Impact of COVID-19 on the Restaurant Franchising

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Abstract

The last two years of human development took place under the influence of the COVID-19 pandemic that affected each and every field of socio-economic life. The restaurant industry is one of the most affected sectors as a result of the measures taken by states for limiting the spread of the Corona virus. The initiatives for keeping social distance, restricting free movement nation- and world-wide, full or partial lockdown resulted into a number of negative consequences for the restaurant activity like job loss and closure of outlets. When recessions happened before the franchising business model turned out to be a sustainable and leading model for growth. COVID-19 created unprecedented challenges to the franchising community, however, the franchisors and franchisees react quickly and carefully in order to minimize losses through implementing a number of activities. It is exactly in this respect that the goal of this study is set: to present and summarize the main impacts of COVID-19 on the world franchising industry and, in particular, on the development of restaurant franchising.

Keywords: restaurant franchising, restaurant chains, pandemic, Covid-19

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Introduction

The world has found itself in an unprecedented situation. The last two years of human development took place under the influence of the COVID-19 pandemic which affected each and every field of socio-economic life. I am not going to point out the health, social and purely human aspects of the issue. Without any doubt, the harms inflicted by the crises will probably not be even close to something similar the world has endured in its historic development (Seetharaman, 2020). In economic life the sudden and powerful decline of supply and demand affected almost all sectors of economy. The restaurant business is one of the most strongly affected sectors as a result of the measures taken by states for keeping social distance, limiting free movement world- and nation-wide, for full or partial lockdown lead to an unprecedented decrease of employment, loss of millions of job positions and billions of potential revenues (Gössling, Scott, & Hall, 2020; Dube, Nhamo and Chikodzi, 2021). In mid February 2020 till about the end of the month in the activity of the international restaurant business one observes almost no changes compared to the same period in 2019. Only twenty days after the World health organization declared the spread of the COVID-19 pandemic on 11.03.2020; in the restaurant activity worldwide there was a registered decrease of 99.91% (OpenTable, 2020). Similar to all activities in the field of services, the revenues from restaurant activity are lost for a long time because in the coming years in more favorable conditions one cannot compensate for sales undone. That is why in the last two years numerous researches in the sphere of economics aim at studying the effects of the pandemic on restaurants on various levels and with various scopes, as well as the chances to renew the activity. That is the aspect of the goal of this study: to present and summarize the basic impacts of COVID-19 on the world restaurant industry and, in particular, on the development of restaurant franchising. The paper views the way the pandemic affects the relationship between franchisors and franchisees, as well as the measures taken for adapting the business model to the unfavorable conditions.

1. Emergence and development of restaurant franchising

In the contemporary socio-economic development franchising is a widely spread format of managing business. In restaurants franchising is widely applied as a form of strategic management and a powerful tool for non-capital expansion of the restaurant chains and corporations (Dabeva, 2013; Roh, 2002). I am not going to go into details in respect to the conceptual definition of restaurant franchising since there are plenty of researches where the term is viewed in various scopes, on different levels, with a different focus by individual researchers or by specialized institutions and so on. The researchers define franchising as a marketing system (Lashley and Morrison, 2000); as an organizational or business form (Contractor and Kundu, 1998; Cunill, and Fortenza, 2010); as a strategic analysis (Xiao, O'Neill and Wang, 2008; Vaishnav and Altinay, 2009); a method for territorial expansion (Ball, 1992; Hsu, Jang and Canter, 2010); a type of contract between two parties (Ball, 2000) and a form of licensing (Vasileva, 2010; Turner and Guilding, 2010).

For the goals of this study I will use two definitions as working ones:

Institutional, belonging to the European franchising federation, according to which: "Franchising is a system of selling goods and/or services and/or technologies that is based on close and ongoing cooperation between financially and legally independent parties, respectively a franchisor and a franchisee. The first party provides the second one with the right and assigns to it the duty to run the business in compliance with a particular concept. The franchisee is given the right and obligation in exchange for direct or indirect financing, to use the brand and/or trademark and/or the service brand, knowhow, business and technical skills and other items of intellectual property of the franchisor who has to provide ongoing trade and technical support during the time of the contract signed between the parties" (Code of Ethics, 2016). This definition is a classic one and can be applied to every economic sector, incl. restaurant business.

