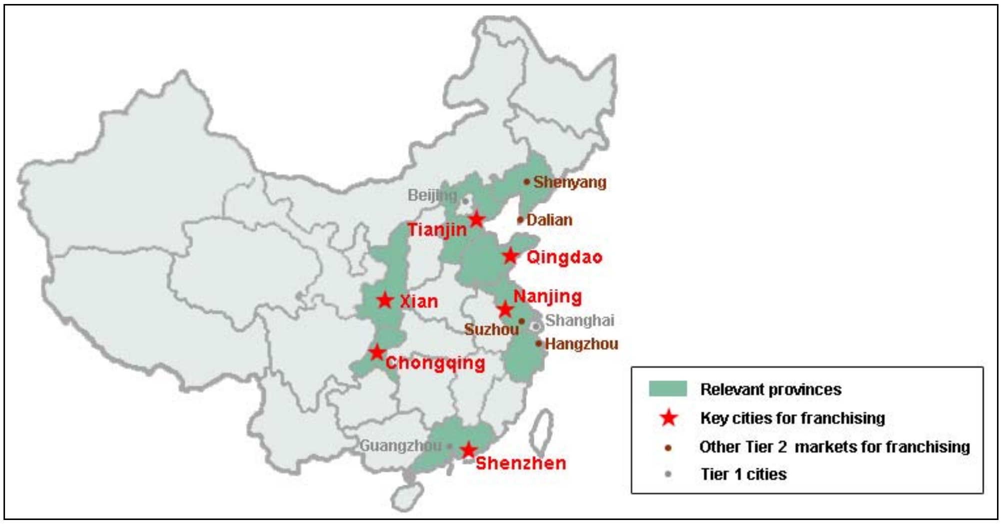
The following section provides a snapshot of franchising in 10 cities – 6 cities presented in greater details, and another 4 in brief. The 6 key cities for franchising are *Tianjin, Qingdao, Nanjing, Shenzhen, Xi'an,* and *Chongqing*, as shown in the map below.



Source: JLJ analysis

The following table shows the key indicators for the ten cities, with Tier 1 cities provided for comparison. The numbers of outlets for two key foreign F&B chains are included as they are a good indicator of overall purchasing power in the city - *KFC* representing fast food segment, and *Pizza Hut* representing the casual dining segment.

Table 7 – Key indicators by city

Region	Population [M]	Per capita urban disposable income [2005, $]	Per capita dining out spending [2006, $]	Per capita education spending [2006, $]	No. of fitness club ranking[20]	Investment Climate ranking[21]	No. of KFC	No. of Pizza Hut
Beijing	15.8	2,323	174	n/a	1	23	135	40
Shanghai	13.7	2,390	190	157	2	17	166	52
Shenzhen	8.4	2,755	165	152	3	2	95	18
Tianjin	10.6	1,620	126	92	10	19	52	6
Nanjing	7.0	1,923	86	120	Not in top 10	21	44	9
Qingdao	7.5	1,656	109	98	9	7	28	3
Chongqing	28.0	1,313	112	99[22]	8	98	17	4
Xian	8.1	1,234	114[22]	121[22]	Not in top 10	70	7	4
Dalian	6.0	1,538	N/A		9	11	26	6
Shenyang	7.0	1,295			Not in top 10	43	37	4
Hangzhou	6.6	2,128			7	13	53	12
Suzhou	7.8	2,087			Not in top 10	3	28	4

Source: National and Provincial Bureaus of Statistics, Ministry of Commerce, WTO, Fitness China, company websites, and JLJ analysis.
Note:Pizza Hut in China is positioned as a casual dining restaurant.

[20] According to Fitness China 2007, which presents a list of the top 10 fitness cities in China, according to number of gyms. Note: *Qingdao* shared 9th place with *Dalian* and *Harbin*, *Chongqing* shared 8th place with *Changsha.*

[21] According to the 2006 WTO report "China: Governance, Investment Climate, and Harmonious Society: Competitiveness Enhancements for 120 Cities in China."

