

# The International Business Environments of Franchising in Russia

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## EXECUTIVE SUMMARY

This article makes a contribution to the state of knowledge on franchising in Russia by analyzing Russia as a target market for international franchising entrepreneurship. First, past research and literature on franchising in Russia and other emerging markets is reviewed. The country's franchising environment is examined in relation to five environmental factors: (1) demographics, (2) economy, (3) social and political environment, (4) culture, and (5) legislation. Some preliminary information on a major franchising system in Russia is presented. A complete SWOT (strengths, weaknesses, opportunities, and threats) analysis for international franchising in Russia is provided in the conclusion section. The article provides an up-to-date overview of Russian franchise environment, integrating research on the topic and collecting some primary information on the ground in Russia.

On a purchasing power parity basis, the average annual income for all income classes reaches about 7,500 USD (The Economist 2004). The purchasing power parity income per capita is a lot higher in Russia than the one calculated using exchange rates because the cost of living in Russia is in general much lower than the one in the United States of America for example.

The initial investments required to set up a franchise business can be rather considerable for small Russian businesses. One way to attract new franchisees is to establish financial arrangements with banks in order to increase the inflow of new requests for franchise agreements with them. For example, Rostic International has signed an agreement with Small Business Credit Bank, which opens two-year credit lines for Rostic's franchisees. Investments required to buy a western franchise are usually higher than a domestic one. Therefore, franchisors willing to expand through franchising in Russia should consider similar arrangements with reliable financial institutions (Sarkisov 2002).

Franchising is a relatively new phenomenon in Russia. The word franchising does not exist in the Russian language, but efforts are being made to educate the public, business and governmental audiences (Alon and Toncar 1999). There are several associations in Russia promoting franchising. The Russian

Franchise Association, RFA, was established in 1997 as a non-profit organization. The RFA promotes franchising as a business concept and lobbies for the amendment of the Civil Code. Association members include franchisors, franchisees, and government agencies, business support organizations, non-government funds, banks, accounting firms and consultants (Sarkisov 2002).

Franchising in Russia is becoming more attractive because of the high demand for Western products, the establishment of a local franchising community and educational directives (Zeidman 1995). Demand for Western products is healthy in Russia, fueling the growth in foreign investments (Alon and Toncar 1999). According to Sarkisov (2002), U.S. franchisors are more popular than other foreign brands, because of the perception that USA is the “motherland of franchising”. Besides the increase in local consumption, the growing tourist sector creates opportunities for franchisors especially in the hotel and motel sector (Alon and Toncar 1999).

Russian society can be rather contradictory. The recent economic stabilization presents Russia as an attractive investment target for international franchisors. A large consumer market with growing income rate is an appealing target market for any company searching for growth. Furthermore, the market is still relatively untapped, the demand for western products is evident and the population is rather concentrated. In addition, several organizations are promoting and supporting the growth of franchising.

The political and economic risk is omnipresent in the country. Legal, political and economic institutions are inter-linked and corruption is rather common. Many Russian citizens are unhappy with the way national wealth was distributed during the privatization of national conglomerates. The gap between the rich and the poor is widening. The rich oligarchs are hated and government actions are mistrusted. Social differences and instabilities will affect the entrepreneurial atmosphere in Russia.

In addition to the instability of the society, there are certain impediments, which are specifically related to franchising in Russia. In spite of the legislation concerning the protection of intellectual property rights, practice has shown that franchisors face it as a challenge. Russian legislative bodies are rather corrupted and there is no guarantee that court decisions will be enforced in real business life. Also, the law on commercial concession is regarded as an entry barrier for foreign franchisors. The code includes parts that clearly restrict franchise practices. Especially the article that allows the franchisee to renew the franchise agreement under the same terms is very restricting and unjustified from a franchisor point of view. Another major shortcoming of the law is the part that sets the franchisor subsidiarily liable for claims filed against the franchisee. This statement contradicts the main principle of the franchise system, the independence of franchisee as an entrepreneur. Nevertheless, it should be noted that some parts of the law, commonly regarded as obstacles for franchising in Russia, could be overlooked by stating the issues in the franchise agreements. In some parts the law gives an opportunity to agree otherwise by stating, “unless provided otherwise in the contract”. Furthermore, companies like Kodak avoid the law by using an agreement of “quality control services”, even though their operation clearly is franchising. Finally, there is no indication that franchisors would have faced problems related to the legislation. In summary, franchising has potential for growth in Russia, but the environment is still difficult to navigate and requires either a good partner or deep pockets in order succeed.

**Keywords:** Global Franchising, Russia, Emerging Markets, International Marketing Entry

## **THE INTERNATIONAL BUSINESS ENVIRONMENTS OF FRANCHISING IN RUSSIA**

“Russia is not a destination for the faint hearted or under-resourced.”  
-- Martin Mendelsohn

The Russian market has generally been considered as a highly unpredictable and unfavorable business environment (Mendelsohn, 1996; Alon and Banai, 2000). However, recent economic stabilization programs and government reforms have made the appearance of Russia more appealing in the eyes of foreign investors. The aim of the paper is to provide a general environmental framework for analyzing the international franchising environments in Russia, contributing to franchising practitioners' ability to enter the market successfully.

The U.S. Commercial Service in Russia has identified franchising as a sector possessing a significant potential for development and offering vast opportunities for U.S. franchisors (Sarkisov 2002). The conditions for franchising in the country are becoming more attractive as the economy has shown remarkable stabilization since the economic crisis in 1998. The demand for high quality Western products is prevailing. Russia's effort to join the World Trade Organization, WTO affects positively the business and economic environment. The Russian government is making an effort to build an efficient market and to raise the country's standard of living. Substantial progress has been achieved in improving legislation governing economic, business and investment activity. The state is consolidating its control functions and implementing structural reforms such as moderating the tax burden of enterprises.

