# FRANCHISING IN THE UKRAINE

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**Sibley International**

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**Sibley International specializes in the application of franchising as a development tool for the small and medium enterprise sector in developing economies.**

# FRANCHISING IN UKRAINE

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## LIST OF ABBREVIATIONS & TERMS

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| EBRD - | European Bank for Reconstruction and Development |
| EU TASCIS | European Union’s development initiative for the Newly Independent States |
| Franchisor | The owner of the franchise trademark and business concept |
| Franchisee | The purchaser of the franchisor’s system |
| FSU | Former Soviet Union |
| GDP | Gross Domestic Product |
| GOU | Government of Ukraine |
| IESC | International Executive Service Corp |
| IFC | International Finance Corporation |
| MBA | Master’s of Business Administration |
| NIS | Newly Independent States (of former Soviet Union) |
| SME | Small and Medium Enterprises |
| USAID | United States Agency for International Development |
| WIPO | World Intellectual Property Organization |

# FRANCHISING IN UKRAINE

## Executive Summary

**The Sibley Team met with entrepreneurs, business development professionals, economic analysts, legal professionals, banks, donors, and government representatives, over a two week period to assess the viability of franchise development in the Ukraine. The Team concluded that there are no legal or other constraints specifically prohibiting franchise development. It further concluded that franchising is a more effective response to the Ukraine investment climate than most independent business development strategies.**

Like most economies in the Former Soviet Union, Ukraine has achieved a large measure of economic stabilization, but is still in the early stages of market reform. The economy is still shrinking and much of the industrial and agricultural sectors are under state ownership. Unemployment is rising and is likely to continue to do so as large numbers of medium and large scale enterprises undergo substantial restructuring or bankruptcy.

The economy desperately needs the new jobs and economic dynamism that small businesses (SME's) can create. Unless the benefits of market reform can be felt and seen throughout the economy, the somewhat precarious popular support for further reforms will evaporate. The environment for all private investment however is extremely difficult. Legal protections are slim and the hostile regulatory and tax structure make it nearly impossible to comply with the law and still operate profitably. This is especially destructive for small businesses which do not have the resources to cope with the withering tax regime and regulations. It is estimated that this framework drives 50% to 60% of all economic activity into the “shadow economy”. To further complicate the task, bank financing is scarce and alternative sources of organized financing almost non-existent.

Despite the hostile environment and numerous operating difficulties, <u>small enterprises are operating profitably in Ukraine</u>, and the jobs they create are like food for a starving man. Franchising is an enterprise development strategy that starts with these successful businesses and systematically replicates their experience working with the energy and resources of other entrepreneurs. It was devised by business owners to expand their successful operations into markets when they didn't have the capital or other resources to do so on their own. It is the most successful business startup and expansion strategy ever developed, and the world's fastest growing source of independent small businesses.

The Team found only the most rudimentary understanding of the franchise concept among all the parties consulted, among both development programs and entrepreneurs. The Team also found that Ukrainian franchises would enjoy substantial advantages over other private enterprises. Because of the franchisor/franchisee relationship they could;

- better cope with the difficult investment climate,
- be more likely to expand without bank financing, and
- not be constrained by the lack of sophisticated business skills.

Franchising will come to Ukraine and transform the way businesses are run, especially in the small business sector. USAID and other donors have the opportunity to greatly accelerate that arrival and create job growth now. The Team considered the relative merits of a Franchise Program compared to more general business counseling and training activities, or an incubator concept, as mentioned in the Mission Strategy. A Franchise Program would be;

- more cost effective per job or enterprise created because of the replication effect,
- more sustainable since technical assistance and training become "commercialized" in the franchisors, and
- less risky since franchise businesses are 8 to 9 times more likely to succeed.[1]

In order therefore to substantially contribute to the Mission Private Enterprise objective of "<u>accelerating the development and growth of private enterprises</u>", the Team recommends that the Mission;

- Demonstrate the viability of franchising and promote it as a business strategy for Ukrainian entrepreneurs
- Ensure the legal, regulatory and tax environment is supportive
- Build the capacity of Ukrainian institutions and professionals to support franchise development, and
- Adopt a comprehensive approach that will ensure the best use of available resources

[1] U.S. Department of Commerce Study, 1991

# FRANCHISING IN UKRAINE

## I. Introduction

Franchising is a method of rapidly expanding a proven business concept. It was devised by business owners to expand their successful business concept into markets when they didn't have the capital or other resources to do so on their own. It is the most successful business startup and expansion strategy ever developed, and the world's fastest growing source of independent small businesses. While it is most evident in U.S. food services, it has been successfully applied to over 60 different market sectors, around the world, including personal services, business services, telecommunications, drug retailing, building maintenance, auto repair and transport systems.

## II. Why is Franchising a Tool for Economic Development?

Transition economies such as Ukraine especially need the new jobs and economic dynamism that small businesses (SME's) can create. The majority of new job growth in the U.S. and most European economies as well is coming from small businesses. Job growth and investment is especially important in Ukraine, where the restructuring of large scale state enterprises is creating a large pool of unemployed. The result is that high impact programs are needed to foster the creation and expansion of private businesses, whether formerly state owned or new start ups.

Typically, the environment for small businesses in transition economies is especially harsh, with high administrative, tax, and other legal or regulatory barriers to new startups or expansions, and few business skills or institutional sources of financing such as bank loans. The systemic constraints evident in the overall investment climate require concerted efforts to resolve, and a period of transition, but jobs and economic dynamism are required immediately if the benefits of market reforms are going to be felt.

