

# FACTORS AFFECTING INTERNATIONALIZATION OF INDONESIA FRANCHISE COMPANIES

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## ABSTRACT

*Franchise is one of successful business strategies in business expansion. Franchise format has been already adopted in all countries. The success is proven in the world and also in Indonesia. Franchise system can be implemented not only in franchisor country but also in other countries. The spirit of internalization is not only because of market saturated, but also to increase reputation of franchise companies and to follow competitors or customers. Important thing discussed in this research is the franchise life-cycle, franchise growth model, and franchise companies' profile. It is found that the Indonesia franchise companies are in the introduction stage. The stage in life-cycle shows its reputation. This study used literature review as methodology, and the purpose of this study is to give a big picture for Indonesia franchise companies to make internationalization. There are some Indonesia franchise business profiles in the discussion part. The factors affecting franchise internationalization were analyzed by PESTEL analysis. Some strategies should be prepared in making decision to go international. At the end, there are some recommendations and future research relating to internationalize franchise business.*

**Keywords:** *internationalization, franchise company, growth, PESTEL analysis*

## ABSTRAK

*Waralaba adalah salah satu strategi sukses untuk ekspansi bisnis. Format franchise sudah diadopsi di seluruh negara. Sukses franchise sudah terbukti di dunia dan juga di Indonesia. Namun, sistem waralaba bukan hanya diimplementasikan di negara asal pewaralaba, tetapi juga di negara lain. Semangat untuk internasionalisasi tidak hanya karena pasar yang sudah jenuh tetapi juga karena keinginan untuk meningkatkan reputasi dari perusahaan waralaba tersebut dan mengikuti pesaing serta pelanggan. Hal penting yang didiskusikan adalah riset tentang daur hidup dari waralaba, model pertumbuhan waralaba, dan profil perusahaan waralaba. Ditemukan bahwa perusahaan-perusahaan waralaba Indonesia ada pada level introduksi. Level itu menunjukkan reputasi dari perusahaan-perusahaan tersebut. Tulisan ini menggunakan metode tinjauan pustaka dan tujuan dari tulisan ini adalah untuk memberikan gambaran kepada pewaralaba dalam melakukan internasionalisasi. Terdapat bagian dalam tulisan yang mendiskusikan tentang profile dari perusahaan-perusahaan waralaba di Indonesia. Faktor-faktor yang memengaruhi internasionalisasi waralaba dianalisis dengan Analisis PESTEL. Beberapa strategi disiapkan untuk dapat menjadi perusahaan di tingkat internasional. Pada akhir tulisan ini ada beberapa rekomendasi dan riset lanjutan untuk melakukan internasionalisasi bisnis waralaba.*

**Kata kunci:** *internationalization, franchise company, growth, analisis PESTEL*

## INTRODUCTION

Franchising has a track record as a way to speed up growth through the expansion of business. Recent estimate has anticipated franchise unit growth of becoming turbocharged, in the 12 to 14 percent range. Franchise based business format has been responsible for tremendous growth in franchising since 1950s. It has enjoyed long term growth over the past 25 years. In 1972 there were 189,640 franchise establishments with the gross sales of USD 28.7 Billion. Then in 1987 the number increased by almost 163,000 units (about 86%) while the sales increased to USD 170.8 billion (nearly a 600% increase). In 1997, it was estimated that there were about 380,000 franchise units in the US that accounted for about USD 410 billion in gross sales. It was also estimated that there were more than 100,000 franchise units of United States franchise system (Cherkasky in Justis and Judd, 2006).

Franchise system has been known in Indonesia since 1970s. The system has started to spring up since International Labor Organization (ILO) funded a franchise study in year 1991 in Indonesia (Sukandar, 2006a). Starting from the end of 1997 until 2003, the number of franchise companies has fluctuated in Indonesia. The number of foreign franchise companies has decreased from 230 to 170 – 180 companies and the number of local franchise companies has grown until 85 companies. It was estimated that there were 400 local franchise companies and more than 9,000 franchisees included company-owned in the year 2006 (Sukandar, 2006a). And between the period of 2000 to 2004, in Indonesia there were significant growth of local franchise companies in around 60% and 27.35% for foreign franchise companies which has a negative growth in the year 2003 (Rachmadi, 2007).

