Master International Franchising in China:

The Case of the Athlete’s Foot

One day in late 2001, Rick Wang, the managing director of RetailCo Inc., the master franchisee for The Athlete’s Foot in China, was reviewing the most recent sales report of his company. He found that the sales volume for the past six months had declined precipitously, down almost one-third from what it had been only one year ago. Inevitably, Rick was concerned.

RetailCo Inc. had had a banner year in 2000; however, the company had experienced a cascade of problems beginning in 2001. At the start of that year, the company was forced to deal with pressure due to a supply shortage of major products, which could deal a deathblow to any small retailer. In quick succession, financial crises and sales problems related to the lack of product created a systemic disaster. Unless he acted quickly and decisively, RetailCo. might not survive this confluence of major problems.

Rick Wang and RetailCo. Inc.

Rick Wang was a typical American-born Chinese, able to speak native American English and Chinese. His parents had immigrated to Taiwan and then America when they were fairly young; regardless of their geographic location, however, the family maintained strong cultural ties to its homeland. Rick was raised in a traditional Chinese family in the US. After graduating from the University of Southern California with a degree in Communications, he began his career as an Account Director at Lintas, a well-regarded international advertising agency. After that, he transferred to work for Foremost Dairies Ltd., a leading manufacturer of milk and ice cream in Taiwan, as a Marketing Director, and thus gained experience in short-shelf-life consumer goods.

This case was prepared by Prof. Ilan Alon with the assistance of Amber Xu at CEIBS. The case was prepared as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Certain names and other identifying information may have been disguised to protect confidentiality.

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In 1992, he moved to his parents’ hometown, Shanghai, and worked for Shanghai Fuller Foods Ltd. as vice president of marketing. He assisted in the building of the company’s factory in Jinqiao district and developed new brands of Fuller milk and ice cream. Under Rick’s leadership, the brands “Qian Shi Nai” (milk) and “San Marlo” (ice cream) quickly achieved market leadership in the area, known by almost all the residents in Shanghai. In late 1997, Shanghai Fuller Foods Ltd. was sold to Nestle; Rick decided to strike out on his own.

As a result of a chance encounter, Rick Wang became acquainted with the athletic footwear industry and became a retailer. Rick retains a vivid memory of the day he was introduced to the possibilities of this retailing niche:

One day, when I was playing softball with a bunch of my American friends who then worked at Nike, one of them said to me, “Rick, since your ice-cream business has been sold, what do you want to do now?” I said, “I don’t know yet. Maybe I’ll go back to San Francisco, or back to Taiwan.” He said, “Why don’t you consider overseeing our Nike stores in Shanghai?” I asked, “Nike stores? Can I make money?” And he replied immediately, “Sure, they can make a lot of money!” I asked for the financial statement, which he showed me the next day. After looking carefully I said, “Ok. Let’s do it.”

Rick Wang, at that time, had no experience in either the sports footwear industry or any direct knowledge of in-store retailing, but he was very excited about his new business venture. RetailCo Inc. was established with the intention of managing the retail realities of athletic footwear sales.

His optimism notwithstanding, Rick’s hasty involvement and lack of experience in the footwear retailing industry led to the poor performance of his stores. In the six months after the company was established, no profit would be made. As the situation worsened, Rick anxiously sought expert advice. He began by educating himself on the Internet, searching terms such as “athletic footwear retail”, “sport retail”, and “sports shoes retail”; surprisingly, he found that almost every page of his searches revealed one American company, The Athlete’s Foot, Inc. Like many entrepreneurs, Rick recognized the value inherent in modeling his own activities on those of an industry leader.

The Athlete’s Foot, Inc.

