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PARIS BAGUETTE: THE EXPANSION QUESTION

Kevin Kim wrote this case under the supervision of Professors Bryan Hong and Ji-Hwan Lee solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

"Out of the billions of loaves we bake, a customer may judge us from the one slice of bread she tastes."
— Honourary President Chang-Sung Hur

INTRODUCTION

It was May 1, 2014. Young-In Hur, chief executive officer (CEO) of Paris Baguette (PB), the largest bakery chain in South Korea (Korea), was troubled. The Korean bakery industry had become saturated, and PB's domestic expansion had slowed to a halt as a result. The recently enacted legislation restricting the expansion of bakery chains in the country had made the situation even more difficult. Also, Tous Les Jours, the second largest bakery chain in Korea owned by the giant CJ conglomerate, had been aggressively catching up to PB in its expansion, both domestically and internationally. Given the circumstances, PB's publicly stated goal of achieving revenue of 4 trillion won[1] by 2020 seemed distant. Hur wondered how the company could expand successfully to accomplish its goals.

COMPANY BACKGROUND[2]

The company was founded in 1945 as Sangmidang[3] and was located in the city of Wongjin, home of the founder and honourary president, Chang-Sung Hur. When Sangmidang relocated to Seoul, the nation's capital, in 1948, it faced fierce competition. To successfully compete, managing costs was critical. After extensive experimentation, Chang-Sung Hur developed "hard coal still," a method of using powder coal for baking instead of conventional white charcoal. Ten times cheaper than white charcoal, the use of powder coal dramatically reduced the company's variable cost of baking relative to its competitors. Sangmidang reinvested the cost savings into developing new technologies, which improved its product quality.

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[1] Cdn$1 = KRW957.6763 (won) on April 4, 2014, according to https://ca.finance.yahoo.com/currencies/converter/#from =CAD;to=KRW;amt=1, accessed July 26, 2014.
[2] Company interviews.
[3] The English translation of Sangmidang is "the Hall of Beautiful Rewards."

While visiting Japan in 1964 as part of a delegation of observers at the Tokyo Olympics, Chang-Sung Hur was stunned after touring several Japanese bakeries and discovering how advanced their facilities were in automating the production of baked goods. After returning to Korea, he hired Korean-Japanese technicians and invested heavily in improving the automation of his bakery facilities. That same year, the firm was successful in fully automating its bread production process and introduced new “cream bread,” a bread pastry filled with cream, which quickly became popular with customers. As the company continued to expand, it was renamed Sam Lip General Food Company (Sam Lip) in 1968.

In the 1970s, Chang-Sung Hur began to plan a transformation of Sam Lip from a bakery company to a general foods company. To achieve a reliable supply of edible oils and fats for its bakery business, Sam Lip established an edible oils and fats factory. In 1972, it also established Shany Inc. (Shany), a specialized mass producer of premium cakes. Based on the knowledge of bakery automation accumulated over the years, a separate manufacturing business named Sung-Il Machinery was also established.

In 1981, Young-In Hur, Chang-Sung Hur’s second son, inherited the Shany business, which was only one-tenth of the size of Sam Lip Foods at the time. Young-In Hur believed it was essential that a manager develop an intimate understanding of the bakery production process in order to manage a premium brand. Consequently, after his first seven months as president of Shany, he took a leave of absence and left to study at the American Institute of Baking. While he was studying in the U.S., Hur was able to learn about the American franchise business model, which was uncommon in Korea at the time. By the time he returned to Korea, he had acquired enough expertise to analyze a bread’s fermentation condition by simply smelling it and examining its texture. His first executive decision after returning was to establish a food technology research centre, the first of its kind in the Korean bakery industry. As a result, Shany developed various products including breads, European pastries and cakes, as well as handmade cookies.

In 1986, Hur established Paris Croissant and opened a French-themed bakery, called Paris Baguette (PB) in 1988, in the Gwanghwamun neighbourhood of Seoul. The bakery offered croissants, brioche and other pastries as main products and also sold sandwiches, muffins and coffee. To achieve economies of scale and create consistent brand recognition among consumers, PB positioned its first set of stores in Seoul. This also mitigated the difficulties associated with training franchisees and lowered the cost of transporting ingredients.

Through rapid expansion, PB became the largest bakery chain in Korea in 1997. In 1999, a second factory was established in the city of Sungnam, and PB developed a production process called the “bake-off system,” where factory-made dough was distributed to the stores, which baked the various breads themselves. This produced a high level of consistency in the quality and taste of PB’s products across stores without compromising freshness. By contrast, PB’s competitors at that time either baked their bread in-store from scratch or shipped the final products baked in large factory facilities to nearby stores. PB’s bake-off system maintained the freshness of the dough and prevented it from spoiling by automatically adjusting its temperature and storage twice a day.

PB had a long tradition of focusing on product innovation. Every month, the bakery developed 100 new bread items, of which 20 were introduced after performing marketability analyses. Hur continued to spend a considerable amount of time in the product development process, personally tasting new products every week for approval. He viewed these approval meetings as a critical opportunity for him to communicate with the research and development (R&D) team and align his vision with PB’s products, as well as continuing to refine his own knowledge and expertise of the bread-production process.

In 2013, PB operated over 3,200 stores in Korea alone; almost three times as many stores as the next largest Korean chain, Tous Les Jours (see Exhibit 1).