The Asian financial market crash, global economic fluctuation and highly competitive internal–external market environments have either directly or indirectly given great impacts on the success and failure of businesses. In this context, there has been a progressive focus on the strategies that may assist in building a successful business strategy, which are the franchise business (Castrogiovanni and Justis in Inma, 2002).

Nowadays franchise business in the US generates about \$1 trillion of sales each year; one of twelve US retail establishments is a franchise business; franchise business sales from franchisees contributes for over than 50% of total annual US retail sales and employs over 10 million people in 2002 (International Franchise Association in Sherman, 2004).

### **Franchise Success**

Success in franchise can be broadly classified into four main areas: financial measures, growth, market position and satisfaction (Inma, 2002). There are also success factors that can be divided into short-term and long-term factors. The short-term factors primarily relate to the financial benefits, which have a significant and immediate effect on franchise organizations, while the long-term factors relate to survival and growth which ensure the franchise operating effectively over a period of years (Inma, 2002).

### **Reason to Internatiolize**

According Bradley (2002), reasons why a firm decides to internationalize are: (1) small or saturated market or better opportunities abroad (2) excess capacity and resources or unique competence of the firm, (3) need to follow competitors or customers abroad (4) Managements aspiration or international orientation of the company, (5) an opportunistic response to unsolicited or request from potential foreign-based customers and (6) backwards or forward integration to reduce costs and increase control.

For some company the reason to internationalize is to increase company reputation. By increase company reputation, company can increase brand awareness and at the end can increase their market not only in the domestic country but also in foreign country.

## **Problem Identification**

Since franchising is often viewed as an effective business arrangement that generally survives such economic turbulence and also offers a high business success rate, companies have to know how to succeed their franchise business go international, what factors that companies need to prepare in open new franchise outlets in other countries and what will be faced when internationalize their franchise companies.

## **RESEARCH METHODS**

This study explores a literature research using PESTEL analysis to find factors and strategy for Indonesia franchise companies to go international. Some researches of growth as one of measurement of success were used since growth as one of franchise success measurement that has sufficient information to explore compare to financial measurement (sales and profit of companies), satisfaction and market position.

### **Definition, Criteria and Growth as Measurement of Success**

Franchising may be defined as a business opportunity by which the owner (producer or distributor) of a service or a trademarked product grants exclusive rights to an individual for the local distribution and/or sale of the service or product, and in return receives a payment or royalty and conformance to quality standards. The individual or business granting the business rights is called *the franchisor*, and the individual or business granted the right to operate in accordance with the chosen method to produce or sell the product or service is called *the franchisee* (Justis and Judd, 2002).

Franchising can also be described by International Franchise Association as “a continuing relationship in which the franchisor provides a licensed privilege to do business, plus assistance in organizing, training, merchandising, and management, in return for a consideration from the franchisee” (Kostecka, 1983).

Franchising can be approached from the perspective of both the franchisor and the franchisee. Franchising allows the expansion of a proven concept and method of operation from a single unit to a large operation with multiple locations and multiple product or service offerings for the franchisor. And from the side of franchisee, franchisee has the opportunity to utilize proven methods of operation, large-scale, high-impact advertising, recognized brands or trademarks, and continuing managements and technical assistance (Justis and Judd, 2002).

Sukandar (2006b) defines the criteria of for a company to become a franchise business: (1) success. This success can be proved by the number of customers, increasing of sales and other authentic proof (2) have some prototypes. These prototypes are used as a model that can be copied by franchisees to develop their business (3) uniqueness. Franchise business has a uniqueness that cannot be copied by competitors. The uniqueness is possible in the products, services, system, process or operational system (4) standardized (5) transferable. The business can be transferred to the franchisee in the short period (6) efficient and profitable (7) long product life-cycle. Still have a long product life-cycle or in the growth stage and (8) has a customer base.

