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Reasons Why Foreign Firms Are Forsaking Franchises

By Irina Filatova

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Every morning Christopher Wynne, an American living in Moscow for the last 10 years, is off to a battlefield, armed not with an assault rifle but a rolling pin and pizza cutter.

Wynne, who is chief executive of Papa John's Russia, a local franchisee of the U.S. pizza delivery chain, said his company faces many problems, including bureaucracy and high interest rates.

"Doing business in Russia is somewhere between sport and war every day. You have to face a lot of challenges," he said.

These problems, however, are typical for most franchises operating in Russia and result in some foreign companies giving up franchising in order to run their operations directly.

"Foreigners are cautious about the political and economic situation in Russia. The franchising scheme requires stability and predictability of the economy," said Alexei Mogila, head of the trade real estate department at Penny Lane Realty.

It is also not that easy to get a loan to open a new chain because interest rates are high compared with other countries, Penny Lane Realty said in a statement.

Annual interest rates for a franchisee seeking a loan in France and Britain are 4 percent and 7 percent, respectively, while the rate in Russia reaches 18 percent a year, Penny Lane Realty said.

"One of the best ways for small businesses to grow in the West is with debt. You can get long-term cheap financing for small businesses in Europe or America, but here it's very difficult," Wynne said by telephone.

But while Wynne's firm is doing well, with 20 restaurants operating in Moscow and two in Siberia, Mogila said about 15 foreign companies have refused to prolong their agreements with local partners over the last couple of years and have started to manage their outlets by themselves.

"A stable trend has appeared in the retail real estate market as many companies are considering the opportunity of working independently today," he said.

Growing sales in the local market result in foreign companies seeking to work independently in order to retain control over the brand, Mogila said.

Such firms include German denim brand Mustang, which opened a subsidiary in Moscow in 2009 after its contract expired with local distributor Jeans Symphony. The company was in charge of Mustang's local supplies and developing the brand's franchising program locally.

Although Mustang, which currently has 19 stores in Russia, was satisfied with its local partner's work, the jeans maker decided "to take our business to the next level," said Robert Scanlon, chief executive of Mustang Russia.

"We actually repeated the experience of many Western brands in Russia who initially test the water by working with a local distributor and subsequently move on to open their own companies in Russia," he said in e-mailed comments.

Scanlon said having wholly owned stores "provides greater control over the brand, customer service, product flow, [and] merchandising."

At the same time, other foreign fashion retailers like Mango, Promod and New Yorker prefer to develop corporate stores along with the franchising program, said the head of a Russian franchisee of a European fashion brand.

"To cancel an agreement with a franchisee means to lose everything. No one rejects his partners," he said, adding that it is much easier to work with a local partner, which has market knowledge.

Companies that cancel franchising agreements have to either buy out their stores from a local partner and then deliver on all the obligations with shopping centers, or close them, he said.

According to Fashion Consulting Group, a market researcher, working independently provides a number of advantages for foreign companies that are not involved in the distributors' competition and can implement brand development strategies and reduce expenses that inevitably arise from working with an agent.

On the other hand, the "unpredictability of the market" and need to make operative decisions without having the opportunity to rely on a local partner with market knowledge involve certain risks, Fashion Consulting Group said in e-mailed comments.

Although launching a franchising program is more convenient because a franchisee bears the major expenses, directly managing stores ensures that advertising budgets are spent properly and foreign firms' corporate standards met, said Mogila, of Penny Lane Realty.

Some local franchisees fail to meet corporate standards, which results in foreign firms canceling franchising agreements, said Yury Mikhailichenko, executive director of the Russian Franchising Association.

"Foreign firms are used to working in line with high standards, while a store in some regional town doesn't always meet these standards due to the poor infrastructure and low cultural level," he said by telephone, adding, however, that this is rather the exception than the rule.

Wynne, of Papa John's Russia, said executives from the U.S. headquarters come to Russia every month to check whether the franchisee is meeting corporate standards, which range from the ingredients used to prepare pizza to the way the staff dresses and the restaurants are designed.

Another possible reason for giving up the franchising scheme is that some franchisees violate agreements. Some local partners "start taking the business as their own and cease to pay royalties," Mikhailichenko said.

One recent example is Israel's fashion retailer Castro Model, which canceled its agreement with Russian franchisee Plaza Group earlier this year, saying the firm had repeatedly violated the conditions of the agreement.

Both Castro Model and Plaza Group declined to comment on the issue last week, but Castro told online industry newspaper Retailer.ru in February that the company had made a decision to cancel the agreement because the franchisee owed it a total of $1 million and "never paid its debt on schedule."

The Israeli company also demanded that the franchisee close the three local stores operating under the Castro brand, Retailer.ru reported, citing Castro.

However, the Castro stores in Mega Belaya Dacha shopping center in Moscow, as well as two others — in Volgograd and Yekaterinburg — appeared to be working when contacted last week.

The store managers declined to comment on the issue.

According to Penny Lane Realty, only 40 percent of the domestic franchise market belongs to U.S. and European brands, while the rest are domestic chains.

Among recent entrants that have come to Russia's franchise market over the last two years are Dunkin' Donuts, Cinnabon, GAP, Wendy's and Victoria's Secret.

Despite the challenges, many companies — foreign and domestic — are opening franchising chains in Russia, with the number of local franchisees having increased 30 percent over the last year, said Mikhailichenko.

It is rather difficult for a foreign company to manage its stores remotely and handle logistics without a local partner, he said.

"As a rule, managing a few stores is not a problem, but if a well-known brand is expanding its business in Russia, it's very difficult to cover the country's territory with its remote cities like Vladivostok or Khabarovsk without a franchising program," he said.

Wendy's, one of the world's largest fast-food chains, which opened its first restaurant in Moscow earlier this year and plans to launch at least 180 locations across the country, said the franchising model "has proven effective" for the company.

"We are predominately using a franchise business model as we expand the Wendy's brand in key markets around the world," Wendy's spokesman Bob Bertini said.

The company's Russian franchisee, Wenrus Restaurant Group, has good restaurant experience and market knowledge, he said in e-mailed comments.

However, Wendy's biggest rival McDonald's, which is represented by franchisees at about 80 percent of its outlets around the world, still owns and directly manages the nearly 300 restaurants it has set up across the country in the 20 years it has been operating in Russia.

"It's important to create a strong operational base and effective logistics before we start developing franchising in Russia," the company said in e-mailed comments.

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