[22] 2005 figures

Shenzhen

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Macro-economic overview. *Shenzhen*, the first city in China to be designated as a Special Economic Zone, is located in the *Pearl River Delta* in *Guangdong* province. The city's superior geographical location is one of the reasons for its rapid economic development in the last decade. Besides being near the *Pearl River* which facilitates domestic connectivity, *Shenzhen* is also only a short distance away from *Hong Kong*. With a GDP per capita of about $8,904, *Shenzhen* is one of the wealthiest cities in China. The city is also a popular location for foreign investors, attracting $3.2 billion worth of FDI in 2006 (about 4.6% of China total).

Franchising. Foreign brand acceptance is high due to its proximity to *Hong Kong*, which has fostered *Shenzhen's* rapid economic rise through foreign capital and the introduction of foreign brands. The macro-economic indicators in table 7 indicate that *Shenzhen's* population is willing and able to spend money on food and education at levels close to those of *Shanghai*. Its fitness market is the third largest in China. Per-capita expenditure spent on fitness increased 20% in 2006[23]. Major franchise brands have a presence in Shenzhen, including *Adidas*, *Blenz Coffee*, *Subway*, and *Taipei Ice House*.

Potential partners. Due to *Shenzhen's* open climate and proximity to *Hong Kong*, most reputable partners are either international or from *Hong Kong*, with *Jinjiang* representing the only domestic company. Real estate companies are included as potential partners, especially for fitness franchises.

- ***Cheung Kong Ltd –*** Leading *Hong Kong* based group active in 55 countries. Its portfolio includes commercial and residential property development in 15 Mainland Tier 1 and Tier 2 cities.
- ***China Everbright International Ltd –*** Property & infrastructure developer from *Hong Kong* with its major Mainland properties situated in *Shanghai* and *Shenzhen*.
- ***Fu Wah International Group*** – A *Hong Kong* based multinational with a diverse portfolio that includes real estate, hotels, clubs and tourism. Active primarily in *Beijing*.
- ***Jinjiang International*** – One of China's leading hospitality groups with business including hotels, food, travel, and real estate. Present in ~22 Tier 1 and Tier 2 cities.
- ***New World Development Company –*** *Hong Kong* group that manages hotels (*Beijing, Shanghai* and ~4 Tier 2 cities), property and department stores (both in ~16 Tier 1 and 2 cities).

Tianjin

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Macro-economic overview. One of the three Autonomous Municipalities in China, situated in the *Bohai Economic Zone* – one of the three largest nationwide. This regional financial hub has been targeted by *Beijing* to become the center of the region through preferential policies and a free trade zone. It is already one of China's wealthiest Tier 2 cities, Northern China's largest commercial port, and is well connected to other cities.

Franchising. Current disposable income and dining out levels indicate that there is a market for food (especially casual diners) and fashion franchises. There may be a smaller demand for education, considering the relative lower amount spent on education compared to other cities. *Tianjin* has about 43 gyms, 26 of which are franchised stores. Existing franchises include *Macros, Mizuno,* and *Subway*.

Potential partners. *Tianjin* is also dominated by *Hong Kong* and foreign groups. *Haohua* is a domestic company with a diverse business portfolio and active only in *Tianjin*.

- ***Tianjin Haohua Group*** [24] **–** Local group with a portfolio including business hotels and entertainment. Its hospitality business is located solely in *Tianjin*.
- ***Jinjiang International*** – One of China's leading hospitality groups with business including hotels, food, travel, and real estate. Present in ~ 22 Tier 1 and Tier 2 cities.
- ***New World Development Company –*** *Hong Kong* group that manages hotels (*Beijing, Shanghai* and ~4 Tier 2 cities), property and department stores (both in ~16 Tier 1 and 2 cities).

[23] Per-capita expenditure on fitness is currently not separately recorded in RMB but as a part of the larger per-capita expenditure on entertainment and fitness indicator.
[24] The Chinese name is 天津皓华集团, as the company can be difficult to find without knowing the Chinese written name.

Nanjing

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Macro-economic overview. *Nanjing*, the capital of *Jiangsu* province, ranks among China's most rapidly growing cities. The GDP of *Jiangsu* province, at $276 billion, is ranked third in China overall after *Guangdong* and *Shandong. Nanjing* has a GDP of $35.6 billion is also an attractive destination for foreign investment. Over 1000 American companies are doing business in *Nanjing* and the *US* ranked *Nanjing* as its second largest trading partner after *South Korea*.