## Growth as Measurement of Franchise Success

Inma (2002) classified franchise success factors as: (1) the most important: a high quality system, (2) the nature of the product or service, (3) the detailed franchisee knowledge about local conditions, (4) their personal investment encourages franchisees to put all their efforts into beneficial activities and day-to-day outlets' operation.

Inma (2002) found a strong relationship between reputation, growth and organizational background characteristics. Price of franchises and their growth orientation were significantly related to franchisor reputation. Initial franchise fees positively related to franchise reputation. There are significant effects between the duration of the franchise relationship and performance outcomes suggest franchisees. The limited duration of the franchisee presence in the franchise relationship may drive the franchisees to focus on short-term gain, rather than long-term success (Inma, 2002).

Ehrmann and Spranger (2005) base their research on a sample that covering data more than 20 years of organizational development for 925 US franchise system. 500 samples are from Entrepreneur Magazine. Entrepreneur Magazine has published a yearly survey called the Franchise 500, listing most successful franchise systems each year. Ehrmann and Spranger also added 425 samples that were evaluated in year 2003 but not listed among the best 500 for that year. The data used for their analysis represents approximately 62% of all franchisors and 86% of all franchised and company-owned outlets. In the year 2003, IFA (International Franchise Association) estimated refers to roughly 1500 franchisors and to about 320,000 outlets in the US.

Ehrmann and Spranger (2005) also found that the organization structure adopted up to about 11 years of business experience is largely stable during the further maturity and growth. The variable growth in this research used a ten-year-period growth. From the Pearson Correlation table was found a positive correlation between ten-year-period growth and business experience, size, average investment, average franchise fee but a negative correlation with average royalty fee. The standard duration of a franchise contract for their sample is 11.5 years for their sample.

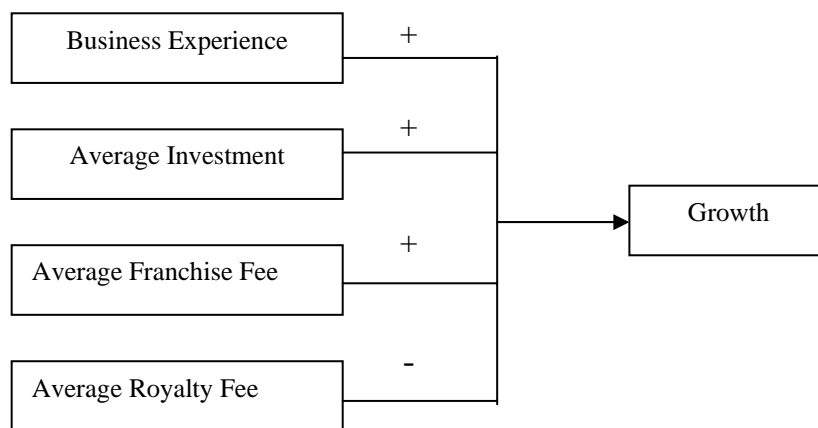


Figure 1 Correlation between franchise profile and growth

## Franchise Life Cycle

Justis and Judd (2002) stated that the relationship between the franchisor and the franchisee is the most critical side. This relationship often follows the basic steps of a new business or a product life cycle; that is, it goes through the following stages: (1) introduction, (2) growth, (3) maturity, and (4) decline.

