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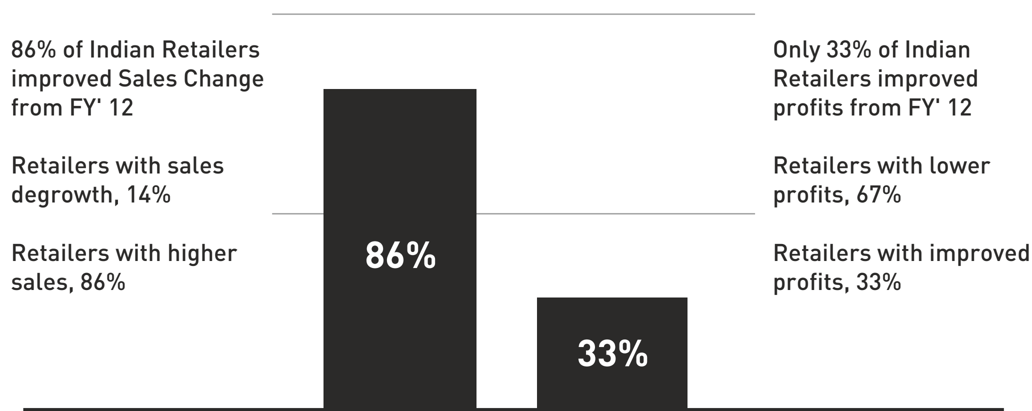
Leveraging Franchisees for Profitable Growth in Retail

by **Vector Consulting Group**

"If you give me a lever and a place to stand, I can move the world"
– Archimedes

The Indian retail market is considered as one of the most attractive markets in the world in terms of market size and potential. This is reflected in the Rs 30,000-crore Retail Franchising industry in India, which is growing at an annual rate of 30%. However there are kinks in the growth story. As per study, by Vector Research Team, of top 21 retail companies (amounting to a cumulative turnover of Rs 21,000 crore in FY'12), close to 60% of the retailers are making losses. Most companies reported growth in sales but the increase in sales growth is not reflected in the profits – 67% of these companies reported lower profits in FY'12 compared to that in FY'08.



At the same time most retail companies have tremendous growth potential in terms of reach in the country. They can grow by expanding the retail footprint by way of own stores and of late-through franchising. However, many established players are still to take the growth route forward in a rapid pace, possibly because of their current declining profit trend.

A profitability pressure has always been a reason for a cautious approach toward growth. Thus, rapid growth in retail can be achieved only when profitability is maintained (if not increased) along with growth. Franchisee appears to be one such option where growth can come without increasing the operating expenses. On face value, it looks like the key leverage for the growth story. However, often, what appears obvious may not be as easy! If most retailers are struggling to make money, a franchisee can turn out to be just an exercise of transferring the "monkey" off one's back to someone else. Hence, making the franchisee model profitable is closely related with making the retailing profitable in the first place.

To understand why retailers are not on a solid ground, let us reiterate the pressures that a typical organized retailer faces today in the existing business:

- Increasing competition in home markets, other retailers looking to expand, internet retail, and global retailers entering India
- More demanding consumers looking to extract the best value for money
- Limited negotiating power to increase margin with established brands

- Increasing operating costs due to inflationary pressures
- Slowdown in the Indian Economy, resulting in decreased number of consumers and reduced discretionary spend

We can appreciate the implications of the above by taking the instance of an Indian retailer who is making the business plan for the next year.

Let us take the case of a Retailer who is gaining a typical throughput (gross margin) of 25% and is at breakeven, ie, fixed costs constitute 25% of sales. Considering the inflationary pressures on salaries and other fixed costs, it is reasonable to budget a 10% increase in fixed costs.

To maintain break-even in the next year, such a retailer needs to grow by 10%!

25% Throughput	Base year	Next year with 10% cost increase
Sales	100	110
Cost of goods sold (COGS)	75	82.5
Throughput/gross margin	25	27.5
Fixed costs	25	27.5
Net margin	0	0

In fact, this gives us a thumb rule: A retailer who has reached break-even must grow throughput at the rate of fixed cost increase, irrespective of the gross margin %.

To this, let us add another factor that retail is facing – the pressure to reduce margins to protect/gain market share. Assuming a 2% lower gross margin in the same example, sales need to increase by 20% just to maintain break-even.

25% Throughput	Base year	Next year	Change over base year
Sales	100	119.5	~20% Sales increase
Cost of goods sold (COGS)	75	92.0	2% Margin loss (ie, 77% COGS)
Throughput/gross margin	25	27.5	
Fixed costs	25	27.5	10% Increase
Net margin	0	0	

Let us examine a case of a retailer having 14% gross margin, with 10% increase in fixed cost and 1% margin reduction. Such a retailer needs to grow sales by 27% to maintain break-even!