A particularly scientific definition which defines franchising in hotels and restaurants as: an economic and social system, with a certain organization and elements and is based on a contractual form of partnership in which a hotel and/or restaurant chain transfers to the individual hotel and/or restaurant owners against payment a successful brand and the tangible and intangible assets associated with it (Dabeva, 2013). The main emphases in this definition are:

- Restaurant franchising is a system, i.e. it has a particular uniformity and stands out relatively in the environment by presenting itself on the market and awareness of the target audience as an integrated unit.
- Besides being economic, this system is also social because it comprises a number of social communications both between the participants in the negotiation and many respondents from the environment.
- It is pointed out that it is a matter of contract and the character of relationships within the system is briefly defined.
- The type of franchisors and franchisees is defined.
- It is pointed out that the ground of the restaurant franchising is the transfer of a successful brand.

As a form of managing business franchising is introduced into restaurants for the first time in USA in the beginning of XX C. It is said that franchising in the restaurant sector dates back to the '30s of last century by Howard Johnson (Ball, 2000). He opened an ice-cream parlor in 1925 and in 1928 he convinced a partner of his to open a restaurant where his ice-creams could be sold. The venture turned out exceptionally successful. Johnson decided to give his concept and brand for rental and in 1939 he already had 107 franchising outlets in six states (Ball, 2000). Other sources point out the year 1910 as the start of restaurant franchising having in mind Bain's Deli (Price, 1997) or 1925 with the A&W Root Beer Restaurants (Parsa, 1996). No matter who was first, most authors support the idea that the effective development of restaurant franchising started in USA during the '50s of XX C with the concept of McDonald's.

The history of the company proves an immense entrepreneurial success. In 1937 Patrick McDonald opened „The Airdrome" restaurant next to the Monrovia airport in California. A hamburger cost 10 cents and an unlimited quantity of orange juice – 5 cents. Several years later in 1940 Patrick's two sons Morris and Richard moved the restaurant in San Bernardino, California and changed its name to "MacDonald's". The outlet developed well but its real success came eight years later in 1948 when the two brothers introduced the innovative concept of Speedee Service System.

It laid the out the principles of a modern quick service. The concept is based on a limited menu, quick service, low prices and a huge volume of sales. For less than 50 cents the client received a cheese-burger, French fries and a shake. To achieve maximum efficiency, the McDonald brothers equipped the restaurant kitchen as an assembly line. The limited menu allowed cooking the food to boil down to simple repetitive operations which can be mastered quickly even by completely inexperienced workers. In 1954 the 52-year-old entrepreneur and retailer of machines for milk shakes Ray Kroc (1902-1984) learnt that in a single restaurant there were used eight of the multifunctional mixers he was selling. Amazed with the fact he left for San Bernardino in order to meet the McDonald brothers and their business. Attracted by the huge potential of the two brothers' concept, Kroc offered them to open new outlets and sell the right to use the trademark of McDonald's and the service technology. The McDonald brothers, however, were unwilling to make their activity more complicated; that is why Kroc took the duty to sell the brothers trademark for USD 950 at least and in return obtain 1.4% of the profit. He received the right to open restaurants with the name McDonald's all over the territory of USA but for California and Arizona – for these two states the brothers McDonald already had a license. In 1955Ray Kroc set up the McDonald's System Incorporation and opened his own first restaurant of the future chain in Des Plaines, Illinois, near Chicago, which quickly turned into a lucrative business. In 1961 the McDonald brothers agreed to sell Kroc their business for USD 2.7 m. According to the contract Kroc received also all rights for international franchising of the chain – this is how its world success started.

Approximately at the same time colonel Harland Sanders noticed the potential of the franchising concept and, as a result, the first "Kentucky Fried Chicken" opened in Salt Lake City, Utah in 1952 (Jakle and Sculle, 1999). Eight years later in 1960 the company had almost 200 franchisees. The same year the franchise system of Burger King started developing, then it was called Insta Burger King and used to be the main rival of McDonald's – with a similar product but with a suitable market niche because it is still on the market and is developing all right. First applied to fast-service outlets with burgers as the main product, the franchising continues developing by comprising also other products like pizza, cafeteria and coffee-shops and others.

