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Executive insight: evaluating the market size for service franchising in emerging markets

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Abstract

Purpose – The purpose of this article is to propose a framework for analyzing the comparative economic market size for service franchisors in emerging markets using current and available data from the World Bank.

Design/methodology/approach – Data is transformed through simple manipulations to derive information-filled rankings of 20 popular emerging markets. Emerging markets constitute the largest and most dynamic markets for international franchisors.

Findings – The findings show that Brazil, Russia, and Mexico outranked China and India as the markets with the largest economies for service franchising. Future research should enhance the economic analysis and measures developed in the article and use them in conjunction with other environmental, industry, and company variables to estimate the market potential and select the appropriate markets for entry.

Practical implications – Attempting to estimate the market size of emerging markets is often only the first step in international market selection.

Originality/value – This paper encourages managers to think beyond simple measures of market size when considering the attractiveness of franchising opportunities which hitherto has been under-emphasized in the extant literature.

Keywords Franchising, Market entry, Emerging markets, Developing countries

Paper type Conceptual paper

Introduction

While the United States of America is the largest economy in the world, franchising is becoming saturated in the market and the competitive environment is fierce. Additionally, about 96 percent of the world's population lives outside the borders of the United States.

Eighty percent of the world's population lives in emerging markets and the Department of Commerce estimated that 75 percent of the expected growth in world trade in the next decade will come from emerging markets (Alon and Welsh, 2001). Emerging markets embody the most dynamic opportunities for service franchisors, but their market potential varies considerably. How can international franchisors who want to take advantage of opportunities in emerging markets evaluate the market size of the service economy?

After reviewing a number of approaches that have been used previously in the franchising literature, the author develops a general framework for assessing the economic potential of a country from the perspective of an international franchisor. The results can provide a starting point for economic and international market entry analyses.

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The article contributes to the literature of international franchising by providing a systematized approach to the assessment of economic market potential, giving guidance to service franchisors wishing to enter emerging markets, and, hopefully, stimulating additional research on specific emerging markets with high potential for franchising development.

The findings of this article will show that we may want to move beyond the conventional wisdom that India and China are the most attractive emerging markets to focus on because some sectors, such as the ones found in service franchising, may indicate at least in a short-to-medium term that franchisors should consider other alternative locations in their international expansion.

Model development

Models for estimating market size vary with respect to needed data, complexity, validity and reliability. On the one end of the spectrum are models that suggest variables that need to be examined, without reference to how they can be used in selecting a market, and, on the other end of the spectrum, are econometric models that cannot be easily understood or applied by service franchisors. It is the desired objective of this article to bridge the gap between these two desperate streams of research to develop a model that can be understood and applied using previous research and findings.

We start by an assessment of popular variables that are used to evaluate the economic potential in emerging markets: population, GDP per capita (adjusted to purchasing power parity), urbanization and income distribution. We then use an approach that combines there variables and adjusts consumption the relative size of the service sector and the savings rate to assess the macroeconomic environment of service franchising.

Population

The level of population is an often-touted measure of economic potential in emerging markets. In the domestic market, franchisors often use the level of population to price the franchise and estimate the demand. Internationally, Alon *et al.* found that the level of population is the single most correlated measure with international franchising distribution around the world.

With a population of over 1 billion people, China and India (two of the biggest emerging markets) are considered to be among the most attractive locations for expansion. The reality is that the majority of the population in these countries does not earn sufficiently to afford western-style products and services and does not live in the major urbanized areas in which international franchisors are accessible. India with its vast population has 86.2 percent of its population living under $2 per day. China's number is just about 54 percent of its population (World Bank, 2001).

