

Basic Institutional Principles of Franchising Development in the Republic of Kazakhstan

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Abstract: Solution of many economic problems of the Republic of Kazakhstan requires new economic mechanisms. One of such mechanisms is franchising. The franchising market in the Republic of Kazakhstan grows rapidly. Every year, the number of foreign and domestic franchises increases, which evidences the rise of interest of small businesses to franchising products. Despite the measures taken by the government with respect to assistance in development of franchising relations, a series of issues remains unsolved, including poor availability of financial resources, lack of governmental incentives and preferences for the franchising sector as well as the high price of real estate.

Key words: Franchising • Franchising schemes • Franchiser • Franchisee • Brand • Investments • Financing

INTRODUCTION

Presently, growing interest is observed in Kazakhstan with respect to the development of business using the franchising concepts being an efficient organizational form of expansion and multiplication of successful business models and advanced technology. Franchising allows to make the best use of local environment, combine the advantages of large and small businesses and involve private initiative. Intensive growth of multiplication of successful business models and technology encourages the improvement of the overall efficiency of the economy, which manifests itself in higher rates of economic growth, employment and living standards of the population. Franchising is an efficient tool for development of the domestic branding, which promotes the growth of capitalization and strengthening of the local businesses' competitive advantages [1]. Expansion of franchising systems allows franchisers to save their own capital and involve active investors in the development of their businesses (franchisees) [2].

Currently, the issue of improvement of tools and methods of regulation of economic relations in the franchising system emerge full blown. The Government of Kazakhstan takes measures on development of the governmental support and franchising regulation mechanisms. However, despite favorable economic and political environment, there are certain obstacles in

Kazakhstan that encumber better dynamic development of this sector. The objective to find the optimal solution of problems and select possible lines of franchising development in Kazakhstan becomes very topical.

First of all, in order to remain as correct as possible at consideration of franchising development, it is necessary to clarify the terms, because different specialists may interpret most part of concepts differently.

Franchising is the sale or the temporary grant of a trademark or original methods of organization (firm-specific technology) for a consideration (the royalty). In its essence, franchising is the leasing of own brand capital, which allows novice entrepreneurs to establish their own businesses with minimum risk and financial investments [3].

Franchising relations involve two subjects: the franchiser and the franchisee. Franchiser is the owner of rights for a trademark or technology. Franchisee is the commercial entity, which acquires the right to use a trademark or technology. Franchise is the package of intellectual property rights or rights for usage of a trademark, which is transferred on a temporary basis to the franchisee.

From the economic point of view, franchising is a method of providing chargeable access to a resource, which is excessively available with one of the partners and which the other partner lacks. For a franchisee, it is the acquisition of access to the intellectual property of the

Table 1: The dynamics of the growth of franchising relations in Kazakhstan

Indicator	2010	2011	2012	Change	
				+/-	%
The number of foreign franchises	220	240	350	130	59.1%
The number of Kazakhstani companies, which own or develop their own franchises	9	11	30	21	233.3%
The number of Kazakhstani franchises represented abroad	2	4	5	3	150.0%
The share of franchising relations in the structure and in the total number of small and medium business entities, %	3	3.5	7	4	133.3%

franchiser, where the franchiser gains the opportunity to use the franchisee's capital. Though traditionally it is understood that only the franchisee pays a usage fee (in the form of the initial fee and royalty), in fact, the franchiser also pays in an implicit and not regulated form for usage of the capital, as the franchisee gains the whole income from sales (except for royalty) that the franchiser could receive if it would carry out the sales activity under its own brand [4].

Internationally, franchising was mastered and implemented a long time ago, which is another evidence of the success of this business model. Franchising has been being applied in the international practice for a long time; the first franchising network was arranged in the late XIX century by Zinger, the American company, which manufactured sewing machines. Later on, franchising was assimilated by other business areas: cars, hotels, fuel filling stations, etc. [5]. Since the 1980s, European businesses started to show their interest to the franchising development.

Where the franchising business model became very popular in the whole world a long time ago, in Kazakhstan, the franchising institution is quite a new instrument, which is currently at the initial stage of development.

Before 1994, there were no businesses in Kazakhstan working under a franchising agreement. The first franchising *business ideas* appeared in Kazakhstan simultaneously with the entry of the world brand of Coca-Cola into the Kazakhstani market. Their factory was built under a sublicense of the Turkish franchisee in 1994. This was the beginning of the history of franchising in Kazakhstan. This famous drink ceased to be a foreign product any longer and became a domestic product, as local residents were engaged in its production. The same year, the Kazakhstani hotel Rakhmat Palace 5* was opened, which later on operated under the franchising brand of the Hayatt Regency international network [6].