The article aims to analyze Russia as a target market for international franchisors. First, past research and literature on franchising in Russia is reviewed. The country analysis includes five parts, (1) demographics, (2) economy, (3) social and political environment, (4) culture, and (5) legislation.

### **LITERATURE REVIEW: INTERNATIONAL FRANCHISING IN EMERGING MARKETS**

In recent years, franchising has experienced phenomenal growth both in the U.S. and abroad. The success factors are well documented (e.g., Shane and Spell, 1998; Alon, 2004). Past research describes three primary motivations for franchising (Dant, 1995). First, the resource constraint perspective suggests that franchising is an efficient way to collect three fundamental resources a growth-oriented company needs: financial capital, market knowledge and human capital. Second, the efficiency perspective emphasizes that franchising is a vehicle to achieve a variety of scale economies, especially in production, promotion and coordination. Finally, agency theory perceives franchising as an effective answer to the classical principal-agent problem, because franchising eliminates the shirking problem often related to principal-agent relationships.

Alon (1999) investigated the effect of five company-specific independent variables on the decision of professional business service franchisors to internationalize their operations. A model using resource-based theories and agency theories for its theoretical foundation was developed and tested. The results indicate that internal characteristics of the franchising system, especially the number of outlets, significantly influence the intention of domestic franchisors to seek franchisees overseas. This confirms that resource-based explanations and, perhaps, agency explanations may help explain the internationalization of the franchise system in addition to the use of franchising in any one country's context.

Doherty and Quinn (1999) examined international retailing and franchise research in the context of agency theory to explain major elements of international franchise activity and internationalization. The

same authors, Quinn and Doherty (2000), examined the mechanisms used to control and co-ordinate the international franchise network and reported the findings from an in-depth, ethnographic study of the internationalization activity of one retail franchise company.

Pizanti and Lerner (2003) examined the franchisor-franchisee relationship from two theoretical perspectives - agency theory and exchange theory, and tested their ideas on a domestic firm and two international firms in the restaurant industry - McDonald's and Burger King. Their research indicates that domestic and international franchisors are distinguishable in some respects showing varying forms of integration of control and autonomy among the three chains.

Since the markets of developed countries are becoming more saturated and competition is diminishing profit potential, more and more franchisors are looking to emerging market economies (Alon and Toncar 1999). While in the U.S., Canada, and parts of Western Europe franchising has reached domestic market saturation, emerging markets remain relatively untapped. Emerging markets, accounting for 80% of the world's population, are among the fastest growing target markets for international franchisors (Welsh and Alon 2001). Franchising has been advocated as a method of growth for developing countries, providing know-how, and advanced marketing and management practices that are of high importance in the post-communist countries (Alon and Toncar 1999). Because business format franchising focuses on the transfer of retail know-how rather than on product distribution, it is the form of international franchising most likely to have a direct effect on the economic development of developing countries (Kaufmann and Leibenstein 1988).

A number of authors have identified emerging markets as a topic that needs further investigation (e.g., Welsh and Alon 2001; Kaufmann and Leibenstein 1988). This article provides an overview of franchising conditions and opportunities in one of the biggest and fastest growing markets, Russia. Even though the business conditions are similar to those in other emerging economies, the high quality of human resources and patterns of consumption come close to those in developed countries (Alon and Toncar 1999). Previous studies and analyses on franchising in Russia can be divided into four streams of research described below.

Firstly, investigations have focused on case studies of franchise systems penetrated into Russia. These include for instance Pizza Hut (Christy and Haftel 1993), Baskin Robbins and Subway (Gorovaia 2003). The first case study focused on Pizza Hut's rationale for entry into the country describing the company's objectives and plans, whereas the latter paper addressed the performance of Baskin Robbins and Subway.

Secondly, prior examinations have concentrated also on specific industries. Swerdlow and Welsh investigated the Russian hospitality industry in several papers. They conducted a cross-cultural research by a series of in-depth interviews of Russian and US hospitality firms 1992 - 1994. Their studies focused on job satisfaction, and organizational commitment and training (Swerdlow and Welsh 1992; Swerdlow, Cummings and Welsh 1997; Roehl, Swerdlow and Welsh 1999).

Thirdly, the majority of the articles describe the franchising environment in Russia by analyzing the opportunities and/or threats it offers to foreign franchisors. The macro environmental approaches have concentrated on either specific environmental issues, such as legal aspects (Kellman 1989), or on a more comprehensive overview of the economy (Christy and Haftel 1992; Alon and Toncar 1999; Swerdlow, Roehl and Welsh 2001). According to the authors' own acknowledgement, the first empirical study concerning franchising in Russia was a survey conducted by Welsh and Swerdlow in 1990. The focal point of the inspection was the opinions of the Soviet university students about the future prospects of

franchising in Russia<sup>1</sup>. The conclusion of the study was that franchising has a promising future in the country, but at the same time the results pointed out confusion about what franchising means.

Finally, some articles have pursued a more general perspective. In 1996 Russian Franchise Association (RFA), together with a U.S. franchise consulting firm, Sibley International, carried out a survey among Western franchisors operating in the markets. The results suggested that financing was the biggest operational challenge for foreign franchisors. Alon and Banai (2000) examined the environmental factors, the four Ps (i.e. product, price, place, promotion), and entry strategies available for prospective franchisors offering a normative framework of franchising entry into Russia. The U.S. and Foreign Commercial Service and U.S. Department of State have published two general reports analyzing franchising in Russia. The reports discuss market highlights and best prospects, a competitive situation, consumer markets, and market access (Kuzmina 1997; Sarkisov 2002).