Table 1. The first franchise restaurant chains in the world

Company	**Year Founded**	**Headquarters**	**Year Franchising Started**	**Current No. of Locations**
A&W	1919	Lexington, Kentucky, USA	1925	1100+
KFC	1930	Louisville, Kentucky	1952	20925
McDonald's	1940	Chicago, Illinois, USA	1955	37241
Dairy Queen	1940	Edina, Minnesota, USA	1940	6800
Dunkin' Donuts	1948	Canton, Massachusetts, USA	1955	12400
Jack in the Box	1951	San Diego, California, USA	early 1970s	2200
Sonic	1953	Oklahoma City, Oklahoma, USA	1956	3606
Burger King	1953	Miami-Dade County, Florida, USA	1953	15200

Source: 10 Oldest Fast Food Chains in the World. Retrieved from https://www.oldest.org/food/fast-food-chains/. Accessed on November 23, 2021.

As a form of managing restaurant business, franchising in Europe came into practice from USA on a later stage. The first international market to which US restaurant chains directed their efforts was UK and it was viewed as "a door" of US companies to the European market (Acheson and Price, 1992). In 1957 Wimpy opened the first restaurant franchise in UK, KFC did the same in 1965; however, at first franchising was scarcely applied in the European restaurant business. The situation changed with McDonald's entering the market mid '70s. The dynamic development of the franchising concept in restaurants continued in the '80s when US chains reached other European markets.

In the modern development of restaurants franchising has been widely applied under various forms, types and combinations; this makes it difficult to study its actual parameters (Dabeva, 2013). According to data of the European franchising federation, eight out of the ten most developed franchising systems in Europe (as per number of outlets) are in the sphere of restaurant business (Table 2).

Table 2. Top 10 European Franchises - Ranking

№	Company	Units	Country	Industry
1	7-eleven	60000	USA	Retail Franchises
2	Subway	44819	USA	Food Franchises
3	McDonald's	36500	USA	Food Franchises
4	Kumon	25840	Japan	Education Franchises
5	KFC	19955	USA	Food Franchises
6	Pizza Hut	15605	USA	Food Franchises
7	Burger King	15200	USA	Food Franchises
8	Domino's Pizza	13200	USA	Food Franchises
9	Spar	12176	Netherlands	Food Franchises
10	Dunkin' Donuts	12000	USA	Food Franchises

Source: Franchise Europe. (2021) Top 500 European Franchises - Rankinghttps://www.franchiseeurope.com/top-500/.

In Europe the largest franchise restaurant systems are the chains of fast- service outlets with main products burgers, pizza, chicken and doughnuts. There prevail US companies, out of the eight only one is European – from the Netherlands.

Table 3. World Top Restaurants Companies List by Market Cap as on Sep 1st, 2021

№	COMPANY	Headquarters Country	Market Cap in USD billion	Annual Revenue in USD million	Annual Net Income in USD million	Units
1	**Mcdonald's Corporation**	USA	177.340	19 200	4 730	38 695
2	**Starbucks Corporation**	USA	138.530	23 510	928	32 660
3	**Chipotle Mexican Grill**	USA	53.474	5580	350	2 788
4	**YUM! Brands** (KFC, Pizza Hut, Taco Bell, The Habit Burger Grill, WingStreet)	USA	38.739	5 590	1 294	43 617
5	**YUM China Holdings** (Pizza Hut, Taco Bell and KFC in China, as well as local chains - Eastern sunrise, Small sheep, Huang Ji Huang and COFFii & JOY)	China	25.910	8 263	784	11 415
6	**Haidilao International Holding** (hot pot)	China	23.916	3 998	352	1597
7	**Restaurant Brands International** (Tim Hortons - donuts, coffee, tea; Burger King – burgers; Popeyes - chicken)	Canada	19.806	4 960	486	27 000
8	**Darden Restaurants** (Olive Garden, LongHorn Steakhouse, Bahama Breeze, Seasons 52, Yard House, Cheddar's Scratch Kitchen, Red Lobster Eddie V's Prime Seafood and The Capital Grille)	USA	19.633	7 807	-52	1500+
9	**Domino's Pizza**	USA	19.050	4 117	491	17 000
10	**Subway**	USA	n/a	n/a	n /a	n/a

Source: World Top Restaurants Companies List by Market Cap as on Sep 1st, 2021. (2021) Retrieved from https://www.value.today/. Accessed on November 23, 2021.