PB'S KOREAN OPERATIONS[4]

PB's operations were divided into three main stages: (1) supply of raw materials, (2) processing of raw materials and (3) shipment to stores and store operations.

Supply of Raw Materials

Wheat, the main ingredient in baking, was supplied by PB's subsidiary, Mildawon, a leading Korean company that accounted for 7.95 per cent of the Korean wheat refinery market.[5] PB received a steady and reliable supply of wheat after acquiring the company in 2008, while also diversifying its business portfolio into a related enterprise.

Purchasing the ingredients was a complex operational challenge, since PB offered over 600 kinds of bread using more than 1,000 different ingredients. To optimize purchasing decisions, PB introduced the "e-procurement system" in 2008. This system enabled the procurement division to manage all purchases for the entire enterprise from general office supplies to raw materials. As a result of this systematic approach, purchases became more streamlined and transparent, reducing waste and allowing for bulk purchasing where available. Moreover, the database created from utilizing the system enabled purchasing to be based upon more accurate demand forecasts, which gave PB a cost advantage over its competitors.

Processing of Raw Materials and Shipment

Raw materials were gathered at four manufacturing plants operated by PB that were responsible for making "dormant dough." Dormant dough was made by suppressing fermentation by freezing and storing the dough in a refrigerator. It was a critical element of production for PB since large quantities of bread needed to be produced with a high level of consistency in taste. Competitors could replicate some components of PB's manufacturing facilities, but ultimately the mix ratio of ingredients and yeast-based techniques made the firm's dormant dough production process difficult to imitate precisely.

PB's four manufacturing plants were dispersed geographically throughout Korea. The dormant dough was shipped to 16 warehouses, which in turn supplied dough to PB's over 3,200 retail outlets throughout the country. Because the bakery industry had relatively low profit margins, it was crucial for bakery franchises to manage costs by achieving economies of scale. Having a low factory-to-store ratio was key to keeping costs low. Deliveries were made at least twice a day to all of PB's stores in Korea, while competitors' stores typically received deliveries only once every three days.[6] This frequent delivery enhanced the freshness of products such as sandwiches and cakes, which had a short shelf life before spoiling, and allowed for better quality products to be offered to customers.

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[4] *Sungmin Ryu, Kyunghee Kim and Woohyun Lee, "Paris Baguette's Global Growth Strategy," Korean Logistics Academy, 2012, pp. 173–180. 류승민, 김경희, 이우현. 파리바케트의 글로벌 성장전략 사례분석 2012 년 (사)한국유통학회 춘계학술대회 발표논문집.*

[5] *Korea Investors Service, "Wheat Refinery Industry Report, June 2014," (한국신용평가 "제분 Industry Report 2014,6").*

[6] *Tous Les Jours delivered dormant dough to its stores once a day.*

Store Operations

Once the dormant dough arrived at stores, it was activated to its fermented state, baked into finished products and then displayed and sold to consumers. Although making bread from scratch at each of the stores might have added more freshness to the products, it posed significant difficulties in ensuring consistency in quality and taste across stores. By using the bake-off system, PB was able to capture both freshness and consistency with a variety of freshly baked products offered in its store locations. Also, using dormant dough helped to lower labour expenses and increase margins relative to other competing bakeries that produced bread from scratch. Seventy per cent of the products that PB stores offered were prepared using the bake-off system. The remaining 30 per cent were received from the factories completely ready-made to keep prices low.

ROYALTY STRUCTURE

In a conventional franchisor-franchisee relationship, the franchisor mainly dealt with recruitment, education and monitoring of franchisees, as well as overall marketing of the brand. Royalty fees, which were usually a fixed percentage of the franchisee's revenues, were then collected from franchisees.

For PB in Korea, however, the relationship with franchisees was more complex. Since PB had vertically integrated with ingredient suppliers and developed its own food processing capability, it had considerably more control over the value chain (see Exhibit 2). Leveraging its control over the supply of dormant dough, PB did not collect royalty fees based on franchisee revenues but earned revenues by selling its dormant dough to franchisees. PB had considerable flexibility in setting the price it charged for dormant dough and was able to change its pricing when necessary.

MARKETING

PB allocated considerable resources to marketing, spending 79 billion won in advertising expenses and 14 billion won in promotion expenses in 2013. The company hired famous Korean celebrities to promote its products in TV commercials. It also offered "Happy Points," its loyalty program, to retain its customers and analyze buying patterns. Registered customers received points with every purchase, which could be used to buy PB products.

Korean consumers tended to have a positive view of PB's brand image and mainly purchased its products because they were both delicious and affordable. They also valued having the wide selection of products — each store's over 600 stock-keeping units (SKUs) of products were updated monthly with new items. With more stores than any other bakery franchise, consumers found PB accessible and convenient.

Internationally, PB's typical marketing strategy consisted of premium positioning and localization. When PB first entered a foreign country, it differentiated itself with premium branding targeted towards wealthier consumers and concentrated on opening stores in locations that fit its intended brand image, such as central commercial districts, luxury shopping malls and large department stores. Company-owned stores were established first to ensure that the presentation, marketing and quality of products were aligned with the standards set by corporate headquarters. Also, PB appealed to the local market by taking advantage of its R&D competencies to develop products that fit local consumer tastes. These locally tailored products accounted for 20 per cent of the total products produced by PB. As a result, the product range offered in China was, in some segments, substantially different from that offered in the United States (see Exhibits 3 to 5).

