INTUITION
30 MAY 2025

The franchise model: a buffer in tough times

In the face of heightened economic uncertainty, businesses are forced to tighten their belts, delay expansion, and reconsider their cost structures. Within the fast-food sector, one model has shown remarkable resilience: franchising. Rather than just an engine for growth, franchising has proven to be a defensive asset, helping brands withstand economic headwinds with agility and efficiency. This article illustrates how quick-service restaurant brands benefit from the franchise model.

SPEED READ

- **Amid policy shifts, tariffs, and geopolitical tensions, businesses are cutting costs, delaying expansion, and reassessing strategies to stay resilient.**
- **The franchise model offers resilience during economic uncertainty by reducing capital needs, offloading operational risks, and ensuring stable revenue through royalties.**
- **McDonald's success illustrates the benefits of franchising. By strategically shifting to a more franchised model from 2015-2023, the company achieved significant margin expansion.**
- **More recently, Yum China has accelerated development of its franchised restaurant network as weak consumer sentiment continues to pressure the economy.**
- **In the face of economic uncertainty and looming recessionary risks, we remain focused on quality companies with strong defensive capabilities.**

James Clark

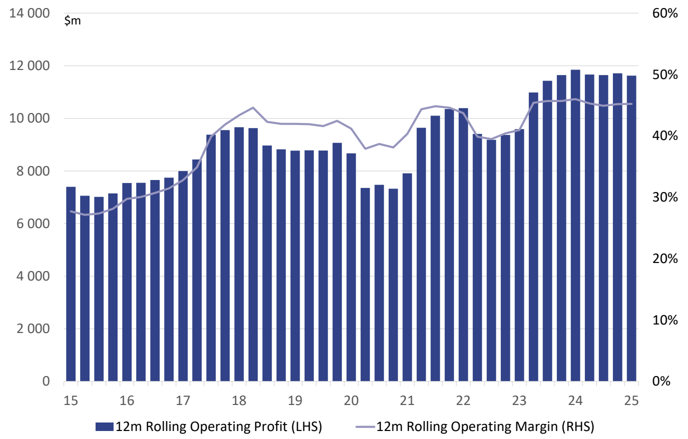
Rising economic uncertainty, fueled by Trump's tariff announcements and unpredictable economic policies, has elevated inflation expectations and shaken consumer confidence. Recessionary risks are prevalent in the U.S. with the potential to lead to a broader economic slowdown. In this climate, we remain focused on high-quality companies with strong defensive traits. One model that continues to demonstrate resilience is franchising, particularly within the fast-food sector.

Franchising involves two players: the franchisee and the franchisor. The franchisee pays a fee to use the franchisor's established brand, products, and operating system. By following the franchisor's operational guidelines, the franchisee runs a location as their own business. This model allows franchisors to outsource their day-to-day operations, scale rapidly with minimal investment, and gain access to local expertise. Offloading operational and capital burdens from the franchisor to the franchisee creates a leaner, more insulated business, which is paramount for companies, particularly in recessionary periods. The franchise model protects fast food brands in the following ways:

1. Lower capital expenditure: Since franchisees typically fund the expansion of new restaurant locations, franchisors don't need to allocate substantial capital for growth. This capital-light structure is highly advantageous during periods when liquidity is scarce.
2. Reduced operational risk: By outsourcing day-to-day operations to franchisees, franchisors avoid the full brunt of rising labor costs, inflationary input pressures, or localized economic slowdowns.
3. Stable revenue streams: Royalties are generally based on a percentage of sales, not profit. This means that even in tougher times, franchisors continue to earn income from their franchisees, offering a reliable revenue stream, which is less sensitive to fluctuating margins.
4. Franchisee incentive alignment: Franchisees are often highly motivated to keep operations efficient and competitive, especially during challenging periods. This typically translates into greater operational discipline and adaptability on the ground.

McDonald's provides an interesting case of the defensive quality that the franchise model provides. By intentionally increasing its franchise mix (the proportion of franchised to company-owned stores) from 82% in 2015 to 95% in 2023, the company was able to reduce its direct operational footprint. This strategic shift coincided with a substantial increase in operating margins, from 29% to 45%, even throughout periods of macroeconomic stress. The company's asset-light, royalty-driven model made it more resistant to inflationary and labor cost pressures.

