Deutsche Bank Research

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Franchising in Germany coming of age

Strong growth in the franchising business. Over the last ten years franchising (a marketing collaboration between independent undertakings) has nearly tripled its nominal turnover in Germany to EUR 38 billion, whereas GDP has grown by only 25% or so. One reason for this has been that business in veteran franchising sectors like fast food has continued to expand at good rates, while inroads have also been made into lucrative new segments such as wellness. Nevertheless franchising's contribution to GDP remains comparatively low at around 1.6% (1996: 0.7%).

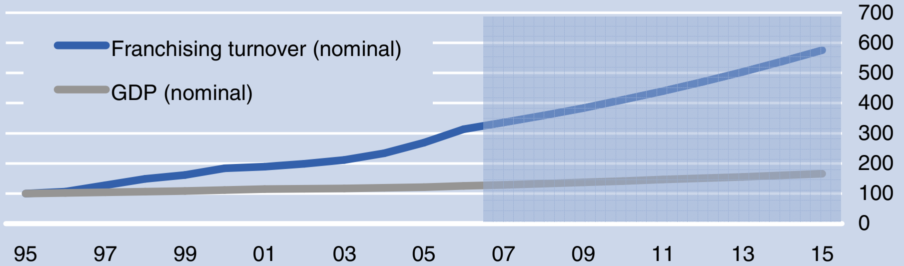
Services becoming more important. The service sector has been the main growth driver in the franchising business over the last few years, accounting for over 50% of growth. Franchising has also expanded in the restaurant and catering business, whereas in the distributive trade it has contracted owing to the poor performance of the retail sector. The skilled trades' share remained low at about 7% due to the negative impact of legal restrictions.

Expansion to continue at a slower rate. Until 2015 sector turnover is set to grow by 7% p.a. – a slower rate than in the past – to some EUR 70 billion. Between 1996 and 2006 the growth rate was 11% p.a., due primarily to the low starting base. The high share in the US (around 6% of GDP), the motherland of franchising, is unlikely to be reached in Germany for the foreseeable future. We see good growth opportunities in Germany in the health, ambulatory care, education/training and environmental/energy segments. Franchising is still a long way from breaking into the virtually untouched domain of professions such as lawyers, tax consultants, chartered accountants, auditors and architects.

Financing is a major hurdle. Financing the capital outlay and the initial fee are often major hurdles for franchisees. Despite the growing importance of franchising many banks in Germany still offer hardly any franchising-specific products. Only once these obstacles have been overcome will there be good prospects for franchising to expand. According to an analysis by the University of Münster, the failure rate of enterprises during their first four years of existence is significantly lower for franchisees than for start-ups as a whole, because – among other things – a franchisee benefits from the expertise of the franchisor.

Increase in franchising turnover much higher than GDP growth

Index 1995=100



Sources: German Franchise Association (Deutscher Franchise-Verband), German Federal Statistical Office, DB Research forecasts

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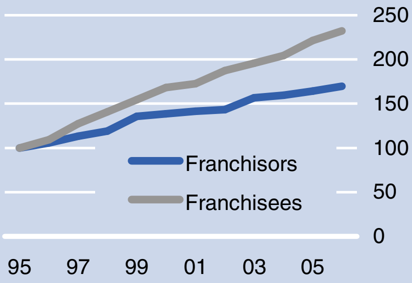
1. Current situation

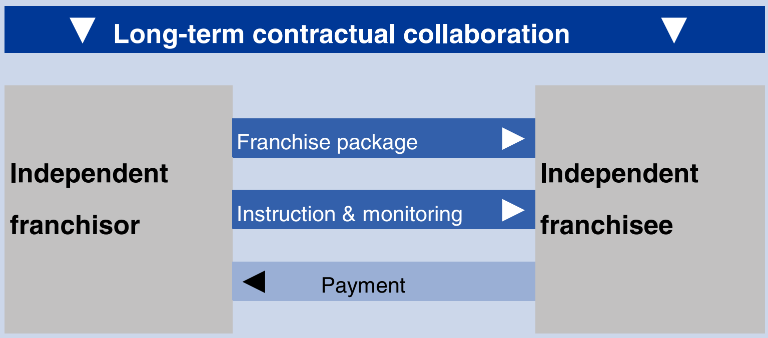
Rapid growth in franchising
Number, Index 1995=100



Source: German Franchise Association 1

The franchising[1] method of distributing goods and services originated in the US and already underwent major expansion there as early as the middle of the last century. The best known franchise system is McDonald's. Franchising is defined as a form of collaboration between legally independent undertakings that is governed by a contract. Usually the contract is signed for a limited period with renewal options. Under the terms of this venture the franchisor provides the franchisee with access to a system package that includes, among other things, a procurement, sales and organisation concept. The franchisor has extensive rights to issue instructions and conduct monitoring in order to ensure compliance with the terms and conditions of the contract. In return, the franchisee as a rule pays a one-off fee and ongoing fees comprising several components: the fee for entering the system, payments based on turnover and advertising fees. In addition, the franchisee is often required to make not insignificant investments, e.g. for shop-fitting, for the equipment needed for business operations and the basic inventory of goods.