Environmental factors have been shown to be useful for international franchisors in evaluating a host country for expansion (Alon and McKee 1999). The present analysis provides an up-to-dated overview of Russian franchise environment, integrating research on the topic and collecting some primary information on the ground in Russia. The section that follows analyses the macro environmental conditions of franchising in Russia focusing previously-established franchising-specific influential variables relating to the demographic, the economic, the financial, the social, the political, and the regulatory environments. It should be noted that while we contribute to the literature by updating previously published information on the international business environments of franchising in Russia, Russia fast changing and sometime chaotic environment is hard to predict, and rapid changes can ultimately change the favorability of the environment for franchising, or any other business type.

## ENVIRONMENTAL ANALYSIS OF FRANCHISING IN RUSSIA

### **The Demographic Environment of Franchising**

Population size, the level of urbanization and female labor participation (Alon, Toncar and McKee 2000) together with the size of the middle class (Alon and McKee 1999) are regarded as the main host country demographic factors from a franchisor perspective.

Russia is geographically a vast country with 144 million inhabitants. In spite of a negative population growth, there is a great market demand. Female labor participation is half of the total labor force (World Bank 2003). According to Alon, Toncar and McKee (2000) high female labor force participation is a positive factor from the franchising point of view. The fact that rather highly educated labor in Russia is plentiful and inexpensive is also a positive sign for an international investor wishing to mobilize the labor force (Alon and Banai 2000). Table 1 presents a comparison of key demographic information of Russia and the USA to give the reader a reference point for key demographic variables.

The middle class currently represents one fifth (20%) of the Russian population (or approximately 10 million families). According to a survey of the local consumer market, carried out by the Expert Magazine, the middle class accounts for more than half of the consumption<sup>2</sup>. The average annual income of the middle class in Russia is approximately 3,900 USD with an annual growth rate of 8-10% between 1999 and 2001. This figure is even more favorable when examining central cities in Russia. Seven out of ten Russians live in cities. Traditionally Moscow and St. Petersburg have attracted most of foreign investments, since improving infrastructure has increased opportunities in the regions. However, there are

<sup>1</sup> The results were reported in two separate papers (Welsh and Swerdlow 1991; Swerdlow and Welsh 1992).

<sup>2</sup> Middle class includes people with a monthly income of more than 150 USD in the regions, and 200 USD in Moscow.

thirteen cities with a population of more than one million, ten of which are underlined in the map of Russia (See Figure 1).

**TABLE 1**  
**Demographics: A Comparison between Russia and the USA.**

Demographics	Russia	USA
Population (Million)	144,1	288,4
Population Growth Rate (Annual %)	-0.4	0.9
Surface Area (Million sq. km)	17.1	9.6
Population Density (Inhabitants/ sq. km)	8	30
Urbanization (%)	72.9	77.7
Life Expectancy, Male/Female (Years)	64/73	74/80
Female Labor Force Participation (%)	49	46
Poverty Rate (% of population below 1 USD per day)	6.1	na

*Source: World Bank 2003*

### **The Economic Environment of Franchising**

Current Russian economy is rather modest with GDP of 346.5 USD billion. The GDP per capita is only 2,390 USD, which accounts for less than ten percent of the corresponding number in the USA and European Union countries on the average.<sup>3</sup> On a purchasing power parity basis, however, the average annual income for all income classes reaches about 7,500 USD (The Economist 2004). The purchasing power parity income per capita is a lot higher in Russia than the one calculated using exchange rates because the cost of living in Russia is in general much lower than the one in the United States of America for example.

Given an unequal distribution of wealth in Russia, a segment of the population exists that is very wealthy and can lead international franchising development. Such individuals, also known as “new Russians,” often have local ties and knowledge, access to large sums of money, and other related businesses and are, thus, ideal candidates for buying multi-unit franchising outlets. The efforts of these individuals can promote local entrepreneurship and stave off capital flight. Multi-unit franchising is an important source of entrepreneurship globally (Grunhagen and Mittelstaedt 2002). Multi-unit franchising in Russia gained popularity in the 1990s, but given the low level of control that it entails, the contractual arrangement sometimes failed because master franchisees have acted opportunistically or failed to abide by the rules of the franchisor (Alon and Banai 2000).

At least three main reasons can be found to account for the lag of the economy. First, bartering is still common in Russia. A number of transactions involve no money. Second, the black economy is rather prevalent, but naturally not included in the official statistics. Third explanation for the small GDP is the low-income rate of the citizens. Nevertheless, during the past four years the economy has been growing stronger than in OECD countries on the average. Between 1999 and 2002 the Russian gross domestic production faced an annual average growth rate of 5.7%. In the first half of 2003, Russia’s economic

<sup>3</sup> In the USA, GDP per capita was 36,061 USD in 2001.

performance exceeded the most optimistic expectations with estimated 7.2 percent growth rate (World Bank 2003).

**FIGURE 1**  
**Map of Russia.**



Note: Cities with more than 1 million inhabitants include Moscow (10.1 million inhabitants), St. Petersburg (4.67), Novosibirsk (1.43), Nizhni Novgorod (1.31), Yekaterinburg (1.29), Samara (1.16), Omsk (1.13), Kazan (1.1), Tsheljabinsk (1.08), Rostov (1.07), Ufa (1.04), Volgograd (1.01) and Perm (1.0).