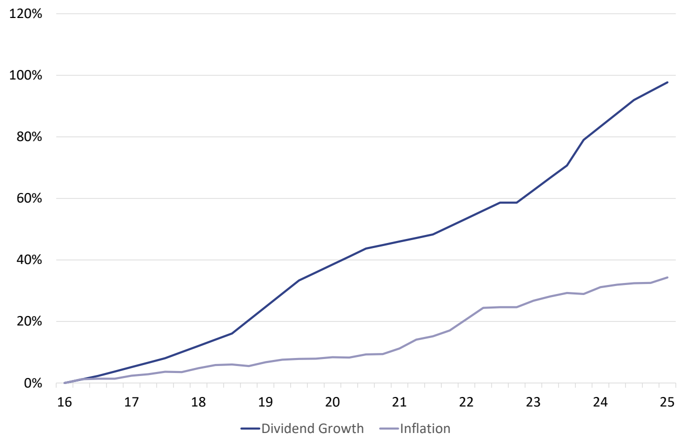
MCDONALD'S: OPERATING PROFIT AND OPERATING PROFIT MARGIN



A shift to a more franchised model helped McDonalds grow its profitability.

Royalties from franchisees have led to consistent and predictable cash flows, which have enabled the business to provide consistent and growing dividend payments to shareholders since 1976.

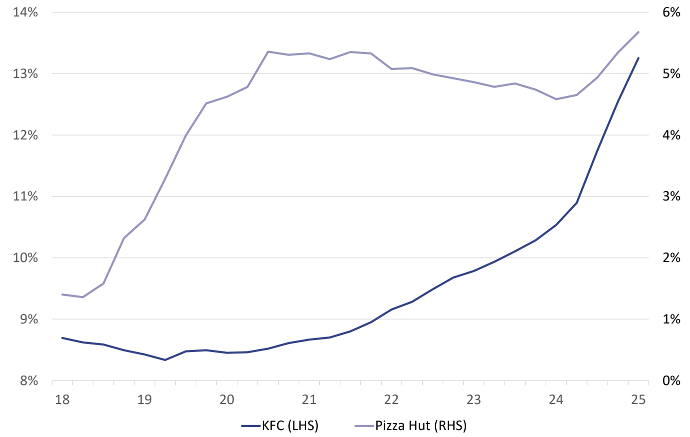
MCDONALD'S: DIVIDENDS VS INFLATION-ADJUSTED DIVIDENDS



Predictable cash flow generation through franchising has enabled McDonalds to sustain and grow its dividend payments above the rate of inflation.

Yum China has also indicated an intent to shift to a more franchised model, particularly in more recent years as China's economy has been challenged by suppressed consumer sentiment. Yum China owns a portfolio of over 16,000 stores across 2,300 cities in Mainland China, mostly consisting of KFC and Pizza Hut stores. These stores are predominantly company-owned, as only 9.5% and 5.7% of the company's KFC and Pizza Hut stores are owned by franchisees, respectively. To strategically fortify the business, the company expects the franchise mix of new stores to reach 40% - 50% for KFC and 20% - 30% for Pizza Hut over the mid-to-long term.

YUM CHINA: FRANCHISE MIX



Yum China's strategic shift to a more franchised model has accelerated over recent years as the economy remains under pressure.

Franchising is a defensive model, creating an attractive investment proposition for fast food franchise chains, such as McDonalds and Yum China. Additionally, the quick-service restaurant sector is supported by several long-term growth drivers, including urbanization and rising demand for convenience. Technological advancements have streamlined food production and distribution, making eating out an affordable luxury for a growing consumer base.

As global economies contend with inflation risk, supply chain disruptions, and shifting consumer behavior, companies with a strong defensive model, like franchised fast-food chains, are well-positioned to preserve profitability and operational stability. As a team, we are focused on identifying these high-quality businesses, as their stable earnings support reliable cash flows and consistent dividend returns, aligning with our income-driven investment philosophy at Harvard House.

Our next Insight seminar will be held in June. As usual, we will take stock of how our economy and markets are faring six months into the year."

Topic:	Mid-Year Update
Natal Midlands	
Date:	12th of June 2025
Venue:	Christ Church Howick, 23 Mare Street, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	3rd of June 2025
Venue:	Rosebank Union Church, Cnr Winne Mandela Drive and St Andrews Road, Hurlingham
Time:	7am for 7.30am

Cape Town	
Date:	5th of June 2025
Venue:	SSISA Conference Centre, Boundary Road, Newlands, Morne du Plessis Boardroom, 4th floor
Time:	7.30am
Venue:	ABRU Motor Studio, Lourensford Wine Estate, Somerset West
Time:	5.30pm for 6pm

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