Even transition economies have pockets of growth. Some small businesses find ways to operate profitably despite the hostile environment, and the jobs they create are like food for a starving man. These entrepreneurs may have accumulated resources and gained experience trading, or have capitalized on their ability to manipulate the regulatory system to their advantage and are ready to become more conventional investors and operators. Franchising is an enterprise development strategy that starts with these entrepreneurs who are succeeding in the difficult environment, and builds on their success to create similar opportunities for many more. During this period of transition and afterward, it can lay the foundation for the emergence of a vibrant small business sector more quickly than through any other enterprise development strategy. This is particularly evident when compared to business counseling and generic business training efforts.

**In the U.S. franchise outlets account for approximately 50% of all retail sales.**

**In an informal survey in Russia that did not include McDonalds Corporation, the largest franchise investor in the country, it was estimated that the number of franchised businesses will grow from 70 in 1994 to over 600 in 1997. A large number of these are Russian franchise businesses with uniquely Russian concepts.**

**Individual units are predominantly small scale, new start ups that mobilize Russian capital and rely very little on foreign investment or sophisticated technical support. This is despite an inhospitable investment climate. Franchise businesses today employ over 25,000 Russians.**

It is only recently that this successful private sector concept has been "discovered" by development professionals. It is increasingly being viewed by USAID, the World Bank, TACIS and the Know How Fund as a highly effective economic development tool, with projects in Russia, Kazakstan, Philippines, South Africa, Morocco, Swaziland and Ghana.

In its simplest form, a franchise project takes the best features of franchising - a business system, the financial controls, the transfer of technology and know-how, the training and support, and the marketing expertise - and replicates them with the energy and resources of other small entrepreneurs. Other project elements such as training or regulatory work build local expertise and improve the environment for private businesses generally, and franchises in particular.

There are substantial benefits to the donor from using franchising as a tool for economic development. They are apparent on at least five levels;

1. Once started, franchises continue to expand on their own, creating new businesses and transferring western management practices without further expenditures from donors;
2. Franchise programs can succeed in environments where there is a low level of business skills and very limited availability of capital;
3. Franchises don't rely on foreign capital or sophisticated technology to succeed, in fact the most effective development strategy is to franchise a local business concept;
4. Franchise businesses are 8 to 9 times more likely than other businesses to succeed beyond the start up phase, so assistance and investment are rarely wasted, and;
5. The methodology can be successfully applied to programs focused on micro, small or medium sized enterprises;

## III. The Ukraine Assessment

In December, 1996 USAID Kiev requested the services of ***Sibley International*** to determine the feasibility of a franchise program for Ukraine. The team set out in particular to determine whether there existed any constraints, legal or otherwise, that would preclude franchising from being successful in this market, as both a business and economic development strategy.

Sibley fielded two experts in franchising and private sector development for a period of two weeks during January, 1997. Due to the very short duration of the assessment, the Team did not set out to gather primary data in this assessment. Instead it relied on the surveys, analyses, and Ukraine field experience of other private sector teams, and added to this their own expert observations. Through a series of interviews with entrepreneurs and professionals in Ukraine, and reviews of secondary data and analyses of the private sector there, the team compiled a series of findings and formulated its recommendations. Efforts were focused on three principals areas; the legal and regulatory framework; key institutions for private sector development such as financing, training, or promotion; and key market segments and enterprises that lend themselves to franchise development.

Using a series of briefings and three short seminars, the team also introduced the key elements of franchising to business promotion professionals and government officials in Kiev during the this period. Seminars were conducted for the USAID NewBizNet Project Staff from all regional centers, key staff at the Ministry of Economy brought together by the International Finance Corporation (IFC) Post Privatization Project, and for the trainers at the EU TASCIS-funded Agency for the Development of Enterprise. These presentations were supplemented by the distribution of educational and resource materials in English, Russian and Ukrainian.

## IV. The Environment for Franchising

### A. Market Reform

While a large measure of economic stabilization has been achieved in 1996, market reform in Ukraine is still in its early stages. A substantial amount of the economy is still under outright state ownership and/or heavily dominated by former Soviet structures, and the overall economy is still contracting. Basic enabling legislation is still being debated, private ownership of land is largely prohibited, and taxes and regulations are difficult to determine, let alone comply with. The investment climate is therefore very difficult, in particular for small and medium enterprises.

These problems have been well documented in a range of surveys, analyses and the recent USAID Strategy for SME Development[2]. There is widespread consensus among economists, reformers in government, donors, and others about the need for liberalization and further market reforms. Rather than recount these problems here, the following observations briefly summarize them and relate each to its impact on the economy in general and/or specifically in private sector investment in franchises.

### B. Small Enterprises in the Economy

Ukraine needs an explosion of small, privately owned businesses. With GDP down by 10% and unemployment likely to increase as large numbers of medium and large scale enterprises face substantial restructuring, the economy desperately needs the dynamism that small enterprises create in nearly every other economy. Without the benefits of job growth, new investment, and entrepreneurial innovation, the popular and somewhat precarious political support for further reforms will evaporate.

It is admittedly difficult to gauge the number and importance of such enterprises today. It is estimated that up to 65% of retail sales in Ukraine go unreported, and 40 to 50 percent of GDP comes from the shadow economy. But in this $30 billion economy, only 5% of employment is attributed to small private enterprises. In European countries that number is 60 to 85%, and even in Russia it is already estimated at 20%. The good news is that

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[2] "Ukrainian Rapid Enterprise Survey (URES)", Soros International Economic Advisory Group, Vol 2, Jan. 20, '97.
"Quarterly Ukrainian Rapid Enterprise Survey", Dec. 5, 1996.
"The Needs of Ukrainian Entrepreneurs: Small Business Survey", International Finance Corporation, Oct. 10, 1996.
"Ukraine in Numbers-Nine Months 1996 Review", Economic Bulletin, No. 21, Nov. 1996
"Top Twenty Legal Impediments to Doing Business in Ukraine", Myron Rabij, The Ukrainian Legal & Economic Bulletin, Vol IV, Aug-Sept, 1996.
"Strategy for SME Development in Ukraine (Draft)", prepared for USAID Kiev by Management Systems International, Oct. 11, 1996.

there is widespread acknowledgment among government officials, donors, and others that this situation must be remedied, and they are acting to do so.