In addition to GDP growth, monetary and exchange rate stability is important because it affects royalty repatriation, payments of imported goods, and consumer income. The Russian business life suffers from high exchange rates and inflation (Alon and Banai 2000). After the major devaluation of the ruble in August 1998, the exchange rates have been stabilizing. Inflation has gradually been declining although still remaining high (15.1%) from a western point of view. The key macro environmental factors of the Russian economy are presented in table 2.

The growing income rate has led to an increase in the volume of the consumer market. ("Expert" No. 45, Dec. 3, 2001; in Sarkisov 2002) Overall, the (per capita) real cash income has been gradually growing during the 21<sup>st</sup> century, although it still remains rather low. (See table 2). Despite of the general income growth, poverty remains a severe problem in the country where 6.1 percent of the population survives with less than one dollar a day.

The infrastructure in Russia varies, and in this way is similar to other developing countries. The level of development in both traditional transportation and telecommunications changes by location. Poor infrastructure can restrict franchisors' activities and reduce the desired control which franchisors may wish to have (Alon and Banai 2000).

In 1998, the Russian economy dived into a serious recession. The crisis later referred as the Russian Crisis resulted in a major devaluation of the Russian currency, ruble and reduction of disposable income

of Russian citizens. Also, the prices of input and the level of economic uncertainty increased (Alon and Banai 2000; Swerdlow, Roehl and Welsh, 2001). However, the Russian economy has seen an upturn, and since 1999 the main economic trend in Russia has been stabilization (Sarkisov 2002). Three relevant economic indicators can point out stabilization: GDP, inflation and exchange rates.

**TABLE 2**  
**Main Macro Economic Indicators in Russia from 1997 to 2002.**

Indicator	1997	1998	1999	2000	2001	2002
GDP	436.0	277.8	184.6	246.9	302.2	346.5
GDP Growth Rate (%)	+0.9	-4.9	+5.4	+8.3	+4.9	+4.0
GDP Per Capita (USD)	3,047	1,840	1,249	1,697	2,140	2,390
Inflation (%)	11.3	84.5	36.5	20.2	18.6	15.1
Unemployment (%)	11.2	11.8	12.4	9.9	8.7	7.1
Average Exchange Rate*	5,875	9.7	24.6	28.16	29.19	31.39
Real Personal Cash Income**	106.4	84.0	88.1	113.4	110	110.3
Foreign Direct Investment	3.90	3.36	4.26	4.43	3.98	4.00
Foreign Portfolio Investment	3.3	0.191	0.031	0.145	0.451	0.472
Total Exports	86.9	74.4	75.6	105.0	101.6	106.9
Total Imports	72.0	58.0	39.5	44.9	53.8	60.5

Notes: Figures in USD billions if not mentioned otherwise;

\* RUB/USD;

\*\* percent of the same period a year ago

Source: U.S. Department of Commerce 2002; The Central Bank of the Russian Federation 2003

Naturally, the Russian Crisis had a negative effect onto the development of foreign investments. Russia has had the image of a country with highly unpredictable and unfavorable business environment. Nevertheless, attractiveness for foreign investments has recently been growing. Economist Intelligence Unit surveyed 75 international companies operating in the country in 2001. According to the findings, foreign companies have a generally positive view of the country's current business environment. Over 80% of the respondents reported making a profit in 2000. Six out of ten firms were operating at the pre-crisis 1998 levels, and more than half expected a sales growth of ten up to twenty-five percent in 2001. No company assumed that political risk was getting worse, while the overwhelming majority (82%) viewed it was improving. Half of the companies believed that Russia offered a favorable business environment. These expectations of attractive business prospects have begun to spark renewed interest among foreign firms. (Sarkisov 2002)

Russia's competitiveness is found to be rather low. The World Economic Forum (2003) has investigated nations' competitiveness worldwide and ranked countries accordingly. Recently Russia's ranking has been rather low. In 2003 Russia's ranking was 70, whereas Mexico, for example, took the 47th position (See table 3).

**TABLE 3**  
**Growth Competitiveness Index Rankings in Selected Countries in 2003.**

Russia	NAFTA	European Union
Russia 70. (65.)	USA 2. (2.)	Highest: Finland 1. (1.)
	Canada 16. (16.)	Median: Luxembourg 21. (-)
	Mexico 47. (45.)	Lowest: Italy 41. (39.)

*Note: 2002 rankings in brackets Source: World Economic Forum (2003)*

Financial environment. Several scholars (e.g. Hanson 1995; Mendelsohn 1996; Alon and Banai 2000) have stated that one of the main franchising related impediments in Russia is the poor availability of financing. Funding a business in Russia is both limited and expensive (Alon and Toncar 1999). Anyway, political and institutional stability, coupled with declining inflation and real ruble appreciation over the last three years, has significantly increased the availability of financing for small businesses. A number of Russian commercial banks offer micro and mini loans to start-ups. For example, Sberbank offers micro loans of up to 30,000 USD and small loans of up to 200,000 USD, with maturity of one year and two years respectively. The loan application process is relatively simple and the banks generally decide within one week from application. Financing is thus becoming more available, but estimates indicate that less than 50% of small businesses have even considered applying for loans. (Sarkisov 2002)

The initial investments required to set up a franchise business can be rather considerable for small Russian businesses. One way to attract new franchisees is to establish financial arrangements with banks in order to increase the inflow of new requests for franchise agreements with them. For example, Rostic International has signed an agreement with Small Business Credit Bank, which opens two-year credit lines for Rostics' franchisees. Investments required to buy a western franchise are usually higher than a domestic one. Therefore, franchisors willing to expand through franchising in Russia should consider similar arrangements with reliable financial institutions. (Sarkisov 2002)

### **The Cultural Environment of Franchising**

The unique Russian culture creates conditions, which have to be taken into account in doing business. One of the biggest challenges is the Russian language, the role of which should not be underestimated in the business life. Thus, one needs to consider, for example, whether or not to translate the trade name into the Cyrillic alphabet.