The ranking of Value.Today (Table 3) ranks the world largest restaurant companies according to market capitalization. A big part of the companies own several brands with various product 2 Most companies manage franchising outlets and their own outlets, the latter usually having smaller share in the overall structure of the chains. Out of the ten restaurant companies with the largest capitalization more than 2/3 are based in USA. The corporations that do not come from across the Atlantic are relatively new organizations: YUM China Holdings since 2016, Restaurant Brands International since 2014 and Haidilao International Holding since 1994.The indisputable leader is the McDonald's Corporation, not only per market capitalization but also per the criterion „annual net income", the difference from the remaining companies being considerable.

2. Specifics of restaurant franchising

Franchising in restaurants can be defined as various and rich in content (Dabeva, 2013). For the goals of this survey there were looked through a number of publications in the field of the topic studied – from various databases like Google Scholar, Ebsco host, Emerald, Science Direct, JSTOR and others. On the ground of this review one can come up with the following more significant particularities of restaurant franchising:

» Franchising in restaurants is an effective form of organization for business and territorial expansion because of the opportunities for growth it provides to companies by way of decreasing costs (Brickley and Dark, 1987; Norton, 1988, Ball, 2000). Researchers explain the development of franchising with two theories: the resource scarcity theory and the agency theory for managerial costs. The first one explains the decision for company growing through franchising with the lack of resources needed for developing the company like financial capital, human resources, management experience, knowledge and information about local markets, image and reputation and others (Norton, 1988; Minkler, 1990). In addition, some authors suggest another theoretical argument – the chance to share risk. According to it, revenues from franchise fees which are relatively less susceptible to variable market conditions cushion the business risk for franchisors by spreading it among many franchisees; this leads to relatively stable business performance (Martin, 1988). The agency theory is based on the unity of franchisor's (principal's) goals and the managers of the separate business units (agents). When the owner of the outlet and the manager are different individuals, the latter often acts in his own interest instead of that of the company. He/she is not interested in making enough effort because extra profits are not meant for him but for the owner, especially if the remuneration is fixed. That is why the company invests considerable volume of resources into managerial costs and especially into monitoring and stimulating managers (Brickley and Dark, 1987; Norton, 1988). And in the franchising system the latter "turn into entrepreneurs" motivated to manage profitable outlets, the volume of costs for monitoring being essentially smaller (Taylor, 2000).

» Usually the franchisors in restaurants are large restaurant companies and chains, the biggest being the US restaurant chains of fast-service outlets.

» The restaurant companies apply various ways for development through franchising (Ball, 2000): market penetration on an existing market (Burger King's 'Breaking the Rules' campaign of the early 1990s was a direct attempt to penetrate McDonald's stronghold in UK); market development through existing products (When KFC franchised many of its outlets in 1976, franchisees opened for longer periods than managers in the company-owned and operated outlets. As a result, they obtained greater revenues); working out new products for the existing market (home delivery, for example); new markets and/or diversification (horizontal integration or vertical integration).

» In restaurants the subject of franchising are restaurant products that could be easily applied to every single outlet, often by owners who do not have previous experience in the field. This presupposes, on the one hand, a relative homogeneity of the product and, on the other, designing a system of standards in respect to the superstructure and service operations (Dabeva, 2013). This is why the luxury gastronomic outlets do not develop by way of franchising.

» The restaurant product subject to franchising is a clear, distinctive, famous and well-established brand, the name of the corporation being most often included in the franchising package in the field of restaurants. One of the leading elements of the franchising package is the trademark because of its numerous functions, legal protection and its fundamental role for forming the brand (Dabeva, 2013).

» The franchising package includes also knowhow, mainly those in the service operations, but it is rarely patented. In the modern stage its significance is increasing due to the comparatively high level of the superstructure and the orientation towards servicing and the attitude to guests as a leading competitive edge.