Simplified principle of franchising

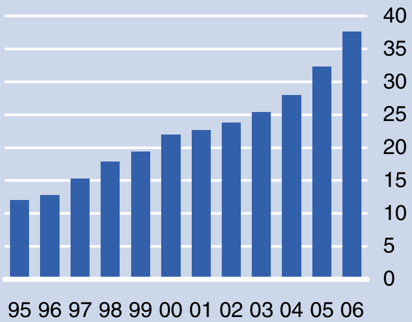


Source: Westfälische Wilhelms-Universität Münster 2

Sector statistics

All sector indicators in Germany were on a clear uptrend between 1996 and 2006. For example, the number of franchisors increased 5% p.a. during this period to 900 and the number of franchisees rose 8% to more than 51,000. The number of franchisees per franchisor in 2006 averaged around 60 compared with 40 in 1996, which underlines the expansion of existing systems. In 2006 the sector provided employment for a total of around 430,000 persons; this represented an increase of 180,000 compared to 1996 (a rise of over 70%). This makes franchising roughly as important as the chemicals industry in Germany. What needs to be taken into account, however, is that in the franchise business a very large percentage of employees work part-time. The average number of people working in each franchise system is currently around 480 (1996: 450). The sector managed to nearly triple its turnover between 1996 and 2006. In the three-year period from 2004 and 2006 the sector's average growth rate of 15% p.a. was significantly faster than that of the economy as a whole. In the three preceding years

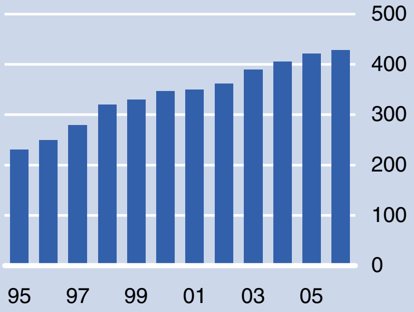
Franchising turnover growth exceeds 10% p.a.
EUR bn



Source: German Franchise Association 3

[1] The term comes from the French language and originally signified the exemption from taxes and duties. Its meaning was later broadened to include the right to produce goods and/or trade in them.

Franchising industry workforce has grown sharply
Employees ('000)



Source: German Franchise Association 4

sector growth was much weaker – in line with the economic downturn – at about 5% p.a. Average turnover per system is currently EUR 42 m compared with just EUR 23 m ten years ago and sales per employee are EUR 87,000 (1996: 51,000).

The success of franchising primarily stems from the fact that independent enterprises sell products and/or services under a brand name that is often very well known with the same level of service at several locations.

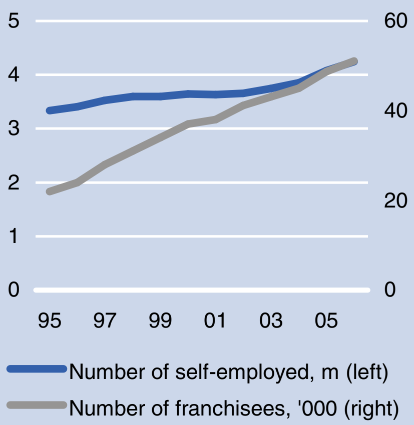
Differentiation from other marketing structures

From the outside this does not make franchising appear any different from a chain store concept. The internal structures of the two distribution formats are, however, very different. While franchisees are the owners of their outlets, chain store managers do not hold any equity in the outlets that they manage. As a company employee the manager receives a fixed salary. By contrast, franchisees derive their remuneration from the profit generated by their franchise.

In a cooperative system independent enterprises jointly maintain a head office. The latter's functions include supporting its members in purchasing and selling goods as well as in managing operations. The main difference between them is that unlike franchisees the cooperative partners are economically independent of their head office as they are both its constituent members and its owners. The most similarities with franchising can be found in the authorised agent system, which is widespread within the motor vehicle trade. Authorised agents are granted the right by a company to distribute the latter's products. They are independent traders, but the strict marketing, compliance and control system that is standard with franchising is not so pronounced.

Significance of franchising for the economy as a whole

Number of franchisees rose 8% p.a.



Source: German Federal Statistical Office 5

The growth of franchising relative to the overall economy has been even more impressive than suggested by the bald statistics for the sector. While nominal sector sales almost tripled between 1996 and 2006, nominal GDP increased by only 25%. The franchising share of GDP thus increased by nearly 1 percentage point to 1.6%. The number of people working in the sector nearly doubled, whereas the workforce as a whole increased by only 4% or so. In the last few years, however, several segments of the franchising sector have hired large numbers of part-time workers and/or converted full-time jobs into part-time positions (in the hotel and catering sector, for example). Nevertheless, the franchising share of the workforce in these segments also remained at a very low 1% at last count. The picture is similar with regard to the number of franchisees as a share of all self-employed persons, which is currently also 1% and has risen only slightly over the last ten years.