Cultural variables affect the feasibility and acceptance of a franchise system (Alon and McKee 1999). Cross-cultural research has often employed the work of Hofstede who divides cultures along four dimensions: (1) individualism/collectivism, (2) power distance, (3) uncertainty avoidance, and (4) sex role differentiation (masculine/feminine). Alon, Toncar and McKee (2000) have argued that particularly high levels in masculinity and individualism are preferable franchising country-related factors. Considering this, Russia is not among the most appealing host country alternatives, because the culture is very feminine. In the individualism/collectivism dimension the countries score is somewhat average. Furthermore, power distance and uncertainty avoidance (both of which are considered as negative features) are high in the Russian culture.

Attitude towards franchising. Franchising is a relatively new phenomenon in Russia. The word franchising does not exist in the Russian language, but efforts are being made to educate the public, business and governmental audiences (Alon and Toncar 1999). There are several associations in Russia

promoting franchising. The Russian Franchise Association, RFA was established in 1997 as a non-profit organization. The RFA promotes franchising as a business concept and lobbies for the amendment of the Civil Code. Association members include franchisors, franchisees, and government agencies, business support organizations, non-government funds, banks, accounting firms and consultants. (Sarkisov 2002).

A related business development organization is the Russian Association for the Development of Franchising (RADF) which started around 1997 and whose primary functions are to train businesses, educators, and consultants and to hold tradeshows, seminars and publications encouraging the use of franchising (Mendelsohn 1996). The RADF and the RFA organized the first International Conference and Exhibition “Franchising in Russia” in November 2002. The International Conference and Exhibition aims at becoming a center of franchising business activity and establishing contacts between both local and foreign franchisors and franchisees.

Another association, Center for Franchise in Small Business, is established through the State Committee for the Promotion of Small of Business. Its main task is to promote franchising in the regions of the Russian Federation and to help local businesses identify business opportunities and establish contacts between potential franchisees and franchisors. Association also provides counseling, information support, and organizes conferences on franchising topics. (Sarkisov 2002)

Demand for Western goods and services. Franchising in Russia is becoming more attractive because of the high demand for Western products, the establishment of a local franchising community and educational directives (Zeidman 1995). Demand for Western products is healthy in Russia, fueling the growth in foreign investments (Alon and Toncar 1999). According to Sarkisov (2002), the U.S. franchisors are more popular than other foreign brands, because of the perception that USA is the “motherland of franchising”. Besides the increase in local consumption, the growing tourist sector creates opportunities for franchisors especially in the hotel and motel sector (Alon and Toncar 1999).

### **The Political Environment of Franchising**

Political risk. Host country’s political instability is important for a franchisor, because country politics directly affects the business environment. The political risk remains high despite the government’s efforts to stabilize the economy. Governmental instability, corruption and organized crime are still omnipresent in Russia (Alon and Toncar 1999). The democracy is somewhat different in Russia than in the Western countries.

Corruption. Transparency International has measured corruption rates in several countries worldwide. The indicator is Corruption Perception Index (CPI) score, which ranges between 10 (highly clean) and 0 (highly corrupt). In 2002 Russia’s score was 2.7. Consequently, it can be noted that corruption is rather common in Russia. Further results are presented in table 4.

**TABLE 4**  
**Corruption Perception Index Ratings in the Selected Countries in 2002.**

<b>Russia</b>	<b>NAFTA</b>	<b>European Union</b>
Russia 2.7	Canada 9.0	Maximum (Finland) 9.7
	USA 7.7	Median (Germany) 7.3
	Mexico 3.6	Minimum (Greece) 4.2

*Source: Transparency International 2003*

Russia's CPI has been gradually increasing since 2000 when the score was as low as 2.1. Although Russia has passed laws that resist corruption, their effective implementation remains uncertain. For example, a reform enacted in 2001 aimed at cutting down courtroom bribery by introducing a fivefold increase in judges' salaries. (Transparency International 2001-2003)

### **The Regulatory Environment of Franchising**

Russian legislation is under a constant change. Some of the laws are new, whereas others derive from the Soviet times. Legislative reforms are needed to revise confusing, insufficient and partially contradictory laws. The problem is that sometimes the reforms are difficult to manage and the outcomes can be unpredictable.

The Civil Code in its treatment of competition law, intellectual property law and general contract law contains provisions that clearly permit franchising practices and normal contractual arrangements (Mendelsohn 1996). In addition to the general contract law, a code of laws for franchising was established. The law referred as "Law on Contract of Commercial Concession" is included in the Chapter 54 of the Russian Civil Code, which became effective in 1997. Mendelsohn (1996) considered the creation of the law difficult to understand, because at the time franchising was barely known in Russia. Apparently the law was created for educational purposes, although a code of law seems a very strange method to choose for education purposes. Further, a law that clearly takes positions on issues, many of which are difficult for franchisors to live with, does not encourage franchising development in Russia. (Mendelsohn 1996) In the countries, where franchise is regulated with special legislative acts, the main attention is paid to the obligation for the franchisor to make full disclosure of information about his business to potential franchisees planning to invest into a new business. And exactly this important theme finds no reflection in the Chapter 54. (Mailer 2003)