The Athlete’s Foot, Inc, based on Kennesaw, Georgia in the United States, is the world’s foremost franchisor of athletic-footwear operations. It grew from a small, family-run store to an international retailer in three decades. Today, The Athlete’s Foot owns about 800 corporate and franchise stores in over 40 countries. (See Exhibit 1)
The history of the growth of the Athlete’s Foot is a model of aggressive business behavior. In 1971, Robert and David Lando opened the world’s first athletic-footwear specialty store—named The Athlete’s Foot—on Wood Street in Pittsburgh, Pennsylvania. The very next year, The Athlete’s Foot, Inc., began franchising its business model domestically. The first franchise agreement was signed by Killian Spanbauer, who opened a store at the Sawyer Street Shopping Center in Oshkosh, Wisconsin. After that, The Athlete’s Foot began a period of focused expansion: by 1976 there were more than 100 stores; only two years later (1978), there were more than 200 Athlete’s Foot outlets in America.

That same year, the company began to internationalize its franchising efforts; in 1978, the first of what was to become many international franchises opened, at 16 Stevens Place, in Adelaide, Australia. This milestone event encouraged The Athlete’s Foot to franchise an additional 150 stores in international markets by 1979.

After a decade of successful market penetration, the Athlete’s Foot, in its second decade, began a period of adjustment. In the early 1980s, Group Rallye purchased the Athlete’s Foot from the Lando family and became the owner of the Athlete’s Foot. This buyout provided crucial financial support to the company at a time when it needed to pay more attention to product design and customer service—rather than focusing exclusively on expansion. For example, the company inaugurated a system-wide commitment to customer service. In order to help customers to find the “right” footwear, or at least to help to determine the proper fit, sales associates underwent training at “Fit University,” introduced by the Athlete’s Foot Wear Test Center to provide education on the physiology and anatomy of the feet and to enable sales associates to properly fit athletic footwear. This focus on educating its sales force—who, in turn, educated customers about the value of relying on The Athlete’s Foot as a consumer-oriented facility—paid almost immediate dividends.

In the 1990’s, the Athlete’s Foot consolidated its market standing even as it continued its enviable international growth. The Athlete’s Foot changed its name to the Athlete’s Foot, Inc. and moved its headquarters to Kennesaw, Georgia, after Euris purchased Group Rallye in 1991. The company’s structure was reorganized into two divisions as a result of this change in ownership: a marketing team serviced franchises and a “store team” operated company-owned stores. The marketing team did an impressive job in the years following the reorganization. The Athlete’s Foot, Inc. grew to more than 650 stores worldwide in 1997 and was named the No. 1 franchise opportunity by Success magazine that same year. After a dynamic new CEO, Robert J. Corliss, joined the company in 1999, the company experienced a record growth year—opening 37 corporate stores in six countries and 87 franchise stores, the most franchises in company history. The other division, the operations’ team that managed company stores, also achieved significant success during this period. The company launched a new-store design featuring an innovative, customer-oriented technology called the
FitPrint System\(^1\). This innovation was to lead to a competitive advantage for the Athlete’s Foot, Inc. As a result of franchise oversight and marketing innovations, the company was awarded the “Trendsetter of the Year” award by the sporting goods community for 1999 and 2000.

The growth story of the Athlete’s Foot became a model for franchising even as it successfully continued its almost-three-decades-long tradition of domestic and international expansion. Many would-be entrepreneurs were drawn to the company, for reasons linked to the company’s focus-points: customer service, aggressive marketing, and control of the pipeline from production to point-of-sale. Comments from franchisees illustrate the company’s magnetic effect on franchisee development. Jaclyn Hill from Auburn said that her “decision to join The Athlete’s Foot was based primarily upon them having an established, customer-service focused program to sell athletic shoes.” Powell’s Kyle H. Johnson commented, “The Athlete’s Foot was my choice when I decided to enter the retail industry for several reasons. Some are obvious such as access to vendors, reasonable franchise fees, and fair royalty rates. Beyond that, they offer a tremendous amount of support.”\(^2\)

### An Athlete’s Foot Master Franchisee in China

Rick Wang was one of many entrepreneurs interested in pursuing business opportunities in the footwear retailing sector; Rick, however, had not followed the less-risky entrepreneurial path of franchising, but had struck out on his own, with problematic results. His research on the successes of the Athlete’s Foot’s management model led him to contact that company. At that time, Rick had little knowledge of how franchising worked, or what potential benefits he might realize. In fact, his ostensible reason for contacting the company was his belief that he might pick up some pointers from this more-experienced retailer:

> “I was not a believer in franchising,” recalls Mr. Wang. “I did not believe in franchising because I did not believe in paying so much money to buy somebody’s brand and then putting more money in to build it. I can do by myself. But I decided to contact the Athlete’s Foot because I really knew that I needed help.”