Franchising. Dining out levels in *Nanjing* are comparatively low while expenditures on education are quite high. The fitness market is still relatively undeveloped as Nanjing did not figure in the top ten. Present franchises include *Burger King*, *Little Caesars, S·DEER*, and *Subway*.

Potential partners. There are several reputable domestic groups based in *Nanjing* while there is relatively less presence of Hong Kong and foreign groups.

- ***Jiangsu Yueda***[25]*,* **–** Based in *Jiangsu* province, *Yueda* has a diverse portfolio of products. Most of this does not center of F&B, but *Yueda* is JV partners with *Carrefour* and recently with *UK* chain *Costa Coffee* in *Shanghai*. It is present in a number of Tier 1 and Tier 2 cities.
- ***Jinling Hotels & Resorts –*** Focused on hotels and resorts with some 18 locations, most of which are in Tier 1 to Tier 3 cities in *Jiangsu* province.
- ***Suning Group –*** Chinese group famous for its electronics and appliances. Its portfolio in *Nanjing* also includes hotels and real estate.

Qingdao

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Macro-economic overview. *Qingdao* occupies a prime geographical position in the East Asian market, close to both Korea and Japan. It is also one of the largest ports in China, the major commercial center of *Shandong* province, a popular tourist destination, and a favorite spot for FDI. During the past years, FDI in *Qingdao* has risen to among the highest in China to reach $3.7 billion in 2007.

Franchising. Resulting from its colonial history, people are familiar with foreign influences and brands, Income and expenditures on dining out and education are at reasonably high levels. *Qingdao's* took 7th place in the fitness top ten, and interest in fitness can be expected to grow as *Qingdao* is the venue for the 2008 Olympic water sports events. In 2006, 44 gyms existed in the city, 12 of which were franchised Franchised brands already located there include *Jack & Jones, Lejazz* and *Little Caesars*.

Potential partners. *Qingdao* presents an even mix of potential domestic, Hong Kong, and foreign partners.

- ***Gloria Hotels & Resorts –*** Chinese hospitality group present in some 13 Tier 1 and Tier 2 cities.
- ***Jinjiang International*** – One of China's leading hospitality groups with business including hotels, food, travel, and real estate. Present in ~ 22 Tier 1 and Tier 2 cities.
- ***Shunfeng Food & Recreation*** – Domestic restaurant and recreation group present in all Tier 1 and four Tier 2 cities: *Qingdao, Xi'an, Shenyang* and *Jinan*.
- ***Qingdao Construction Group –*** Construction group that also deals in real estate in *Qingdao*.

Chongqing

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Macro-economic overview. *Chongqing* is the youngest but largest autonomous municipality in China. Previously part of *Sichuan* province, *Chongqing's* reclassification as an autonomous municipality in 1997 was a significant step in government efforts to develop central and Western China. *Chongqing* is an important economic and industrial center for the Southwest region. Upon completion of the *Three Gorges Dam* project, ocean-going ships will be able to reach *Chongqing*.

Franchising. The presence of foreign brands is still relatively limited compared to other Tier 2 cities, as its purchasing power is still low. Regardless, franchised brands such as *Adidas*, *Lejazz*, and *Little*

[25] Although most of *Yueda's* portfolio does not center on F&B, it partners with *Carrefour* and recently with *Costa Coffee* in *Shanghai*.

Caesars are presen. Disposable incomes are about half of those in *Shanghai* but expenditures spent on dining out and education are similar to those in *Qingdao*. *Chongqing* ranked 8th place, together with *Changsha (Hunan* province*),* in the fitness top ten. There is good mid term potential in *Chongqing* as it is still a relatively new and undeveloped market for foreign brands.

Potential partners. Reliable partners are spread out evenly across domestic, *Hong Kong*, and foreign in the F&B field.

- ***Cheung Kong Ltd* –** Leading *Hong Kong* based group active in 55 countries. Its portfolio includes commercial and residential property development in 15 Mainland Tier 1 and Tier 2 cities.
- ***Chongqing Changan Group* –** Leading car manufacturer with real estate dealings in *Chongqing.*
- ***Chongqing Xiya Group*[26] –** Group focusing on restaurants and hotels, only in *Chongqing*.
- ***Gloria Hotels & Resorts* –** Chinese hospitality group present in some 13 Tier 1 and Tier 2 cities.

