More (Inclusive) Entrepreneurship in South Africa: The Role of Franchising

Bailey Klinger

CID Research Fellow and Graduate Student
Working Paper No. 137
June 2022

Working Papers
Center for International Development
at Harvard University

More (Inclusive) Entrepreneurship in South Africa: The Role of Franchising

Bailey Klinger
The Growth Lab at Harvard University

June 2022

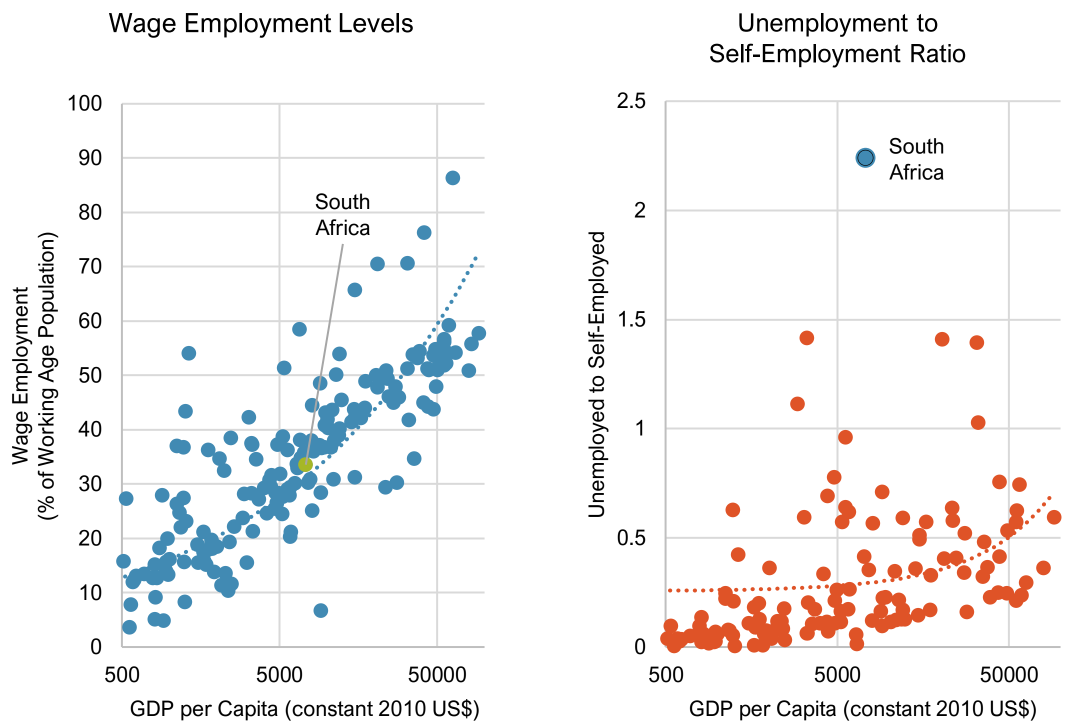
Abstract

This paper explores franchising in South Africa, and its potential to help resolve the economy's challenges of low entrepreneurship and concentrated ownership. South Africa features a large franchising sector, with half a million formal workers and a large number of small businesses owners competing directly with vertically integrated chains. Traditional franchising may not have much space for further growth as a percentage of the economy, but it can be made more inclusive with innovations in franchise finance that broaden the base of potential franchisees, as well as enforcement of consumer protections to ensure franchisee-franchisor relationships are balanced. The expansion of the franchising model to less capital-intensive business concepts and serving lower-income consumers (micro-franchising) is one area with expanding growth potential for the country, while the application of the franchising model to public services and socially driven organizations is less promising. Finally, while the franchising model is only directly applicable to particular sectors, there are features of franchising and the capabilities built up around the franchising that could be applied to other priority areas of the economy, in particular to smallholder agriculture. The success of traditional franchising shows the power of a menu of standardized proposals and contracts in a marketplace with a range of franchisors (in this case up- and downstream agriculture corporates) offering different opportunities to potential franchisees (in this case smallholder farming communities), along with training and technology transfer at scale.

1. Introduction

As explored in detail in Shah (forthcoming), while the percentage of formal salaried workers is not low in South Africa given its level of income, the country is an outlier in terms of low self-employment, particularly given the high unemployment rate. Another feature of the South African economy is that a smaller number of larger firms continue to dominate many sectors (Fedderke Obikili and Viegi 2016, Aghion Brown & Fedderke 2008). There is a need to generate more, and more inclusive, entrepreneurship in the country to reduce the degree of concentration of ownership and create new opportunities for a larger number of South Africans.

Figure 1. South Africa's Labor Markets



Source: author's elaboration based on World Bank WDI

To this end, entrepreneurship and small business growth have featured heavily in the country's growth strategies throughout the years (e.g., the Accelerated and Shared Growth Initiative for South Africa of 2008; Zuma's 9-point plan to boost economic growth in the 2015 State of the Nation address, and the National Treasury's 2019 'Economic transformation, inclusive growth, and competitiveness: towards an economic strategy for South Africa'). But progress remains elusive, and unemployment and concentration of ownership continue to challenge the country.

One area of the South African economy that has received relatively little attention within these efforts is the franchising sector. This is surprising, and a gap worth filling, for the following reasons. First, franchising is explicitly an alternative form of business organization to vertical integration. Franchises compete directly with fully integrated firms in the same industry. For example, Starbucks, which is integrated, competing with franchised coffee shops like Vida e

Caffe. In fact, most franchisors themselves operate a dual distribution model, and run some fully vertically integrated units in parallel to franchised units (Blair & Lafontaine 2005). What this means is that in some cases, growth through franchising is both a superior option for the expanding firm and at the same time increases self-employment and broadens ownership in the South African economy. Understanding why this distributed ownership works well in some areas of the South African economy could bring lessons for other sectors which feature highly concentrated ownership.

