Case studies

Learning From the Largest: Franchising in Emerging Markets – Case Study

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This case is suitable for undergraduates and graduate students in a course on franchising, global strategy, international business and/or entrepreneurship. Within any of these modules, it would be most appropriate as part of a unit on investing abroad, expanding internationally, and entering foreign markets.

Teaching Objectives

- Discuss opportunities and challenges franchisors face when entering emerging economies.
- Understand how to analyze a foreign market opportunity using the PEST analysis framework.
- Explore how franchisors choose an entry strategy when entering an emerging market.

Introduction

Navigating emerging markets poses a distinct challenge for first-mover emerging franchisors, given the scarcity of guidance in this relatively uncharted territory. The theoretical challenge has been that learning from first-hand experience may be impossible when the firm seeks to replicate its international strategy from developed countries in emerging markets (Kelepouris, 2023). Most emerging franchise firms operate as privately owned entities, resulting in limited accessible data concerning their decisions, outcomes, and motivations. Consequently, emerging franchisors entering these markets find themselves in a knowledge gap. Considering this, they can derive invaluable insights from the world's largest franchisor, McDonalds, which has successfully negotiated the complexities of entering new and diverse markets. Drawing on the experiences of this industry leader becomes an essential strategy, enabling emerging franchisors to decipher the unique challenges and capitalize on the opportunities that arise in the dynamic landscape of emerging markets.

Consider the intricate circumstances surrounding McDonald's deliberation on entering or abstaining from involvement in the unpredictable Moldavian economy during the 90s. Despite the apparent scarcity or ambiguity of information, it mirrors the exact conditions and data available to McDonald's during that era. This scenario closely parallels the challenges contemporary emerging franchisors encounter when venturing into specific emerging markets.

McDonald's Business Model & Expansion Strategy

Franchising, as an organizational structure, arises from a contractual agreement between the Franchisor (Parent Company) and the Franchisee (Company or Individual granted a license to use the Parent Company's intellectual property). This arrangement typically involves the franchisor granting the franchisee a license in exchange for a yearly flat fee and royalties or sales commissions (Shane, 1996).

The widespread success of franchising is evident in its substantial impact, accounting for an estimated $800 billion in gross sales in the U.S. alone and representing forty percent of retail trade (Swartz, 2001). Its pervasive influence extends to markets in the US, Canada, and parts of Western Europe, making emerging markets an enticing focus for international franchise investment. The growth of franchising in emerging markets has been remarkable since the 1980s, exemplified by the surge in franchisors in Brazil and the substantial international sales of top U.S. food chains (Welsh et al., 2006).

McDonald's, a prominent player, operates its franchised restaurants under three structures: conventional franchise, developmental license, or affiliate (McDonald's, 2015). The conventional approach involves McDonald's owning the land and building, while the developmental license approach requires licensees to provide capital for the entire business, and the affiliate approach involves equity investments in limited foreign affiliated markets. McDonald's various structures align with two primary categories for franchises expanding into international markets: direct investment, where the franchisor operates a company-owned store, and indirect investment, which includes the developmental license or affiliate approach. The latter, especially the Master Franchisee model, is favored by international firms entering emerging markets due to its benefits such as local market knowledge, resource access, faster adaptation, and expedited development of prospective franchisees (Nair, 2001; Welsh et al., 2006).

Opportunity

Moldova, a former USSR country nestled in Eastern Europe between Romania and Ukraine, declared its independence in 1991. Initiating a shift toward a market economy in 1992, the country replaced the Russian Ruble with the Moldovan Leu in 1993 (*The World Factbook: MOLDOVA*, 2023). Amidst its strategic foray into Eastern Europe, McDonald's directed its attention towards Moldova in the mid to late 1990s, contemplating foreign direct investment and singling out the capital city, Chisinau, as its initial target (McDonald's Press Office, 2017). The decision for McDonald's to enter Moldova wasn't a matter of if but rather when and how. The dilemma encompassed considerations of direct or indirect investment, potentially incorporating a hybrid strategy akin to the approach taken in Belgrade, Yugoslavia. Given Moldova's status as a transitioning economy, characterized by specific challenges for foreign investors due to structural issues (Estrin & Meyer, 1998), McDonald's drew upon lessons learned from previous experiences in emerging markets.