Advantages and disadvantages of franchising…

The boom in the franchise business should not however be allowed to blind us to the fact that the sector offers not only opportunities but also pitfalls for both franchisors and franchisees.

… for franchisors

One advantage for the franchisor is that the distribution model enables rapid growth while tying up little capital. The outlay is much lower than it would be for setting up one's own chain store system, for example. This is largely due to the fact that most of the wage

The Top 10 in the sector*
2007

Franchise system	Sector	No. of German outlets
TUI/First**	Travel agent	1,405
McDonald's	Fast food	1,264
Schülerhilfe	Priv. tutoring	1,090
Studienkreis	Priv. tutoring	1,040
Kamps Bakeries	Bakery	950
Foto Quelle	Photographic	950
Ihr Platz	Retail	717
Fressnapf	Animal food	625
Ad-Auto Dienst	Car repairs	600
Musikschule Fröhlich	Music teaching	541

*Number of outlets in Germany = Franchise outlets + outlets operated by franchisor
**Data as of 2005

Source: German Franchise Association 6

costs are borne by the franchisee. Nevertheless the franchisor retains control of its business idea and has access to local market data. The entrepreneurial risk is low for the franchisor since its partners (the franchisees) are legally independent enterprises that have to fund their own investments. For providing its services the franchisor receives a one-off fixed sum and then fees based on turnover.

There are, however, also disadvantages for the franchisor. The main one is that the franchisor forgoes a share of earnings – unlike the chain store systems. Also, there is a danger of the concept and image of the system becoming diluted if the franchisee does not adhere strictly to the instructions issued by "head office".

… for franchisees

In this system the franchisee benefits primarily from the image of the brand and can utilise existing know-how. There are fewer bureaucratic obstacles to overcome than is the case for "normal start-ups". Also, the business risk for the franchisee is limited as it is usually adopting a proven business model. Furthermore, the franchisee should receive support in procuring resources and operational management as well as with marketing and training. According to a 2005 report by the International Centre for Franchising and Co-operation at the University of Münster, the failure rate of start-ups during their first four years is lower among franchisees than for businesses in general in Germany. The KfW has analysed every company founded in Germany between 2000 and 2006. Around 14% of the 1.3 m people who started their own businesses in 2004 had thrown in the towel one year later at the longest. After two years the corresponding figure had risen to no less than 24%.[2] Older reports from the US, however, come to the conclusion that franchisee start-ups do not enjoy better prospects for survival than "independent" start-ups. The most significant research into this sector was published by Timothy Bates in 1995. It came to the conclusion that of the franchise companies founded in the US between 1984 and 1987 only some 65% were still in business in 1991; for independent start-ups this figure was in fact considerably higher at 72%.[3]

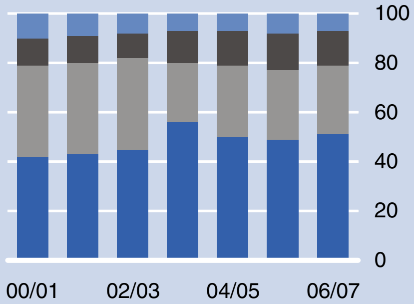
German Franchise Association provides a useful checklist and preparatory seminars

The franchisee's entrepreneurial freedom is restricted by its obligations to the franchisor. It is, for example, restricted to a specific product portfolio and has to pass on a share of its revenues to the franchisor. In addition, the franchisee – in contrast to an "independent" company founder – runs the risk that its franchisor ceases operations. One frequent problem is that the franchisor is fully acquainted with its system, whereas the aspiring franchisee has insufficient information about it. Potential franchisees should therefore prepare well for their role and, for example, make use of the checklist drawn up by the Deutscher Franchise-Verband – German Franchise Association (DFV). In addition, the DFV offers numerous events (business start-up days, seminars) that provide useful assistance for franchisees.

[2] See KfW-Gründungsmonitor 2007. Frankfurt am Main.
[3] See Dieses, Patrick (2003). Beschäftigungsperspektiven bei Franchisesystemen im internationalen Vergleich. Report commissioned by the German Ministry for Economics and Labour. Institute for Economic Policy Research at the University of Mainz.

Service franchising gaining share

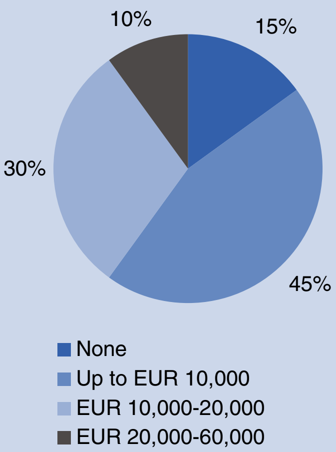
%



Source: German Franchise Association 7

Entry fee for franchisees

Breakdown



Source: German Franchise Association 8

Significant structural shifts in the past

Franchising has changed the face of Germany's city centres in recent years. Cases in point are Tchibo, Apollo, Kamps and Esprit. All the same, growth rates have varied widely between the individual franchising segments.