GDP per capita and purchasing power parity

Emerging markets are often classified based on their GDP per capita (GDP divided by the level of population). This measure is used because it is a good proxy for the level of individual income and the general level of economic development in the country. The World Bank divides countries based on income brackets classifies based on their gross national income per capita. The groups are: low income, $825 or less; lower middle

income, $826-3,255; upper middle income, $3,256-10,065; and high income, $10,066 or more (World Bank, 2005). Most markets considered "emerging" fall into the lower middle and upper middle income categories. Divisions of countries based on income per capita are usually arbitrary and a continuous measure of income per capita is preferred for international franchisors because different products may have varying *income thresholds* from which demand can rise.

Studies of international franchising underscore over and over the need to examine the relative income of the population in international market selection. Arthur Andersen (1995) reported that the average income of the citizenry is considered an important determinant to international expansion. Yavas (1988) found that per capita income was significantly and positively correlated to the number of international franchisors in a host country. Alon *et al.* (2000) confirmed Yavas' and Andersen's studies and found that per capita GDP alone can "explain" as much as 23 percent of the variation in international franchising development.

When examining the economic potential, it is important to adjust the GDP per capita of a country to purchasing power, particularly in emerging markets. This is because the prices of inputs and the cost of living are significantly lower in emerging markets compared to the major industrialized countries. Thus, the purchasing power of the citizenry of emerging markets is often higher than what the official unadjusted GDP per capita statistics may show.

While not intended for international franchisors in particular, using two of the measures we proposed – population and PPP GDP – Arnold and Quelch (1998) suggested that total market potential is the product of population plus population growth in the planning period and the difference between average PPP GDP in developed markets and the emerging market. UN population forecasts can be used to estimate the future population. The potential demand for the country will be materialized if population forecasts are correct (and they are usually not too off the mark) and if the PPP GDP per capita equalizes with developed markets GDP per capita. The second element of the formula, they argue is important because above certain threshold income levels, one may expect disproportionately large increases in the demand especially if consumer credit is available. The model assumes that emerging markets will catch up with personal incomes of industrialized countries and develop congruent demand. This assumption is more difficult to accept in many cases in the developing world.

Urbanization

Alon and McKee (1999) developed a macro-environmental model of international franchising in which they propose the level of urbanization to be an important determinant for international franchising success. Additionally, the level of urbanization was ranked as the fifth most important factor of the acceptance of the franchise system in a foreign market with 73 percent of respondents reporting it as either important or very important (Arthur Andersen, 1995).

Several factors may have contributed to the variable's importance: first, as a shift in the population from rural to urban life occurs, the opportunity cost of time will increase for the city dwellers and they will wish to buy some of the services previously produced. Second, even in developing and less developed countries, large cities have an adequate number of affluent consumers, providing fertile ground for international

franchising expansion. Third, urban areas usually have a higher average income than the country in general because a concentrated population offers more efficient selling, advertising and distribution (Arnold and Quelch, 1998). Finally, inputs of the franchise service, including materials, unskilled as well as skilled labor, infrastructure, and supporting industries, are relatively more abundant in densely populated areas. Therefore, urban areas can be more easily served by international franchisors and are usually the points of entry into emerging markets. In the People's Republic of China, for example, Beijing, Shanghai, and Guangzhou are popular entry points to the mainland.

Urbanization as a function of franchising success fits into the experience of Starbucks which has been very successful in the urban environments of Chinese cities such as Shanghai. A similar experience has occurred with franchised restaurant chains such as TGI Fridays in Central and East Europe. Surprisingly, Alon *et al.* (2000) found that the level of urbanization taken alone has a low explanatory power for international franchising ($r = 0.07$). What this means is that countries that have large segments of their populations in urban areas will not necessarily draw more international franchisors to their metropolitans. Urbanization in emerging markets is a necessary, but insufficient condition for international franchising development.

Income distribution

GDP per capita, even after adjustment to purchasing power, is only an average. There are some people that make much and others who make less. Furthermore, the distribution of income is not normal because the people in the upper brackets of income make disproportionately more money than those in the lower income scales.