Xi'an

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Macro-economic overview. Sited in the relatively underdeveloped *Shaanxi* province, this city is home to the famed Terracotta Warriors as well as many other as yet undeveloped historical assets. In spite of being the largest city in this region and a hot spot for tourism, it has suffered from sluggish development, mainly due to poor transport linkages. However, distribution channels are fast maturing across *Shaanxi's* major cities.

Franchising. While disposable income is only 50% of *Shanghai* levels, expenditures on dining out and, especially, education are good (67% and 83% of *Shanghai* levels respectively). *Xi'an* is not in the top ten fitness cities, but there is potential as the fitness market is new but growing. The city is a key expansion point for chains already established in the East Coast, especially for education but also for food and cheaper apparel. Established franchises include *Little Caesars, Mizuno,* and *Subway.*

Potential partners. *Xian* also possesses a good mix of domestic and foreign companies, although the real estate sector is predominantly domestic.

- ***Gloria Hotels & Resorts* –** Chinese hospitality group present in some 13 Tier 1 and Tier 2 cities.
- ***New World Development Company* –** *Hong Kong* conglomerate that manages hotels (*Beijing, Shanghai* and ~4 Tier 2 cities), property and department stores (both in ~16 Tier 1 and 2 cities).
- ***Shunfeng Food & Recreation*** – Domestic restaurant and recreation group present in all Tier 1 and four Tier 2 cities: *Qingdao, Xian, Shenyang* and *Jinan*.
- ***Xian Ginwa Group* –** A local group that has dealings in hotels and real estate, *Xian* only.

[26] *Xiya Hotels* are a JV between the *Xiya Group* and a US company.

Other Tier 2 markets

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Dalian. With a population of 6 million, it is the second biggest city in *Liaoning* province, whose port and strategic location has been the key to its rapid growth and development. *Dalian* has the largest deep-water port in Northeast China, and strong international trade links. The city is also equipped with advanced infrastructure capable of supporting sophisticated logistics needs. In 2006, its GDP reached $33 billion. *Dalian* is also a major industrial base and one of the largest oil refinery bases in China.Currently established franchised brands include *Little Caesars* and *Subway*.

Shenyang. Capital city of northeastern *Liaoning* province, the city is an important industrial center in China and the region's top commercial and logistics hub. In recent years it has made opening up to the outside a top priority. Traditionally focused on heavy industry, it has recently begun developing the software, automotive and electronic sectors. Franchised brands such as *Blenz Coffee* and *Subway* are present.

Hangzhou. *Hangzhou* is the provincial capital of *Zhejiang*, the fourth largest production base in China, which also ranks fourth in GDP among all provinces. *Hangzhou* is an economically dynamic city attractive to foreign investment. The GDP of *Hangzhou* grew 17% to reach $44.1 billion in 2006. The city's disposable income also ranks among the top few cities in China. *Hangzhou* is also equipped with modern transportation facilities and is linked to *Shanghai* and surrounding cities by a number of expressways. *Banana Leaf* and *Macros* are some of the locally present franchised brands.

Suzhou. *Suzhou*, located in *Jiangsu* province, ranks among China's most rapidly growing cities. Famous throughout history for its silk production, *Suzhou* is now a major international hi-tech production hub as well as a manufacturing base for other products including steel, chemicals, paper, machine tools and motor vehicles. In 2006, the city achieved a GDP of US $61.8 billion. *Suzhou* has experienced an impressive average annual growth rate of about 17 percent in recent years, and has become a major target of foreign direct investment - over US $6 billion in 2006. Brands that are franchised include *Blenz Coffee* and *Little Caesar.*

CONSIDERATIONS FOR US COMPANIES AND CONCLUSIONS

Key Considerations

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Key opportunities. The previous sections highlighted the key opportunities for US companies in the four sectors. In general, middle to high-end positioning and high quality products are increasingly in demand. This is driven by the growth of the middle class[27]. The middle class currently constitute 5% of households, but are expected to increase to 45% of all households by 2020. This presents significant long term potential, and is part of the reason why some foreign companies that use the franchising model overseas choose to invest in direct-owned outlets in China, as the potential revenue generated by direct-ownership of stores is higher.