KOREAN BAKERY INDUSTRY[7]

In 2013, the Korean bakery industry consisted of roughly 15,000 bakery stores earning total revenues of 4.6 trillion won. Despite the slow economic recovery and increase in manufacturing costs due to the rise of oil and grain prices, the industry posted growth of 4 per cent over the previous year, with a positive future growth outlook. The industry was affected more by changes in consumer preferences than by changes in macroeconomic factors, with the shift from rice to substitutes such as bread and noodles supporting the steady growth. Recently, healthier and more premium products were becoming increasingly popular, pressuring bakeries to use locally sourced premium ingredients to produce differentiated products.

Currently, franchise stores accounted for 30 per cent of the total stores in the industry and 55 per cent of industry revenues in Korea. These were bakeries owned by franchisees and followed the product and service guidelines provided by franchisors. Two large franchise bakery chains, PB and Tous Les Jours, dominated the segment. Both chains had aggressively expanded their total number of stores and invested heavily in new product development to meet consumer tastes. Several large franchise chains produced over 600 products and developed 15 to 20 new products per month.

Regulations

Recently, franchise bakery firms had been criticized for encouraging the opening of new stores within close proximity of their own existing stores, increasing overall sales for their brands but reducing franchisee sales due to cannibalization. After receiving complaints from franchisees, the Korean Fair Trade Commission decided to ban large franchises such as PB from opening new stores within 500 metres of existing store locations.[8]

In February 2013, the Korean National Commission for Corporate Partnership introduced another set of regulations to protect small independent business owners by limiting the expansion of various franchise businesses in the food service industry. Independently owned bakeries, which accounted for 65 per cent of stores in the industry and 40 per cent of industry revenue[9], had been struggling to fend off franchise competitors in recent years. As a result of the new regulations, bakery chains such as PB were no longer allowed to open new stores within 500 metres of any existing bakeries, as opposed to only their own existing stores.[10] The chains protested, arguing that they were being unfairly penalized. However, their arguments were largely ignored by the government, which had taken a firm stance on protecting the independent bakeries.

Competition

In Korea, only a few firms competed in the bakery franchise business. Although capital requirements to enter the bakery franchise market were not that significant, it was difficult to obtain distribution channels and economies of scale due to high fixed costs. Consequently, increases in competition from other chains

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[7] Junghee Lee, et al., "Processed Food Segmented Market Analysis: Bakery Edition," February 2011, 이정희 외. 가공식품 세분화 시장 현황조사: 제과빵시장 편.
[8] Jaeseok Jeong, Hannara Jeong, Kihyeon Ko, Junghoon Moon and Hyong Goo Kang, "Success Factors of Paris Baguette's Bakery Franchise Business: Industry Competition and Core Competence Analysis," Asia Marketing Journal, 15.2, July 2013, pp. 1–27.
[9] HNCOM "Korean Food Almanac" 2014-2015, 2013-2014.
[10] Jaeseok Jeong, Hannara Jeong, Kihyeon Ko, Junghoon Moon and Hyong Goo Kang.

typically came not from smaller new franchise entrants but from the expansion of major companies into the franchise bakery industry. In particular, CJ,[11] one of the largest conglomerates in Korea, expanded into the bakery industry as Tous Les Jours, as part of its business diversification.

With strong support from its parent company CJ, Tous Les Jours had been rapidly expanding. It currently operated more than 1,250 stores in Korea alone, with sales of KRW600 billion. Tous Les Jours followed a business model very similar to that of PB, including its own version of the bake-off system. It was the only competitor that could realize the same magnitude of economies of scale as Paris Baguette, and operated a single manufacturing plant that supplied all of its bakery stores.

However, Tous Les Jours had recently been struggling in the saturated domestic market. Compared to PB, who had been transitioning to focus on operating larger café-style stores that offered higher margin products such as coffee since 2003, Tous Les Jours' stores had only recently begun the same transition and mainly focused on offering bakery products.[12] As a result, its domestic average annual sales per store was KRW422 million, lagging behind PB's KRW673 million. In response to domestic market saturation, Tous Les Jours had focused instead on achieving growth in overseas markets and had expanded to seven countries with 140 stores. It also invested substantial amounts in marketing, spending KRW5 billion in advertising and KRW21 billion on promotions in 2013 to maintain its market share and position.[13]

PARIS BAGUETTE'S INTERNATIONAL EXPANSION

Since the 1990s, PB had looked abroad for expansion opportunities. Hur had grown concerned with the increasing saturation of the Korean market and knew that one day PB would have to expand overseas to sustain its growth. In 2004, PB began its international expansion with the opening of a company-owned store in Shanghai, China.

With the opening of its 100th store abroad in 2012, Hur's ambition for global expansion was crystalized. By 2013, PB operated 119 stores across China. Also, since opening its first store in 2005 in Los Angeles' Koreatown, PB had opened 38 stores across the United States centered around Los Angeles and New York, two areas with large ethnic Korean populations. Based on the positive feedback received in these countries, it launched the brand in Ho Chi Minh City, Vietnam and Singapore in 2012.