## C. Legal & Regulatory Framework

### 1. The Current Framework

Enterprise managers, government reformers, and most analysts now point to the hostile legal and regulatory framework as the single biggest impediment to the growth of new private investment. The framework is no worse for franchise businesses than any others. In fact, as we shall explain later, franchise businesses will have several unique advantages because the "parent" franchisor can provide substantial support in this regard.[3]

The framework is dominated by a withering set of tax, licensing, and registration requirements that combine to make it administratively and financially impossible for most businesses to fully comply with the law and still operate profitably. Not only is the sheer weight of these requirements stifling but the rules change regularly and their applications are reportedly arbitrary and inconsistent. A small business owner in Kiev reported filing 45 forms per month to satisfy these requirements, none of which helped him understand how well the business is performing. Hence, the huge "shadow market" portion of the economy and large amounts of unreported sales and unregistered employment.

It seems possible that reformist local governments are able to make special provisions that do encourage small business development, and have some discretion in the application of regulations. The impact of these initiatives is relatively low, however, and too random to have a significant impact.

### 2. The Impact on Operations

[3] See also comments about the migration of successful "traders" into the more permanent sector offered by the emerging franchise opportunities that can be created in the Ukraine.

Those who operate successfully spend a disproportionately large amount of their entrepreneurial skills and resources dealing with the “administrative” aspects of operating instead of expanding or improving their business. Instead of rewarding the best entrepreneurs, this framework places a premium on the skills and connections necessary to circumvent the more onerous requirements, thereby further eroding the competitiveness of legitimate businesses. The system therefore perpetuates inefficiencies and discourages the emergence of a dynamic class of small business owners.

The impact is particularly harsh on small businesses that rarely have the resources to contend with the system. Especially so on the most economically attractive of all small enterprises, i.e. those who are viable and poised to expand beyond their immediate market environment. The disincentives to such owners of exposing themselves to new regulations and different interpretations can be overwhelming. ( a successful business that becomes a franchise can provide great value to the franchisee in this context by providing help and guidance with such compliance issues)

## 3. The Framework For Franchise Businesses

Current enabling laws in Ukraine do not provide adequate legal protection for private investment. In January, 1997 the government submitted to Parliament a completely new civil code that, if passed, will transform this framework into one resembling that in use in most modern market economies. Opinions vary greatly on when passage will take place however, mainly because support for such reforms varies greatly.

Despite its inadequacies, there is a system in place under which private entrepreneurs are now operating. We were repeatedly advised however that even this does afford material protection since enforcement procedures are far too unpredictable to be relied upon. We were advised that businesses often resort to extra-legal means to enforce contracts and obligations, or simply operate without legal protections.

In addition to the normal legal framework required for any business to operate, such as company and contract law, bankruptcy and collateral, securities regulations, etc. a franchise system requires some form of protection for trademark and intellectual property. The new civil code in Ukraine includes a law on Franchising (Chapter 74), as well as the Licensing of Intellectual Property (Chapter 73) provisions. There are also Chapters relating to Trademarks and Intellectual Property protection. It has not been possible in the context of the limited scope of this project to conduct formal legal reviews of these Chapters. Their provisions are highly technical and require a specialist to assess.

However the Team offers comments on Chapter 74 on Franchising and the general circumstances relating to the need for such provisions in **Appendix A** of this report.

## 4. How Entrepreneurs Can Cope

Franchise networks normally rely on a combination of legal and other strategies to ensure a close and cooperative working relationship with franchisees. There is currently a means to protect trademarks in Ukraine, although the businesses we spoke with said they do not rely on it for protection because of enforcement difficulties. Like franchisors worldwide, they sought other protections instead, such as exclusive rights from international suppliers to import essential raw materials or ownership of vital equipment.

So, for example, a dry cleaning franchisor would obtain exclusive rights to the cleaning chemicals, and ensure he had highly valued maintenance technicians to keep equipment running. In this way a franchisee has strong incentives to observe the franchise agreement regarding use of the trademark or risk losing these items which are essential for operating. In other countries franchisors use equipment lease arrangements as another way to control franchisees. Even the McDonald's Corporation owns the property where restaurants are operating, acting as landlord and leasing it to its franchisees as another way to cement the relationship to the franchise network. Where, as in Ukraine, some successful businesses are reluctant to openly report revenues for fear of being put out of businesses by regulators, franchisors have negotiated alternative royalty agreements, often a fixed fee based on projected revenues, without reference to actual performance.

To the extent that success for small businesses in Ukraine lies in sorting out how to operate a reasonably good business concept in a harsh environment, then franchise businesses will enjoy a substantial advantage. Franchisors are always well equipped in this regard and have a strong economic interest in ensuring their franchisees can also cope successfully.

**The proposed reforms now under review are significant and adequate for franchising, so substantial additions are not required. The conclusion of the Team is that while the current legal and regulatory framework may cause international franchisors (McDonald's is an exception because of its size and strategy) to pass up Ukraine in favor of many other markets, local firms are already finding ways to operate despite its weaknesses. A franchise business strategy is no more disadvantaged for its mode of operating than any other private enterprise, and can in fact be a much more effective response than an independent business strategy**.