Franchising systems are always dominated by the ***service sector*** (excluding retailing and hospitality). It has quietly developed into the biggest segment within franchising, with a share of over 50% (2006) and dynamic growth totalling 40% in the five-year period between 2002 and 2006. The number of systems currently totals about 460 compared with only around 330 in 2001.

The ***hospitality sector*** has also managed to expand. Its share of the whole franchising market rose from a good 10% in 2001 to nearly 15% in 2006. The biggest and best known system in this segment is McDonald's with 1,260 restaurants in Germany. Every year the company receives some 2,500 solicitations, which exceed the number of new franchise locations to be allocated many times over. There are currently said to be 800 potential franchisees still on the waiting list.

By contrast, the ***retail trade***, which in 1985 still accounted for half of all franchise systems in Germany, saw its share decline. In 2006 its share was down to just 28% compared with 37% in 2001. One factor was the general weakness of the retail sector in recent years. Nevertheless, there are also flourishing systems like "Vom Fass" with 170 franchisees. Vom Fass customers can buy and bottle the exact amount of uncorked high-quality wines and spirits they require.

The ***skilled trades*** have a share of just 7% of all franchise systems at present, because – among other things – growth in this segment is hampered by restrictive provisions in Germany's *Handwerksordnung* or Skilled Trades Code. In key segments only master craftsmen are allowed to apply. This means that in Germany an applicant must have passed the master craftsman's examination and be registered in the relevant guild. There are, however, a series of skilled trades and allied occupations (listed in Appendix B of the *Handwerksordnung*) that merely require registration in and membership of the Chamber of Skilled Trades and not a master craftsman's certification.

Furthermore, the protracted recession in the German construction sector has prevented franchising from becoming more widespread, as a large proportion of craftsmen work in the construction business (e.g. painters/decorators, heating engineers, plumbers and roofers).

2. Medium-term development

Boost from innovative growth areas

In the medium term the number of franchisors and franchisees is set to rise. In traditional franchising it is primarily the existing systems that will be expanded further. In addition, the sector will also be boosted by the growing importance of hybrid and conversion franchising (see below). Further momentum for the franchising business will mainly be generated by growth areas in the health, education and environmental segments.

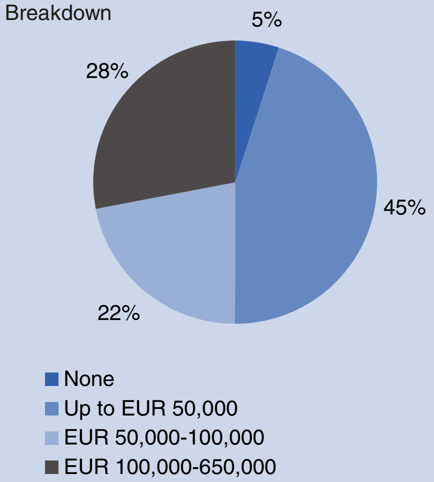
Traditional franchising remains on course for growth

Although the established franchise systems will probably continue to grow going forward, it has become difficult to launch new franchise systems in largely saturated markets such as the retail sector, restaurant & catering and some segments of the wellness sector.

Hybrid franchising brings benefits

Capital expenditure for franchisees

Breakdown



Source: German Franchise Association 9

One means of marrying the advantages of the chainstore system with those of franchising is provided by hybrid franchising. In this model the franchisors also operate outlets for their own account. Their primary purpose is that they allow franchisors to test new business ideas before they are relayed to franchisees. Nearly one-third of McDonald's restaurants in Germany, for example, are operated by the company itself. Tchibo also prefers this strategy and operates an even larger proportion of its own outlets than does McDonald's.

In conversion franchising the premises of other distribution formats are converted into franchise outlets. This is one way of achieving growth in saturated markets. The reasons for conversion are the greater commitment shown by franchisees compared to store managers as well as greater flexibility. For example, the strategy being pursued by TUI is to convert travel agencies with an established clientele into franchise outlets instead of opening new outlets itself. In the hotel sector, too, attempts are being made to convince the owners of independent hotels to become franchise partners. Research by the University of Mainz found that converting outlets into franchise systems boosted turnover in nearly 60% of the 50-plus cases examined, while in 25% of cases turnover remained virtually the same.

Potential for boosting efficiency of franchise systems

One potential problem for the franchisor is mitigated by the fact that the applicants undergo a selection procedure. For example, candidates for McDonald's complete 15 months of training at the head office and in a test restaurant. Only after they have passed the examination are they awarded a contract.