The second reason to examine franchising in the context of South Africa's growth challenge is that unlike other areas of the South African economy where progress has not matched expectation, the country stands out as a success case in franchising. As detailed in Section 2, the franchising sector is surprisingly large in South Africa, in franchising's share of GDP and its contribution to employment. The data suggest that there are more low-skilled formal jobs in the franchising sector than there are small-scale agricultural workers in the economy. Yet the former does not seem to receive much attention (as can be seen in the growth strategies mentioned above, both of which discuss smallholder agriculture but not franchising).

The purpose of this paper is to explore franchising in South Africa to evaluate if and how it can contribute to greater entrepreneurship and more distributed ownership in the broader South African economy. We will discuss the economics of franchising, the state of traditional franchising in South Africa, and the potential areas for growth of this sector. In addition, we will explore some new directions where the traditional franchising model may be expanded, such as micro-franchising and social franchising. Particular attention will be given to how aspects of the franchising model, as well as South Africa's broader economic capabilities in enabling traditional franchising, could be leveraged to a particularly challenging sector of the economy: smallholder agriculture. The paper concludes with a summary of policy implications to achieve this potential.

2. The Economics of Franchising

Franchising is a strategy of corporate expansion found primarily in geographically dispersed service businesses such as restaurants and hotels. Instead of a corporation directly owning each unit delivering its product or service and managing the employees at that location in a vertically integrated structure, the corporate (or franchisor) licenses the concept to disperse owners (franchisees) who own and operate the delivery units. The franchisees must abide by terms of the franchise agreement including detailed operational and production guidelines, but in other senses are more like independent entrepreneurs than managers. They must find start-up capital, and individually take the risk to launch and operate the business themselves with relative independence, directly earning the profits from their unit (less a royalty fee to the franchisor).

The reason an expanding firm may opt for franchising is based on the agency costs for a geographically dispersed set of professional managers weighed against the incentives for innovation and contracting costs of a network of more independent franchisees. As such, the economics of franchising falls directly within the broader economics literature on vertical integration (transaction cost economics as in Wiliamson 1975, 1985, and Property Rights theory as in Grossman & Hart 1986, Hart & Moore 1990).

A clear way to understand this is to think of franchising as a middle ground with forces pushing towards two poles. First are forces pushing towards disintegration. When the quality of a product or service depends significantly on its local delivery, it is useful to have ownership and management as close as possible to the end customer because of the higher-powered incentives that result. For example, the product quality of a night at a hotel or of a freshly prepared steak depends significantly on the work of front-line employees directly interacting with the customer. Managing such a geographically dispersed workforce is difficult and expensive from a centralized headquarters, which pushes towards disintegration. Compare producing a steak dinner to producing a product like a television, where quality doesn’t depend on local delivery and therefore production can be more centrally managed and controlled. Innovations in product/service quality for products like televisions happen in centralized R&D and plants, not at the touchpoints with customers. So the forces towards disintegration are greater in those sectors where there is geographically dispersed service delivery.

There are other forces pushing towards integration. When the agency costs of overseeing and incentivizing professional managers are lower, integration is more profitable because all profits remain with the single firm instead of being shared with other firms. Moreover, economies of scale in activities like R&D and purchasing push in the same direction. In particular, there can be steep economies of scale in product development and marketing. It is very expensive for every independent unit to develop a product and educate potential customers about it. Such an investment can be more worthwhile when each unit’s customers are and remain local, but mobile customers are more dispersed and therefore more expensive to reach, and they seek to limit their own search costs by following known brands which offer them a uniform product no matter where they are. If a consumer doesn’t want to spend the time figuring out what is a good restaurant in every shopping mall, they depend on a brand they know that operates across shopping malls. Therefore, particularly for products and services that serve mobile customers, there are forces towards integration with other units to provide a uniform product or service in multiple locations and share marketing and other costs across them.

These two forces help us understand why we see full integration in some sectors and complete disintegration in others. For example, plumbers provide a service that depends significantly on local delivery, similar to a restaurant, so front-line incentives and quality are important, and the agency costs of an integrated mega-firm of plumbers is high, making disintegration more profitable. Moreover, customers only need a plumber in one location, near their home. They don't use one near home, one near work, one in a mall they sometimes frequent on the weekends, and one at the airport they sometimes transit through, which is the case for restaurants. There are also few economies of scale for a common brand and standardization across plumbing services. So while the forces towards disintegration are strong, those towards integration are weak, and most plumbers are independent, with few vertically integrated companies providing plumbing services across multiple geographies. In manufacturing, on the other hand, vertical integration means quality can be controlled centrally, R&D and marketing costs can be spread across a larger number of customers, and agency costs for local managers and distributors are low because they are simply selling a finished product, which is why integration is more common.

Franchising is a middle ground between these two poles, and it emerges in cases where both forces are strong. In cases where local delivery matters for product quality and agency costs are high, but at the same time there are some important economies of scale from integration, that is where we often find franchise models thriving. In those cases, it is worthwhile for the franchisor to give a greater share of revenues to local owner-operators than if they were just salaried managers, and worthwhile for the franchisee to contribute to a central entity that designs the business concept and builds the brand that brings customers through the door. This is particularly the case in geographically distributed retail and services business with somewhat mobile customers, and that is where the majority of franchising activity is found (Blair & Lafontaine 2005).

It is important to note, however, that franchising creates significant costs. First there is simply the cost of the high-powered incentives. Franchisors' royalty rate is typically 3-6% (Blair & Lafontaine 2005), with the rest going to the franchisee. So franchisors give up a large share of the profits from their business concept. At the same time, franchisors still have to invest significantly in monitoring and control. This is because the umbrella brand only has value to the degree that customers can depend on a uniform product or service across the franchised units. However, particularly for non-repeat customers, each individual franchise operator has lower incentives to spend on product quality because that benefit spills over to other members of the franchise network, while at the same time they can free-ride on the quality investments of others in the network. Therefore, franchise agreements must specify operating procedures and minimum product quality standards in significant detail to avoid free-riding. These agreements must feature monitoring of quality by the franchisor, which is costly.