China

In 2013, the Chinese bakery industry had grown to RMB130 billion,[14] with an annual growth rate of 20 per cent and primarily developing around major metropolitan areas.[15] With increases in consumer income and international trade, China provided a potentially exciting opportunity for Western-style bakeries, as Chinese consumers continued to demonstrate enthusiasm for trying such goods.

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[11] *CJ had many subsidiaries under its portfolio, Its 20 main subsidiaries ranged from the food service industry to entertainment and media, with more subdivisions as independent brands. For example, Tous Les Jours was part of the CJ Foodville group of companies, which was a subsidiary of CJ in the food services group.*
[12] *A Tous Les Jours store was on average 85 square metres, while the average PB store was 115 square metres.*
[13] *Company files.*
[14] *Cdn$1 = CNY5.6196 (yuan) on April 4, 2014, according to https://ca.finance.yahoo.com/currencies/converter/#from =CAD;to=CNY;amt=1, accessed July 26, 2014.*
[15] *Sungmin Ryu, Woojung Jang and Hyejung Cho, "The Chinese Expansion Strategy of a Global Franchise: Paris Baguette Case," Creative Economy and the Logistics Industry, pp. 109–115. (류승민, 장우정, 조혜정. 글로벌프랜차이즈의 중국진출 전략: 파리바게뜨 케이스 창조경제와 유통산업).*

The Chinese bakery market was originally dominated by the domestic chains Marco Polo and Cosongbang, and the Taiwanese chains Christine and GANSO, which mainly displayed and sold bread made in centralized manufacturing facilities. More Taiwanese bakeries entered the Chinese market in the 1980s and began expanding rapidly during the 1990s as Sino-Taiwanese relations improved. In the early 2000s, more premium bakery brands were introduced, such as 85C (Taiwan), BreadTalk (Singapore), PB (Korea) and Yamazaki (Japan). Also, domestic Chinese bakery chains began to expand more aggressively. Although competition in the Chinese market was becoming more intense, no company had yet achieved overall market dominance. Instead, local brands in each of the regions possessed comparable market share. Most brands aimed to achieve market dominance in their region of origin first before expanding to neighbouring regions[16] (see Exhibit 6).

Although the Chinese market showed great potential, doing business in China had its difficulties. The Chinese government maintained a complex set of regulations compared to Korea.[17] While the Korean bakery market had low capital requirements for entrants, the Chinese market required significant amounts of initial capital investment to satisfy stringent regulations. Also, capital was difficult to raise in China for a foreign franchisor, although successful franchise expansion required substantial amounts of money to ensure smooth operations and new franchisee investment. This was due to highly regulated local capital markets and the Chinese financial institutions' preference to lend to local firms. Korean financial institutions were also not enthusiastic about funding franchise expansions into China.

In China, franchise businesses were still a new concept and franchise-oriented growth strategies posed risks with respect to the relationship between franchisor and franchisees. For example, Café Bene, a Korean coffee shop franchise, had recruited a franchisee for expansion to China. The franchisee changed the interior design of its store without consulting the franchisor and failed to respond to Café Bene's request to change it back. Ultimately, the franchise contract of the first store was cancelled. In another instance, the Singaporean bakery franchise BreadTalk experienced difficulties because it did not have sufficient franchisee management measures. In Shenyang Province, a franchisee assaulted a reporter who had written an article criticizing the franchisee. Although the incident was resolved, BreadTalk's brand image had been damaged. These types of incidents were not uncommon in China, as few companies had managed to develop an adequate franchisee management system in the Chinese bakery industry.[18]

Labour costs in China were also increasing by approximately 10 per cent each year, affecting the profitability of local bakery franchise chains. Companies that attempted to take advantage of the lower labour costs by producing in China and exporting to other markets outside of China were having difficulties as a result. On the other hand, companies that had entered the Chinese market to sell domestically in China were doing comparatively well.

PB in China

In 1997, PB began to consider entering China. Since sufficient public information on the Chinese market did not exist at that time, PB sent its own employees to explore the nation's potential for bakery expansion. For seven years, research was conducted on the local food and beverage industry, analyzing the appetite and dietary culture of Chinese consumers and examining local commercial real estate to form a carefully developed market entry strategy.

[16] *Sungmin Ryu, Woojung Jang and Hyejung Cho.*
[17] *Jo Chan, "Franchising in China," China Law & Practice, June/July 1999, www.chinalawandpractice.com/Article/1694949/Channel/7576/Franchising-in-China.html, accessed July 1, 2014.*
[18] *Sungmin Ryu, Woojung Jang and Hyejung Cho.*

Based on extensive market analysis, PB positioned itself as a premium bakery brand in central commercial areas and luxury residential areas in major Chinese cities such as Beijing, Nanjing and Dalian. These locations were chosen to reach out to PB's target consumers, who were increasingly interested in luxury brands and higher quality foods. For example, the Daning store in Shanghai was located in a central commercial area where young Chinese consumers watched movies and shopped for clothes in stores offering many foreign retail apparel brands. Located in the centre of Beijing, "The Place" location was also in a famous shopping mall, which served as a popular tourist attraction. The central commercial and residential areas also had better transportation infrastructure, which allowed for more convenient shipping of ingredients to stores.