Navigating this opportunity involved a nuanced analysis of Moldova's institutional landscape, where strong market institutions could potentially allow reliance on internal resources or joint ventures with local firms leveraging in-country networks (Meyer et al., 2009). Recognizing the inadequacy of a resource analysis alone, McDonald's delved into understanding the formal and information institutions of Moldova. This approach aligns with the tenets of New Institutional Economics, emphasizing the role of institutions in reducing transaction and information costs, establishing stability, and facilitating interactions (Hoskisson et al., 2000). The intricate differences in institutional infrastructures between emerging and developed markets played a pivotal role in shaping McDonald's strategic orientations.

To craft a suitable entry strategy for Moldova, McDonald's engaged in a comprehensive analysis. This involved assessing internal resources for competitive advantage, conducting a PEST analysis (political, social, economic, technologic) to gauge the opportune timing, and evaluating the pros and cons of direct and indirect strategies concerning both resources and Moldovan institutions. This meticulous approach allowed McDonald's to tailor a strategy that not only capitalized on its strengths but also aligned with the unique dynamics of Moldova's transitioning state.

PEST Analysis

Political Institutions

The dissolution of Communism in 1989 ushered in a new era of rapid-growth countries in Central and Eastern Europe known as transition economies. Committed to bolstering their market mechanisms through liberalization, stabilization, and the encouragement of private enterprise, these nations, including the Republic of Moldova, sought transformation (Hoskisson et al., 2000). Designated as an emerging market by the European Bank for Reconstruction and Development in 1998, Moldova faced a unique paradox in its political landscape.

Despite being the poorest country in Europe, marred by ethnic conflicts and undergoing a significant economic downturn, Moldova maintained a commendable commitment to free speech for over a decade. Its elections, deemed free and fair by post-Soviet standards, and a relatively independent judiciary highlighted the complexities of its political environment (Solonari, 2003). The newly independent Republic of Moldova exemplified "pluralism by default," where elites benefited from weak networks inherited from Soviet times. Characterized by strong individualism amid political polarization on identity issues, the civil war conflict between Moldova and Transnistria played a pivotal role in shaping political discourse throughout the 1990s.

As Romania progressed towards Council of Europe membership in the summer of 1993, Moldovan parliamentarians faced a dichotomy between "West" and "East." This choice influenced the country's trajectory towards Romania, Europe, or Russia and former Soviet republics (King, 1994). Stalled reforms, a stagnant economy, and persistent political instability tarnished Moldova's image in the late '90s (Solonari, 2003).

The public administration in Moldova grappled with challenges, marked by a lack of trained personnel, unclear appointment rules, and perceived corruption and incompetence. Loyalty to the Communist party, a relic from Soviet times, ceased to exist after independence, leaving a void filled with unclear and non-transparent rules. Low administrative capabilities were identified as a fundamental cause of Moldova's difficulties, with little effort to address the issue (Solonari, 2003).

In navigating these challenges, Moldova passed the "Law of the Republic of Moldova on Franchising" (No. 1335) on January 1, 1997. While this law didn't explicitly outline required disclosure documents, it specified essential contents of the franchise agreement (Peters, 2015). Moldova's franchise law, encapsulated in Law 1335 (1997), outlined key provisions, including the obligation for all parties to deal in good faith, the necessity of clear statements on reciprocal obligations, contract duration, termination, and extension. Additionally, it delineated the franchisor's duties related to licensing and supporting the franchisee, along with the requirement for the franchisee to pay recompense calculated based on the franchising program's contribution to sales volume.

Economic Institutions

Economic Trends

Moldova faced severe economic challenges in the aftermath of the USSR's dissolution, ranking among the hardest-hit post-Soviet countries with a staggering 40% to 50% deterioration in terms of trade. The year 1992 witnessed a significant surge in the costs of petrol, natural gas, and coal, posing formidable challenges. In response, earnest economic reforms took root in the latter half of 1992-1993, culminating in the successful introduction of the national currency, the leu, which effectively curbed inflation (Solonari, 2003).