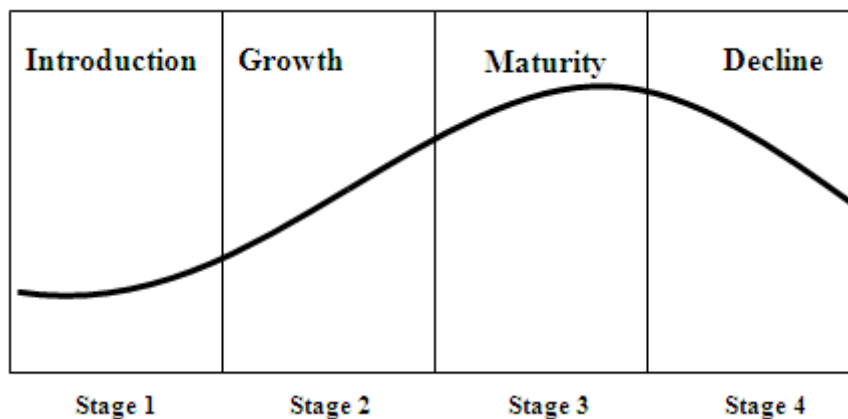


Figure 2 Franchise Life Cycle  
(Source: Justis and Judd, 2004)

According to Bradley (2002), the international marketing environment components are: resources, culture and value, customers, competitors, political economy and technology. This business environment is commonly used to analyze the business strategy of a company as PESTEL (Political, Economic, Socio-culture, Technology and Legal) analysis.

### Innovation Diffusion in Western and Eastern Market

Bradley (2002) made a differentiation between the rate of innovation in Western and Eastern markets. In the West, particularly in the United States, the diffusion of new products and new ideas is thought to follow the traditional normal curve, rising slowly at first, maturing and then declining in a predictable way (Figure 3). In the East, however, because of peer pressure among groups of consumers, the response pattern is quite different. After a relatively cautious start, groups rush to buy the innovation, and later, on reaching maturity in the market, these same groups desert the product or service rapidly in great numbers, causing pronounced changes in the shape of the innovation diffusion curve thought to apply to consumers in the East. The reasons why the rate and patterns of diffusion are different between the East and the West may be attributed to: (1) an attempt to avoid uncertainty in Asia, (2) shopping is done in groups, (3) for Asians the social risk of trying a new product first is high, (4) the proportion of innovators and laggards is much lower among Asians, and (5) referral is a very powerful way of expanding product trials by the first wave of consumers in Asia.

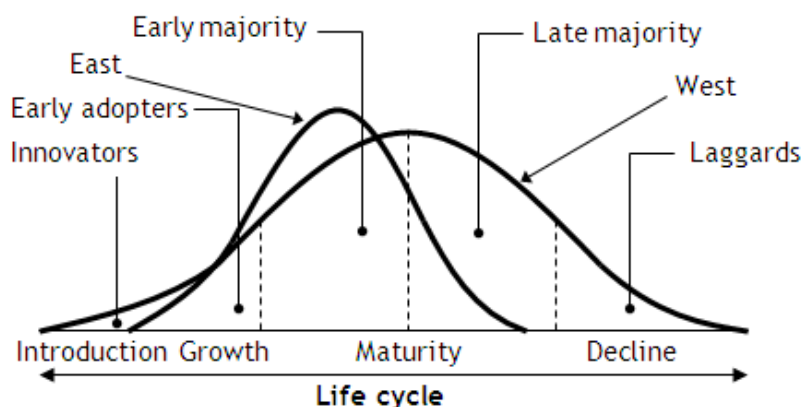


Figure 3 Innovation Diffusion in Western and Eastern Markets  
(Source: Bradley, 2002)