In China, PB focused on developing a menu catering to local tastes. Other French bakery cafes such as Paul and Fauchon, which offered healthy French breads of high quality, had attempted to expand to Shanghai with a premium brand strategy without modifying their products to cater to Chinese consumer tastes and had ended up withdrawing from the market. Taking this into account, PB decided to concentrate on aligning product development to match the preferences of Chinese consumers, who generally favoured oily products with more filling, such as cream filled donuts and fried bread. To meet these needs, PB also developed new menus including rousong (meat wool) bread and skewer pastries.

To increase brand awareness, PB implemented a wide array of socially conscious programs, such as the "Cake Academy of Love," a baking course for disadvantaged youths initiated in 2005, and sponsoring a local orphanage as well as large events such as the HSBC Golf Tournament and F-1 Racing competition. As a result, PB won significant praise and awards such as being named a "AAA Brand," one of the "Top 10 Brands in China" and "Five-star Store" China, solidifying its premium brand image.

However, PB's Chinese operation faced challenges as well. Without a free trade agreement between China and Korea, trade tariffs were too high for PB to ship its dormant dough to China. Also, the geographic area of China was too large for one factory to service both the southern and northern provinces. Consequently, PB operated two factories, one in Beijing and the other in Shanghai.

PB stores in China offered fewer products than in Korea, although they still offered greater product selection than their competitors. This increased management expenses and production costs both at the company and store level, leading to an overall increase in costs. However, PB felt it was a necessary investment to capture market share in its affluent Chinese target market, which valued variety.

In June 2010, PB opened its first franchise store in Shanghai and began to expand its franchise business very conservatively to ensure product and service quality. Although the infrastructure was in place to implement a franchise structure similar to the one it had in Korea, PB had not yet seriously committed to it. Only six of 43 stores in Shanghai were currently franchise stores.

United States

In the United States, bakery cafes were becoming increasingly popular. The industry had experienced robust growth since the 2009 recession and outperformed the overall food service sector, driven largely by changing consumer preferences. Consumers were increasingly demanding healthy, gourmet and custom-made cuisine at an affordable price. Based on these trends, industry revenue grew at an average of 6.5 per cent per year from 2008 to 2013.[19]

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[19]*Andy Brennan, "Bakery Cafes in the US," IBISWorld Industry Report OD4319, October 2013, www.ibisworld.com/industry/bakery-cafes.html.*

The industry had undergone heavy consolidation over the past five years as major chains such as Panera Bread Company (Panera), Einstein Bros. Bagels and Tim Hortons expanded rapidly. The franchise model used by the major players had accommodated the rapid growth as operators required less capital and took on lower financial risk while growing market share. A number of small, independent bakery cafes that had traditionally serviced local markets were driven out of business, unable to compete with the geographic reach and marketing spend of the major chains. However, many savvy independents operated profitable businesses with high-end niche offerings such as cupcakes or macaroons.

The dominant firm in the market was Panera, which accounted for 53.3 per cent of the market with more than 1,700 bakery café locations in the United States and Canada. Roughly half were operated by franchisees, many of which ran multiple locations. In total, 38 franchisees operated an average of 22 locations each.[20] Panera's cafes were primarily located in urban, suburban, strip mall and regional mall locations. Its strategy was to straddle the line between affordability and high quality, similar to that of PB in Korea. Periodically, the company acquired stores from its franchise operators. This strategy helped increase company revenue, since the total sales for those locations were then earned by the company rather than the franchisee.

The industry was expected to continue on a growth trajectory over the next five years. Economic fundamentals such as consumer spending and disposable income were anticipated to perform strongly, creating a favourable operating environment for bakery cafes. From 2013 to 2018, industry revenue was expected to grow at 5.9 per cent per year on average to $9.5 billion.[21]

PB in the United States

PB began to take an interest in the U.S. market in the early 1990s, when it established a local office in Los Angeles as part of a joint venture with Allied Domecq (currently Dunkin Brands Inc.). Since PB could easily access public information on the U.S. franchise bakery market, it did not send a separate market research team there as it did in China.

While PB's marketing strategy in China was premium positioning, in the United States, the company emphasized wide product selection and high quality of products, offering more than 300 kinds of bread products made with fresh ingredients (compared to an average of 100 different kinds of bread offered by conventional bakeries). Its products also contained less sugar and calories compared to other bakeries, satisfying U.S. consumers who were increasingly becoming more health conscious. Also, PB again concentrated on localizing the menu by offering products, especially pastry products such as sandwiches, croissants and decorated cakes, which were preferred by U.S. consumers.

PB increased customer interaction with its product selection by displaying its bread products throughout the store and having customers choose what they wanted to purchase using a tray and tong. This method dramatically reduced the waiting time of customers, who would have had to wait in line to tell store employees which items they wished to purchase, one person at a time. The interior store design was also well-received. Where local bakeries used small-scale traditional interior designs, PB offered modern interior designs with a premium image concept, which reinforced the bakery's pleasant atmosphere.

To manage its human resources in the United States, PB combined company employees who had experience in running PB retail stores in Korea and U.S. employees who were more familiar with the

[20] *IBISWorld.*
[21] *IBISWorld.*

local environment and culture. This allowed PB to implement management know-how from its headquarters in Korea and adapt it to local market conditions.