The GDP of Moldova experienced a sharp decline in 1992 and 1994, attributed largely to drought and war. Following the Russian economic crisis in August 1998, prices for food rose by 33%; for non-food by 38%; and for services, such as energy, public utilities, and telecommunications, by 63%. The CPI (consumer price index) of food increased from 168.8 in January of 1995 to 257.2 by December 1999 (International Monetary Fund, 1999). As McDonald's contemplated entry into Moldova in the mid-1990s, expectations of economic resurgence were palpable both domestically and internationally.

Unemployment Rate and Workforce Factors

Moldova endeavored to attract foreign investors by offering special tax incentives and a low-cost labor pool. In 1998, the country ranked as the second-poorest in the region, with an average monthly wage of $47 USD. Government statistics revealed that around 80% of the population lived below the poverty level, with 10% of the rural population earning less than one-quarter of that level. A majority of citizens struggled to afford basic necessities like fish, meat, milk, and dairy products regularly, leading to minimal excess spending (US Department of State, 2000).

While the officially reported unemployment rate was less than two percent, a mid-1998 labor force study found that 1.7 million people, constituting 49% of Moldova's total population, were employed, resulting in an unemployment rate of approximately 9.5% (International Monetary Fund, 1999). The International Monetary Fund cautioned that this figure substantially understated the actual unemployment rate, with agriculture being the largest employer, representing about 40% of total employment.

Social

After 50 years of Soviet propaganda the national identity of citizens is torn between being Moldovan or Romanian (Ma-Ni, 2017). Regardless of ethnic identification, there is a sentiment of disarray as an independent state whose output has diminished since the fall of the Soviet Union. Factors such as the GDP dropping as much as 50% and inflation raising as high as 2,200% has led individuals to still rely on the barter system in the 90s (International Monetary Fund, 1999). The economic hardships caused a steep contraction in birth rates and also a migration both legally and illegally out of the country looking for work and a better life (Makhanov, 2024).

Technology Resources

Moldova underwent varying stages of infrastructural development following the dissolution of Communism in 1989. Resistance to privatization lingered among the Communists, particularly in key sectors like wine production, tobacco, and telecommunications. The privatization of these enterprises moved forward hesitantly due to unattractive offers and the enterprises' poor condition after a decade of mismanagement by the state (Solonari, 2003).

In the late 1990s, significant institutional reforms enhanced the regulatory environment and performance of Moldova's electricity and gas sectors. Two-thirds of the electricity distribution network underwent privatization, marking improvements in the energy sector (The World Bank, 2016).

Unsustainable land use and lack of proper waste management during the Soviet era had severe consequences on Moldova's water quality. Over 90% of wells, the primary source of rural drinking water, exceeded national standards, with high E. Coli counts. Infrastructure deterioration, minimal maintenance, and inadequate investment led to severe interruptions and increased pipe breaks (Michel, 2011; The World Bank, 2004).

Moldova witnessed the establishment of its first internet service provider (ISP), Relsoft, in 1992, with the .md domain recorded in 1994. The first "Fiber to the Building" internet connection, linking Bucharest and Chisinau, was established in 1996, while Relsoft began offering dial-up internet in 1995.

The agriculture-dependent economy faced challenges due to poorly maintained roads, trucks, and railways. Aging trucking fleets, poor-quality rolling stock in railways, and limited air services hampered trade. Leasing arrangements for trucks were underdeveloped, and the transportation infrastructure faced setbacks due to damage and thefts during transit (Bouton et al., 2004).

The agricultural sector's transformation saw collective and state farms owning 90% of agricultural land in 1990, reduced to 10% by individual farms in 2001. Livestock production declined significantly, and the agri-food production chain faced challenges due to a lack of collaboration, critical infrastructure, and technological advancements (Coser, 2012; Moroz et al., 2014).

Questions

Equipped with the information outlined above, McDonald's confronted pivotal decisions. How would you advise them to proceed? Would your recommendations differ if you were consulting for an emerging franchise system?