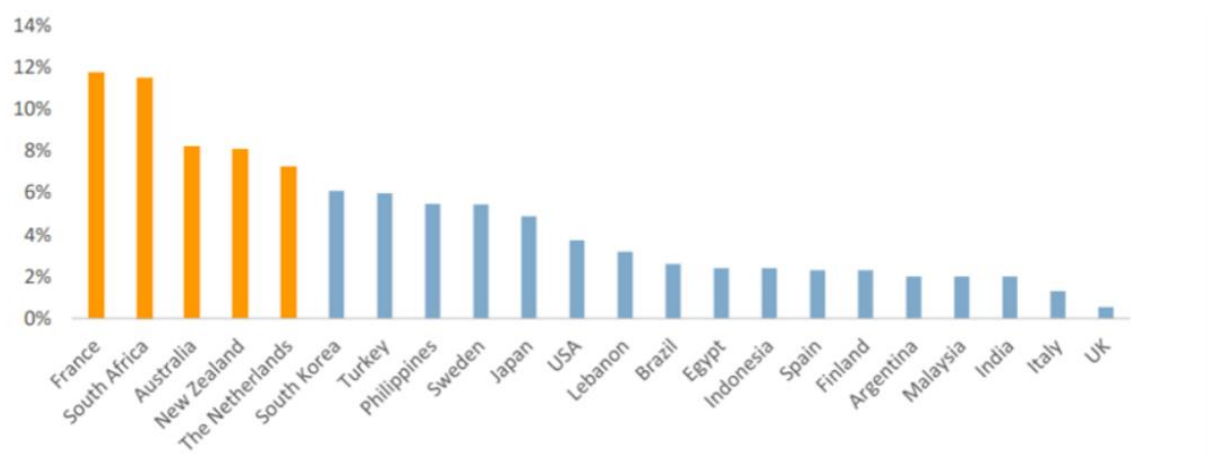
It is only worthwhile for franchisors and franchisees to bear these costs when the benefits of franchising justify them — that is, where product quality depends on local delivery but steep economies of scale for certain activities remain, and where customers that are mobile between local units value a uniform product or service between them.

These forces limit the direct applicability of the traditional franchising model to certain sectors of the economy. The economies of scale in manufacturing for example are a strong push towards integration. Similarly in agriculture, agency costs are much lower than in distributed services businesses because output and productivity of workers is easier to observe and incentivize. The incentive and transaction costs of franchising are justified where there are simultaneously benefits from high-powered incentives close to product/service delivery combined with economies of scale and high value of brand recognition for mobile customers. As such, franchising is almost exclusively found in restaurants, business aids and services (e.g., copying and printing), some home improvement and maintenance (cleaning, gardening), some non-food specialty retailing (body shop, GNC), convenience stores, automotive services (e.g., oil changes, tires), hotels/motels, and educational products/services (e.g., test prep, languages) (Blair & Lafontaine 2005).

3. Traditional Franchising in South Africa

Casual observation suggests that South Africa features a much more active franchising sector than its peers, and this has been the case for decades. Franchises feature heavily in the restaurant and retail sectors in South Africa. The World Franchising Council conducts a survey via its member associations and, according to that data, South Africa has the second highest contribution of franchising to national output in the world and is the only emerging market in the top five (Figure 2). According to South Africa's Franchise Association (FASA), there are approximately 850 franchisor brands active in South Africa, with 4,000 franchisees and 35,000 units. Most franchise units in South Africa are operated by multi-unit franchisees, which contributes to the scale. In the United States, the median franchisee has multiple units, with a small number of those operating very large networks of franchise units, and this also seems to be the case in South Africa (Blair & Lafontaine 2005). Interestingly, according to FASA, two-thirds of South African franchises are home-grown brands, rather than foreign brands, which is different from what is observed in other emerging markets and a legacy of more autarkic development during apartheid.

Figure 2. Franchising Output, % of GDP



Source: https://www.fasa.co.za/franchisings-massive-contribution-to-global-economic-output/ Derived from World Franchise Council (WFC)'s 2017 Survey on the Economy Impact of Franchising Worldwide. More rigorous studies are available in countries with detailed public data. For example, in the United States, Franchising is found to represent approximately 12% of GDP, and that this figure is largely unchanged since the mid-1980s (Blair & Lafontaine 2005). This US figure is inconsistent with the data provided by the World Franchise Council. The US Department of Commerce data includes both Traditional and Business Format franchises, and if you consider only Business Format franchises (removing franchised distribution systems like petrol stations) the figure is closer to the WFC's results. Yet conversations with members of the franchising sector in South Africa suggest that the WFC's figures for South Africa do include traditional format franchises. So, there are some reasons to be skeptical of the data quality in these figures. Regardless, even if incorrect in terms of levels, the figures should still be telling about the relative importance of franchising between the different countries in the Council's survey as long as the same criteria are used across countries. Moreover, they do match the anecdotal evidence in our conversations with sector experts that South Africa is a country with a relatively active franchising sector that has had a steady contribution to GDP for over 20 years.

What is clear is that franchising is an important contributor to formal employment in South Africa. According to FASA, there are 500,000 employees working in franchised units in the country. This is a large number. For example, Cousins (2018) estimates the total number of South Africans working in all types of small-scale agriculture to be approximately the same amount (400,000-700,000), almost all informal. The majority of these franchising jobs are relatively low-skilled customer service jobs and are formal jobs meeting legal requirements for pay, benefits and protections. Given the importance of growing formal low-skilled employment in the country, franchising should clearly be on the radar of policy makers. Yet it is surprising that, despite employing a similar number of people as small-scale informal agriculture, franchising receives much less policy attention as a sector.

It is important to note that unlike employees, the owners of franchises in emerging markets tend to be higher-skilled and of relatively high-wealth (Dalberg 2009). This is consistent with the international experience as well: compared to entrepreneurs starting independent businesses, franchisees tend to have higher levels of education and work experience, and in many ways look more like professional managers than entrepreneurs (Blair & Lafontaine 2005). This makes sense, first because franchisees do operate in a more restricted and managed system under the franchisor, and second, because the franchisee must make a significant up-front payment to purchase a franchise. Conversations with South African franchisors corroborate these results, where much of the search for new franchisees is among the ranks of retrenched (laid off) professionals. Just as franchising is a business model somewhere between independent and vertically integrated units, franchisee entrepreneurs are somewhere between independent entrepreneurs and professional managers. And in terms of decreasing inequality, franchising's positive impact on low-skilled employment is clear but its impact on business ownership by race and income is more ambiguous.