PB's first U.S. outlet, opened in 2005, was in Los Angeles's Koreatown. In 2007, it opened its first outlet on the east coast in the Palisades Park neighbourhood of New Jersey and its first Manhattan outlet in Koreatown on 32nd Street. As part of its initial strategy, PB opened stores in locations with significant ethnic Korean populations. This provided significant savings on operating and marketing costs since Korean consumers in these areas were already familiar with the brand, and rental costs in these neighbourhoods were relatively inexpensive.

However, the three new stores in Manhattan that PB had opened since 2013 were in prime commercial districts. The Upper West Side, for instance, was a high-end shopping district favoured by upper-middle-class New Yorkers, where PB competed directly with Au Bon Pain, Panera and Pret A Manger. Although a significant amount of capital was required to open stores in these central commercial areas, PB chose them to increase brand exposure and to test whether its business model would work in the U.S. mainstream bakery market. So far, the performance of the new stores had been positive, with each store attracting over 1,000 customers daily, 80 per cent of whom were non-Korean.[22]

Since a Free Trade Agreement existed between the United States and Korea, PB manufactured dormant dough at its manufacturing facilities in Korea and shipped the dough across the Pacific Ocean without paying prohibitively high tariffs for the U.S. retail outlets to bake and sell. Although importing dough incurred extra costs, this allowed PB to avoid constructing a manufacturing plant in the United States until the number of stores there grew large enough to profitably support a full factory facility.

In 2011, PB recorded a profit in its U.S. operations for the first time after seven years and had been increasing profits every year since then.

OPTIONS

Hur wondered what the best course of action would be for the future of PB. Should the firm concentrate its expansion efforts in the Asian markets such as China or in the United States, home of the franchise business model? Each market had different challenges but also offered significant potential for growth. It was unlikely management would be able to execute aggressive expansion in both at the same time, so one market had to take priority. If PB succeeded in either market, it might not only reach its stated goals but also become the leading global bakery chain brand. On the other hand, perhaps PB was better served by simply improving its domestic operations in Korea at the moment, given the challenges that lay ahead for international expansion. Hur considered the different options.

China

The Chinese market had high growth potential and was in an early stage of industry maturity, creating an attractive opportunity for bakery chains like PB to expand. Since the Asian countries surrounding China shared cultural similarities and had similar economic growth trajectories, Hur was confident that PB would be able to replicate its strategy and growth in Korea. This confidence was partly based on the increasing popularity of Korean dramas and pop music throughout Asia.

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[22] *Chagjae Yoo, "Paris Baguette Captures the New York Market With Its 'Healthy Bread' After Landing in Manhattan," Korea Economy, April 1, 2014, www.hankyung.com/news/app/newsview.php?aid=2014040186381.*

If PB was to focus on expanding in China and other neighbouring Asian markets, Hur saw two possible options. Since the market in China was not yet saturated and still dominated mostly by regional players, PB could attempt to become the first national bakery chain by expanding aggressively throughout China through franchising. Gaining dominance over the largest future bakery market in the world would ensure PB's profitability in the long term. Currently, the cost of opening a store in China was comparable to Korea. However, Hur was worried whether the lack of experience potential franchisees had in China with the franchise business model could damage the brand's image in China, as it had done with other franchise brands. Also, if PB chose to partner with large, well-capitalized Chinese firms as franchisees, it could fuel rapid store growth but also pose significant risks to the brand if the relationship became strained. Choosing smaller franchisee partners might mitigate such risks but would then require managing many franchisees with limited experience to achieve sufficient store growth.

As a second option, PB could leverage the current Chinese operations as a stepping stone to expand to other Asian countries nearby using company-owned stores. PB's factories in China could supply the dormant dough for expansion into neighbouring Asian countries. Competitors, such as Tous Les Jours, had already begun to open stores in Southeast Asia. Since the bakery franchise business was new to these countries, now might be the time to capture the first mover advantage and establish presence there before other competitors entered, building the foundation for successful franchise expansion in the future.

However, Hur wasn't sure how successfully PB would be able to navigate expansion in China or its other Asian neighbours. How would the brand choose its franchisee partners if it expanded in China? How could it avoid the costly experiences of other chains there? PB had conducted seven years of research in China before its first store opening there. How long would it take to understand the consumer tastes of other Asian markets?

United States

The U.S. market also seemed very appealing. The legal environment and business practices were more mature and stable compared to Asian countries, which made transactions more efficient and increased the predictability of business operations. Also, PB could potentially leverage its stores in the United States as a stepping stone into other foreign markets far away from Korea. For example, Times Square in Manhattan attracted 1.5 million visitors a day from all over the world, which would provide significant global exposure if PB chose to open a store there. On the other hand, the United States had significant cultural differences, which could pose unforeseen challenges. PB's current success with its 38 stores, many of which were located in areas with large ethnic Korean populations, might not be indicative of the brand's future success in the rest of the country. How would other parts of the United States respond to the PB brand identity, a Korean bakery chain with a distinctly French name in its branding? Also, even though the U.S. bakery industry was not yet saturated, there were many other entrenched franchise competitors, such as cafes and fast food restaurants. The cost of opening a store in the United States was also approximately 30 per cent higher than in Korea and China.