Control system required for quality assurance

Also, the franchisor has to try and keep his monitoring and control costs low by improving the incentive structures. Systems with a fixed fee, like the DB ServiceStore, a Deutsche Bahn subsidiary, of EUR 500-1,000 or the Academy driving schools that charge nearly EUR 200 per month do not, however, have an optimum incentive structure. A better fee structure is the levying of a percentage of turnover, which is standard procedure with many systems. It also requires an ingenious control system, so that the franchisee does not gravitate towards providing services that do not meet the quality standards prescribed by the franchisor. One option is to provide operation manuals, some of which are very extensive.

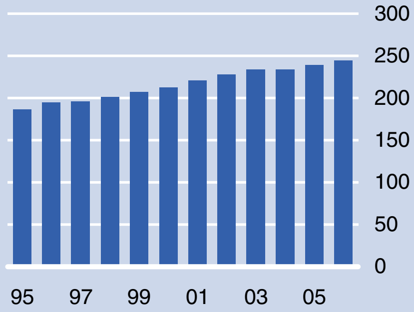
Economies of scale and scope boost efficiency

Efficiency can also be enhanced via economies of scale and scope. In particular the input factors that contribute to delivering the service can be procured more cheaply than is the case for a single company. The main examples in this respect are system catering and bakeries. Expanding these systems will enable even more economies of scale to be generated in future, which will make these franchise systems continue to become more attractive.

Differing growth potential in major growth areas

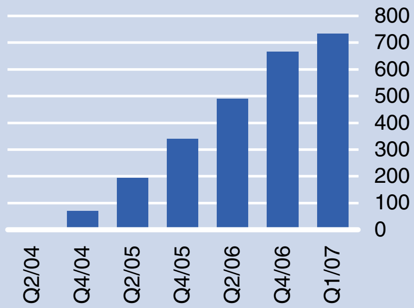
In principle, every business model can be organised as a franchise operation. We see opportunities for new franchise systems to be set up especially in the health, ambulatory care, education and environment/energy sectors as well as in the professions and

Healthcare expenditure rising inexorably
EUR bn



Source: German Federal Statistical Office **10**

Medical Treatment Centres on the advance
Number



Source: KBV (Kassenärztliche Bundesvereinigung) **11**

generally in outsourcing. We shall now detail a number of markets with special growth potential for franchise systems.

Lots of potential in healthcare

Franchise systems can loosen up the rigid structures of the healthcare sector, although the latter is heavily regulated. Furthermore, this segment offers major growth potential. The constantly rising private expenditure on healthcare services shows that both the older and younger generations are prepared to spend more on healthcare.

The pioneer in this segment was Fielmann, which opened its first opticians' store in Germany back in the 1970s. Today there are some 570 stores, employing around 11,100 staff who generate turnover of EUR 913 m. Every outlet is managed by a certified master optician, as prescribed by law. In the meantime, Apollo has become the biggest chain of opticians in Germany in terms of number of outlets at around 600 (Fielmann however generates the most turnover). The franchisees can in this case, too, utilise numerous services of the system such as central spectacle manufacturing, business management analyses and training seminars. Potential franchisees are also given advice on issues regarding store location and shopfitting (including store design). It is only very recently that a number of franchise models have also established themselves in the pharmacy market and the dental treatment segment as well as in the health and beauty sectors.

More franchise surgeries planned

There are already three systems operating in the dental treatment segment: McDent, Dr. Z and McZahn. The first Dr. Z surgery was opened in Düsseldorf at the end of 2006. The business model consists of providing the standard dental prosthetic service at no extra cost, which is made possible by the low-cost manufacturing of dental prostheses in Turkey. In addition, the surgeries use the franchise framework terms and conditions (including surgery management, advanced training, quality standards). This chain plans a major expansion in the medium term. The intention is to grow to around 400 surgeries by the end of 2009. Whether the opening of franchise surgeries for dental treatment can be maintained at this rate, however, is doubtful, especially as only a few branches currently exist. Dentists are put off by the high entry fee and the ongoing fees.

The Medizinische Versorgungszentren – Medical Treatment Centres (MVZs), which have been licensed since 2004, could also be organised as a franchise system. The advantages of MVZs over individual surgeries lie in the bundling of medical expertise from various specialties at a "one-stop-shop" and time savings for patients thanks to the shorter distances they have to cover to attend their appointments and the shared use of medical equipment. Both makers of medical equipment and hospitals could operate as franchisors. From early 2004 to early 2007 the number of MVZs rose from 7 to more than 730, and an end of the boom is not yet in sight.