Growth & Risks

We have seen that in South Africa, franchising is larger share of GDP than in most comparator countries, which suggests that there may not be much room for growth. We simply don't see other countries with a significantly higher degree of franchising in their economies. Consistent with this, in conversations with leaders in the sector, there does not seem to be an expectation that franchising in traditional sectors (for example restaurants, retail, hotels, automobile services in formal urban cores) could significantly increase its proportion of GDP, which has been quite stable for decades. Rather, overall growth of these sectors likely depends on growth in demand for these services.

But this certainly does not mean that traditional franchising is not important for South Africa. With half a million formal employees, franchising is responsible for over 5% of formal workers in the country (StatsSA 2021), and it provides a particular type of job which has been difficult for the country to generate elsewhere: formal and low-skilled. Traditional franchising therefore is an important sector and indications from experts suggest that until recently, it has not been given the attention from government that its economic weight deserves. FASA has noted it has only recently been included in forums like small business roundtables and government working groups.

Though there may not be much room for further growth of traditional franchising, experts in the country do point to downside risks which could reduce franchising's contribution to GDP. The most mentioned risk is adequate disclosure and balanced franchise agreements from franchisees along with protection for potential franchisors. The high-profile failure of the Old Fashioned Fish & Chips franchise in the mid-2010s is an example of this risk.[1] A franchisor may pursue rapid profits from up-front franchise fees, promoting and selling franchises that have

[1] Sunday Times: https://www.timeslive.co.za/sunday-times/business/2015-03-22-franchisees-flounder-after-fish-company-goes-belly-up/

little chance for survival. Franchisors can be convinced by franchisor marketing and projections to sign one-sided franchise agreements and hand over their life savings for an unsustainable franchise brand that fails. Though franchising does entail risks for franchisees, protecting traditional franchising's contribution to broad-based business ownership and output requires that efforts be placed on resolving legal disputes in cases of network failures, and to ensure minimum disclosure and standards to avoid future failures. In South Africa, franchisor protection falls under general consumer protection legislation, with more specific franchisor codes of conduct being only volunteer agreements within trade groups who lack any enforcement power. It is worth studying examples from other countries to determine if and how South African's can be protected from 'fly by night' franchisors in the future.

More Inclusive Franchising

There is one area of traditional franchising that could be improved in order to make traditional franchising more inclusive: franchise finance. Franchisees tend to be wealthy, educated professionals, limiting the inclusiveness of its contribution to more distributed ownership in the South African economy. One of the reasons for this are the up-front capital requirements for new franchisees. Innovations in franchise finance could help reduce these barriers.

South Africa has an exceptionally well-developed financial system compared to other emerging markets, with its commercial banks and specialty lenders offering financing for franchisees through dedicated franchise finance units. Nevertheless, even in this environment, the minimum requirements for owner's equity contribution limit the pool of potential franchisors to the relatively wealthy. Despite ample availability of external financing, owner's capital contributions are required to ensure that franchisees are committed to their businesses and that they will not walk away if a better opportunity comes along. Owner's capital contribution is a commitment device that lenders require and is typical of business loans more generally. But it is not just lenders: the franchisors themselves usually require owner's capital contribution from potential franchisees. In well-functioning franchise models, the franchisor is earning the bulk of their returns from ongoing royalties rather than up-front fees, and franchisee failures are very harmful to the value of the brand. As a result, most franchisors screen who they will allow into the network based on commitment, and one of their screening mechanisms is owners' capital contribution.

This creates an obvious inclusion challenge, as only those franchisees who can come up with this contribution are able to participate. This system may be passing over pools of entrepreneurial talent, who have both the drive and skills to run a successful franchise but do not have the wealth. Instead of searching for these individuals, franchisors end up marketing opportunities to recently laid off workers who they know were given retrenchment packages that could be used for owners' equity for opening a franchise. It does not seem optimal to screen on wealth rather than things like entrepreneurial drive and market/industry knowledge for potential franchisees.

Given this inclusion challenge, and given franchising creates so much low-skilled employment and transfers skills to new franchisees, it is not surprising that there have been efforts to provide grants and other external funding to allow potential entrepreneurs who lack the necessary owner's equity to launch franchises. In our conversations with industry participants, these efforts are viewed positively by some, but with skepticism from others, particularly franchisors and providers of franchise finance. In the words of one industry leader: "the 30% requirement is what it is, it cannot be reduced. If the franchisee can't find it, that shows a lack of energy and commitment."

Reducing owners' equity contribution to new franchises would likely increase franchising activity in the country and importantly, open up the opportunity to previously marginalized groups. However, this must be done with an understanding of the purpose those requirements serve, that is without blunting the alignment of incentives and importance of this contribution as a commitment device. This will require some experimentation and innovation.

For example, the Small Enterprise Finance Agency (SEFA) provided concessional finance for potential franchisors to cover owners' equity contribution, but which still required monthly repayments. Lenders were skeptical of potential franchisors with this funding because the projected cashflow of the business could not support the additional monthly payment, particularly in early years of franchise operation, and it was viewed as unsuccessful. But if the real value of owners' equity contribution is a commitment device that does not impact cash flow of the business, perhaps a different financial product would be more appropriate, such as a grant which converts to debt should the franchise fail. As long as the entrepreneur does not walk away, that grant portion of financing would not have to be repaid. This retains the function of the commitment device (assuming it is not easy to walk away from the debt) and increases the upside returns for the business owner, without impacting the cash flow underlying the remaining financing of the business.

This is just one potential idea, there are surely others, and further refinements to make. The key message is that searching for innovations in franchise finance, specifically those that expand the pool of potential franchisors by reducing minimum owners' capital contribution, but at the same time which do not blunt the economic function of that contribution, is one fruitful avenue for further work to expand inclusion in traditional franchising.