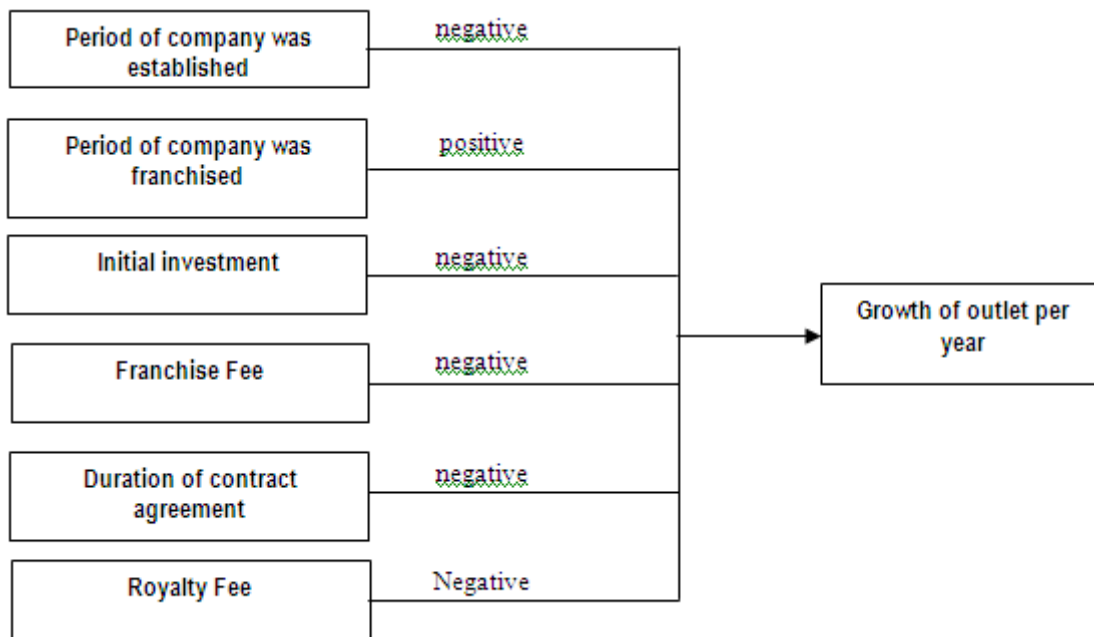


Figure 4 Relation between Franchise Profile and Growth in Indonesia  
(Source: Halim, 2008)

## RESULTS AND DISCUSSION

The reason to go international of franchise companies, as stated by Bradley (2002), not only because of small or saturated market or better opportunities abroad but also to follow competitors or customers abroad. The most reason for Indonesia franchise companies that already go international; to go international is to increase company reputation. They assume by go international, the reputation of the company will increase. The increase in reputation will increase franchisee confident to franchisor. Reputation is very important for franchisor. It is a strong correlation between reputation and franchise growth. The confident level of franchisee or investor will increase when the reputation of a franchise company increase. Franchisees or investors are more confident to the company in order to buy a new franchise business. The good relation between franchisor and franchisee will increase sales and profit for both parties.

Some researchers found that a good relationship between franchisor and franchisee will satisfy both parties. Royalty fees as the obligation for franchisees to franchisors will become a thankful reward from the side of franchisee to franchisor. A good relationship will keep franchisee to repay future franchisee fee in the next term contract. A good relation also will make the franchise business become well known to other candidate franchisee or investors.

### Indonesia Franchise Business' Characters and Profile

Mostly Indonesia franchise businesses are in the beginner stage in franchise life-cycle; in this stage companies choose a rapid growth orientation. So, the relationship between the franchisor and the franchisee should be trustworthy, mutual interdependence, and a shared desire for success and profitability. The franchisee starts out the relationship as an extreme optimism and expectation of great success while the franchisor is interested in making a very positive and friendly approach to the franchisee.

Research of Halim (2008) found that there are two pairs of variables: (1) number of year of company was established and number of year company was franchised and (2) franchise fee and royalty fee have a highly correlated in Indonesia growth model. The period of company was established is statistically significant and highly correlated with the period of company was franchised to company growth. The period of company was established gives a significant negative impact to the growth. It means, the longer a company was franchised the lower the growth is. It is because the product life-cycle for some products or services of franchise companies in Indonesia is declining, the market is already saturated and no uniqueness for new franchise's products. This fact is supported by Sukandar (2006b).

Halim (2008) also found, the period of company was franchised gives a positive impact to the growth. It is because the period of company was established and the period of company was franchised is highly correlated. Since the experience of local franchise brand in Indonesia is still low, the pioneer in franchise business will certainly get more benefit compare to other new brands.