Opportunities in the pharmacy market

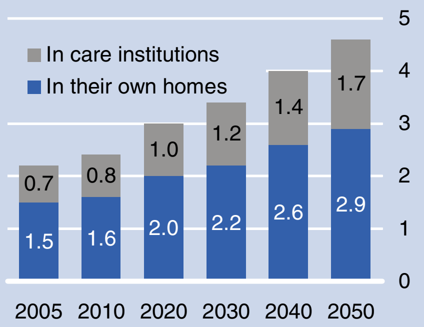
European Court of Justice could call time on ban on foreign ownership and multiple pharmacy ownership

The pharmacy market is also undergoing an upheaval and is gradually opening up to competition. Many pharmacists could seek their salvation in a partnership. The mail-order medicines supplier DocMorris already operates some 40 branded partner pharmacies

throughout Germany and new ones are continually being added. By the end of 2007 their number should have risen to 100 and in the medium term to no less than 500. These partner pharmacies, however, have to fork out large sums to climb on board.
In return the pharmacy is granted the right to trade as a DocMorris pharmacy, and the pharmacist can utilise the company's expertise. The pharmacist is also guaranteed an exclusive territory. If the European Court of Justice should call time on the bans on foreign ownership and the owning of more than one pharmacy that currently still apply in Germany, other companies – e.g. drugstores – are also then likely to set up their own pharmacy chains in greater numbers.
In addition, the healthcare and beauty segment offers scope for the expansion of new franchise systems. One example in this respect is Weyergans High-Care which offers a combination of treatment methods and products for facial and body care. The appliances (for treating problem veins, for example) have been developed in collaboration with the German Aerospace Society (Deutsche Gesellschaft für Luft- und Raumfahrt). Although there are currently just four High-Care centres in Germany, there are plans for further expansion. The company receives five written franchise applications per month on average. Outside Germany, by contrast, there are already some 100 franchise partners in over 30 countries, two-thirds of them in Europe.

Long-term care requirements rising sharply

Persons receiving long-term care (million)



Sources: German Federal Statistical Office, DB Research

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Nursing care services offer good growth opportunities

The rising proportion of elderly people in the population means that the market for nursing care services is characterised by high growth rates. Although between 1999 and 2005 the number of people requiring long-term care increased by only about 1% p.a. to 2.2 m, the number of long-term care patients receiving treatment from providers of ambulatory services rose by over 2% to a good 470,000. At the same time there was a decline in the share of people requiring long-term care who had this care administered at home by relatives. By 2050 we expect the number of people requiring nursing care to increase to 4.6 m (a rise of almost 2.5 m). The number of people requiring nursing care who can be looked after at home will grow by 1.4 m.[4] Although to this day there are no nursing care services organised as a franchise system, this may well change in future.

Services for the elderly and household assistance on the advance

Domestic services becoming more important

Domestic services that can make everyday life easier are becoming more important, not only for the elderly but also for those in work. Institutions like the German Red Cross, the Order of St. John and the Arbeiterwohlfahrt charity already provide services like the "meals on wheels" catering service. The future will also see growing demand for professional building superintendent services, cleaning and laundry services as well as care for the elderly, assistance with shopping, holiday service and even gardening services. In these areas there are also signs of opportunities to provide these services via franchise systems.

Language schools and technical training becoming increasingly important

Education in greater demand

Although the education sector is already home to some franchise systems, the growing significance of this sector means we can expect expansion or the establishment of new businesses (such as internet training courses, software development). The most widely

[4] See Just, Tobias (2007). Presentation: "The Market Potential of Long-Term Care Facilities". BFW-Arbeitskreis Seniorenimmobilien. Berlin.

known examples are currently the Berlitz and Fokus language schools. All Berlitz centres offer the same method, the same materials and the same quality of teaching. The picture looks similar at Fokus. The only major differences are in the entry fee and the start-up investment. There also established chains providing private tutoring such as Studienkreis and Schülerhilfe.

Energy-saving boosts the environment/energy sector

Skilled trades still virgin territory for franchising

The German government's objective of raising energy efficiency can be achieved using modern heating systems and thermal insulation. According to data supplied by Germany's Ministry for the Environment, Conservation and Nuclear Safety, currently nearly 90% of household energy consumption is expended on heating and hot water (excluding fuel for motor vehicles). By far the largest share is accounted for by heating, of which a large proportion still goes to waste due to substandard walls, porous windows, roofs, doors and floors. To date, only a few franchise systems are active in this lucrative segment. The best known is Portas, which has around 260 partners in Germany. The firm is the market leading supplier of replacement doors and windows. Also worth a mention, however, is Achenbach, which plans to expand by around five partners per year and makes front doors, windows and roller blinds. In the building renovation segment there is also Isotec, which specialises in eradicating rising damp and fungal decay from the internal and external fabric of buildings. Specialist skilled trades can benefit from the incentive programmes operated by the federal government. For example, the budget for financial aid for modernising old buildings has been increased by two-and-a-half times to EUR 3.5 bn. This provides good prospects for companies focusing on thermal insulation.