4. New Frontiers in Franchising

Although the size of traditional franchising in South Africa implies that the sector may not expand beyond the overall growth-rate of the economy, there are potential extensions of the franchising model to areas of the economy where traditional franchising is not usually relevant. Moreover, the large and successful franchising sector has created a set of capabilities in the South African economy, such as detailed regulations and case law, specialist franchise finance units in commercial banks, and experienced training specialists. These capabilities are an asset that could be applied to activities similar to, but not exactly like, traditional franchising. Here we will discuss three such avenues for potential expansion beyond traditional franchising: micro-franchising, social franchising, and the application of franchising to smallholder farming.

Micro-franchising

Micro-franchising is exactly what it sounds like: very small franchises, even of one person per unit with no employees. They are businesses that target lower-income franchisees as owner-operators, who in turn sell products and services targeted at lower-income customers (Fairbourne Dyer & Gibson 2007). As such, they represent a growth area that could generate a more representative set of franchisees in South Africa.

Micro-franchising, particularly in retail and distribution, is well established in emerging markets. For example, bicycle-mounted ice-cream vendors, or cosmetics companies like Natura who distribute through personal networks are micro-franchises. These franchises are popular for a number of reasons. For the franchisor, they represent a cost-effective way to reach a large number of very small lower-income customers which are challenging to reach with traditional marketing in a vertically integrated distribution business. These ‘traditional format’ distribution franchises are particularly popular micro-franchises in emerging markets because very little up-front capital is required from the franchisee because there is little to no capital investment. Franchisors usually only have to pay a small fee for up-front training and inventory. Finally, as compared to ‘business format’ franchises such as restaurants and hotels, traditional format distribution micro-franchises are very non-intensive in their use of legal institutions. They sidestep many of the transaction costs listed above because the distributors are more independent, distributing finished goods with only a small service component (such as measuring eyeglasses or giving cosmetics demonstrations), and usually paying for inventory up-front rather than royalties on sales.

Note that this definition of traditional format micro-franchises would also include ‘network marketing organizations’ or ‘multi-level marketing’ firms, where franchisees rather than the franchisor recruit their own ‘sub-franchisees’. As members of these networks apply more and more of their effort and earn more and more of their income through recruiting additional distributors rather than selling products, they become less of product sales strategy and more of a classic pyramid scheme. Such schemes are economically harmful, especially to the poor, and agencies such as South Africa’s National Consumer Commission spend a great deal of effort to combat them. Our focus here is on legitimate micro-franchises, where participants earn their income through selling products and services, rather than on-selling franchises.

In South Africa we can also observe micro-franchising expanding from re-selling into less capital-intensive business format franchises. This is a market response to the challenges of franchise financing described above. To take an example from South Africa, where starting up a KFC franchise could require a franchisee investment of $100,000. There are emerging chicken restaurant franchises appearing that are engineered to be one tenth of that cost, operating from converted shipping containers rather than traditional retail locations.

Finally, new micro-franchising activities have emerged based on mobile-enabled applications, where independent operators provide location-specific services under an umbrella brand. In South Africa, this can be seen in transportation services (e.g., Uber), delivery (Mr D), home cleaning (SweepSouth), low-skilled microjobs and surveys (M4Jam), and tourism (AirBnB, MySafari). These platforms appear to be growing rapidly in the country. The employment nationally of temporary workers, which includes these workers, went from 2.6m in 2017 to 3.9m in 2018. According to Fairwork, there are 35,000 workers in app-enabled driving and cleaning services, which are growing by more than 10% per year (Fairwork 2020).

Just as there is a fine but important line between micro-franchised distribution businesses and pyramid schemes, there is a fine but important line between app-enabled micro-franchisees and what can simply be efforts recategorize employees as independent contractors to sidestep regulations and taxes. Defining this line to enforce labor laws while also enabling mobile-enabled micro-franchises to create new opportunities for the unemployed will be an ongoing and challenging legal and political issue, not just in South Africa but internationally as well.

Related to this issue of determining the correct classification of employees versus independent micro-franchise owners is the issue of formal micro-franchises competing on an uneven playing field with informal enterprises. This challenge was raised by every franchisor we interviewed looking to expand into lower-income areas of South Africa. Though the country does feature low rates of informality overall, it does tend to be concentrated in the food, hospitality, and retail sectors in lower-income areas of the country (Shah, 2022), which are precisely where micro-franchise expansion is focused. Micro-franchises are typically required by their franchisors to be formally registered, abide by health and safety regulations, and to formally hire their workers and pay the corresponding taxes and benefits. It is difficult for a restaurant, bar, auto servicer, or retail shop to pay all of these costs of formality and compete with informal restaurants, shebeens, and spaza shops who do not.

As noted in Shah (2022), informal work absorbs a much larger segment of the working age population in other countries with similar levels of income than it does in South Africa, and there is an argument for efforts to unlock greater own account work, even if informal, to deal with South Africa's unemployment challenge in the short term. On the other hand, tax, safety, and labor regulations exist for a reason, and enforcement of those rules would be expected to expand to lower income areas of the country as they develop. The government must balance the implementation of these rules and the creation of a level playing field for micro-franchises to compete with the desire for more labor-absorbing work, even if informal.

In summary, adapting South Africa's traditional franchising sector to lower-income consumers and lower-wealth franchisees offers an exciting direction for more, and more inclusive, entrepreneurship. This requires regulations and enforcement that balance the benefits of this growth with the need to stop pyramid schemes, prevent employment law evasion through apps, and expand formal safety, tax, and employment rules to lower-income areas as that becomes appropriate.

Social Franchising

Public service provision has been a challenge in South Africa for some time. From electricity to water to sanitation to health services, the country has endured shortages and consequent protests.[2,3] Given these shortfalls, the provision of basic public services would be an attractive area for greater franchising activity.

Social franchising refers to the provision of services traditionally delivered by the government, such as education or health, by franchised chains. Dissatisfaction with the availability of public services in emerging markets has led to wave of interest in social enterprises, whereby entrepreneurs with a social mission launch private businesses to fill the gap. Given franchising is a proven method of scaling many services and distribution businesses in other industries, the social enterprise enthusiasm spread to social franchising as a way to solve scalability challenges apply franchise-powered expansion to social enterprises (Forbes 2018).

