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MARKET CLUSTERS FOR INTERNATIONAL FRANCHISING

Amir Shoham

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ABSTRACT

While many studies of franchising have examined the organizational antecedents of internationalization, few have examined how differences among markets lead to this internationalization. Studies linking environmental factors to the companies' decision to internationalize showed that various political, social and economic factors either attract or repel international franchising investment. We build on these studies' selected variables to understand the similarities and differences among international franchising markets. Using these variables, our results show that countries divide into eight clusters with similar international franchising market characteristics. A discussion of each cluster follows with implications for franchising research.

1. INTRODUCTION

International franchising research has advanced in recent years and, with it, the state of knowledge on why and how franchising companies expand into new markets. Initial research into the emergent field of international franchising has focused on both organizational and environmental determinants. Organizational determinants, which are among the causes of internationalization (Dunning 1981), included size, age, growth,

franchise fee and royalties, and dispersion (Elango, 2007; McIntyre et al., 2006; Fladmoe-Lindquist et al., 1995; Alon, 1999).

The international franchising sector has become a major player in the development of countries, particularly Anglo Saxon ones. But franchising development has been uneven. One of the factors that impact the type and quantity of the international franchising is the local environment of the host country. Currently there are no studies which categories countries according to factors that are important to franchising decisions. Categorizing countries by cluster analysis is a common method in the international business field (Ronen and Senkar, 1985). The innovation of this research is finding the relevant environmental variables for international franchising and using these variables in the formation of national clusters that can help in franchising analysis.

Building upon a variety of franchising studies including survey (McIntyre et al., 2006; Arthur Andersen 1996), empirical (Elango, 2007; Yavas 1988), and conceptual (Eroglu 1992; Burton and Cross 1995; Alon and McKee 1999) research in international franchising, previous studies examined several location-specific characteristics relating to franchising firms. Among the environmental determinants are economic, demographic, social and political factors affecting international franchising. We use these variables to cluster countries for international franchising market entry and selection.

Understanding international franchising market clusters has both research and practical implications. Clusters are needed for a variety of reasons as suggested by Haritgan (1975): **Naming** – Clusters can be names and thus identified for further analysis; **Summarizing**- Each cluster helps to described nations by using both cultural and socio-

economic variables related to franchising; **Explaining** -- Grouping suggests similar variables that impact franchising.

From a research perspective, inferences can be made from environmentally-similar clusters. International franchising clusters allows for more robust analysis of contextual and environmental differences affecting franchising. Franchisors can use these clusters to better understand commonalities among markets, leading, for example, to selection of new markets for expansion, organization of markets for the purpose of control and/or the establishment of regional offices, to mention a few uses.

For the purpose of this study, we define international franchising as "a foreign market entry mode that involves a relationship between the entrant (the franchisor) and a host country entity, in which the former transfers, under contract, a business package (or format), which it developed and owns, to the latter" (Burton and Cross 1995, p. 36). The host country entity can be a master franchisor, a domestic franchisee, or the franchisor itself. International franchising is a unique method of entry into a host country that is different from licensing, exporting, and foreign direct investment because the franchisor can change the ownership structure over the life of the franchise system (Burton and Cross 1995). International franchising is, thus, a unique form of international business involving both contractual rights and obligations along with varying levels of financial investment (Shane, 1996). Differences between international franchising and other forms of international market entry were explored in Alon (2005).

In summary, this paper contributes to the literature of international franchising by

delineating the relevant environmental variables for international franchising and, then, using these variables in the formation of relevant clusters for franchising analysis. We first discuss the literature of franchising in the context of environmental variables. We then construct a database from available variables and apply cluster analysis to the data. Finally, resultant clusters are discussed and analyzed.

2. LITERATURE: ENVIRONMENT DETERMINANTS OF INTERNATIONAL FRANCHISING

In general, the more favorable the environment of the host country, the more likely international franchisors will select this host country for international expansion (Eroglu 1992). Therefore, in the aggregate, it is expected that countries with more favorable conditions will have more international franchisors. But, what are the market conditions making international franchising investment attractive?

In an empirical article, Yavas (1988) found that among the economic factors market size (typically measured in GDP) was positively associated with international franchising, while among the demographic variables the ratio of female workers to the total labor force was positively related to international franchising. Markets that are more developed, with greater proportions of female labor participation, are more likely to be attractive to international franchisors. He did not, however, examine the effect of political and cultural variables on international franchising.