Taxation. One of the main weaknesses of economy is the complex tax structure. The number of taxes targeted on firms' profits is numerous. As a consequence, firms try to avoid taxes by various accounting methods. The Russian government has been working on a simplified tax structure to cut off the black economy. One of the latest tax reforms is the simplification of small business taxation. Since the beginning of 2003, small businesses are given a choice of paying either a unified tax rate of six percent of turnover or fifteen percent of income<sup>4</sup>. (Sarkisov 2002)

The head of the RFA, Mr. Alexander Mailer, has gathered a comprehensive list of the main shortcomings of the law. The key elements of his analysis are compiled and presented in Appendix 1. His analysis shows that the existence of the Chapter 54 of the Civil Code has a negative influence on the development of franchising in Russia. The most radical solution would be to stop enactment of this chapter, or to exclude it from the Civil Code. Other chapters of the Civil Code, concerning contract relations between the legal bodies such as the Trade Mark Law and antimonopoly legislation create necessary legislative basis for successful development of franchising in Russia. (Mailer 2003) The RFA also adapts The Code of Ethics created by The European Franchise Federation. Even though law does not enforce the Code, the members of the RFA are obliged to comply with the Code.

## **CURRENT STATE OF FRANCHISING IN RUSSIA**

Most franchisors entered Russia right after the fall of the Soviet Union and the opening of the market economy. However, franchising as a business method did not start to flourish until the mid 1990's.

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<sup>4</sup> Small business is an enterprise of up to 100 employees and an annual turnover of no more than 470,000 USD.

Sarkisov (2002) listed the main impediments that have constrained the development of franchising in Russia as follows:

- Legal environment was lacking clarity that would boost the development of the sector.
- Local businesses had very limited knowledge of the mechanisms and advantages of franchising.
- Until recently, the state did not undertake any significant efforts to support SME development.
- Cultural and psychological particularities of local business ethics made the idea of purchasing intellectual capital unattractive.
- There was a high degree of mistrust among businesses, and inadequate protection of ownership rights.

The development of franchising in Russia is difficult to estimate, because no reliable statistics are available. The franchisors and franchisees prefer to register franchise agreements under various legal forms such as licensing agreements or sales contracts making the compilation of statistics impossible. (Sarkisov 2002) The franchise agreements used to be registered in the State Registration Board of the Russian Ministry of Justice. In 2002 the responsibility was transferred to the Russian Federation Ministry of Taxes. (Ernst and Young 2003) Still, if the agreements are not registered as franchise agreements, no statistics can be prepared. The Russian Association for Franchise Development is making an effort to create a “Franchise in Russia” database. The database includes the basic information on franchise companies operating in Russia as well as on companies planning to enter franchise operation. (Russian Association for Franchise Development 2003).

It is estimated that franchising accounts for one percent of the retail in Russia (Picot-Coupet and Cliquet 2003), whereas in the USA the comparable percentage is over forty. In 1997, Sibley International reported that there were thirty-three franchise systems operating in Russia. According to the data provided by the Franchising Center for Small Businesses, there were approximately forty companies that had franchise agreements in 2000. In 2001, the number exceeded fifty, and by the mid 2002, more than 100 franchisors were present on the local market (Sarkisov 2002). Moreover, Kamins (2002) estimated that there are 75-100 franchise chains operating in Russia. On the other hand, Kuzmina stated already in 1997 that according to experts, there were 200 franchising firms at the time. Furthermore, Picot-Coupet and Cliquet (2003) reported that the number of franchise networks is 200. However, it should be noted that these figures might contain also franchisors that do not have any franchised outlets in their channel of distribution. For example, McDonald’s runs only company-owned outlets in the country. The lack of data on franchising continues to be an impediment to comprehensive market research in Russia.

Both foreign and local franchisors are present in the Russian market. Table 5 shows information on selected franchising chains in Russia. The number of foreign franchisors is estimated to be one third of all market players. The primary entry modes used by international franchisors include sole ventures, joint ventures, direct franchising, and master franchising (Alon and Banai 2000). Currently, the main stream of potential franchisees is seeking agreements with franchisors in the following business sectors: fast food, printing and copying services, photo-shops, auto repair and maintenance services, body and health care services, and retail sale. (Sarkisov 2002)

**TABLE 5**  
**Description of Selected Franchising Chains in Russia**

Company (home country)	Industry	Entry year in Russia	Company-owned/franchised outlets	Initial investment (USD)	Initial franchise fee (USD)	Royalty (USD)	Marketing fee (USD)	Term of the agreement (years)
<b>ABK (Russia)</b>	Retail	1997	17/1	na	2 000	1,5 %	-	na
<b>AMD Lab (Russia)</b>	Retail (cosmetics)	1995	0/24	na	5 000-10 000	-	300/year	5
<b>Chemdry (USA)</b>	Service (cleaning)	1994	0/3	20 000-	-	100-300/year	-	3
<b>EF English First (Sweden)</b>	Service (language school)	1995	na	160 000	30 000	10 %	10 %	10
<b>Enton (Russia)</b>	Retail (clothing)	1990	3/3	100 000-120 000	-	-	5 %	1 →*
<b>Grillmaster (Germany)</b>	Fast food	1978	0/5	70 000 →	25 000	5 %	-	5
<b>Kodak (USA)</b>	Photography	1992	0/1300	40 000-120 000	-	200/year	-	1
<b>Masterfibre (Australia)</b>	Recycled rubber products	2001	1/1	na	15 000	-	-	5
<b>Rostiks (Russia)</b>	Fast food	1990	12/23	250 000-350 000	25 000	6 %	2-5 %	na
<b>Лабка Жизни (Russia)</b>	Retail	1995	0/2600	na	-	0-5 %	-	1 →*

(Source: Russian Association for Franchise Development, 2003)

N.B. The percentages from net sales

\*Minimum term one year.