There are many examples of social franchises across social sectors. The HealthStore Foundation launched franchised networks of combination medical clinics and pharmacies in underserved areas of Kenya, Ghana, and Rwanda. VisionSpring's "business in a bag" combines the eyeglasses for sale along with basic training in vision testing and sales, and has been franchised across South Asia, Africa, and Latin America alongside other distribution models.

Some of these initiatives have reached scale, such as HealthStore's 80 clinics in Kenya. But unfortunately, most models have failed to reach any level of financial sustainability (Dalberg 2008). A large study of health franchises targeted on the poor found that every single one continued to rely on subsidies and grant capital to survive, and the only ones that approached profitability either offered a niche service or served high-density urban populations with higher income levels (Montagu et al. 2009).

The discussion above of the economics of franchising offers some clues as to why social franchising has not yet achieved much success in terms of financial sustainability. Franchising means you bear the high monitoring and enforcement costs of integration without keeping all the profits of integration. That is worth it when there are large benefits of both a uniform umbrella brand and high-powered local incentives, like a coffee shop serving mobile customers. But is it the case for services like education and health which are provided near home to repeat customers who are not moving between units in the franchise? Or for mobile salespeople of glasses who could just as easily receive training in exchange for the purchase of inventory that will be re-sold in an arms-length commercial transaction between independent entities? In fact, VisionSpring moved from franchising to this more transactional distributor relationship which did seem to unlock reaching scale with over 2,000 salespeople in Bangladesh.

Franchising is therefore not well suited to many of the products and services provided by social enterprises. And more generally, as detailed in Dalberg's 2008 study, expansion via either franchising or full vertical integration just does not solve the challenging unit economics of selling these public goods and services on a private basis; it only replicates them. It is extremely challenging to sell these goods and services sustainably, and many social enterprises attempt to scale unprofitable operations with the idea that eventually economies of scale will make them profitable, which is very rare (Dalberg 2008).

There are examples of social franchises that continue to operate despite not being profitable by relying on ongoing grant funding. For example, Mental Matters, which organizes nurses that

[2] Frequent and scheduled power outages for 'load shedding' can be seen in real time at https://www.eskom.co.za/distribution/customer-service/outages/municipal-loadshedding-schedules/

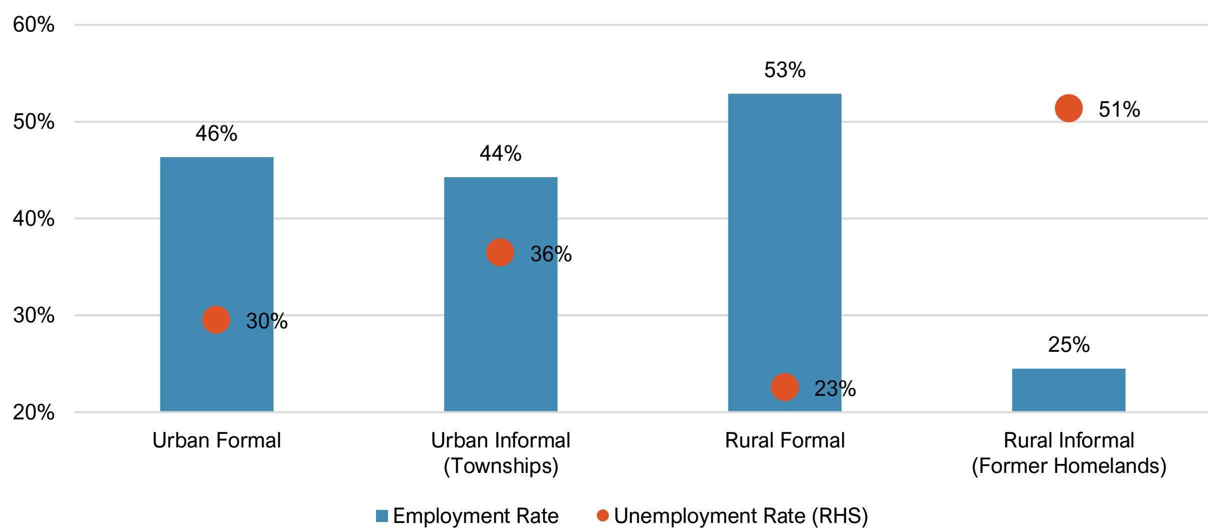
[3] For example, over 900 service delivery protests in the second half of 2020. https://www.defenceweb.co.za/featured/900-service-delivery-protests-in-south-africa-over-six-months/

provide post-natal care and training to very poor new mothers in South Africa. This may be an effective way for donors to leverage social spending. However, the experience to date suggests that those donors should plan for these to be open-ended commitments rather than temporary support until franchise-powered scale achieves profitability. In the words of one franchising leader in South Africa: “they [social franchises] are great, but it’s not a business”.

Franchising and Agriculture

Agriculture is a particularly important sector for South Africa, in part because of its dysfunction. It highly dualistic, with a small number of highly efficient, modern farms co-existing alongside a large number of smallholder farmers, the vast majority of which do not produce more than they consume (Sihlobo & Kirsten 2021, Cousins 2018). The country clearly has “two agricultures” (Sihlobo & Kirsten 2021). While large farms are investing outside of the country for future growth, there remains nine million hectares of largely idle land in the country, primarily government-owned land and communal land in the former homelands (Sihlobo 2022). This dualism striking when comparing employment rates between urban/rural and formal/informal areas in the country’s General Household Survey (Figure 3). The rate of employment in formal rural areas where modern commercial farms are located is the highest in the country, even higher than in formal urban centers. Meanwhile, the lowest rate of employment by far is found in the former homelands, where informal and small-scale agriculture is located.