Greater penetration of the professions as well

Competitive advantage for franchising even in professions

There is still a long way to go before franchising penetrates the hitherto barely charted domain of the professions. These include not only lawyers but also tax consultants, chartered accountants, auditors and architects. The foundation for these segments was laid in Germany in 2002 by lawyers with "Legitas", the first franchise in the legal advice market. The trend towards large legal practices worsened the competitive position of small law firms. The Legitas system enables the individual lawyer to maintain his independence and nevertheless benefit from the advantages that otherwise only large practices can offer. For example, the lawyer is provided with management services for his law firm. In addition, Legitas promotes knowledge transfer both from the system to the lawyers and vice-versa as well as between the lawyers themselves. Although the system to date exists in only five German towns and cities a nationwide expansion is planned.

Opportunities for outsourcing and innovative offerings

Current example: Outsourcing office services saves costs

Despite the extensive penetration of outsourcing (the transferring of parts of the value chain to an external provider) niches can still be found where business processes can be made more efficient and costs saved. Franchise systems can play an important role in this regard. One example is service systems that are designed to lighten the load of routine tasks borne not only by small and medium-sized firms but also by the self-employed. This applies, for example, to the postage and packaging of parcels, printing and copying, postbox service and computer usage.

Environmentally friendly dry cleaning with extra service for working people

One lucrative area is also the Fred Butler cleaning service, in which textiles are treated ecologically with biodegradable solvents. The textiles are collected from the customer's premises and then delivered to their door after cleaning. "Drop-off points" for working people are located centrally at their respective workplaces. Moreover, apart from independent Fred Butler outlets there are shop-in-shop collection points in large stores and shopping centres. There is also a business-to-business service for work apparel; clients include airlines and hotels.

Further franchising opportunities exist in facility management, which extends far beyond the simple caretaker and administrator activities. Potential areas of activity are hospitals, airports and sports facilities as well as the service operations of industrial companies.

Internationalisation advancing apace

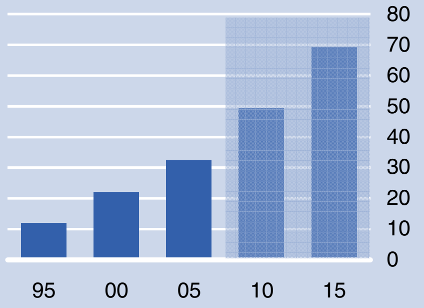
40% of franchisors plan to venture abroad

We see growth potential for German franchise systems not only in the domestic market but also abroad. According to research by the University of Münster, less than 40% of the nearly 100 companies surveyed in 2004 were active in international markets; around 21% planned, however, to venture abroad in the subsequent few years.[5] In direct foreign franchising, which is primarily suited to expansion into neighbouring countries, the franchisee receives direct support there from the system head office. With the master franchise system, by contrast, the partner acquires the function to set up a franchise system abroad. The master franchisee then becomes a franchisor in his own country and grants franchises. All the same, domestic franchise models cannot be transferred to other countries unchanged, but must be tailored to the respective national demands. As a rule this requires a not insubstantial financial outlay.

One example of a successful foreign venture by a German franchisor is Fressnapf, a vendor of animal feed and supplies. Seven years after opening its first discounter in Germany it expanded into Austria. In 2006 the company was already operating nearly 200 stores in ten countries (outside Germany), and more outlets are due to be added. In 2005 and 2006 the company's foreign activities grew by some 40%, which is much faster than the domestic market (nearly 10%).

Strong increase in franchising turnover expected

EUR bn



Sources: German Franchise Association, DB Research forecast

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Turnover forecast for the franchise market until 2015

The examples quoted illustrate only a fraction of the potential of the franchising distribution format. We are therefore optimistic that the sector will continue to grow in Germany. However, the growth in turnover of the franchise industry until 2015 will probably be lower than in the past ten years simply on account of the now higher base. While turnover rose between 1996 and 2006 by a nominal 11% p.a. to EUR 38 bn, we expect it to grow at a slower rate until 2015 of 7% p.a. to some EUR 70 bn. The growth potential of franchising in Germany is being held back by the still high share of the sector taken by retail businesses and the poor growth prospects in this area. Until 2015 we expect the retail sector to post nominal growth in turnover of just around 1.5% p.a., since many product segments such as textiles, clothing, shoes and household goods as well as

5 See Ahlert, Dieter et al. (2005). Franchising – Erfolgsgarant für Existenzgründungen? Internationales Centrum für Franchising und Cooperation. Westfälische Wilhelms-Universität. Muenster.

food, beverages and tobacco are suffering from signs of saturation.[6] All the same, franchise systems in the retail sector should grow faster than the market as a whole. Nevertheless, the growth will be driven primarily by service sector businesses (excluding retail and hotel & catering), which in the past have already managed to rapidly grow their share of franchising. The hospitality segment is, however, also set to expand, thanks mainly to the opening of additional outlets by existing chains in medium-sized cities above all. By contrast, franchising in the skilled trade segment is likely to continue being hampered by the restrictive legal framework in the medium term.