In the other hand, the initial investment gives a significant negative impact to the growth. It means the bigger initial investment is the lower the growth is. Price of franchise is not only defined by initial investment, but also from franchise fee and royalty fee in a new market like Indonesia. The franchisee feels that the price of the franchise is too high because there isn't any promising reputation (the initial investment is a cost from the side of franchisee in Indonesia). The image of the franchise success is also not too strong. So even though franchise has been already known since 1970s, but the local Indonesian brand is not significantly well known and there isn't great enthusiasm in developing franchise. That also explains why the royalty fee negatively impacts the growth significantly.

In Indonesia franchise businesses, the duration of contract agreement negatively impacts the growth significantly. It means that the longer the duration of contract agreement is, the less confident the franchisee to the franchise license sold by the franchisor. It is because the franchisor and the franchisee can make changes in the organization more flexible when the term is short. That's why, franchisees in Indonesia are more confident for short-term contracts.

The stage position of franchise life-cycle in Indonesia, a high growth rate of the population in the short-term and the late starting franchise express the innovation of diffusion life-cycle in Indonesia shifting to the left, which supports the theory of innovation diffusion in Western and Eastern markets from Bradley (2002). Mostly Asia countries are early adoption compare to western countries. It also means that ASEAN countries are early adoption countries. By understanding this characteristic of countries, franchise business companies can understand what kind innovations or unique product should be proposed to other countries.

## **PESTEL Analysis**

Since opening a new business in foreign country is not the same as opening in domestic country, franchisor must concern the business environment in other countries. To go international, discussion of Indonesia franchise business will use Politic, Economic, Socio-culture, Technology, Environmental and Legal (PESTEL) analysis. Other factor can also be added in this analysis such as: competitors and resources.

### **Politic**

Politic is a major factors for Indonesia franchise business to enter new international market. Politic condition of other countries supports the existence of the business when opening a business in other countries. International relation between countries is very important to keep the business in other countries. It is very dangerous to open new business in a country that has no politic stabilization.

Embassy office and consulate office with good relation with the local government are helpful factor to open new business in foreign country.

ASEAN countries collaboration within members is one of best practice to increase politics stabilization within countries. Indonesia as one of ASEAN member is one very important country in ASEAN region in facing ASEAN Free Trade Area (AFTA) and China-AFTA in recent future.

Issues relate to politic aspect in foreign countries are: politic environment stabilization, tax policies and the impact to franchise business, government regulation relate to industry, trade wage and franchise specially, the government involvement in trading agreement and foreign-trade regulation.

### **Economic**

A good politic condition is followed by a good economic condition. A good economic condition of one country is one success factor to invest in that country. Some economic factors such as: unemployment, GDP, inflation, interest rate, easiness of investment are considering opening new market in foreign market, employment level, exchange rate level and how it affect the production, distribution of product and services. Some emerging countries are interesting to invest in developed country but the barriers are a lot.

The economic condition will be different in day to day activities. It will be depend on the politic of its country, region country and global effect. It mean that fluctuated condition of one country is risky for franchise company to have strategic partner or even doing foreign direct investment by opening new outlet by the company itself.

### **Socio-culture**

Mostly, Indonesia franchise businesses are come from culinary business (food and beverages). Different country has a different culture, value and habit. Some Indonesia culinary business (not a franchise business), that already go international, have to make some adaptation when delivery their products to customers in international market. Sometimes the uniqueness of one product in the domestic country has to be changed. The taste, design, habit and culture in other country will be different. Some ASEAN country have sameness but also difference in the other way.

Culture can be obstacles for entering market in new country especially for some culinary business. Indonesia franchise companies should be aware to the foreign local culture when opening new outlet in foreign countries. Although “Malaya” cultures that is the same core culture for Indonesia, Malaysia and Singapore, but there are some difficulties when one to other country proposes new products. There will be some adaptation and maybe some changing to enter international market.

Social-culture is one a very sensitive aspect that should be aware by franchise companies relate to the products or services, marketing strategy, pricing strategy and the way how to sell the business to international investor.