3. Impact of COVID-19 on the development of the restaurant franchising

The researches in respect to the impact of COVID-19 on the activity of restaurant companies are still not enough because of the short time period; besides, most of them are done by US institutions and study the changes in US economy. Despite this fact, the available publications allow one to make some initial conclusions on the development of restaurants and restaurant franchising internationally, since the spread of COVID-19 has been pandemic and affects the whole world. The restaurant industry is one of the most affected sectors as a result of the measures taken by states for restricting the spread of the Corona virus. The initiatives for keeping social distance, limiting free movement internationally and nation-wide, for full and partial lockdown lead to a number of negative consequences in the restaurant activity in several basic trends:

- temporarily closed outlets;
- terminally closed outlets;
- laying off employees due to inability to cover costs for paying salaries;
- accumulating considerable debts to the state and other institutions.

The negative consequences listed above have direct impact on the restaurant franchising in particular:

✓ Dramatic decline of the interest in signing franchising contracts in the restaurant business. According to data of FranConnect, a company for managerial decisions in the sphere of franchising, in 2020 the US corporative restaurant brands mark a decline of 36% in the number of deals. The chain of fast-food outlets registers a decrease of 63% in the deals they make, and there are nearly 80% less deals of the chains in the classic restaurant business (Walsh, 2020).

✓ Delayed financial growth. The annual financial reports of the large restaurant chains show decline in the level of company performance.

Table 4. Change of Revenues and Units of restaurant companies for the time period 2019 - 2020

Company	Revenues		Increase/ decrease	Units		Increase/ decrease
	2020	2019		2020	2019	
McDonald's	19208	21365	-10.1%	39198	38695	1.3%
Starbucks	23518	26508	-11.3%	32660	31256	4.5%
YUM! Brands	5652	5597	1.0%	50000	43 617	14.6%
Restaurant Brands Int.	4968	5603	-11.3%	27025	27086	-0.2%
Domino's Pizza	4117	3618	13.8%	17644	17020	3.7%

Source: The table is made by the author using data of companies' annual reports

The data in Table 4 show that for most of the leaders in the world restaurant business there emerge negative changes in respect to revenues from sales despite the absolute increase of the number of chain outlets. The exception is Domino's Pizza where one observes a significant growth of revenues from sales and smaller increase of the number of outlets, as well as the YUM! Brands Corporation where, despite the growing number of outlets with nearly 15%, the growth of revenues is very small. Domino’s Pizza is a chain developing mostly due to the concept of “home delivery”, that is why it is not surprising that the spread of the pandemic and the measures for restricting it haven’t had a negative effect on the company performance.

✓ Delayed physical growth. The information presented in Table 5 allows one to see that all sectors of franchising have been affected by the COVID-19 pandemic, yet, the hospitality industry has faced the biggest negative impact since the start of 2020. In restaurant franchising one observes the largest number of closed outlets – 14 200 out of which 10 105 have closed temporarily and almost 2% have terminated their activity forever. Since the biggest restaurant chains report a growth of units (Table 4), one can suppose that the closed outlets are part of smaller local and national chains.

Table 5. Estimated Unit Closures in the franchising sectors (As of Aug 2020) in USA

Industry	**Franchised Business Establishments (As of Feb 2020)**	**Permanent Closures**	**Closure Rates**
Commercial & Residential Services	239 491	1 516	0.6%
Retail Food, Production & Services	156 016	2 870	1.8%
Hospitality	29 781	591	2.0%
Restaurant	230 515	4 095	1.8%
Personal Services	119 753	1 804	1.5%
Total	**775 556**	**10 875**	**1.4%**

Source: Franchise Business Economic Outlook, 2021 Retrieved from https://www.franchise.org/franchise-information/franchise-business-outlook/franchise-business-economic-outlook-2021. Accessed on November 25, 2021.

✓ Loss of professionals. According to information of the International Franchise Association, employment in the US restaurant sector dreases by 11.2% in 2020 as compared to 2019 which in absolute terms amounts to about 905 400 job positions (Franchise Business Economic Outlook, 2021). As a result of inability to cover expenses, a large part of franchisees cut down the number of their employees drastically.

Table 6. Job and output losses in franchising sectors (As of Aug 2020) in USA

Industry	**Job Losses**	**Output Losses** (in USD billions)
Commercial & Residential Services	79 428	39.2
Retail Food, Production & Services	86 539	15.4
Hospitality	215 227	21.5
Restaurant	905 400	73.7
Personal Services	65 608	35.5
Total	1 352 203	185.3

Source: Franchise Business Economic Outlook, 2021 Retrieved from https://www.franchise.org/franchise-information/franchise-business-outlook/franchise-business-economic-outlook-2021. Accessed on November 25, 2021.