Rick Wang decided to fly to Atlanta, to view the company’s headquarters and evaluate the company and its team. This trip was fruitful. As a potential Chinese partner, Rick received a warm welcome from the CEO and the entire management team during his visit. Among his stops, he was especially impressed by the inventory control system in the merchandize department. Rick recalled,

> I wasn’t very excited until I walked into the merchandize department and I saw

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\(^1\) According to Athlete’s Foot, Inc., the FitPrint System is a proprietary state-of-the-art computerized technology that measures pressure points at different phases of a customer’s gait.

\(^2\) www.theathletesfoot.com
their buying team, how they bought products. I saw how intensively they controlled the inventory system, using a very high-tech system. And then I started to learn the science behind the retailing. And I started to realize perhaps I need to pay the tuition to learn this. It’s always the case: if you want to dance, you have to pay the band.

After Rick returned to China, he immediately started his franchise and retail plan. He first persuaded the board of RetailCo. to agree to his idea of becoming the master franchisee of an Athlete’s Foot structure in China. Second, he efficiently worked out a negotiations’ plan with the US franchisor on the subjects of sales territory and royalty fees. He suggested separating the huge Chinese market into three regions: East China Area, North China Area and South China Area. The region of East China, stretching to the cities of Chengdu and Chongqin, was the biggest and potentially the most important market in China; it was in this area that Rick planned to focus his efforts. The region of North China, including Beijing, although a potentially lucrative market, was to be a secondary consideration. Last, development of the South China Area was to be delayed until after the first two regions were penetrated: the proximity to Hong Kong, with its history of appropriating brand names and flooding the market with cheaper copies, made immediate consideration of this region a risky and ambiguous proposition.

In terms of royalty fees, Rick fortunately negotiated a fairly good deal with The Athlete’s Foot, Inc. The monthly royalty was to be 2.5 percent of net sales. Other initial-area development fees — including franchising fees, fees for additional stores, purchasing an MIS system, an employment-control system, etc.— totaled a few thousand dollars per store. In addition, Rick requested discounts related to any future fees for local marketing. All the funds for initiating business were to be self-financed.

When the deal was made, Rick, together with his six colleagues, went to Atlanta for the “New Owner Training” at Athlete’s Foot’s, Inc. Within six weeks, they had completed their “On Site Training” and had practiced operating the business: they worked in a store, sold shoes, helped people with their fittings, and even worked in the warehouse, experiencing first-hand the realities of inventory control. They also learned how to work internal-control systems and marketing procedures. Overall, their training covered issues related to marketing, merchandizing, operations’ management and employee sales training. Rick commented: It was just fascinating, like going back to school. It was very enjoyable.

Their efforts paid off. In September 1998, the first store of the nascent master franchisee’s China operation was opened in the Parkson Department Store on the Huaihai Road in Shanghai—in the East China Area. The Parkson was the most popular department store with an ideal demographic: the youngest customers between the age of 20 to 35—those considered most devoted to brand-names and most style conscious—shopped on fashion-oriented Huaihai Road. Therefore, the first store was
actually in the fashion center amid a favorite venue of young consumers. The store was opened on the ground floor of Parkson’s with the same store design and equipment as those in the US. Beautiful store design and abundant/diverse name-brand products made the store attractive to customers.

Rick achieved success in starting his retail franchising at a time when the franchise concept in the Chinese market was new and innovative, and the sports footwear market was underdeveloped. His business instincts, his knowledge of the Shanghai market and his training at Athlete’s Foot, Inc.’s headquarters combined to initiate a signal success in what was then a relatively new entrepreneurial concept.