Currie and Alon (2005) developed a model for estimating market demand using the variables discussed above – purchasing power parity GDP and population – with income distribution and the number of people per household to estimate the market potential for Kodak film. By multiplying the share of income that belongs to different income classes by the PPP GDP and then dividing by the number of people belonging to the income class, they show how to derive the PPP income per capita for different income classes. By multiplying the individual income per capita by class by the number of people in each household, they estimate income by class at the household level. They then relate this number to the potential demand for Kodak film using the stated income elasticity – the relationship between household income and market demand for film.

To assess market demand in such a fashion requires the company to know the relationship between demand for its product and income levels and the shape of its demand curve. Unfortunately, most franchising companies do not have sufficient experience in differing income markets and understanding of advanced econometrics to accurately model their demand using this approach.

Model application

A need exists to estimate the general economic market potential for service franchisors using commonly available data. In this section, we show how to utilize socio-economic statistics from the World Bank to estimate the industry's potential demand. In using this assessment framework, we make a number of assumptions:

(1) averages that apply to the population as a whole can also be applied to specific segments of the population,

(2) the number obtained from the World Bank on emerging markets are reliable, and

(3) general statistics can be particularized through proxies to the franchising sector using mathematical manipulations.

To illustrate our model, we selected 20 emerging markets for which data were available, and examined their population (see Table I). From the table you can see that China, India, Indonesia are the top three markets, respectively. If we only used these data, we may surmise from the table that China's market is about nine times larger than that of Russia (the fifth largest country by population in our sample).

Since population by itself provides incomplete understanding of market size, we take the next step and multiply the population by the PPP GDP per capita to arrive at total PPP GDP. Table II shows the relative ranking of PPP GDP of our sampled emerging markets. One can note from Table II that now using the Russian example, China is only four times larger in terms of PPP GDP, and has only about 48 percent of Russia's per capita PPP GDP.

Another way to look at the data as suggested by the literature is by urban population. Table III shows the urbanization rate in percentage and in absolute numbers for our selected emerging markets. The reader can notice that as compared to raw population, Russia and Brazil now overtake Indonesia in potential, and that China is only about four times larger than Russia in urban population.

Up till now, we relied on previous theories for our variable selection – population, PPP GDP, and PPP GDP per capita. There are a number of additional

Country name	Population
China	1,253,595,008
India	997,515,200
Indonesia	207,021,616
Brazil	167,966,672
Russian Federation	146,200,000
Mexico	96,585,696
Philippines	74,258,872
Turkey	64,385,000
Egypt, Arab Rep.	62,654,940
Thailand	60,245,800
South Africa	42,106,232
Colombia	41,539,000
Poland	38,654,000
Argentina	36,580,000
Peru	25,230,000
Venezuela, RB	23,707,000
Malaysia	22,710,000
Chile	15,017,800
Czech Republic	10,278,180
Singapore	3,952,000

Table I.
Emerging markets' population

Country name	GDP per capita PPP (current international $)	GDP PPP (current international $)
China	3,617	4,534,864,183,296
India	2,248	2,242,030,600,192
Brazil	7,037	1,181,980,426,240
Russian Federation	7,473	1,092,615,077,888
Mexico	8,297	801,325,842,432
Indonesia	2,857	591,543,861,248
Argentina	12,277	449,093,140,480
Turkey	6,380	410,785,841,152
South Africa	8,908	375,092,346,880
Thailand	6,132	369,445,699,584
Poland	8,450	326,626,050,048
Philippines	3,805	282,559,250,432
Colombia	5,749	238,797,438,976
Egypt, Arab Rep.	3,420	214,302,654,464
Malaysia	8,209	186,418,642,944
Czech Republic	13,018	133,801,451,520
Venezuela, RB	5,495	130,267,840,512
Chile	8,652	129,933,164,544
Peru	4,622	116,623,319,040
Singapore	20,767	82,070,167,552