Overall, a full-fledged franchise expansion in the United States seemed promising for PB, with the country's franchise friendly business environment. There would likely be many franchisee partners with more experience and understanding of the franchise business model in the United States. However, Hur was not sure whether PB could succeed in the United States by simply repeating the same strategy it had followed in Korea. PB's Korean franchising model, where revenues were collected by selling dormant dough to franchisees instead of royalty rates, might not be as attractive to potential U.S. franchisees, who were accustomed to the conventional royalty rate model. Competing franchise chains in the United States typically charged their franchisees 5 per cent of revenues as royalty fees.

Korea

Although PB's stated goals implied aggressive international expansion plans by 2020, Hur also knew that the company would ultimately be judged based on its profit growth. Taking this into account, improving the profitability of the firm's domestic operations in Korea also offered an attractive opportunity. While the Korean domestic market was saturated, PB could still increase profits by offering more premium products at a higher price point. With over 3,000 stores and KRW2.5 trillion won of revenues, increasing the average price of products by even 10 per cent could bring in the same amount of revenues as opening 500 stores abroad.

This option was worth considering for two main reasons. First, Korea was the market that PB understood best, and the firm had several key advantages that it lacked in other markets. PB's stores sent sales information on all of its products to the company's headquarters in real time, which provided substantial opportunities for improved analytics to detect consumer trends and changes in demand. Second, the financial cost of implementing this option was considerably lower than expanding abroad, since no additional capital investment was needed. However, successfully implementing a price increase would require a substantial amount of analysis and management resources. Hur doubted he would be able to execute both a successful international expansion and significant improvements in PB's Korean product offering at higher prices simultaneously.

Also, Hur was not sure whether focusing on the domestic Korean market was sustainable in the long run. One important reason why Korean consumers bought PB's products was their affordability. Although domestic consumers might be willing to accept higher prices, there was a limit to how much PB could increase its average price if it wanted to retain its current customer base. Also, competitors such as Tous les Jours and Panera were currently aggressively expanding in international markets. As Hur looked out his office window, he considered the options, knowing he would have to come to a decision soon.

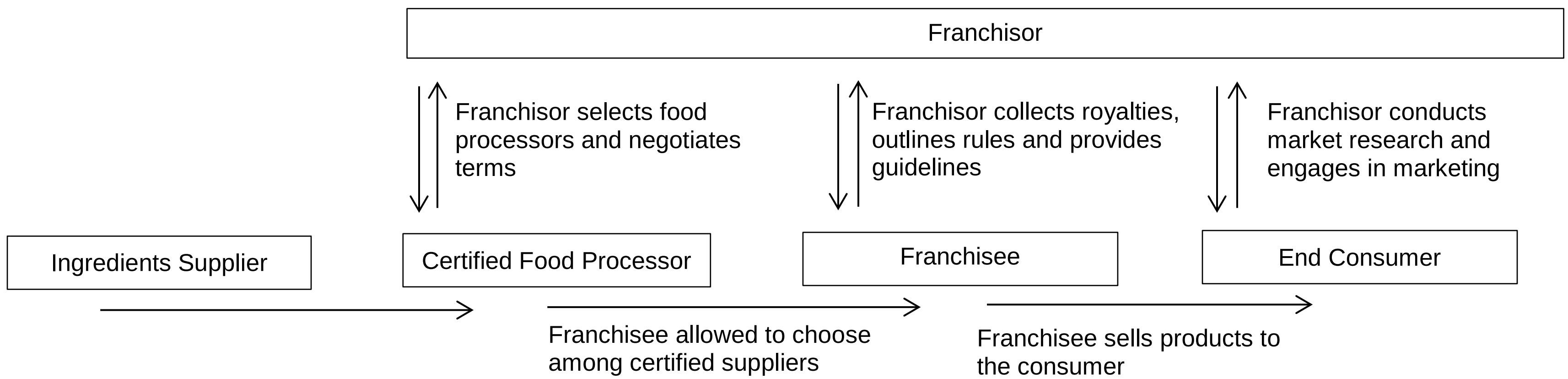
EXHIBIT 1: PARIS BAGUETTE VS. TOUS LES JOURS STORE COUNT IN KOREA

Year	Paris Baguette			Tous Les Jours		
	Franchise	Company Owned	Total	Franchise	Company Owned	Total
2013	3,220	38	3,258	1,238	20	1,258
2012	3,175	38	3,213	1,260	20	1,280
2011	3,095	46	3,141	1,281	22	1,303
2010	2,675	41	2,716	1,401	24	1,425