### D. Financing

As is stated in USAID's strategy paper, "capital is the lifeblood of a business". Institutional financing, from banks or specialized financing companies, is largely unavailable for all but a very select few private businesses. The problems are the same as those found in most transition economies; tight restrictions on lending, predominance of state owned banks, limited capital, strong economic and political disincentives for banks to develop the right lending skills, and ill-defined legal rights and enforcement procedures regarding secured transactions.

Such programs as the Western-NIS Enterprise Fund, Eurasia Foundation-Small Business Loan Program, the new German government's new credit fund and EBRD's Credit Facility all offer the possibility of demonstrating how private lending can take place. And banker training programs offer the hope of developing a new cadre of bank professionals. But their impact at the enterprise level will only be felt in the medium to long term.

During this period of transition, for all the reasons noted above, it is unlikely that banks will be an important source of capital for significant private investment, especially for small businesses. Instead, capital for this growth will more likely come in small amounts, from numerous informal sources such as internal and extended family savings, retained earnings, and supplier credits. This will no doubt greatly inhibit medium and large scale restructuring and expansion efforts, and stifle the growth of enterprises whose capital requirements extend beyond the means of these informal sources. As in other transition economies such as Poland, the Team believes job growth and innovation in Ukraine therefore, are not likely to come from the restructuring and refinancing of larger, more sophisticated enterprises with significant capital requirements.

In the face of this dysfunctional financial market, during the transition period small businesses present the greatest opportunities for economic growth. Among the various scale of businesses, they occupy a somewhat more advantageous position because they can grow, albeit in limited way, without bank financing. Their capital requirements are relatively smaller and they are much more effective exploiting small niches in the marketplace with available resources. Even in relatively efficient financial markets, small businesses find it difficult to obtain significant bank financing to do this. This is especially so for new start ups that rely almost exclusively on informal "personal" financing sources. Therefore, investing donor resources in this sector (and franchises dominate this sector worldwide) is likely to yield greater results than restructuring efforts aimed at larger scale firms requiring more effective support from financial markets and more sophisticated business skills and legal protections.

Lenders in Western economies often welcome franchise clients because the franchises offer both the opportunity to see the business concept in operation and gauge its actual financial performance rather than relying solely on the business plan. This reduces the due diligence requirements. They also welcome the training and technical support provided by the franchisor, and the franchisor's vested interest in keeping the franchisee profitable. Banks in Ukraine may act on these advantages as well if given some exposure and the opportunity to finance sound proposals.

**The Team, therefore concluded that, like the hostile legal and regulatory framework, the absence of financial services does not disproportionately disadvantage a franchise business strategy. In fact, franchise businesses have a distinct advantage in such environments since expansion of a franchise concept can mobilize numerous informal pools of capital for each independent franchise unit, thereby growing the business without large scale bank financing. The Team also concluded that a focus on smaller enterprises is more likely to yield growth in the near term than a similar strategy aimed at restructuring existing large scale enterprises**.

### E. Business Skills

As in most NIS economies, the level and extent of formal business skills among adults is very limited. The Team visited several institutions of higher learning turning out MBA's, for which we were advised there is a high demand. These programs, combined with business counseling services provided by USAID and other donors seem to fulfill an important demand for information. Based on discussions with these groups the Team discovered, not surprisingly, a great deal of interest, but almost no information or experience among service providers to support franchising development.

Like most of their colleagues of the FSU, Ukrainians are comparatively well educated, and the growth of small businesses does not depend heavily on formal business skills. As was discussed earlier, to succeed in this environment requires at least as much “street smarts” and other “administrative” skills, as good business instincts and the basics of marketing. We met with one (maybe the only) franchise operator in the country, and several operating in a similar fashion. They relied entirely on information and expertise drawn from the U.S. and Europe to begin their operations.

Whether or not the provision of business information and counseling leads to business formation and new investment in Ukraine is unclear. Franchisors typically rely more on “life experience” than an MBA and specific technical expertise when selecting good franchisee partners. Their perception is often that it is better to have someone willing to learn than someone who is convinced they already know everything needed to operate. The franchisee must be simply able to learn the system and apply it to the letter with vigor.

**The Team therefore concluded that there is practically no information on franchising available, nor expertise regarding its practical application. The low level of formal business skills would not be a significant constraint to franchise development. Indeed, the well structured franchise package with all the procedures for successfully operating is an excellent response to the Ukraine environment where business skills are low and education levels are relatively high.**

## V. Franchising in business development programs

The Team met with enterprise development and financing entities to gain their insight into the possibilities of franchising as a growth strategy for Ukraine, to determine whether existing projects could practically advance franchising as a business strategy, and identify the interest and potential for future collaborations.

The Team first briefed the Project Directors in each of the USAID NewBizNet, USAID Alliance, IFC-Post Privatization Project, and TASCIS Agency for Development of Enterprise and provided their staff with seminars on the concept of franchising as a business strategy and tool for economic development. None of the Directors or staff members had any experience developing franchises, nor had they ever worked with this concept in their programs.

Once briefed on how it could be applied and its advantages, each of the Directors expressed vigorous support for promoting franchising and gauged the market ready for such a strategy. Staff members had similar reactions, especially the those working outside of Kiev. Although we were not able to gauge this ourselves, we were advised on several occasions that these concepts would be particularly welcome outside of Kiev where local government and other institutions are more eager to take on new initiatives.