Currently, such internationally renowned brands operate in Kazakhstan as World Class, Pizza Hut, Burger King, Gloria Jeans, the Rosinter Restaurants Holding line of brands, ZARA, Rixos, Coca-Cola, Baskin Robbins, Adidas, Benetton and many other brands. At the same

time, low budget franchises are also very popular in the consumer goods retail market as well as in the services, handicraft, mass media, Internet technology and other markets. We can also observe new generation franchises entering the Kazakhstani market, namely social and event franchises, such as, for example, the Global Entrepreneurship Week franchise.

If compared to 2002 when there were only two national franchises in Kazakhstan, already 30 franchises existed in the country by December of 2012, five of which operated abroad, including Happyllon, ShBS, Mimioriki, Biba and Zibroo. During 2012, the number of Kazakhstani companies, which owned or developed their own franchises, increased more than 2.7 times. In 2012, the number of Kazakhstani franchises represented abroad increased by 25% and equaled to five franchises. And there are 350 foreign franchises in the Kazakhstani market presently versus 240 franchises a year before (Table 1).

The share of franchising relations in the structure of small and medium business entities equaled to 7%, which is twice as much as in 2011. By the end of 2012, 3,000 franchising businesses operated in the Republic of Kazakhstan employing over 25,000 people. The turnover of the franchising sector reached one billion US Dollars per year [7], which is 10% more than in 2011.

Currently, the leaders by the number of franchising systems in the market of Kazakhstan are Russian companies, the share of which equals to 37.5% of all franchising companies (Figure 1).

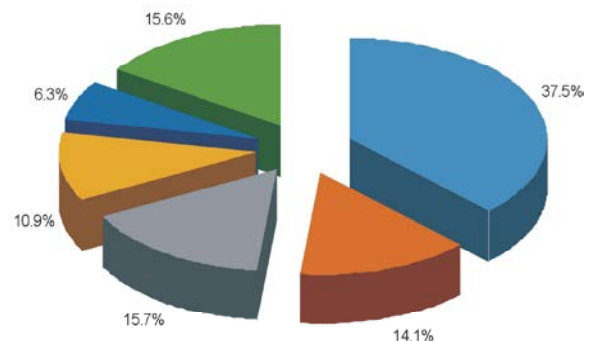


Fig. 1: The share of franchising companies in the market of the Republic of Kazakhstan by countries

Goods franchising is the most developed one in Kazakhstan. Various clothing and perfume stores, medicine centers and real estate companies operate under franchise. The fast food, fashionable clothing, business services, fitness and education lines look very perspective for franchising development.

However, there are precious few projects in the market of the Republic of Kazakhstan, which are oriented to cooperation of large companies with small businesses. Franchising incurs transfer of a brand, technology, etc. from renowned and solid ventures to small and medium businesses. As for Kazakhstan, large companies tend to open their own subsidiaries, rather than franchising points of sale.

Over the last years, there have been quite many bankruptcies among franchising networks, including such vendors as Aimar, Arzan, SM-Market and Vester (Russia). However, the share of bankruptcies is rather small – just 5% of all concluded transactions. Besides, seven largest franchising networks, namely Pyaterocjka, Sbarro, Le Futur, Red Cube, Coffee Tun and Tinkoff, underwent early termination of franchising agreements and left the market of Kazakhstan.

The main cause was the initially inefficient arrangement of the terms and conditions of agreements, inconsistency between the franchisers' promises and the expectations of franchisees, misconduct of partners, breaches of the System standards and provisions of agreements, as well as the growth of excise duties for certain groups of products. It is to be noted that there is no law in Kazakhstan concerning compulsory disclosure of full information about franchisers. In western countries, it is a mandatory document, which must be submitted to the potential franchisee before signing an agreement.

The main franchising trends in Kazakhstan *during* 2010-2012 were penetration into regional markets and interest in franchising shown by investors of all levels. This sector has some peculiar attributes and the most important of them is the sub-licensing. The majority of international brand owners are not eager to cooperate with local businesses directly; they prefer to work through Russian or Turkish companies, which are granted general master franchises (sub-franchises). The Kazakhstani franchisees in this case act as sub-franchisees.

According to expert reports, currently over 200 foreign franchisers actively search for partners in Kazakhstan and over 5,000 of them are potentially ready to cooperate with Kazakhstan entrepreneurs [8].

Interest to Kazakhstan is shown by foreign franchisers and many of them search for partners actively, including such internationally renowned brands as Sbarro, Grillmaster, Broaster Foods, Jani-King, Crestcom, ECCO, Gold's Dym, Finn Flare, Fastrackids; the Russian brands – Belpostel, Masterfiber, Yolki-Palki, Ikornaya Zakuska, Confael, Econika, Topay-po-Khoroshemu and other brands.

The International Information Center expects by 2016 a twofold increase of the number of foreign brands in the Republic of Kazakhstan operating based on providing franchises to Kazakhstani entrepreneurs and a threefold increase of the Kazakhstani franchisers, 10% of which will be represented in foreign markets.