Issues relate to socio-culture are: lifestyle trends, current demographics, level of education and income, local dominant religions and the relation with the consumer attitude, level of consumerism and local attributes toward work and leisure.

### **Technology**

Franchise business identically known as unique products or services. Uniqueness also can be created using a technology or new innovative invention. On the other hand, technology can be used as tool of control for remote franchise units. Information system could help franchisor to control the



activity of franchisees. The using of internet is a low cost strategy in technology application recently. A recent information system such as *Business Intelligent* is a proven success IT tools that increase the business performance, decrease cost, increase customers satisfaction and decrease time consumption in process.

Nowadays, the using of *business intelligent* not only implemented in big size companies but also can be implemented in Small Medium Enterprise (SME) by using open source business intelligent tools. It is better franchisor consult to the IT consultant to choose an appropriate business intelligent tools or other IT solution. Using inappropriate tools is not only unsuitable to business strategic of the company but also can be costly for franchisors and franchisees.

### **Environment/Resources**

New market means new customers. Make sure that franchisors have a high reputation in domestic country before go international. For company that already well known has a high bargaining power to the local suppliers. For some reason, it is very costly to export or bring products 100% from franchisor's country. There are about customs, tax, time delivery and regulations, so local resources are very important for franchisors.

Franchise companies should be careful with issues relate to environmental such as: environmental-protection laws, regulation regarding waste disposal and energy consumption, activities of international pressure group such as: Green Peace, PETA and Earth First and the environmental issues relate to franchise business.

### **Legal**

The franchisors must be aware of legal issues. Franchise business has a strong relation with legal issues such as: government regulation, contracts, trademarks, patents, copyright, trade secrets, know-how and design. For some reasons, legal issues take a lot of cost therefore franchisors have to pay lawyers to avoid future problems.

In some countries, the issue of opening new company will take time and costly. It's very important to have some strategic partners to reduce risk. Some franchisors offer *master franchise* to some local partners. The involvement of local people is very important. But if the franchisor has a confident to make decision to go international directly, the franchise company can use foreign direct investment (FDI) by opening new outlet by themselves.

Also, franchise companies need to aware to the issues relate to monopoly and private property, consumer laws, government regulation relate to employment, health-and-safety and product-safety laws.

## **CONCLUSION**

Based on the discussion of some researches, can be conclude that to success in opening new franchise business in foreign countries some factors should be consider: 1) Indonesia franchise companies are in the growth stage, in the franchise life cycle level. It is mean not easy to promote and propose an early franchised business in foreign country. 2) Indonesia and ASEAN countries are early adoption of innovation. 3) Franchisor should be careful in setting the franchise profile such as: franchise fee, royalty fee and contact duration in foreign country. 4) Franchisors should analyze franchise business growth model before implementing a decision to internationalize their franchise

business. 5) It is better franchisors to start opening new franchise business in ASEAN region in order to eliminate socio-culture gaps. 6) Franchise companies have to start in some countries that have good relation in politics and stable economic condition. 7) It is better for franchisors to have strategic alliance when opening new franchise outlet. Local partner will help franchisors in reducing some obstacles. 8) Using information system in foreign country outlet to control the activity of franchise and or strategic partner. 9) Using local resources as suppliers of product component. Using local source can decrease the cost, make sure the continuation of supply, decrease time consumption and 10) Choose an appropriate business intelligent tool or IT solution. 11) Legal issues are very important issues to be prepared by franchise companies. Foreign country regulation will be different in every country

### **Recommendation and Further Research**

Some recommendation to go internationally in franchising are: 1) Indonesia franchise companies need to make a study of the prospective country. 2) Franchise companies or researchers should make a study in setting the franchise profile such as: franchise fee, royalty fee, and contact duration in foreign country. It will be different within countries. 3) Analyze or study of franchise business growth model in the prospective country. 4) Study by franchisors or franchise companies of local resources or local partner. 5) Study of choosing an appropriate business intelligent tool or IT solution in prospective country for specific business. 6) Study of legal issues is very important issues before entering a new foreign country.

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