**Business Context**

**Franchising in the Chinese Market**

The franchise concept first entered the Chinese market in the early years of the 1990s with the emergence of reputable international franchising companies such as KFC and McDonald’s. They originally entered China in the early 1990s, building corporate stores first. After having achieved steady sales volumes and sufficient economies of scale, they cautiously but aggressively expanded. These pioneer global franchisors included dominant players in the fast-food industry and various master franchisors in other industries such as 7-Eleven convenience stores, 21st Century Real Estate, EF education, Avis auto rental, Kodak film developing, Fornet laundry service, etc. These firms contributed to China’s franchising market development—and created an awareness among an increasingly entrepreneurial class that franchising held substantial positive outcomes for those able to enter into such relationships.

Overseas franchisors tended to adopt one of two approaches when operating in the Chinese market: the franchise of a product or trade name (product name franchising), or the franchise of a particular business model in exchange for fees or royalties (business format franchising). Corporations which had a strong capital background, like McDonald’s and KFC, would choose an offshore franchise retail model (See Exhibit 2) to ensure effective control over product quality and company operations. Small- and medium-sized franchisors would often choose direct franchising by seeking a local franchisee. Franchisors, licensing to local partners, can take advantage of local knowledge, saving the costs resulting from distance—both in terms of logistics and culture.

Since the end of the 1990s, franchising has become a mature, steady growth opportunity in China. By the end of 1997, there were just over 90 franchisors in China and about 30 franchise stores. One year later, however, the number had grown to over 120 franchisors with sales volume of over 50 million RMB (US$ 6.05 million), among which 40% were franchise stores. By 2000, the number of franchisors

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3 ChinaOnline, August 2, 1999.
approached 600. The sales volume also increased dramatically, jumping about 80% from 1999 to 2000. This remarkable growth (at the time of this article, franchising is growing at a high double-digit growth rate) continued in the years that followed.

Franchised businesses in China vary along a wide spectrum of business sectors. Companies in over 30 industries have chosen franchising as a business model to sell their products and expand in this market. Retail and food/restaurant operations have always been the dominant franchising industries, accounting for 35% and 30% of total franchisors respectively. Other segments experiencing significant growth include education, business services, auto services, interior decoration, beauty & health, laundry, etc. The service sector has also grown in importance in recent years.

**Market Environment**

In the late 1990s, as many in the global market were aware, China was becoming the land of opportunity. China’s strong and steady growth, proven by ten years of continual GDP increases, seemed unstoppable. Economic growth led to an increase in personal incomes, especially in larger cities. The emergence of a large middle class, often consisting of well-educated professionals, added to the consumer demand for globally recognized, quality products.

Domestically, the Chinese government made great efforts to regulate the market and standardize the business environment. To facilitate access to the World Trade Organization, China committed itself to removing more market-entry barriers, creating a more open market for international investors. The laws and regulations governing franchise businesses were, thus, improved. On November 14, 1997, the Ministry of Internal Trade published and released the very first Chinese franchise law, *The Regulation on Commercial Franchise Business (for Trial Implementation)*. Afterwards, the Regulation was revised and improved several times: in 2005, *The Law on Commercial Franchise Business Administration* was eventually released as a basic rule for franchise operations in China.

Market competition in China was less rigorous than that in the United States. In the athletic footwear retailing industry in China, for example, there were few capable players in the early- to mid-1990s. Meanwhile, the demand for high-quality athletic footwear increased as consumers’ incomes increased (See Exhibit 3). Market research for 1998 indicated that people in Shanghai owned only one pair of athletic footwear. By 2005, they had, on average, three pairs. In terms of style, people’s preferences changed from choosing footwear for functional purposes to opting for fashion. Athletic footwear retailers selling name-brand shoes had what seemed to be a promising future.

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5 Ibid.
The Glorious Age

The success of his first store encouraged Rick to open more stores, more quickly than he had initially planned. In the months following his franchise-premiere in Shanghai in 1998, Rick adopted an aggressive expansion strategy, opening a new store every 22 days. After spreading the business to the North China region, the company opened 40 corporate stores in 7 other Chinese cities. The company realized a profit in its second year of operations, reaching a sales volume of US$ 14 million in 2000.