It is clear that the resources present in the nationwide network of business counseling centers, and volunteer business advisors such as MBA Corps, I.E.S.C, and Peace Corps could become a valuable additional conduit through which the concept of franchising could spread quickly. Once trained, organizing workshops and seminars for a fee could be another source of revenue for the counseling centers. Russian and Kazak experience has indicated a big market for such events and a willingness to pay reasonable fees to attend. They would also serve as a valuable network to identify pilot enterprises and future franchisees. Some of the centers even expressed interest in developing a "business services" franchise along the lines of a copy, printing, shipping, fax, postal service such as"MailBoxes, Etc." in the U.S., to be owned and operated by the Center.

The Eurasia Foundation and Western NIS Enterprise Fund were both supportive of franchising as a portfolio lending strategy, particularly in light of the difficulties of lending in Ukraine and the importance of assessing individual borrowers. Neither had ever financed a franchise business and would require initial training and/or orientation. They expressed their interest in working with future clients of a franchise program, although their resources are somewhat limited.

The Team also met with the Ukrainian Legal Foundation, the principal supporter of the new Civil Code drafting initiative. Their program would be the ideal counterpart to a legal review and counseling effort on the intellectual property, trademark protection, and franchise provisions of the new Civil Code. For while each provision may have been well crafted, a lengthy process of consensus building must take place if these provisions are going to be passed into law. In addition, through their legal education and professional development initiatives, a program could assist Ukrainian lawyers can become familiar with the franchise concept and its application in law.

**Regarding existing development programs, the Team concluded that much of their resources and network could be leveraged to assist franchise development and that this would be a cost-effective strategy. It also determined that they would be unable to undertake franchise development without significant external assistance.**

## VI. The Role of Government

The Government of Ukraine is keenly aware of the need to enhance private sector investment, especially in small enterprises. The Team bases this finding on the package of tax and regulatory reforms formulated by the GOU and recently put before the Parliament for debate, in the commitment to reform and support for franchising expressed by the Economic Reform Advisory Board in the Cabinet of Ministers and the head of the State Property Fund, and the widespread interest evident in the Ministry of Economy. This commitment will be given further expression during February, when the government is organizing a two-week retreat for senior and mid-level officials to strategize about what further steps the government can take to foster small enterprise growth .

It is unclear where the locus of responsibility for small business development rests in the government. The system has however produced important initiatives. We were assured by several sources that the administrative, tax, and other reforms proposed by government and being considered by Parliament could significantly enhance the regulatory and tax environment. A vital ongoing function could be performed if the proper body acted as a Small Business Advocate (equally beneficial for franchises), purposefully pushing for reforms throughout the government including tax administration, utilities, and others. Even in a reform mode, these entities typically are not sensitive to small business needs and tend to foster a "one size fits all" approach to licensing, permitting and other requirements.

**The Team concluded that no additional franchise specific legislation or policy reform is needed for franchises beyond that already proposed for private investors and small businesses, which will benefit franchises as well. There is clearly a role for government to see these legal, regulatory, and tax reforms through, and ensure their fair and transparent application, particularly for smaller enterprises**.

## VII. Franchising as a Response to the Ukraine Environment

The Ukraine investment climate suffers from most of the ailments present in transition economies around the world; a poor legal enabling framework, hostile tax and regulatory regime, high interest rates and dysfunctional financial system, and limited business experience among entrepreneurs and potential investors. On the premise that actively promoting job growth and new investment is nevertheless highly desirable, franchising can respond successfully in this investment climate for the following reasons;

a. **<u>Poor enabling legal framework</u>** - While the new Civil Code is being drafted and debated, small businesses have devised ways of coping with only limited legal protections and sometimes capricious enforcement. Franchisors develop these techniques and pass them on the franchisees. They also have a financial interest and are better placed to provide continuing legal advice and even protection to the network of franchisees as the system evolves.

b. **<u>Hostile tax and regulatory regime</u>** - As in the enabling environment, franchisors have developed ways of coping with the requirements and can pass them on to their franchisees and assist them in meeting them. Furthermore, by using a franchisee network of small, independent owners, the franchisor can expand a business (creating investment opportunities for others) without the sophisticated influence or "administrative" skills that are usually required to succeed on a large scale in transition economies.

c. **<u>High interest rates and dysfunctional financial system</u>** - These are stubborn problems that only lend themselves to longer term efforts. In the absence therefore of large pools of investment capital, the economy must rely more heavily on informal mechanisms to channel capital to successful businesses. Franchise networks can expand in these markets because the capital requirements for each unit are relatively small, and depend on numerous small pools of capital drawn typically from informal, non-institutional sources such as extended families, partners, and retained earnings. Furthermore, due diligence requirements for lenders are less since they see the business in operation and judge its performance without relying solely on a business plan.

d. **Limited business experience -** Experienced entrepreneurs and managers are rare in Ukraine. New entrepreneurs typically need a great deal more support than class room based training or counseling to succeed in this environment. Even in the U.S., 70 to 80% of new businesses fail within five years of start up. Franchising addresses this on two levels. First by reducing the need for prior business experience. Franchisors typically depend more heavily on the availability of individuals with above average education and a strong desire to succeed. Sophisticated business training is not usually required since they develop a highly structured business package documenting all aspects of operation, and then back it up with formal training and ongoing support. The generally high education levels in Ukraine suggest that finding such entrepreneurs would not be overly difficult. Secondly, the franchisor provides ongoing support. Instead of classroom based training alone, the franchisee gets the benefit of the guidance of the franchisor who has experienced and solved most start up problems already. Franchise businesses in the U.S. are 8 to 9 times more likely to succeed than independent businesses.