Figure 3. Labor Market Indicators by Geographical Area, 2014



Source: authors’ elaboration based on General Household Survey

The historical roots of this system are deep. But importantly, this dualism has not been reduced since independence in 1994, despite decades of efforts to fix it. For example, the government’s 2001 Strategic Plan for South African Agriculture’s goal was to “bridge the inherent dualism and to maximise the contribution of the sector to economic growth and development.” The government has redistributed 20% of formerly white-owned land since independence (Sihlobo & Kirsten 2021) and dramatically increased spending on extension services, primarily focused on beneficiaries of land reform (Aliber & Hall 2012). But 25 years of these efforts have not achieved their goals, and the ‘two agricultures’ stubbornly remain (Sihlobo & Kirsten 2021).

While this dualism and diminished agricultural output and employment (particularly in the former homelands) is a problem, it is also an opportunity for faster more inclusive growth. Macroeconomic indicators would be improved by output growth in a tradeable sector like agriculture. And employment and poverty indicators would greatly benefit from new opportunities in the former homeland areas which suffer the worst levels of employment and poverty in the country. This opportunity is widely accepted and that is why bridging the gap has been a stated goal of policy for a quarter century. The challenge is how to do it. There is an ongoing debate in the country on this question, and we endeavor to contribute to that discussion in a forthcoming paper.

But to that end, it is useful to consider here what (if anything) can South Africa's success in franchising lend to the problem of agricultural reform and growth in the country?

First, it is important to note the way franchising economics are not directly relevant to agriculture, based on section 2. Franchising is found in geographically dispersed services and retail businesses, particularly where mobile customers make brands valuable. We do not observe direct implementation of franchising in the agricultural sector because the benefits of combining high-powered local incentives with an umbrella brand do not outweigh the high costs of those incentives along with the transaction costs created by not being vertically integrated. A successful large-scale farmer looking to expand does not tend to consider franchising. The trend in agriculture in South Africa, including both primary production and downstream processing and distribution, has been strongly oriented towards integration, and large farms who are limited from further growth under this model within the country because of land availability are more likely to replicate their vertically-integrated large-scale production in other countries.[4]

A franchising-like solution to agriculture would therefore look different in some key aspects. First, though franchising may not be more productive than growth through vertical integration, it could be the second-best solution in areas where growth through replication of vertical integration is not possible. This may be the case on currently underutilized land in South Africa, which is owned either by the government for redistribution, by communities, or in small parcels. Second, it seems less likely that the 'franchisor' would be large sophisticated vertically-integrated farms looking to expand. Rather, it would be other entities such as downstream aggregators and processors, input providers like equipment or seed providers, or socially-minded entities seeking to integrate smallholder agriculture into higher productivity value chains. It is precisely in these areas, and with these actors, that we do observe some franchise-like solutions to the challenges in agriculture, which will be documented in a forthcoming paper.

New franchise-like models for agriculture could leverage certain features of the traditional franchising model, and the capabilities in the South African economy created by its highly successful traditional franchising sector. Here are some features of franchising that could be applied to agriculture:

1. **Contract enforcement and standardization**

As a move away from vertical integration, franchising relies intensively on the legal system to govern the relationship between franchisor and franchisee. Franchisees have incentives to lower quality and free-ride on other network members, so there are extensive monitoring and enforcement clauses in contracts to protect franchisors and their other franchisees. Franchisors

[4] https://www.reuters.com/article/ozabs-safrica-land-20101213-idAFJOE6BC05I20101213

could be abusive and anti-competitive through things like unclear franchise agreements, tied supply, and territory encroachment, so there are legal protections required for new and potential franchisees. This system relies on a deep set of case law, experienced lawyers, consultants, and technical experts, which the country has built up through the decades in traditional franchising. Models in the agricultural sector that move away from vertical integration to more distributed ownership will use these capabilities in contract enforcement to allow a larger number of entities to productively engage with one another.

This legal system that allows for franchisor-franchisee relationships to form at scale also depends on contract standardization. For franchisors to interface with hundreds of potential franchisees, and for franchisees to evaluate hundreds of potential franchisor concepts, franchise agreements have evolved a somewhat standardized structure with a surprisingly standardized set of parameters (Blair & Lafontaine 2005). Where those contracts differ, it is usually along a set of well-understood dimensions, such as the size of the franchise fee, royalty rate, marketing cost, and territory.

A solution to South Africa's duality challenge in agriculture will also require a large number of market connections to be made, which will rely on legal contract enforcement and will require the evolution of a set of standardized contracts. In a forthcoming paper, we will explore traditional forms of smallholder aggregation as well as some newly emerging contractual forms between smallholders and downstream aggregators and processors. Greater experimentation and experience could develop a set of best practices and standardized contracts that allow the same scale found in traditional franchising to emerge in the agricultural sector.

2. A variety of proposals to allow matching in a marketplace

Contracts are standardized to minimize transaction costs, but within those standardized structures, there are a variety of options in the traditional franchising sector so that matches can be found with the variety of potential franchisees, many of which will be seeking different types of opportunities. One franchisee may have easy access to start-up capital for the franchise fee and is looking for a proven, low-risk franchise with predictable income. Another may be willing to bet on a newer, less-proven franchise with a lower up-front fee and potentially more revenue growth, accepting the risk of the new franchise concept failing (which is surprisingly common for new franchising concepts, Blair & Lafontaine 2005).

In South Africa, a wide variety of franchising concepts are marketed by franchisors to a wide variety of franchisees in a series of publications, conferences, and events. Franchisors can compare their offerings to others in the market, attempt to differentiate themselves, and find new franchisees whose experience and interest are the best match with their concepts. This searching and matching process would be much more difficult without this wide variety of proposals circulating in the marketplace.

A franchise approach to smallholder agriculture could similarly evolve to a marketplace of proposals, where different communities and agglomerations of smallholder farmers could select different types of proposals from franchisors based on what they want, instead of a more limited set of top-down solutions like trying to form standardized cooperatives. Some groups of smallholders may want more fixed income with lower risk, others may want more ownership and participation in the up-side. Some communities may want a greater role in management while others are looking to maximize employment. If a wider variety of franchise-like proposals could meet a wider set of smallholder groups in a marketplace of proposals, there will be more productive matching as there is in franchising.