14% Throughput	Base year	Next year	Change over base year
Sales	100	127.0	
Cost of goods sold (COGS)	86	110.5	1% Margin loss (ie, 87% COGS)
Throughput/gross margin	14	16.5	
Fixed costs	15	16.5	10% Increase
Net margin	0	0	

In the current environment, retailers find it difficult to grow at above 10% from existing stores. Hence, the expected way forward for retailers is the following:

- Increase throughput/gross margin by way of private labels sales
- Grow sales by increasing number of stores

The option of private label sales, though increasingly popular, is difficult for most retailers to adopt because:

- Establishing private label acceptance requires high branding investments
- The share of product range available for private label products is limited, as customers visit multi-brand retailers for a large variety of brands available. Most customers need a minimum range of credible brands to finalize their purchase. This is especially true for products that are not repeat buys such as durables, IT, and furniture.

Hence, the only way forward for growth appears to be addition of stores. However, each store added to the retail chain has numerous investment and risks:

- Capital is blocked for store setup and infrastructure
- Recovery period of investment in store is typically long and not assured
- Stores in new locations need high promotions and brand building support
- Attracting, training, and retaining store managerial talent
- With each store added, the growth rate to cover fixed costs increases

Clearly, using own stores for growth is not a very attractive option. Therefore, the only option for growth with low investment of own capital is to set up franchisees. At the first glance, expansion via franchisees addresses all risks:

- Capital invested in the store is that of the franchisee
- Recovery period of investment would ensure a long-term association
- Brand building and promotion costs are shared with franchisees

- The franchisee is responsible for managing the store; thus, the investment in training the franchisee would be for the long term
- Cost increase for retailers to manage franchisees is relatively small

However, to be a true replacement for the own store, the franchisee association needs to be for the long term. This is possible only if the franchisee sees value in the relationship, ie, the relationship ensures the success of the franchisee.

Unfortunately, the reality is that most franchisees face severe hurdles:

- Franchisors push slow selling range/inventory to franchisees
- Unfriendly terms of the contract – high one-time fees, security deposits, royalties, etc
- Majority of performance-related risks borne by the franchisee

Apparently, most franchisors structure the franchisee contracts to protect their own interest. This implies that franchisors do not have high confidence in the success of the franchisee, possibly since their existing stores operate very inefficiently – low inventory turns and low return on investment (ROI). This forces the franchisors to insist on one-sided terms in the franchisee contract, which ensures their protection in case the franchisee fails.

However, franchisors enjoying high inventory turns and high ROI are better equipped to dramatically alter the terms with the franchisee, since they can extend their successful model to the franchisees. In retail, high inventory turns and ROI can be achieved through pull-based supply chain – sales-based replenishment to stores through a central warehouse in conjunction with tight control on range. Such a model ensures:

- Rapid replenishment of sold items
- Continuous availability through the central warehouse, which allows stores to operate at lower inventory levels, thereby improving store ROI

Low excess stocks free up capital to source the entire range and avoid margin erosion due to discounts on excess stocks

- Dynamic sourcing and stock management based on seasonality and item-wise demand changes
- Lower additional investment in commencing a few new stores, since the central warehouse serves as the aggregation point
- The increase in sales from the first few new stores provides the capital to add inventory for further new stores. A virtuous loop!
- Identification and replacement of slow-moving items. Such items are pulled back to the central warehouse and then made available for other stores

Retailers with such a pull-based supply chain, as their place to stand, can offer franchisees a win-win:

- Tailor-made range and store formats based on location potential
- Range control with support for handling slow-moving inventory
- A guaranteed minimum ROI

Liberty Shoes is a classic example of a retailer using the franchisee route to expand, which could succeed only after revamping its supply chain into a pull-based model. Liberty was in the red and its franchisees operated as per the industry norm of 1.5–2 inventory turns, ie, 6–8 months of stocks, with very low profitability. The introduction of central warehouse, pull-based supply chain, and new store planning with only 45 days of stock helped franchisees to achieve ~40% ROI. For Liberty, the revamped supply chain reduced the overall discounts from 16% to 4%, while also improving the strike rate of new products introduced from 30% to over 60%. Thereafter, Liberty opened 150 new franchisee stores in 18 months, and this resulted in a dramatic increase in sales and in achieving break-even. This year, Liberty Shoes plans to open additional 125 stores. This is possible because Liberty's supply chain model resulted in a paradigm shift where franchisees obtain sustainable higher inventory turns and ROI (more than the industry standard).

Liberty is now working toward replacement in addition to pull-based replenishment, where any product not selling for more than a decided period will be pulled back and replaced by good-selling products. This will ensure that franchisees always have the latest and good-selling range available for sale. Having tasted the fruits of a win-win offer, Liberty is continuously looking toward taking the next step. In contrast to Liberty, we have the average organized retailer who is not able to secure high inventory turns and frequently holds discount sales to clear excess stocks. Such retailers can only operate on a win-lose model with franchisees, and this ensures that the franchisee definitely fails sooner than later. Hence, only retailers with a pull-based supply chain are able to grow rapidly and profitably using the winwin Franchisee model. Perhaps, it is now time to add the 'Right Supply Chain' to that oft quoted maxim – "Retail is all about Location...Location...Location!"

Vector Consulting Group **(www.vectorconsulting.in)**, is the largest Theory of Constraints (TOC) consulting firm in Asia. The firm has been working closely with well-known companies across industries to help them build unique operations and supply chain capabilities that can be leveraged as a competitive edge in the market. Vector now has the highest number of success stories in Theory of Constraints Consulting and has also won several national and international awards for their work.