In a survey study, Arthur Andersen (1996) found that international franchisors considered economic, demographic, as well as political and cultural dimensions of a host country in order to assess the chances of success in the foreign market. Other studies noted the influences of political (Burton and Cross 1995), economic, cultural and demographic environments (Eroglu 1992; Alon and McKee 1999) on franchising expansion. We, first, delineate the economic, demographic, social and political factors affecting international franchising expansion and, then, use these variables in the construction of relevant market clusters.

Economic Factors

Among the economic factors, the effect of per capita gross domestic product on the receptivity of a foreign market to a new franchise concept was identified in several studies as an important factor of international franchising (Yavas 1988; Aydin and Kacker 1990; Arthur Andersen 1996; Alon and McKee 1999). Arthur Andersen (1996) reported that the average income of the citizenry is an important determinant to international expansion; and Yavas (1988) found that per capita income was significant and positively correlated to the number of international franchisors in a host country.

Income distribution was also identified as an important determinant for a franchising market. In a study attempting to rank order the franchising market size of emerging markets, Alon (2006) used the income distribution in addition to the total income to determine the real potential. Taken together, these variables embody the wealth of the citizenry, the general level of economic development, and the extent of the middle class.

Because franchising is primarily in the service sector, Alon (2006) also uses the extent of the service sector in evaluating the market potential for franchising in emerging markets. The research suggests that Mexico and Russia have greater market potential then China, for example, due to the larger service economy.

Demographic Factors

The three demographic variables that were discussed in the literature of international franchising include: (1) the level of the population (Arthur Andersen 1996), (2) the level of urbanization (Yavas 1988; Arthur Andersen 1996), and (3) the proportion of female workers (Yavas 1988; Arthur Andersen 1996). These variables sum up many of the population dynamics that are important to international franchisors.

The level of population is seen as an important predictor of franchise viability. This is because, even in countries with a relatively small middle class, a situation which characterizes many developoing countries, there is a percentage of the population which is affluent; able and willing to spend substantial amounts of money on discretionary products. In countries with a larger population, this relatively small percentage can be a sizable number that can support the expansion of international franchisors. Furthermore, franchisors often think long term when they enter an impoverished but highly populated country, such as Brazil, Russia, India and China (BRIC). The potential of franchising in Russia, for example, has been expressed by one top executive in McDonalds who said: "we know the pay-off is a long way off. But it's an investment in our future" (Love 1995,

p. 465). Thus, both the level of population and income distribution affect the viability of international franchising in a given country.

The level of urbanization is another demographic factor influencing international franchisors. It was ranked as the fifth most important factor of the acceptance of the franchise system in a foreign market with 73% of respondents reporting it as either important or very important (Arthur Andersen 1996). Urban life puts time pressures on the affected individuals, raising the opportunity cost of time. Many individuals, therefore, need to purchase services previously produced at home, increasing the chances of success of franchise systems tailored to fulfill this need.

A highly concentrated market is more efficiently served than a market that is geographically dispersed. This is because a viable market for both the factors of production and output exists in a densely populated area. With this in mind, it would seem that highly urbanized countries would represent more attractive opportunities for international franchisors.

In nearly all countries of the world, men and women have traditionally assumed different duties in the household. Men have traditionally been the primary breadwinners of the family, while women have traditionally been expected to maintain the household. Women have since entered the workforce in increasing numbers, making the dual income family a widespread phenomenon worldwide. However, as women have entered the workforce, they, by and large, have continued to carry their domestic responsibilities as

well. Pressed for time, women around the world have increasingly adopted new products that are faster, easier, more convenient to use, and that reflect the scarcity of free time in their working lives. Yavas (1988) found a positive association between female labor participation the occurrence of international franchisors in a host country. We would expect that as the percentage of women in the workforce increases, so does the popularity of franchise systems, many of which provide products which specifically address the time shortage of working women.

Cultural Factors

Cultural variables influence the feasibility and acceptance of a franchising system (Alon and McKee 1999; Toncar and Alon, 2000). Cross-cultural research in franchising has employed the cultural dimensions of Hofstede (Falbe and Welsh 1998). According to Hofstede, cultures vary along four dimensions: (1) individualism/collectivism, (2) power distance, (3) uncertainty avoidance, (4) sex role differentiation (Hofstede 1991). Updates to Hofstede's dimensions were carried out by the GLOBE research team.

Arthur Andersen (1996) found that an entrepreneurial culture is highly regarded by international franchisors seeking to expand abroad. Sixty five percent of the respondents reported that an entrepreneurial culture is either an important or a very important consideration in choosing a host country. This is because franchisees need to be entrepreneurial, possessing the skills needed to start and run a business. Highly entrepreneurial cultures are more likely to have a qualified market of potential franchisees, a necessary ingredient in developing a successful franchising system (Alon

and McKee 1999).