Table II.
Emerging markets' PPP GDP

Country name	Urban population (percent of total)	Urban population
China	31.6	39,638,675,205
India	28.1	28,010,226,740
Brazil	80.7	13,558,269,969
Russian Federation	77.3	11,307,107,465
Indonesia	39.8	8,247,741,213
Mexico	74.2	7,166,658,348
Turkey	74.1	4,769,640,918
Philippines	57.7	4,283,251,760
Argentina	89.6	3,277,567,944
Colombia	73.5	3,052,285,859
Egypt, Arab Rep.	45.0	2,821,978,555
Poland	65.2	2,521,013,927
South Africa	50.2	2,112,890,735
Venezuela, RB	86.6	2,053,500,405
Peru	72.4	1,827,156,554
Malaysia	56.7	1,286,748,597
Chile	85.4	1,283,120,869
Thailand	21.3	1,282,030,665
Czech Republic	74.7	767,368,956
Singapore	100.0	395,200,000

Table III.
Emerging markets' urban population

adjustments to spending/income that we can make to fine tune our model to the needs of international service franchisors. The first adjustment is with respect to consumption net of savings. Consumers can only spend what they do not save. Since comparable saving rates are available for emerging markets, we derive

income adjusted to savings in Table IV. This is derived by multiplying PPP GDP per capita by (1-domestic savings). Singapore, Argentina and the Czech Republic are the top markets according to this calculation.

Another adjustment to personal income is based on the percentage of income that goes to services. Since most franchisors are based in the service economy, the portion of income that is spent on services is thus critical. Table V shows the relative personal income adjusted to savings and adjusted to service spending/income. It is interesting to note that China, Indonesia and India are the least favorable countries ranked on this measure.

Now that we have derived the personal income adjusted to savings and service spending, we can multiple the resulting number by the urban population to arrive at the total urban market potential for service franchisors (see Table VI). Note that Brazil is now the leading market followed by Russia, Mexico, China and India. China, to take our original example, is shown to have a market potential that is only 81 percent the size of the Russian market, a significant contrast with our original conclusion based on population only.

Management implications and future research

A number of management implication and future research considerations can be drawn from this study and are discussed below.

China and India are not necessarily the most exciting markets

The article provides a surprising conclusion that, all other things equal, Brazil, Russia and Mexico, and not China and India, have the greatest economic market potential

Country name	GDP per capita, PPP (current international $)	Genuine domestic savings (percent of GDP)	Per capita income adjusted to savings
Singapore	20,767	41.2	12,217
Argentina	12,277	8.2	11,271
Czech Republic	13,018	19.5	10,477
South Africa	8,908	10.5	7,971
Chile	8,652	11.3	7,675
Poland	8,450	12.9	7,360
Mexico	8,297	11.3	7,359
Russian Federation	7,473	12.2	6,559
Brazil	7,037	12.2	6,181
Colombia	5,749	(0.9)	5,803
Malaysia	8,209	34.2	5,405
Venezuela, RB	5,495	1.7	5,399
Turkey	6,380	15.4	5,396
Thailand	6,132	25.8	4,551
Peru	4,622	11.3	4,101
Philippines	3,805	12.3	3,338
Egypt, Arab Rep.	3,420	7.0	3,181
China	3,617	29.4	2,555
Indonesia	2,857	15.8	2,405
India	2,248	9.0	2,046

Table IV.
Per head income adjusted to savings

Country name	Services (percent of GDP)	Income spent on services (adjusted to savings $)
Singapore	64.1	7,827
Argentina	67.1	7,565
Czech Republic	52.8	5,537
South Africa	63.7	5,078
Mexico	66.8	4,917
Poland	65.3	4,810
Chile	57.4	4,407
Brazil	60.8	3,761
Russian Federation	55.7	3,652
Colombia	61.2	3,551
Turkey	60.0	3,236
Venezuela, RB	58.5	3,161
Malaysia	43.4	2,343
Peru	55.3	2,269
Thailand	49.5	2,253
Philippines	52.0	1,735
Egypt, Arab Rep.	51.0	1,623
India	46.0	941
Indonesia	37.3	896
China	33.0	843