## CONCLUSIONS AND DISCUSSION

Russian society can be rather contradictory. The recent economic stabilization presents Russia as an attractive investment target for international franchisors. A large consumer market with growing income rate is an appealing target market for any company searching for growth. Furthermore, the market is still relatively untapped, the demand for western products is evident and the population is rather concentrated. In addition, several organizations are promoting and supporting the growth of franchising.

The macro environmental analysis suggests that most problems are related, not necessarily to franchising, but to all business in general. Alon and Banai (2000) listed the unfavorable business environment features as follows: (1) very high political risk, (2) monetary instability, (3) underdeveloped infrastructure, (4) crime and corruption, and (5) limited amount of capital, especially foreign currency. From these features,

it can be noted that actually only the monetary instability has become more favorable, if compared to the situation three years ago. Other problems still remain.

The political and economic risk is omnipresent in the country. Legal, political and economic institutions are inter-linked and corruption is rather common. Many Russian citizens are unhappy with the way national wealth was distributed during the privatization of national conglomerates. The gap between the rich and the poor is widening. The rich, oligarchs, are hated and government actions are mistrusted. Social differences and instabilities will affect the entrepreneurial atmosphere in Russia.

The parliamentary election held in December 2003 delivered a victory to the allies of President Vladimir Putin. The two parties, which would be recognized in the West as liberal, supporting democracy and western market economy, the SPS and Yabloko, both failed to reach the 5% barrier. After nearly four years in the Kremlin, Mr. Putin still appears to have genuine support. The hard line, which his administration has taken against corruption and oligarchs, has gone down well with many voters. However, there is a fear that Russia is taking steps towards a monarchy and nationalism rather than a democracy. Mr. Putin's re-election in April 2004 seems obvious.

Further, the Organization for Security and Co-operation in Europe, OSCE which had about 400 observers in Russia, said the elections called into question Moscow's commitment to Western standards of democracy. The OSCE claimed that the government used resources and control of the media to dominate the election, and criticized the biased use of taxpayers money (BBC 2003). Many people in Russia and abroad have raised alarms over the steady erosion of democratic freedoms, but voters have clearly embraced political stability and economic development that Mr. Putin and his party promise to nurture (New York Times 2003). It is

**TABLE 6**  
**SWOT Analysis for Franchising in Russia**

<i>Strengths</i>
<ol style="list-style-type: none"> <li>1. Franchising represents a less risky entry mode. Sharing the economic risk is essential when entering into an unstable business environment.</li> <li>2. Franchising enables a faster entry and growth because various resources will be acquired from franchisees.</li> <li>3. Franchising is regarded as an effective business method because independent entrepreneurs are assumed to be more motivated than salaried employees.</li> <li>4. International franchising may be better accepted in a host country because most of the revenues will stay in the country. Accordingly, it is possible that local entrepreneurs do not face so much crime and political pressure than international companies do in Russia.</li> </ol>
<i>Weaknesses</i>
<ol style="list-style-type: none"> <li>1. Since franchising is not a well known or common business method in Russia, franchisee recruitment procedures can be rather time- and resource consuming.</li> <li>2. Training and control of franchisees may acquire more efforts than normally.</li> <li>3. Franchisee selection criteria may have to be reconsidered in Russia. For instance, it is probable that that many of the potentially successful franchisees only want to be investors who are not willing to participate in daily business operations.</li> <li>4. Russia's unique culture and language create conditions that require changes in the business concepts and operations. Franchisors need to get familiar with the Russian way of doing business.</li> </ol>

*Opportunities*

1. A large consumer market, an increasing income rate, and a growing middle class with a high purchasing power are all positive factors in the eyes of the foreign investors.
2. The main trends of the Russian economy have been stabilization and growth during the past four years. Economic reforms have been implemented and are expected to continue.
3. Franchising is starting to develop in Russia. Franchising organizations are promoting the growth of franchising.
4. The existence of a growing number of potential franchisees with resources required for buying a franchise. Overall, entrepreneurship is beginning to flourish. The government is starting to support entrepreneurship.
5. A strong need and interest in high quality Western products.
6. The population is rather centralized.
7. The number of educated and skilled labor force is plentiful.

*Threats*

1. Political instability: Black economy, corruption and crime are too common.
2. Economic instability: Political instability has a negative effect in Russian business life.
3. Legal instability: Russian legislation and taxation are still rather complicated.
4. Infrastructure in the county is highly underdeveloped.
5. Franchising legislation creates business conditions that are clearly unfavorable from the franchisor point of view.
6. Protecting intellectual property can be challenging in Russia. The problem is not so much the legislation itself, but the insecurity concerning the enactment of the court decisions.
7. The availability of financing is rather poor.

believed that the election result and Mr. Putin's growing power will positively affect the economic stabilization and support the growth of the economy. President Putin will apparently go on with the economic reforms and international co-operation. Finally, Mr. Putin has been generally positive in relation to international investments into the country, and perhaps he will enable Russia to get the membership in the WTO.

In addition to the instability of the society, there are certain impediments, which are specifically related to franchising in Russia. In spite of the legislation concerning the protection of intellectual property rights, the practice has shown that franchisors face it as a challenge. Russian legislative bodies are rather corrupted and there is no guarantee that court decisions will be enforced in real business life. Also, the law on commercial concession is regarded as an entry barrier for foreign franchisors. The code includes parts that clearly restrict franchise practices. Especially the article that allows the franchisee to renew the franchise agreement under the same terms is very restricting and unjustified from a franchisor point of view. Another major shortcoming of the law is the part that sets the franchisor subsidiarily liable for claims filed against the franchisee. This statement contradicts the main principle of the franchise system, the independence of franchisee as an entrepreneur. Nevertheless, it should be noted that some parts of the law, commonly regarded as obstacles for franchising in Russia, can be overlooked by stating the issues in the franchise agreements. In some parts the law gives an opportunity to agree otherwise by stating "unless provided otherwise in the contract". Furthermore, companies like Kodak avoid the law by using an agreement of "quality control services", even though their operation clearly is franchising. Finally, there is no indication that franchisors would have faced problems related to the legislation.