Every one of RetailCo.’s stores acted in accord with the standard of global Athlete’s Foot, Inc. The stores, equipped with indoor music, sports videos and fashionable designs, established a pleasant atmosphere for shopping. All stores provided the best possible service for their customers. The service staff in every store was trained before they began their work—also in accordance with the model that Rick and his team had seen in Atlanta. In addition, every store was equipped with computers for billing and inventory control. In fact, the inventory-control system was an advantage that distinguished Rick’s stores from other retailers. By adhering to strict, computerized tracking of product, store managers were able to react promptly to shortages or excesses of inventory. The company used the franchisor’s proprietary pricing model by utilizing aggressive price reductions to manage inventory excesses. More important than the store brands the store marketed were famous internationally branded sports goods, such as Nike, Adidas and Reebok, which were available at the stores. A pioneering store atmosphere, an excellent inventory-management model, and an availability of famous brands quickly made the Athlete’s Foot a premier competitor in the Chinese sports retailing industry.

Domestic promotion of the Athlete’s Foot brand name was also done aggressively. Besides media advertising, the company put more emphasis on direct and in-store marketing. It organized three-on-three street basketball games and tournaments to grab the attention of young sports’ lovers. The company also sponsored high-school basketball teams to further inculcate brand-name recognition of both the stores and its products among teenagers. In-store marketing activities included cooperation with the fast food giant, McDonald’s; monthly newsletters advertising the Athlete’s Foot were distributed in McDonald’s stores. Nevertheless, the brand-building process was not as successful as it had been in the US. People responded to the brands of products more than to the retail brand itself: consumers visited stores because they could find internationally known products, not necessarily because they were drawn to The Athlete’s Foot as a brand. This customer motivation would lead to substantial problems for Rick in future years.

In 2000, Rick started, cautiously, to seek appropriate franchisees in an attempt to expand the business. Rick selected one sports’ goods franchising exhibition in Beijing as the venue for promotion of his franchise opportunities. Almost 500 applicants applied for franchises in one day, far exceeding Rick’s expectations. Some applicants
even came with large amounts of cash as testament to their financial abilities (and solvency). Rick was concerned, however, about the values of the applicants; he wanted to ensure that the selected candidates were service-oriented and fully understood the partnership requirements related to franchising. Carefully vetting all of the applicants, Rick short-listed 20 candidates. These finalists had strong financial capabilities as well as fine educational backgrounds; they could understand the vital realities involved in franchising’s partnerships. RetailCo. invited these 20 candidates to come to the Shanghai Office and have face-to-face meetings with the board. Finally, one—out of five hundred—was signed with RetailCo to be the first sub-franchisee of The Athlete’s Foot, Inc. Later, using the same careful scrutiny, 12 additional sub-franchisee stores were developed in second- and third-tier cities such as Nanjing, Wuxi and Ningbo.

Signs of Problems

In 2001, in spite of—or possibly due to—its rapid growth, the company gradually felt pressures related to cash flow, marketing and supply. The first “pressure” came from the need to commit large amounts of capital to obtaining retail venues. Since the location of retail stores is related to sales’ performance, gaining a quality location is crucial. Rick’s good fortune in being able to open his first store at a high-traffic, upscale shopping area in Shanghai was often difficult to replicate at equally moderate rental rates. Obtaining a quality retail space in China usually requires at least a 24-month leasing commitment; in some department stores, a 36-month rental agreement was often the norm. To lock in quality locations in this competitive a retail real-estate market, the company signed long term contracts, looking to best competitors by securing desirable locations. This laudable approach to ensuring franchisee success, however, required an immense commitment of up-front capital. RetailCo. took over prime spaces in department stores, but the cost of doing so was great. Unfortunately, when market conditions changed and sales decreased, the pressure caused by an insufficiency of ready-reserves of cash inevitably increased.