**Kazakstan**

**In common with Ukraine and other former Soviet States, Kazakstan has a complex and even hostile environment for small enterprises. Registration is difficult, taxation is fierce and inspection, both official and unofficial, very frequently interrupts the normal business process. In spite of this, the entrepreneurial spirit is flourishing and an emerging population of private retailers and service providers is finding ways to cope, survive and profit.**

**Some of these are turning to franchising to provide them with the next level of expansion. In a recent 5 month USAID project, <u>four</u> such enterprises were assisted to develop their franchise systems and are now poised for growth in this way. One has already (after only four months of preparatory work) found and signed its first franchisee. Another has plans to open <u>20</u> units over the next two years.**

**<u>Sixteen</u> other enterprises were identified for whom franchising would be a viable business strategy and are a various stages of their decision making and preparation.**

## VIII. Franchise Candidates in Ukraine

Nearly any business that has multiple customers serviced from multiple locations can, in principal, be franchised. There is at least one franchise already operating in Ukraine, and several others operating as “near franchises”, with large distribution networks, some of which are wholly owned, some joint ventures. The Team met several investors and entrepreneurs who had already decided that franchising was the best way to distribute products and services throughout Ukraine. The short duration of the study precluded an in depth analysis of investment opportunities for Ukraine franchises. Having analyzed the investment climate and observed the retail and services markets however, important observations can be made

The following sectors were singled out in particular as showing the right characteristics. The study was short and some of the comments are subjective. Further detailed study and research would be needed to confirm these impressions.

a. **Fast food** - the most obvious sector when considering franchising in any environment, presents an even better opportunity in the Ukraine than it might in more developed markets. This is particularly the case if the concept was to specialize in low-price, good quality local menus. This concept is being very successfully pioneered as a franchise in Russia by the Russian Bistro company. Several Ukrainian entrepreneurs are already developing this idea (at least one of which is fairly advanced).

b. **Business services** - apart from the ubiquitous "Xerox' copy centers (most of which do not actually use Xerox and provide very poor quality copies) there are virtually no business services available to the individual and small business outside of the larger hotels. Even there the service is spasmodic and limited. Opportunities exist to serve this market either in combination with the existing donor-funded business support centers, or on a stand-alone basis.

c. **Dry cleaning/laundry** - again there is an almost complete absence of these services - particularly for the not-so-wealthy. The ownership of domestic washing/drying machines is at a very low level as compared with western households and there is clearly a large market here that is not served.

d. **Auto service and repair** - while there are plenty of what are called “shade tree mechanics who are good at fixing cars with a bent hairpin, a branded, reliable, guaranteed service is not available. Car ownership is starting to increase in the Ukraine and this could be another under served market.

e. **Gasoline stations/convenience stores** - this has been a winning combination in all markets and emerging economies such as Russia and Kazakstan are starting to become targets for Western gasoline suppliers for this type of business.

f. **Building Maintenance** - very successful in developed markets, comprehensive maintenance services for newly established condominium associations are a natural for a market that is dominated in the cities by large apartment blocks, the fabric of which is owned by and cared for by nobody. This is particularly attractive as a franchise because of low startup costs, the ability to charge very little per individual apartment owner, and the advantages of quality of service and security that could be guaranteed to homeowners by a franchise network, as opposed to individual operators.

g. **Personal Care** (hair, nails, beauty treatments, health clubs etc.) - while some of these services are offered, the environment in which they operate and the lack of style and consistency of service is very far below that available elsewhere and it is clear from observation that there is a pride in personal appearance in the Ukraine as much as anywhere. The first Western style operator in this market should be very successful.

h. **Freight Forwarding** - in common with other former command-economies, the Ukraine suffers from poor distribution of supplies, especially perishables. In part this could be addressed by the introduction of an efficient freight-forwarding network, which itself is an ideal candidate for franchising - low initial investment, mutual dependence on the system of management and communication and a need for multiple locations.

In addition to commercial viability, a franchise development program should seek pilots that have additional characteristics that will enhance the economic impact, such as;

- A relatively simple business format
- Marketability already demonstrated
- Capital requirements under $100,000
- Already operating more than one unit successfully,
- Good linkages to other sectors of the economy, such as agriculture,
- Potential for a large number of additional franchise units, and
- An entrepreneur and management team who are determined to expand through franchising and will commit the necessary resources to make this happen.

## IX. Recommendations

Franchising will eventually come to Ukraine and transform the small business sector. The Team makes the following recommendations to significantly advance that arrival by ten years or more.

First, **<u>demonstrate its applicability, promoting it as a viable business strategy for Ukrainian entrepreneurs</u>**. Inexperience and misperceptions have created the false notion that franchising is a strategy only for western multinationals, mostly from the U.S., and is only suitable for American style fast food. It is actually an ideal strategy for all kinds of businesses in the Ukraine environment and entrepreneurs and investors need to understand it to create their own applications. The best way to demonstrate the concept is to undertake a series of pilots that will both reveal operational problems and eventually create a large number of jobs and new investment.

Second, **<u>ensure the legal/regulatory environment is supportive</u>**. While the draft law on franchising appears benign, other aspects of the law should be reviewed by specialists, and drafters, legislators, and the government will need advice and support during this period of Civil Code review and regulatory reform. Furthermore, the licensing, permitting, and other regulatory procedures should be mapped to illustrate the difficulties of small business operators face and serve as a means to lessen that burden.

Third, **<u>build the capacity of Ukrainian institutions and professionals to support its development</u>**. Finance, regulatory, educational and legal institutions, and professional service and consulting practices all need basic training and practical experience applying franchise principals to support industry growth. This know how can be transferred to Ukraine as it has in other countries, such as Russia.

Fourth, **<u>adopt a comprehensive approach that will ensure the best use of available resources.</u>** When undertaken simultaneously, the legal and regulatory work, pilot franchises, and capacity building and promotion, can be a potent force for change. Done in isolation their impact is materially diluted. Existing programs can not support franchising, even at low levels of penetration. Given their make up and understanding of franchising, the most that could be expected is simple distribution of materials and academic style workshops. Implemented in isolation, these are unlikely to bear any fruit for small businesses. As was described earlier, their programs and resources can however be leveraged in a comprehensive program that trained their staff, provided hands on experience, and brought real expertise to Ukraine.