1. Would you recommend McDonald's expand into Moldova in the mid 90s? Why or Why Not? Explain in detail.
2. Should McDonald's enter the Moldova through a direct or indirect investment? Why? Explain in detail.
3. How can McDonald's provide a consistent product offering and experience in a country with no franchise infrastructure?
4. In 1998 McDonalds entered Moldova through a corporate-owned store, subsequently transitioning to a developmental license. Presently, as of 2023, there are nine McDonald's outlets in Moldova. What can emerging franchisors learn from McDonald's expansion into Moldova that can be applied to their own foreign market expansion strategy?

These questions underscore the complexities of international expansion, particularly in emerging markets, offering

valuable lessons for emerging franchisors seeking to navigate similar challenges.

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Teaching Note

ASSIGNMENT QUESTIONS

1. Would you recommend McDonald's expand into Moldova in the mid 90s? Why or Why Not? Explain in detail.
2. Should McDonald's enter Moldova through a direct or indirect investment? Why? Explain in detail.
3. How can McDonald's provide a consistent product offering and experience in a country with no franchise infrastructure?
4. In 1998 McDonalds entered Moldova through a corporate-owned store, subsequently transitioning to a developmental license. Presently, as of 2023, there are nine McDonald's outlets in Moldova. What can emerging franchisors learn from McDonald's expansion into Moldova that can be applied to their own foreign market expansion strategy?

ANALYSIS

1. Would you recommend McDonald's expand into Moldova in the mid 90s? Why or Why Not?

While there isn't a definitive right or wrong response to this question, a thorough analysis of the facts suggests that, during that particular period, the recommendation would lean towards refraining from entering Moldova. Moldova faced multifaceted challenges, spanning from governmental corruption and inefficiency to the country's antiquated and dilapidated infrastructure. The exceptionally high unemployment rate, coupled with the lowest salary in Europe, made it challenging to envision a sustainable and viable earning potential over an indefinite period.

Becoming the first international fast-food franchisor in Moldova would necessitate establishing collaborations with suppliers and food processors, teaching them the specific methods required by McDonald's for consistency and efficiency. Additionally, Moldova was in a phase of reconstruction and development, rendering it inherently fragile. Stable formal institutions were lacking, and those that existed were often young or subject to change. The aftermath of the Soviet Union's collapse and the ongoing efforts to unite the country culturally and ideologically significantly impeded rapid development. While entering at this juncture could have provided McDonald's with a first-mover advantage, it also carried substantial risks.

Moldova's geographical proximity to other emerging markets, however, could serve as an advantage for McDonald's. It could use Moldova as a pilot location to test strategies before venturing into markets with similar cultural traditions. The counterargument for entering Moldova centers around timing. The post-Berlin Wall era presented new markets with low labor costs, yet these markets were underdeveloped and lacked the formal governmental institutions needed to minimize risk. The decision to enter such a market revolves around branding and the myriad benefits associated with being the first mover, creating a loyal customer base for years to come.

2. Should McDonald's Moldova through a direct or indirect investment?

Implementing a direct investment strategy emerges as the most prudent choice for McDonald's in entering Moldova. This approach allows the seamless transfer of core values, tacit knowledge, and mission from existing employees to local staff, fostering cultural understanding crucial for success in a nation unfamiliar with international franchise restaurants. Moreover, it provides access to local suppliers and transportation networks, enhancing operational efficiency.

For the initial entry scale, a cautious approach suggests starting with a single restaurant in the capital, Chisinau. This decision hinges on the concentrated wealth, population, and influence found in the capital, mitigating uncertainties associated with the new market. Subsequent expansion can occur progressively as progress and profitability are achieved.

While the direct investment approach is favored, an alternative consideration could have been a joint venture. This model is optimal for knowledge transfer, especially considering Moldova's workforce limitations at the time. However, the lack of experienced individuals due to the absence of comparable firms still positions direct investment as the superior choice.