A second pressure was related to a problem many “breakthrough” franchisors experience in new markets: since 2001 the Athlete’s Foot had started to lose its “first-mover” advantage. China began in 2000 to finalize preparations for entry into the WTO. The global financial community was increasingly convinced by then that the immense potential of the Chinese market was soon to become a reality. As a result, the athletic footwear market—along with every other foreign franchise business—underwent major changes, foreign direct investment (FDI) increased. In department stores, the space for sporting goods enlarged dramatically from 300 square meters to 700 square meters, then 1000, 1500, and finally to an average of 3000 square meters. This meant that franchising space allotted to The Athlete’s Foot was, as a percentage of total space, gradually diminished. More footwear retailing players joined the industry; for example, Quest Sports started to open its stores in China in 2001. Competition also came from local players, who were able to insinuate
themselves in this market due to competitive pricing, enhanced customer service and increased products’ quality. In other words, these local competitors learned from Rick’s Athlete’s Foot franchises what Rick had learned from the franchisor. A final concern occurred when individual brands opened more of their own stores.

As a result of its success in the market—partly related to the improved business climate in China as a whole—RetailCo./The Athlete’s Foot was, paradoxically, losing its competitive advantage. In 1998, the size of an Athlete’s Foot store was almost 100 square meters, often occupying one-third of the total size of the sporting goods section of a large department store. The typical store was supplied by several world-famous brands, like Nike, Adidas, Reebok, etc. The rest of the sporting goods’ space was devoted to selling locally branded products and sports equipments: footballs, basketballs, tennis rackets, etc. Although the goods sold in an Athlete’s Foot store were exclusive and superior to others, the above-mentioned changes led to a ten-fold increase in the amount of store-space devoted to sporting goods. Athlete’s Foot did not/could not grow as fast, now (post-2001) occupying merely one-fifteenth of the total space devoted to sporting goods in a large department store. Size and visibility matter: the “idea” of Athlete’s Foot became increasingly insignificant in customers’ minds.

Worse, for Rick, was the fact that his suppliers—the producers of the often-popular styles and models his growing customer base demanded—began to increase their own penetration of what had previously been a fairly wide-open market. The Athlete’s Foot multi-brand approach was forced to compete directly with brand-name suppliers who opened their own outlets in direct competition with him. Inevitably, Rick found it difficult to get the most desirable brand-name products for his stores; the home office—although committed to Rick’s status as the master franchisor—was unable to put enough pressure on producers to stem the tide. Rick’s stores were unable to keep current inventory of the most recent styles and most in-demand products.

With declines of comparative store size and product varieties, and increases in competition from local and brand-specific market entrants, the Athlete’s Foot found itself squeezed out of high-value department store venues. Department stores welcomed the single brand retailers because they were content with the smaller ratios of retail space; besides, grouping single-brand retailers together made department store one, huge multi-brand store. The Athlete’s Foot had to move to street-front locations which commanded higher rents and were less popular with the purchasing public. Thus, costs increased but revenue decreased.

What should Rick do?

Rick Wang realized the company was in risk of bankruptcy if he did not immediately address the radically changed demands of the marketplace.
### Exhibit 1: Countries Where the Athlete’s Foot Stores Are Located

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Source: www.theathletesfoot.com

### Exhibit 2: Offshore Franchise Retail Model

![Offshore Franchise Retail Model Diagram]

**Diagram Legend:**
- **Foreign Investor**
- **Chinese Joint Venture Partner**
- **Offshore Investment Vehicle**
- **Equity Joint Venture Cooperation Joint Venture**
- **Branch Store**
  - **Lease Payment**
  - **Fixed Payment**
- **Technology Service Fees**
- **Trademark Licensing Fees**
- **Management Services Fees**

Source: Mendel, Fraser “Legal Issues Related to Franchising in China”
Exhibit 3: Consumption of Recreation Goods in Entertainment and Sports Sector, 1997-2003

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Source: China Statistics Yearbooks

Exhibit 4: Franchise Structures of The Athlete’s Foot in China

The Athlete's Foot Inc. (Franchisor)
- Franchise Agreement
  (Trademark License Contract, Management Service Contract)
- Royalty and Service Payment

RetailCo. China Holdings (Franchisee)

Corporate Store

Corporate Store

Corporate Store

Sub-franchisees

Branch Store

Branch Store

Branch Store