Chinese companies may lack management skills and suffer from a lack of consistency across stores. In addition, investment in R&D and product development is generally low. US companies possess the experience, skill, and know-how for establishing smooth-running outlets, and such consistent branding is key to success.

Key challenges. Although there is a market for the products/services of foreign franchisors, there are still significant challenges in adopting the franchising model, as highlighted below:

1. ***Finding good partners*** **-** In many Tier 2 cities, there are generally only a small handful of potential partners that fit the profile for what many foreign companies are looking for in JV partners. Potential partners usually have capital, but they need to be convinced of the potential of the foreign brand, and its track record in other countries and in China. Generally, potential partners prefer brands with a good international track record (especially in Asia).

2. ***Managing franchisees*** **–** It is generally difficult to find and manage franchisees, especially in Tier 2 cities. Although franchising fees are generally not the issue, start-up costs can be prohibitive due to high rents. Many local franchisees do not follow franchise standards, and sacrifice brand image for short-term profits. Thus comprehensive contractual arrangements are necessary, including those that look out for the franchisee's interests (satisfied franchisees are more likely to abide by the rules). More time and effort needs to be put into providing training support.

3. ***Staffing*** **–** At store level, the talent market for store managers is very competitive, and it is even more pronounced in Tier 2 cities. Direct-owned chains, like *Starbucks* or *Haagen-Dazs*, have direct control over recruitment and retention, generally offer higher salaries for store managers, and are able to devote more resources into training. Most local staff in Tier 2 or 3 cities also need rigorous training, as they have relatively limited exposure to Western chains and service concepts. Direct-owned chains regularly transfer store managers from Tier 1 cities to manage new store openings in Tier 2 or 3 cities and to train local staff, whereas this may not be feasible for franchised chains.

4. ***Localization*** **–** Differences between US and other countries always mandates a certain amount of localization in international expansion. In addition to major differences between the US and China, there are also regional differences within China. It is therefore important to thoroughly analyze potential markets and to never assume success in one region will guarantee success in another.

5. ***IPR issues*** **–** While China's IP laws are on par with international standards, they suffer from a lack of enforcement. The responsibility to track down businesses that infringe on IP rights often falls on the IP owner. Companies should register all trademarks, brand names (both English and Chinese), URLs, and patents before entering the market.

Market Access

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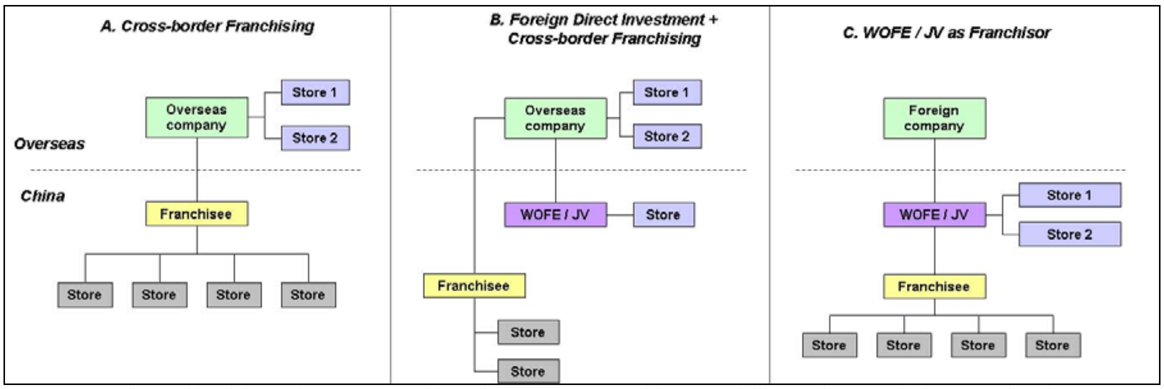
Market entry options. There are two main options available for foreign franchisors looking to enter the Chinese market: 1. Engage in cross-border franchising. 2. Establishing a Foreign-Invested Enterprise (FIE) such as a JV or WOFE, as shown in the following chart.