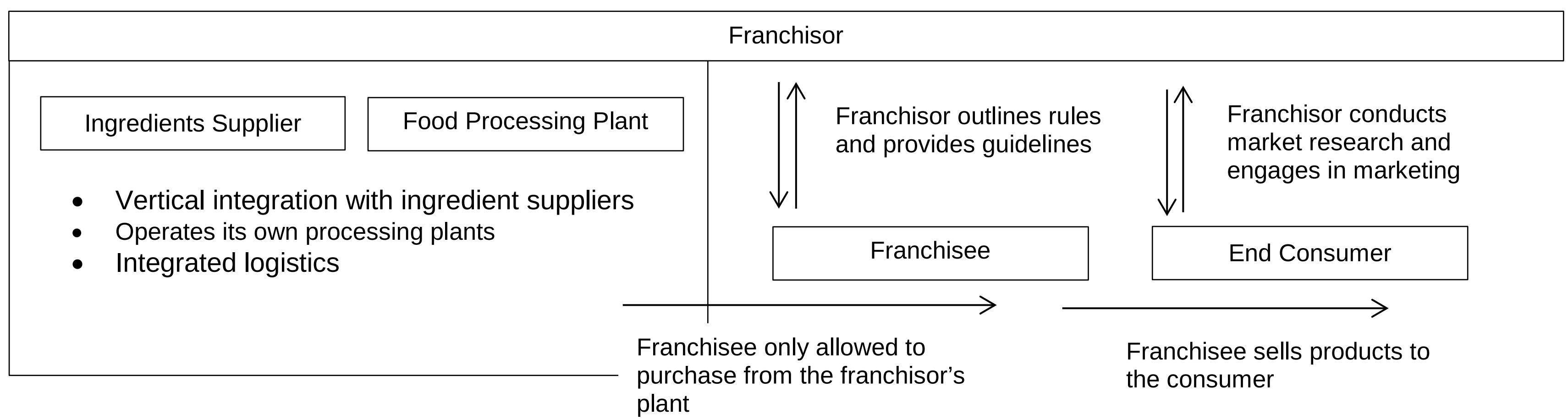
Source: Fair Trade Commission Franchise Business Trade Information Disclosure.

EXHIBIT 2: FRANCHISE BUSINESS VALUE CHAIN

Conventional Franchise Value Chain



Paris Baguette Value Chain



Source: Created by authors.

EXHIBIT 3: PARIS BAGUETTE GLOBAL CONSOLIDATED BALANCE SHEET

in 000,000 won	2013	2012	2011	2010
ASSETS				
Current Assets	406,894	437,231	355,083	261,236
Quick Assets	280,976	302,380	244,634	179,424
Inventories	125,918	134,851	110,449	81,811
Fixed Assets	1,317,112	1,249,457	834,053	81,811
Investments	114,549	113,165	83,078	54,771
PP&E*	950,812	916,951	564,334	515,706
Intangibles	81,714	28,513	8,807	–10,339
Other fixed	170,037	190,826	177,832	156,213
TOTAL ASSETS	1,724,006	1,686,688	1,189,137	977,587
LIABILITIES				
Current Liabilities	687,703	642,198	647,610	533,190
Long-Term Liabilities	264,067	397,771	117,566	99,159
TOTAL LIABILITIES	951,770	1,039,969	765,176	632,350
EQUITY				
Controlling Equity Stake				
Issued Capital	9,292	8,587	7,609	7,609
Capital Surplus	112,388	49,241	6,595	6,619
Capital Adjustments	–581	–614	–483	–497
Other Comprehensive income/loss	23,330	23,015	27,415	4,162
Retained Earnings	374,774	317,625	269,825	214,521
Non-controlling Interests	253,034	248,862	112,999	112,822
TOTAL EQUITY	772,237	646,719	423,961	345,237

**PP&E: property, plant & equipment*
Source: Company annual report.

EXHIBIT 4: PARIS BAGUETTE GLOBAL CONSOLIDATED INCOME STATEMENT

in 000,000 won	2013	2012	2011	2010
Revenue	**2,594,762**	**2,556,685**	**2,255,319**	**1,623,326**
REVENUE GROWTH	1%	13%	39%	
COGS*	1,682,586	1,688,207	1,528,901	1,063,279
Gross Profit	**912176**	**868478**	**726418**	**560046**
SG&A**	789,418	789,775	659,687	492,867
Operating Profit	**122,758**	**78,703**	**66,731**	**67,179**
Non-Operating Income	53,279	53,646	26,478	20,863
Non-Operating Expenses	61,032	38,841	16,957	16,444
Earnings Before Tax	**115,005**	**93,508**	**76,252**	**71,598**
Tax	33,553	21,416	18,928	17,531
NET INCOME	**81,452**	**72,092**	**57,324**	**54,067**

**COGS: cost of goods sold; **SG&A: selling, general and administrative expenses.*
Source: Company annual report.

EXHIBIT 5: PARIS BAGUETTE INTERNATIONAL SALES AND PROFIT (IN 000,000 WON)

	2010		2011		2012		2013	
	Sales	Profit	Sales	Profit	Sales	Profit	Sales	Profit
Korea	1,312,600	44,202	1,573,400	54,652	1,621,400	59,177	1,651,300	65,667
China	31,883	(2,478)	53,507	(1,999)	83,901	(3,736)	120,963	(5,525)
United States	25,749	(204)	33,420	446	45,486	1,536	60,400	2,139
Vietnam	0	0	0	(188)	1,349	(1,314)	5,624	(4,486)
Singapore	0	0	0	(255)	1,717	(980)	7,168	(1,763)

Source: Company annual report.

EXHIBIT 6: INTERNATIONAL STORE COUNT OF BAKERY CHAINS

Country	PB (Korea)	Tous Les Jours (Korea)	85˚C (Taiwan)	BreadTalk (Singapore)	Wedomé (China)	Delifrance (France)	ABC (Singapore)	Panera Bread (U.S.)
Korea	3,258	1,258	–	–	–	–	–	–
China	125	34	244	141	279	–	–	–
United States	37	23	7	–	–	–	–	1,818
SE Asia	16	60	–	126	–	31	29	–
Total	3,436	1,375	251	267	279	31	29	1,818

Source: Company files.