The information presented in Table 6 shows undoubtedly that restaurant franchise has been affected times more than the remaining franchising sectors both in respect to job and output losses. Good professionals in restaurants quit and prefer other spheres of economy that are less affected. As a consequence, one could expect that the restaurant business will suffer shortage of qualified employees much more compared to other spheres of activity.

In previous recession the franchising business model turned out to be a sustainable and leading model of growth. COVID-19 placed unprecedented challenges to the franchise community, but franchisors and franchisees react fast and carefully in order to minimize losses. To make the negative effects of the Covid-19 pandemic and the measures implemented by governments for limiting its spread, companies in the restaurant business quickly undertake numerous activities which can be summarized in the following trends:

› *Corporate support.* Many of the large restaurant chains like Restaurant Brands International, McDonald’s and others, in order to support their franchisees, undertake various reliefs and negotiate more favorable conditions like:

- postponement for paying franchise fees within 14 to 90 days;
- change in the structure of franchise fees from fixed and variable to 100% variable;
- prolongation of the deadline or complete cancelation for indefinite time of planned renovations, repair works and change of equipment;
- creating teams for consulting and supporting franchisees for faster access to economic stimuli for small and medium businesses provided by the government.

› *Employee support*. The reliefs provided by franchisors allow franchisees to redirect free funds to other activities like:

- taking various measures for retaining staff like paying bonuses, incentives and crisis pay and supply team members, in addition to expanding health, wellness, paid time-off and college tuition benefits;
- re-evaluating the roles of the employees that were willing to work. Instead of laying off employees, franchisees try to find out a new role for everyone willing to work and work schedule that guarantees employees’ safety and optimal sales volume. Waiters become drivers for home delivery, hosts become phone operators handling the in-coming phone calls for carry-out orders and so on.

› *Social responsibility*. Despite the tough conditions restaurant chains take part in a lot of initiatives for donating food to hospitals, the Red Cross and to families who relied on school meals for daily sustenance for their children. Many restaurants provide financial or material support to their employees’ families who they laid off under pressure of the pandemic.

› *Innovative decisions for enhancing guest experiences*. The Burger King chain started building new outlets with innovative design which includes (Business Wire, 2021):

- Drive-In - Guests will be able to park their cars in the drive-in area under solar-powered canopies, place their orders through a mobile app by scanning a QR code at their parking spot, and have food quickly delivered to their cars;
- Curbside Delivery. Advance orders placed through the mobile app will have dedicated parking spots for curbside delivery. Guests will be able to notify the restaurant team member upon arrival via the app as instructed on the parking signs;
- Pick Up Lockers. Mobile and delivery orders can also be picked up from coded food lockers facing the exterior of the restaurant. The food will come straight from the kitchen to the pick-up lockers;
- On-Premise Dining. One design option replaces the traditional indoor dining room with a shaded patio featuring outdoor seating for guests who prefer to dine on-premise;
- Drive-Thru. A double or triple drive-thru features digital menu boards and merchandising. The multi-lane ordering and pick-up expedite the process, while a living wall frames the guest’s view into the kitchen interior. An external walk-up window on the glass facade will also be an alternative ordering point for take-out;

- Suspended Kitchen and Dining Room. One innovative design option features a suspended kitchen and dining room above the drive-thru lanes configured to reduce the building footprint, making it ideal for urban driving cities. Drive-thru guests have their order delivered from the suspended kitchen by a conveyor belt system, and each lane has its own pick-up spot. This restaurant design option features a triple drive-thru with a dedicated lane for delivery drivers. Guests who want to dine in can enjoy the dining room and covered outdoor seating situated above the drive-thru entrance. The design of this restaurant allows a 100% touchless experience.

Conclusion

As part of the restaurant industry, the sector of restaurant franchising is exposed to considerable negative impact by the spread of the COVID-19 pandemic. The experience of the large restaurant chains which operate mainly with franchising outlets underlines the strengths of this business model in an exceptionally difficult situation. Restaurant franchising proves its sustainability through fast responding, ability to adjust to changed environment, willingness to cooperate and give a hand, take measures on time and make changes – part of which will be still active after the pandemic ends.

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