A comprehensive approach would have three basic components as summarized below, and could be implemented simultaneously in three or more phases:

1. **Establish the legal and regulatory framework**
   - support reform of enabling laws such as intellectual property rights & trademark protection
   - establish licensing & disclosure requirements
   - identify tax or other incentives for foreign/domestic investment
   - simplify regulatory compliance and ensure transparent and consistent enforcement

2. **Strengthen or create the institutional and professional skills pool**
   - build capacity, through hands on training of managers, local professionals such as legal, financial, and management advisors
   - build capacity of banks and other financial institutions to finance franchise operations as a low risk, small business lending strategy
   - establish industry professional standards
   - establish commercially viable self-regulatory body that will serve as a resource and self-promoting industry organization

3. **Strengthen or create actual franchise operations**
   - overcome practical constraints of establishing franchises
   - use as a means to build local franchising expertise
   - mobilize local capital and create examples for firms to emulate
   - create new jobs, businesses, and investment opportunities

## Appendix A - Law on Franchising

**Comments on the need for and content of**
**The Proposed Civil Code - Chapter 74 - Franchising**[1]

1. There are relatively few countries where there is an explicit law on franchising, since nearly all aspects of the franchise relationship are covered by other enabling laws. The US is the most prominent exception where the franchise law establishes disclosure requirements for the franchisor. Even in the US however, the law goes no further in defining the relationship between franchisee and franchisor, leaving this to be covered by the franchise agreement itself.

2. In legal opinion, provided by Philip Zeidman (of Rudnick, Wolfe, Zeidman and Epstein) under USAID funded projects in Russia Kazakstan and Kyrgystan, on very similar Civil Code Chapters on Franchising, he states the following " We believe that there is overwhelming evidence to suggest that no law on franchising is required, or advisable. In virtually every country in the world franchising has prospered in the absence of laws "permitting" or "governing" franchising. This is the case for several reasons:

a) The existing commercial laws in most countries are quite adequate to accommodate franchising transactions. e.g. contract laws, agency laws, trademark laws, competition laws etc.

b) If there is any evidence of abuse, or the need for remedial action, that can usually limited to the particular industry in which it occurs e.g. the petroleum industry.

c) Those concerned with the need for economic growth that franchising can create, are increasingly sensitive to the fact that, franchisors, faced with a variety of countries from which to choose (for their international development) are likely to avoid

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[1] **a translated copy of Chapter 74 is provided with this Appendix**

those with onerous legislation *(the latter point applies specifically to foreign franchises of course, but domestic developers may be similarly inclined to avoid franchising if laws are in any way hostile).”*

3. On an international level, a working group on franchising of UNIDROIT in France decided - after 8 years of studying the desirability of legislation on franchising - not to propose a model law on franchising and published a study text on franchising instead. Likewise, the Geneva based WIPO decided in 1994 not to promote specific franchising legislation but limited its effort to a franchising guide.

In those countries, other than the USA or the NIS, where a franchise law has been introduced - France, Brazil and Mexico - the main focus is on disclosure rules, i.e. the information that the franchisor is required to disclose, by law , to prospective franchisees so that they may make a reasoned decision before committing to the franchise. *(Such disclosure is typically provided elsewhere under local franchising association codes of ethics).*

4. It should be noted that the drafters of the Russian franchise law, in the light of these comments, offered the following reasons for introducing a Chapter on Franchising in the revised Civil Code:

a) Considering the fierce dispute between market oriented economic civil lawyers and administrative economy oriented lawyers, the drafters introduced in the Civil Code many forms of business transactions in an effort to deprive the economic lawyers of “arguments that may be counter productive to the reform effort”

b) The Chapter on Franchising in the Code also serves as an explanation of the basics of franchising. Seen from an educational point of view, the Code sets out and explains various types of business transactions and forms of distribution available to market participants. Although the Code does not prohibit transactions which are not specifically mentioned in the Code, the drafters considered it necessary to identify as many transactions as possible taking into account the inclination of Russian market participants not to use certain forms of transactions unless they are specifically mentioned in the law. We encountered a similar reaction in Kazakstan and discussions in the Ukraine during this project have indicated that this may be a particularly important point.

c) The drafters in Russia feared that if franchising was not specifically regulated in the Civil Code, others would initiate legislation on franchising separate from the Code. To avoid the adoption of a "bad law" on franchising, the drafters preferred to regulate the subject within the Code and assure the introduction of legislation that would develop, not impede, franchising in Russia. Similar arguments were advanced in Kazakstan and Kyrgystan. It can only be judged by Ukrainian market reformers whether this point is relevant in the Ukraine today.

In the light of the above, and in particular the discussions with the interested parties during the time spent in the Ukraine, it is the opinion of the Sibley consultants that, provided there are no major impediments contained within the new Code, there are no serious disadvantages to the inclusion of a chapter on Franchising in the Civil Code. It would be very important , however to take qualified legal advice on the exact content of the Chapter so that it will enhance, not hinder, the development of franchising in the Ukraine. Specifically, but not exclusively, the following **Articles** give cause for concern:

**Article 1161: The obligations of the owner of the right (franchisor) to liability for claims filed against the user (franchisee)**

This Article implies that the franchisee is the "agent" of the franchisor. This goes against one of the basic principles of franchising, which is that the franchisor and franchisee are independent businesses. (The liability for products manufactured by the franchisor and supplied to the franchisee are a separate issue).