Table V.
Per head income adjusted to savings and services

Country name	Urban population	Income spent on services (adjusted to savings, $)	Urban market potential for services, $
Brazil	13,558,269,969	3,761	50,987,476,988,259
Russian Federation	11,307,107,465	3,652	41,288,588,755,744
Mexico	7,166,658,348	4,917	35,241,162,236,900
China	39,638,675,205	843	33,431,055,237,697
India	28,010,226,740	941	26,357,557,857,833
Argentina	3,277,567,944	7,565	24,795,320,235,822
Turkey	4,769,640,918	3,236	15,432,576,547,810
Poland	2,521,013,927	4,810	12,125,911,301,105
Colombia	3,052,285,859	3,551	10,840,171,522,010
South Africa	2,112,890,735	5,078	10,728,964,012,640
Philippines	4,283,251,760	1,735	7,433,068,576,943
Indonesia	8,247,741,213	896	7,392,796,462,044
Venezuela, RB	2,053,500,405	3,161	6,490,151,377,779
Chile	1,283,120,869	4,407	5,654,933,987,911
Egypt, Arab Rep.	2,821,978,555	1,623	4,580,495,737,715
Czech Republic	767,368,956	5,537	4,248,753,277,261
Peru	1,827,156,554	2,269	4,146,049,612,378
Singapore	395,200,000	7,827	3,093,044,580,937
Malaysia	1,286,748,597	2,343	3,015,088,200,063
Thailand	1,282,030,665	2,253	2,888,771,542,470

Table VI.
Total urban market potential for service franchisors

among emerging markets. Studies of franchising in Brazil, Russia and Mexico were done by McIntyre (2001), Anttonen *et al.* (2005), and Teegen (2001), respectively.

Franchisors wishing to experiment on a smaller scale may choose an emerging market based on individual income spent on services and adjusted to savings. In such cases, Singapore, Argentina, Czech Republic and South Africa may prove to be fertile grounds. These markets also tend to be more stable than the others and more alike the developed markets in which the franchisors have experience.

Global Source hosted by Michigan State University features a website (cited in this paper) that assesses various dimensions of market potential for emerging markets (not with an emphasis on international franchising). Market size is shown as a function of urbanization and electricity usage and given the most weight in the market potential index (for more about the index, see Cavusgil (1997)). Table VII shows the relative rankings of market size and country risk ratings for our sample. Note that both ratings systems agree on the top five countries, but not on the ordering of these markets.

Investment in an emerging market is a function of risk and return. While the return is in part dependent on the market potential, the risk is partly dependent on the country risk. The reader can note that in the top ten countries of our ranking, only Poland is in the top five of the country risk. In the top five markets, Mexico takes the accolade for least country risk.

Adjusting and particularizing the market potential framework

Individual companies may need to adjust the economic potential index based on the characteristics of their industry and organization and other available data. The results presented in our study are only a starting point for analyzing the economic environment of

Country name	Our ranking	Global source market size	Global source country risk
Brazil	1	4	14
Russian Federation	2	3	11
Mexico	3	5	6
China	4	1	7
India	5	2	10
Argentina	6	11	20
Turkey	7	8	12
Poland	8	9	4
Colombia	9	15	15
South Africa	10	7	9
Philippines	11	10	16
Indonesia	12	6	18
Venezuela, RB	13	14	19
Chile	14	17	3
Egypt, Arab Rep.	15	12	13
Czech Republic	16	19	2
Peru	17	18	17
Singapore	18	20	1
Malaysia	19	16	5
Thailand	20	13	8

Source: Data based on Global Source (2005)

Table VII.
Comparative ranking of market size and risk

franchising. Income distribution and household income can be factored in depending on the nature of the company's product as shown in the example given by Currie and Alon (2005). Market growth, intensity, consumption capacity, and receptivity as well as commercial infrastructure, economic freedom and country risk may also be factored into an index as suggested by Global Source (2005). Thus, companies are advised to design a proprietary model for market assessment fitted to their particular needs.