Currently, the necessary legal base has been developed in Kazakhstan and appropriate infrastructure required for franchising development has been created. Kazakhstan is one of the few countries, in which the franchising sector is regulated by a special law, namely the Law "On the Comprehensive Entrepreneurial License (Franchising)" [9]. Along with this law, franchising in Kazakhstan is regulated by the Civil Code. Another law in effect in the republic is the law on trademarks. The following organizations promote the development of the business format of franchising:

- Kazpatent – Intellectual Property Institute;
- CAFLA – Central Asian Franchising and Licensing Agency;
- Damu – Small Entrepreneurship Development Fund, which provides concessional loans to franchisees;
- IAE – Independent Association of Entrepreneurs, which popularizes franchising in Kazakhstan, conducts seminars and organizes exhibitions.

The Government of Kazakhstan encourages the development of franchising in the country. Since March of 2012, the Damu Fund's National Center of Franchising Development Program has been being implemented. This program is one of the top priorities of the DAMU Fund. It is the first time for Kazakhstan that three governmental documents contain measures to support franchising:

- KAZNEX INVEST, the national agency for export and investments, within the framework of the EXPORT 2020 Program provides support to exporters by compensating to them up to 50% of costs related to bringing domestic products to foreign markets. This support includes purchasing franchises in the manufacturing sector targeting to setup production oriented to export;

- The DAMU Fund implements the National Center of Franchising Development Program;
- The Government of the Republic of Kazakhstan issued a decree on awarding governmental grants to novice entrepreneurs for implementation of projects within the framework of the Road Map for Business 2020 Program. Among others, the grants in the amount of up to three million tenges are awarded for purchasing franchises.

According to expert estimates, the existing franchising sector covers only 20% of its potential and has a potential for further growth.

However, despite the favorable economic and political environment, certain obstacles still exist in Kazakhstan, which hinder the development of franchising in the country. They include:

- Availability of finance. Despite positive statistics of their success and resistance to crisis, franchising projects are not very popular with credit organizations. Taking into account the standard requirements for security, banks do not tend to accept intangible assets as pledge, where in western countries granting credits against a renowned brand is a standard practice.
- Lack of governmental incentives and preferences for the franchising sector.
- The high price for real estate, which makes the rate of return on business ideas in Kazakhstan very low, which is another obstacle for franchising development. Along with that, the observed lack of information on the available premises adds to the problem.

At the same time, there are numerous advantages, which lead Kazakhstan to attractive positions in terms of franchising development potential. In order to provide its full-scale usage, the government needs to make additional efforts, including further steps on economical encouragement of activity on the franchising market of the Republic of Kazakhstan.

In order to promote development of franchising relations, especially the development of domestic franchises, it is necessary to:

- Implement new mechanisms of providing financing and loans to franchising in Kazakhstan.

Now, mechanisms are already present in the Kazakhstani financial market, which can be used for providing loan services to franchising companies.

Microlending: This lending mechanism is actively developed in Kazakhstan, especially in the provinces. At the same time, interest rates for microloans are rather high; therefore, they are not very popular among franchisees. In other countries, microlending organizations play an important role in financing franchising deals. The ability of microlending organizations to cooperate with various borrowers is very important and enables franchisees to unite in an investment pool in order to purchase a franchise. Lowering interest rates of the microloans would enable entrepreneurs to create financially stable franchising ventures. Microfinancing is also very important for formation of socially oriented franchises that would use efficient technology. It is not referred to expensive brands, but to affordable franchises, the cost of which is between \$2,000 and \$5,000.

Cooperation of Large and Small Companies: This type of financing is similar to microlending; the only difference is that the financial pool consists of joint funds of various companies, rather than of loan proceeds. It is actively used at financing multipartite franchising deals by large businesses. But a symbiosis of small businesses at implementation of franchising projects is also practicable [10].

Financing of a Franchisee by its Franchiser: Franchisers can develop their own loyalty programs for members of their network. These programs can include deferral of payments with a fixed or even zero interest rate. Another popular practice in western countries is the investing in a franchisee with the purpose of gaining return on the investment [11].

At approaching the issues of availability of commercial real estate, it is necessary to pay attention to the issues of setting rental for non-housing stock, regulation of land lease, organization of fairs, placement of non-stationary points of sale and organization of municipal procurement.

The following proposals target approaching the issue of high rentals:

- Introduction of a decreasing coefficient for rentals for all small and medium businesses of the *segment of special focus*. The coefficient

is to be equal to 0.5 - for ventures operating less than 3 years in the market and 0.3 for other businesses.

- The increase of the rental subsidy amount for small and medium businesses of the *segment of special focus*. The amount of subsidies is to be set based on the budgeted funds at the regional level.

Finally, we would like to note that any efforts of the government would fail to succeed in development of franchising in Kazakhstan unless appropriate measures are taken on concessional lending and implementation of measures on improvement of the commercial real estate availability for small and medium businesses of the franchising sector.

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