**Article 1164 Termination of the franchise agreement**

Provisions for termination and actions thereafter are typically agreed between the parties and included in the franchise agreement. This article implies that such agreements might be superseded and does not address such issues as the rights, or otherwise of the user (franchisee) to continue to operate the same business in the same premises.

**Article 1165. The franchising agreement being in force when the parties to the agreement change.**

This article appears to allow for the transfer of the franchise to a third party without reference to the franchisor. The franchisor is always at pains to ensure that the franchisee is selected against criteria likely to predict success. The transfer of the franchise to a third party, whether by contract or as the result of the death of the franchisee, should be carried out only in the context of the application of those criteria to the potential, new franchisee.

**The principal value of a law on Franchising in the Civil Code may be to dignify the concept, i.e. to recognize it as a legitimate way of conducting business in Ukraine. In the context of previously State controlled economy, this has cultural importance beyond the actual provisions of the law itself.**

**Appendix B - Scope of Work**

## UKRAINE FRANCHISE INITIATIVE

## A. BACKGROUND

The Ukraine privatization program has resulted in the transfer of hundreds of state-owned entities into private hands and other market reform initiatives have established the basics of a functioning marketplace. These reforms promise skeptical politicians and aspiring entrepreneurs the opportunity to invest and reap the returns of a free market. The lack of business experience however presents a real risk that too many new entrepreneurs and investors will fail in the chaotic and sometimes hostile free market.

Two approaches have been widely used to counter this risk and assist businesses to succeed in a post privatization environment, enterprise restructuring and business resource centers.

Most enterprise restructuring approaches seek to provide a highly focused technical assistance effort, targeted at the most strategically important enterprises that are eager to change. These programs are challenged to; 1) gauge management's willingness and ability to change; 2) deliver a full range of services to many enterprise types; 3) achieve economies of scale, and; 4) ensure changes are followed through once they are initiated.

USAID has invested widely in "business resource centers" to provide advice to new owners and new entrepreneurs. The challenges of this approach are it's comparatively high cost, sustainability without continued donor support, a supply driven approach, and a diffuse set of services.

Whether it is restructuring thousands of formerly state-owned enterprises now in private hands, or accelerating the emergence of new small enterprises, delivering on the promise of economic opportunity demands from donors new and innovative approaches.

**Franchising**, as an alternative enterprise restructuring and development strategy offers solutions to many of these problems. It is the most effective private sector business start up and expansion strategy ever developed, and the world's fastest growing source of independent businesses. It is rapidly being adopted by donors as well.

At its core, a franchisor sells to the franchisee a "franchise package" and the right to operate it in a market. The "package" consists of a standardized set of accounting, management, operating, training, marketing and financial systems. The franchisor trains the new franchisee in the package and commits to on-going technical support.

In development terms, the franchisor is training new owners and managers, delivering technical assistance services, and restructuring business operations along commercially viable lines. The franchisor is the ideal "restructuring agent" in the context of enterprise restructuring programs, and "business counselor/trainer" in the context of Business Resource Centers. A franchise program with a systems approach is more effective than these two because once started, it is market driven, and the franchisor has a long term, vested interest in creating a successful small business expansion of his system. Thus a franchise program is less risky, more sustainable, and more cost-effective.

A number of Ukrainian institutions have begun seeking information about how to use franchising as a tool for economic development. The Ministry of the Economy and the Center for Post-Privatization Support requested briefings and background materials. Other Ministries and USAID Projects have developed franchise concept papers or expressed an interest in building this methodology into their projects.

Since franchising has the potential to impact significantly on a large number of Ukranian enterprises, an initial assessment is warranted, to identify the key constraints and lay out what could be accomplished by a variety of institutions and projects to overcome them. This could be followed by a more comprehensive set of activities if warranted.. This proposed work plan is for a three week, Phase I Assessment.

The objective is to assess the feasibility of a franchise program for Ukraine and define its parameters.

## B. TASKS

The following tasks will be performed over three week period in January;

1. Conduct a preliminary survey of market segments conventionally suitable for franchise application and identify potential Ukrainian enterprises. These may include, but not be limited to, laundry, food, training, freight forwarding, or gasoline retailing and distribution.

2. Identify the legal and regulatory framework currently applicable to franchise operations and principal changes needed to improve it.

3. Survey banking, leasing, and development financing institutions regarding their experience with franchising

4. Identify Ukrainian institutions with the potential to serve as counterparts for education and outreach services, such as institutes, universities, business associations, etc., and

5. Survey existing USAID, such as the Volunteer Alliance, and other donor projects as available, for potential collaboration on a franchise program with ongoing initiatives.

6. Brief the USAID Mission, interested Ministries and development institutions, and USAID and other donor projects as available

## C. DELIVERABLES

The results of this Phase I exercise will be an accurate assessment of the feasibility of a franchise development program, to include actions the GOU, donors and others could do to improve the environment for franchising even if Phase II resources are not available.

## D. SKILLS, TIMING, LEVEL OF EFFORT

This will be carried out by two experts with at least ten years of franchise experience in international markets, and extensive economic development experience, including Eastern Europe and the Former Soviet Union. Completion of the above tasks will require 20-24 person days of expatriate level of effort.

The exact dates of in-country work will be agreed to with the Mission prior to arrival in country.

## E. REPORTING

The Consultant will complete the following:

1. One or more oral briefings, as required, for Mission personnel, GOU, USAID Contractors and Grantees regarding findings, and preliminary recommendations before departing country.

2. A written report within 15 days of departing Ukraine, describing findings and final recommendations, to include selected steps USAID and other institutions could take immediately to advance franchising, and an outline USAID strategy regarding a future franchise development program.