If a company knows the *threshold income* level from which consumer demand arises and/or the relationship between income and quantity demanded in the particular service market segment, then it is possible to more accurately assess the potential demand.

Economic differences in emerging markets' franchising environment necessitate operational adjustments, for example, in the price of the final goods, the price of the franchise, the business format, selection of merchandise, investment schedule, required return on investment, the mode of entry, the financing available, the location, and the partners selected. Failure or success of a franchisor in emerging markets relies in part not only on proper economic potential analysis and international market entry, but also on how well the franchisor plans and executes its strategies in the target market.

Furthermore, economic conditions within countries vary significantly as well. Regional differences in income, ethnicity, religion, and language may alter the cultural prerequisites for success and the many social interactions that follow entry. Therefore, fine tuning the economic analysis to the state, province, city, and district is well advised. Economic and technological poles within countries, such as the ones found in Mexico City and Bangalore, may prove to be fertile to international franchising growth. These areas are more exposed to modern influences caused by globalization, easing the transaction costs associated with understanding, operating, contracting, and cooperating. The legal and institutional background of theses cities is also likely to be more stable, fair, and congruent with international standards.

Considering economic potential along with other environmental factors

Franchising is a unique organizational form that requires its own market potential index. Being a contractual and alliance-based form of business in the service sector, it is subjected to particular environmental forces (Alon *et al.*, 2000). Alon *et al.* (2000) found some support to the relevance of socio-economic factors such as female labor participation, the level of individualism in society, sex role differentiation, and political risk. Countries with a high level of female labor participation, level of individualism and sex role differentiation and low level of perceived political risk are more likely to attract international franchising developers. Other environmental variables in the political/legal and cultural environments certainly play a role in market potential assessment and international market entry.

Alon and McKee (1999) identified a number of key factors relating to the economic, political and social environments that need to be valuated before considering entry. Psychic/cultural distance between the franchisor's home market and the franchisee's home market may also deter rapid development as the franchise may first want to firstly deal with environments with which it has relative comfort in knowing the environments. For US-based franchisors, particularly in the south, that often meant that Mexico was the natural choice of emerging markets. Silver Streak – a Texas-based international franchisor in the restaurant sector – is an illustrative case of such entry into Mexico (Hadjimarcou and Barnes, 2001).

Legal and institutional considerations are paramount in franchising relations when considering an entry decision and should be included in future indices of franchising potential. Aside from a lower per capita income, emerging markets have two other differentiating characteristics. First, both their economic and political structures are changing often creating *dual markets* for products and services and, secondly, a move from relation-based to rule-based approaches to governing markets creates a lot of uncertainty and gaps in local market know-how to the foreign entrant. International franchisors cannot assume that what they read as law is applicable in an emerging market, or that enforcement and judgments will be quick, transparent, and honest in case of a dispute. A fair and efficient legal system is a prerequisite for successful franchising, which essentially relies on contracts to govern the relationships with its franchisees. Despite the large market size in Russia, the unfriendly franchising regulatory environment impeded franchising development there (Anttonen *et al.*, 2005).

Opportunities to expand the model

The presented calculations in our framework are based on a single point in time comparison of market potential in emerging markets and are, thus, nestled in a *static* framework. If additional point of data from additional years are accumulated, *comparative static* analysis may reveal important trends in consumption.

A more sophisticated model may attempt to examine the framework from a *dynamic* point of view – looking over time and into the future. Such an approach may attempt to project changes in the studied variables. One challenge in emerging markets, however, is the ability to accurately predict future economic and political conditions due to the transitioning nature of these countries and the lack of reliable data. If done well, however, a more dynamic model has the potential to help with longer term capital budgeting and strategic planning.

After adapting the presented framework to its specific organizational factors, international franchisors are advised to form an index of their leading indicators of demand and track them over time, creating a database from which competitive intelligence can be derived. For example, if such data exists, franchisors can figure out the impact of various environmental variables on the sales in particular regions of the world.

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