Medium-term growth will easily outstrip GDP

Franchising share in Germany remains much lower than in the US

All in all, franchising should grow much faster than the economy as a whole in the coming years. The sector's share of nominal GDP should rise to just under 2.5%. Despite this increase the franchising share is still a lot lower than in the US – the world's biggest and most important franchising nation. There, franchising was already generating nearly 5% of GDP in 2005. This figure should rise to nearly 6% by 2015. One reason for the higher share compared to Germany is that even in the 1950s modern franchising was already a familiar phenomenon in the US, whereas in western Europe and Germany it was not until the 1960s that the concept of franchising started to catch on. In addition, the special characteristics of the US market (for example, consumers' penchant for fast food) are a major factor. For this reason a gulf will continue to separate the German and the US franchise industries in future.

Employment effects remain significant

As new franchise systems are set up and existing concepts are expanded the number of people employed in the sector should rise by 4% p.a. until 2015 to an estimated 610,000; this would be an increase of 180,000 over the 2006 level. Those employed in the sector would then make up 1.5% of the overall workforce, compared with the current share of a good 1%. However, the impact on job creation should not be overstated, as these statistics make no distinction between full-time and part-time employees. Presumably it is primarily start-ups in the franchise business that prefer to employ part-time staff in order to reduce their economic risk. In addition, conversion franchising does not create any new jobs, but merely transfers workers from other distribution channels into the franchise sector. While the gross employment effect states how many jobs in total are created in companies, the net employment effect more accurately reflects the significance of franchising to the economy as a whole. This effect cannot, however, be measured empirically. The analysis is therefore limited to the gross employment effect. By that measure sales per employee in 2015 will amount to around EUR 115,000 compared to EUR 85,000 in 2006, which would represent an annual increase of 3%. However, these figures do include price increases, which means that real growth in sales per employee would be lower.

Start-ups prefer part-time employees

Financing is a major hurdle for newcomers

Banks are main source of financing

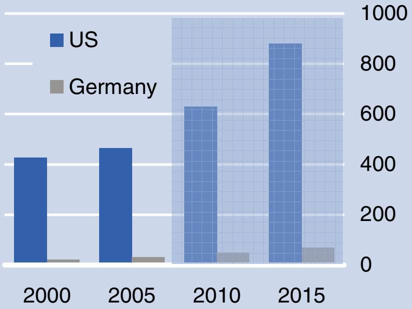
If a franchisee has found a franchisor, a major hurdle that often has to be surmounted is funding the capital expenditure required and the entry fee. On average a sum of around EUR 100,000 has to be

[6] See Auer, Josef (2006). Perspektiven des Einzelhandels sind limitiert. Deutsche Bank Research. Aktuelle Themen. November 6, 2006. Frankfurt am Main. (Available in German only).

found, which in most cases is borrowed from banks. Only a small number of franchisors employ their own resources to offer assistance to their partners with financing or leasing options. Furthermore, there are now budget franchise concepts like Conny's Container (which sells discontinued lines and budget-priced items), where the start-up costs are relatively low at a few thousand euros. Despite the growing importance of franchising many banks still do not offer franchise-specific financing solutions; franchisees have to go through the same lending approval process as "independent" start-ups. This means that the respective bank branch scrutinises every loan application, which includes the details of both the system and the franchisee. This regional principle is often criticised, as it is too complicated, often takes too long and thus does not meet the specific demands of the franchise business.

Gulf between franchising turnover in US and Germany

EUR bn



Source: DB Research 14

3. Outlook

A further liberalisation of the legal framework, particularly of the Crafts and Trade Code, healthcare, competition law and employment protection legislation could unleash additional growth stimuli in the franchise sector.

The *Handwerksordnung* of 2005 in Germany still imposes restrictions on many segments not only with regard to the setting up of traditional franchise systems, but above all the expansion of innovative systems, whose service offering includes jobs performed by craftsmen. If craftsmen with many years of professional experience were allowed to become self-employed in segments where a master craftsman's qualification is currently still a prerequisite for setting up one's own business, the number of potential applicants for franchises would be many times higher.

Dismissal protection restricts growth in Germany

Germany's dismissal protection act also acts as a brake on the development of franchise systems. The low threshold at which the dismissal protection provisions become applicable is particularly detrimental to the growth of outlets. This is undoubtedly also a reason why "multi-outlet franchising" is much less widespread in Germany than in the US. In this system the franchisee is allowed to operate a number of outlets. Increasing the minimum size of a company's workforce at which staff enjoy statutory dismissal protection from five employees at present to 10 or 20 would probably significantly boost the willingness of employers in Germany to hire extra staff. The main beneficiaries could be mini-franchises that are operated according to the shop-in-shop principle, for example.

Should the legal framework improve for the franchise industry, this would give the sector an additional fillip. The German market in particular would probably then become more attractive for foreign franchise systems.

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