[27] Defined by the National Bureau of Statistics as households with annual income of $7,230 to $60,240

1. ***Cross-border franchising*** – The May 2007 regulations have made it fully legal to use cross-border franchising, where the US franchisor (with at least two successful stores overseas) sign a franchise contract with the master franchisee in China, without have a local presence in China *(Example A in chart below)*. However, this method results in a great loss of control and supervision over the franchise as the franchisor has no legal entity in China.

2. ***Foreign direct investment*** **–** This involves establishing either a JV or WOFE. The overseas company can set up a WOFE/JV, and at the same time do cross-border franchising, where the overseas company is the franchisor *(Example B in chart below).* However, if the WOFE or JV is to be a franchisor, then it is required to have owned and operated at least two successful stores for at least one year, before it can use franchising *(Example C in chart below).* While this information is based on interviews with the *Ministry of Commerce* (MOFCOM), it must be noted that this law is still relatively new, and how it is implemented in practice is still unclear; implementation may also vary by region. More time is needed to observe which structures are approved (or rejected) in practice.



Source: Interviews with Ministry of Commerce, China Chain Store & Franchise Association, and JLJ analysis. Note: the above charts are simplifications, and more complex models are possible, for example if the franchisee can engage in sub-franchising.

Tier 1 vs. Tier 2 entry strategies. Entry via Tier 1 cities has been the dominant strategy for the majority of foreign companies since these cities have the largest and most open markets. It is most common for franchisors to establish a JV or a WOFE in Tier 1 cities to set up supply chain networks, and establish brand image through a few direct-owned stores. Further store expansion are done either through direct-owned stores, partnerships, or franchising. With Tier 1 cities becoming increasingly expensive and competitive (e.g. many foreign brands present, difficult to find good locations, etc), many companies are considering entering via Tier 2 cities.

Entry via Tier 2 cities has not yet been done by many companies, but *Dunhill,* for example, entered via Tier 2 markets and later expanded into Tier 1 cities. There are several barriers for entry via Tier 2 cities. Purchasing power is rapidly growing, but still limited; Tier 2 markets are also fragmented, characterized by a large number of potential cities, that can each accommodate only a few number of stores. For example, *KFC*, a relatively mature brand in China, has less than 20 outlets in *Chongqing* compared to more than 150 in *Shanghai*. The implications include release of products in smaller volumes and at reduced prices.

Conclusions

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China is becoming increasingly attractive to foreign franchisors. However, there are several barriers to using the franchising model including difficulty in finding franchisees and in maintaining standards. As a result, many foreign franchisors have chosen not to use franchising in China, instead opting for direct-run stores and partnerships. In all cases, a significant amount of time, effort, and resources are still necessary to maintain the quality of store operations. Companies should also seek professional advice when planning their China strategy.

TRADE EVENTS

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Franchising China 2007 exhibition
Location: Shanghai, Guangzhou, Beijing
Date: 8-9, 12-13, 15-16 November 2007
Website: http://www.franchise.ceconline.com:80/HOME_EN.HTM

China Franchise Expo 2008
Location: Beijing
Date: 19-21, April 2008
Website: http://www.chinafranchiseexpo.com/asic/e.htm

Shanghai International Franchise Exhibition
Location: Shanghai
Date: August 2008
Website: http://www.ccfa.org.cn/sh/e_Why%20to%20Exhibit.htm.htm

China International Hospitality Industry Expo
Location: to be confirmed, likely Beijing
Date: to be confirmed
Website: http://www.hosexpo.com.cn/en/info.asp

RESOURCES & KEY CONTACTS

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China Chain Store & Franchise Association
Tel: +86-10-51916555 ext.8043
*Website:*http://www.ccfa.org.cn/english/

Ministry of Commerce of the PRC
Tel: +86-10-65284671
Website: http://english.mofcom.gov.cn/

Ministry of Education of the PRC
Tel: +86-10-66096114
Website: http://www.moe.edu.cn/english

Asian Academy for Sports & Fitness Professionals
Tel: +852-2578-9877
Website: http://www.aasfp.com/main.htm

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Methodology

This research is based on a combination of secondary and primary resources as well as a continuous analysis and elaboration of all key facts and data throughout the research. Secondary resources included The JLJ Group, US Commercial Office, World Trade Atlas, China Customs, China Statistics Bureau, and other sources. Primary resources include interviews and interactions with key industry players.

About the authors

The U.S. Commercial Service — Your Global Business Partner

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