3. **Transfer of know-how at scale**

In order to offer a uniform product and service across traditional franchise networks, it is necessary to specify all aspects of the business technology in franchise manuals and to train franchisees in this technology. This process is expensive, which is part of the reason an up-front fee is charged by the franchisors in addition to the other set-up costs for a franchise. Because of the challenges of transferring the know-how of a franchise concept, there are a variety of experienced trainers and consultants that work with newly franchising chains to codify operations and design the best training methods. Though not perfect, this system of know-how transfer in traditional franchising operates quite well and enables new franchises to continuously emerge.

Transferring know-how in the agricultural sector is notoriously difficult, particularly to small farmers. While input suppliers may provide training to larger farms, as the size of the farms and their input purchases fall, the costs of providing technology transfer rise, so training at scale by input suppliers is less successful for smallholder farmers. Processors and aggregators attempt to provide training paid for by subsequent output (contract farming), but the high costs of reaching a large number of smaller farmers remain and are exacerbated by the problem of side-selling. The government seeks to provide training and know-how via agricultural extension services to small farmers, but these also tend to be of poor quality and reach. For example, in South Africa, only 10% of farmers in former homelands have had contact with an extension officer despite the fact that expenditure on extension services has risen significantly and "appears to be ample relative to the number of agriculturally active households" (Aliber & Hall 2012).

A franchise approach to smallholder farming would mean the franchisor (which may be a downstream processor, input provider, or aggregator) provides the training and assistance to a large number of smallholders, building on the training industry that has built up around standardizing process and training in the traditional franchising space. Because of spillovers through side-selling and other financial constraints facing smallholders, this may require public funding, though not public delivery via a government-run extension service. This transfer of know-how under a franchise-type approach would be paid by the franchisee to the franchisor, possibly with external funding, possibly with an in-kind contribution to the franchise such as the land use-rights.

5. Conclusions

Franchising offers several directions to generate more, and more inclusive, entrepreneurship in South Africa. The analysis above suggests the following policy priorities to achieve this potential:

- Franchising is already a significant contributor to South Africa's output, formal low-skilled employment, skills transfer, and democratization of ownership. The attention it receives in policy circles does not seem to match this contribution. Therefore, the first policy implication is greater explicit recognition of franchising's importance to the South African economy within national growth strategies. The government should ensure new initiatives do not inadvertently harm this sector and give franchising a 'seat at the table' in setting new policy priorities and when considering reforms. This can be done, for example, by ensuring there is a franchising representative at government-private sector roundtables and advisory councils.
- There is a need to ensure further protection from abusive franchise agreements and 'fly-by-night' franchisors. This is currently covered by general consumer protections and voluntary codes of conduct from trade associations, which appears to be sufficient at present, but over time may require more specific regulations.
- Franchise ownership can be made more inclusive through innovations in franchise finance, to develop financial products that lower the up-front capital barrier for franchisors. This should be done in close consultation with franchisors as well as franchise finance institutions (such as the franchise finance departments of major banks) to ensure acceptable structures that do not blunt incentives for franchisee effort and commitment.
- Greater prevalence of micro-franchising would also generate more, and more inclusive, entrepreneurship. Further growth of micro-franchising must be balanced with efforts to protect would-be franchisees from pyramid schemes, labor law evasion, and informal competition.
- Social franchising is an attractive idea, but results to date suggests it does not offer a solution to South Africa's challenges with public services and is not a growth area for franchising.
- Aspects of franchising are potentially applicable to a key problem for South Africa: overcoming the dualism in the agricultural sector and increasing output in underutilized land. Leveraging the country's strength in traditional franchising and developing new franchise-like business models applicable to agriculture is an important line of inquiry that will be developed in subsequent work. These would leverage traditional franchising's contract standardization and legal infrastructure, build a diverse set of proposals that allow for more matches between aggregations of smallholder farmers and up/downstream corporates, and develop systems to transfer know-how at scale to smallholder farmers as is done today with new franchisees in traditional networks.

References

Aghion, P., M. Braun & J. Fedderke. 2008. “Competition and productivity growth in South Africa.” Economics of Transition 16(4): 741-768.

Aliber, M. & R. Hall. 2012. “Support for smallholder farmers in South Africa: Challenges of scale and strategy.” *Development Southern Africa* 29(4).

Blair, R. & F. Lafontaine. 2005. The Economics of Franchising. Cambridge University Press.

Cousins, B. 2018. ‘Employment in informal-sector agriculture in South Africa’, in: Frederick Fourie and Caroline Skinner (eds.), The informal sector in South Africa: Enabling a promising sector. Cape Town: HSRC Press (pp 353-381).

Dalberg 2009. “Franchising in Frontier Markets: What’s working, what’s not, and why”. A report by Dalberg Global Development Advisors. December 2009.

DuToit, A. 2019 “Agriculture, Value Chains, and the Rural Non-Farm Economy in Malawi, South Africa, and Zimbabwe” in Value Chains in Sub-Saharan Africa, S. Scholvin, A. Black, J. Revilla Diez, and I. Turok (Eds). Springer.

Fairbourne, J., W. Dyer & S. Gibson (Eds). Microfranchising: creating wealth at the bottom of the pyramid. Edward Elgar Publishing, 2007.

Fairwork. 2020. “Gig workers, platforms, and government during COVID-19 in South Africa”. The Fairwork Project. May 2020.

Forbes 2018. https://www.forbes.com/sites/hachemialiouche/2018/12/10/how-social-franchising-can-address-global-social-issues/?sh=7d8228b5437b

Global Entrepreneurship Monitor. 2020. “Igniting startups for economic growth and social change.” Global Entrepreneurship Monitor South Africa 2019/2020 report. https://www.gemconsortium.org/report/igniting-startups-for-economic-growth-and-social-change

Shah, K. 2022. “Diagnosing South Africa’s High Unemployment and Low Informality”. Unpublished Manuscript, 2022.

D. Montagu et al., Clinical Social Franchising: An Annual Compendium of Programs, 2009 (University of California San Francisco, Global Health Sciences, Global Health Group, 2009).

Statistics South Africa, 2021. P0277 - Quarterly Economics Statistics, June 2021. http://www.statssa.gov.za/?page_id=1854&PPN=P0277&SCH=72993