The benefits intrinsic to the direct approach play a pivotal role in the success of the franchise in a developing country like Moldova. Direct involvement allows McDonald's to exercise maximum control and influence, crucial in a region where entrepreneurship and franchising expertise may be limited. The long-term gains outweigh initial costs, enabling the franchisor to directly train Moldovan workers and introduce essential resources that might be otherwise inaccessible.

Recognizing the importance of navigating informal institutions, the franchisor must be culturally sensitive when entering Moldova. While direct investment involves substantial influence, it is imperative to handle cultural differences appropriately, ensuring a harmonious integration into the market.

3. How can McDonald's provide a consistent product offering and experience in a country with no franchise infrastructure?

Ensuring a consistent product offering and experience in a country like Moldova, devoid of an established franchise infrastructure, poses one of the most significant challenges for a franchisor like McDonald's. To overcome this hurdle, McDonald's can leverage the local employees' knowledge to identify and engage with the best local suppliers. Local insights also prove invaluable in determining the most reliable transportation methods for timely and secure supply deliveries to the restaurant. Subsequently, McDonald's expertise in storage and refrigeration techniques, coupled with their substantial financial resources, becomes instrumental in maintaining the freshness of the food—a crucial aspect in providing a consistent product offering.

In addition, McDonald's benefits from tapping into the local employees' knowledge to assess the reliability of suppliers and delivery personnel, ensuring products are grown and delivered as promised, without any issues such as theft. Understanding local values and cultural norms becomes imperative in shaping the restaurant's atmosphere and menu to resonate with Moldovan citizens. Successfully navigating these tasks demands a strategic blend of McDonald's global business acumen and the nuanced understanding provided by local knowledge.

Furthermore, McDonald's must craft a menu that not only ensures consistency but also resonates with local consumers. Given the challenges posed by poor infrastructure in Moldova, relying on local suppliers helps mitigate risks associated with inconsistent supplies by limiting transportation distances. Prudence in adhering to formal laws, rules, and regulations is crucial to avoid legal pitfalls, while addressing informal institutions is vital for consumer acceptance and satisfaction.

Recognizing that immediate prosperity may not be realistic, McDonald's must approach the venture with a continuous learning mindset. Constant adjustment through trial and error is necessary to discern what resonates positively and what may hinder success in this unfamiliar territory. The language barrier presents an additional challenge, emphasizing the importance of hiring locally to bridge communication gaps.

McDonald's success hinges on excelling in both product offering and overall customer experience. In a market with limited experience in the fast-food industry, direct investment is imperative initially, with the potential for transitioning to an indirect method as the market matures. Building relations with both formal and informal institutions within the country is paramount. A nuanced approach that incorporates the globally recognized golden arches theme while respecting local norms ensures a delicate balance. Challenges such as liability and economic disparities must be diligently addressed, considering the potential impact on operations at all levels of the supply chain.

4. In 1998 McDonalds entered Moldova through a corporate-owned store, subsequently transitioning to a developmental license. Presently, as of 2023, there are nine McDonald's outlets in Moldova. What can emerging franchisors learn from McDonald's expansion into Moldova that can be applied to their own foreign market expansion strategy?

The insights gained from McDonald's expansion into Moldova offer valuable lessons applicable to foreign market expansion. Decisions regarding international expansion demand meticulous scrutiny of the target region, encompassing an exhaustive analysis of political, economic, social, and technological aspects, as well as the nation's activities and the organization's capabilities. Key considerations in this process encompass thorough market research, thoughtful entry strategy formulation, strategic partnerships and alliances, sourcing, supply chain management, local adaptation, and the imperative of continuous monitoring and adaptation. Each of these factors holds substantial weight and should be thoroughly examined when contemplating expansion into a foreign market. No matter how thorough the research, making educated guesses still entails an element of risk. Despite facing seemingly unfavorable odds, McDonald's decision proved to be a successful bet.

WHAT HAPPENED

McDonalds first entered Moldova in April of 1998 by opening its own company owned store in the capital Chisinau. In 2009, McDonald's Corporation announced the transfer of McDonald's Moldova to a Developmental Licensee (DL) structure. Presently as of 2023 there are nine McDonalds locations in Moldova (www.mcdonalds.md/restaurants).