Table 6 summarizes the strengths, weaknesses, opportunities and threats (SWOT) for international franchising in Russia. The managerial implications that can be derived from the current analysis include:

(1) Use and take advantage of local legal advice, plan your franchise agreements carefully and follow the Russian legislation. (2) Create relationships with the local decision-makers and be present. (3) Make a long-term investment plan and build up necessary infrastructure inside the country. (4) Find the right partner. (5) Adapt your franchise system to local conditions and support the franchisees in their daily business operations. (6) Invest on quality and respect the local culture, language and people. To sum up, one could say that the most important thing one needs to concentrate on is partner management. To be able to start a business in Russia and run it successfully depends much on the company's ability to create relationships. To achieve mutual trust one has to be present in the market. It is not enough to know your business partners, but also, you need to build up relationships with various stakeholders, including local and governmental authorities.

The present study contributes to the prior research by summing up previous studies and analyzing the franchising environment in Russia. However, there is still an evident gap of empirical research on franchising in Russia. Thus far all investigations have been cross-sectional. Longitudinal research is needed. Instead of descriptive analysis, a more prescriptive, managerially-oriented approach should be applied. Previous studies are rather limited and fragmented. Case studies of both successful and unsuccessful entrants should be conducted and past case studies ought to be updated. Particularly, the normative analysis should focus on the entry phase of the internationalization process, including entry mode choice, franchisee recruitment and franchise system development. Finally, since the Law on Contract of Commercial Concession is regarded as an entry obstacle, the enforcement of the law should be investigated. In summary, we believe that franchising has a large future potential in Russia. While franchising conditions improved in the last five years, they are still difficult and are not suitable for the faint-hearted.

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## APPENDIX 1

### Shortcoming of Franchising Law in Russia

- ❑ Registration of contracts of commercial concession (article 1028) is an absolutely unjustified measure, because it is very hard to imagine any negative impact of unregistered contracts. Agreements usually contain confidential information that might be disclosed to a third person while going through registration bodies. Practice of Russian registration chambers shows that this claim will result in another bothering procedure of "registration for the sake of registration". We can see no reason in registering of agreements for the usage of objects already defended by patent legislation. Once a patent is registered, it's enough, because all franchise contracts include articles on the rights to use a certain brand. (Mailer 2003) Contract registration is in any case a common procedure in Russia and thus franchising makes no difference in relation to other business methods.
- ❑ Remuneration to the franchisor usually has a complex nature, that is why in the article 1030 the conjunction "and" should be used instead of "or". Principally this side of relations between two parties should be regulated by the contract, and not by the Civil Code of Russian Federation. (Mailer 2003) In practice, this does not seem to have an effect, because many franchisors operating in Russia charge several franchise fees.
- ❑ In franchising the quality control over goods and services, produced by franchisee, is the *right* of franchisor, but not his *obligation*, as it's said in the article 1031. This liability of the franchisor is unrealistic, because franchisor is obviously unable to provide such control, if he has substantial number of franchise outlets. (Mailer 2003) However, the article sets the obligation "unless provided otherwise by the contract of commercial concession", which implies that it is possible to agree otherwise.
- ❑ Article 1034 "Right-holder's Responsibility for Claims Filed Against User", stating that the franchisor shall be held subsidiarily liable for claims against the franchisee, contradicts the main principle of the franchise system - the sovereignty of franchisor and franchisee. Subsidiary liability gradually decreases the advantages of franchising in comparison with development by establishing corporate branch enterprises. (Mailer 2003)
- ❑ The statement, that the franchisee "shall have the right on the expiry of the contract term to renew the contract on the same terms" (Article 1035) is not justified, as in 5 - 10 years (usual term of the contract) conditions could substantially differ. Franchisor shall only "have the right to refuse to renew the contract, provided that within three years after the expiry of the contract term he will not conclude with other". (Mailer 2003) The perpetual right to renewal on the same terms without

any permitted leeway to adjust to changing circumstances, business practices and laws makes the education possibilities limited to what one would expect in a managed economy, not in a free one (Mendelsohn 1996). There are a lot of reasons that could emerge in the process of business for the franchisor not to renew the contract with the franchisee. The franchisor should have the right to change his system. Insisting on renewal of the contract “on the same terms” cuffs his hands and legs. (Mailer 2003)

- The possibility of termination of the unlimited contract by simply notifying the other party six months in advance, as written in the Article 1037, is highly disputable. Usually both parties make substantial investments into the business. The usual practice is that the franchise contract would be terminated only in case one of the parties violates its obligations. Unmotivated termination of the contract could result in serious financial losses for one of the parties. (Mailer 2003) Anyway, the article can be overlooked by simply stating the contract term in the agreement.
- According to the article 1039: “Should the rightholder change his firm name or commercial mark the rights to use of which constitute a complex of exclusive rights, the contract of commercial concession shall remain valid with respect to the rightholders’ new firm name or commercial mark, unless the user demands cancellation of the contract and compensation of losses.” The statement is very strange and it is not clear, where such right emerges from, and what “comprehensive reduction” is. (Mailer 2003)