Individualism/collectivism dimension has to do with the extent to which the self or, alternatively, the group, is the prime social identifier (Hofstede, 1997). The GLOBE research distinguishes between "institutionalism collectivism" and "in-group collectivism," the former focusing on the societal and organizational levels while the latter at the individual level (House and Javidan, 2004). As described by de Mooij (1998), individualist cultures are "I-conscious" while collectivist cultures are "we-conscious." It seems that highly individualist cultures would represent much more fertile ground for franchise development than a highly collectivist culture. Cultures that are highly individualistic would be more likely to search out business arrangements that allow them to express their individuality as well as give maximum opportunity for individual achievement and success (Hofstede 1991).

Power distance (PD), a dimension identified by both GLOBE and Hofstede, is the degree to which people expect power and authority to be distributed and expressed equitably or inequitably (Carl, *et al.*, 2004; Hofstede, 1980, 1983). The term was coined by Mulder (1977) who wrote about the degree of inequality in power between a less powerful individual and a more powerful individual, where both belong to the same social system. In the GLOBE project, Power Distance was defined as "the degree to which members of an organization or society expect and agree that power should be shared unequally" (House, *et al.*, 2004, p. 517). High power-distance cultures are hierarchical with strong dependence between a principal and an agent. Since an agency relationship is necessary

between the franchisor and the franchisee, high power-distance cultures would tend to be conducive to international franchising. On the other hand, high power-distance cultures also tend to experience periods of stability followed by periods of upheavals and disturbances. Crises in Russia (2008, 1999), Brazil (1998) and Asia (1997) provide examples of such upheavals. Such periods lessen the attractiveness of these foreign markets for international franchising investments. Therefore, it is not clear how power distance will affect international franchising.

Uncertainty avoidance also common to GLOBE and Hofstede, assesses the degree to which a society's members are able to cope with the unpredictability of the future, and the resulting ambiguity (de Luque and Javidan, 2004; Hofstede, 1980). This relates to the extent to which individuals are made uncomfortable by the absence of structures, rules and conformity. Countries with high uncertainty avoidance cultures tend to generate more rules and have lower tolerance for deviance. Conformity to rules and a strong legal structure that these societies generate seems to be favorable to franchisors. However, cultures high in uncertainty avoidance also tend to reject foreign ideas. Since international franchisors often introduce foreign ideas to a host country, high uncertainty-avoidance, therefore, can be unfavorable to international franchising.

Sex role differentiation (also referred to as Masculinity/Femininity index) refers to the culture's use of gender differences to discriminate between social roles. Cultures that are masculine, and high in sex role differentiation, tend to be more ambitious, assertive, aggressively pursuing material wealth. Masculine cultures are, therefore, more likely to

attract international franchisors who seek these characteristics in franchisees (Hofstede 1991). Hofstede (1980) claimed that one of the most fundamental ways in which societies differ is in the extent to which each prescribes and proscribes different roles for women and men.

Clustering nations and countries by using cultural variables is a well developed method (Toynbee, 1947; Cattell, 1950, Gupta et al., 2002 Ronen and Shenkar 1985). Previous research, from early work of Cattell (1950) to the contemporary study of Gupta et al. (2002), used data for cultural clusters that included variables other than culture, including economic and demographic variables. On the basis of the above mentioned economic, social and political variables we conducted cluster analysis in the next section.

Political Factors

The effect of political factors on the expansion of international franchising has been discussed in the literature. Some researchers, such as Aydin and Kacker (1990) and Hoffman and Preble (1991), suggested that political risk is not an important factor. This is because local franchisees usually assume the risk and exchange risk is relatively low since most of the inputs are local. Other researchers, such as Alon and McKee (1999) and Eroglu (1992), disagreed because political risk may deter international expansion and because political factors such as red tape, monetary and exchange controls, corruption, import restrictions, and ownership restrictions can significantly increase the cost of doing business in the host country. Furthermore, exchange rate fluctuations caused by political risk affect royalties payments measured in domestic currency (Eroglu 1992). Political

risk factors have the potential to raise the price of and complicate business transactions.

3. Method

Sample

Based on the literature in section 2, we gathered a sample of countries that had cultural scores as well as other available factors. We used the Globe study as our sources for culture scores (as it is a more recent framework for cultural scores than Hofsetede, but one that uses roughly the same categories). In total, we used 56 out of the 62 societies of the Globe study. We mainly excluded from our sample countries that had two scores in the Globe study for example Germany that had a cultural score for former east part and another cultural score for former west. Table 1 presents the 56 countries in our empirical study.

Insert Table 1 About Here

Variables

Based on the literature presented in section 2 of the paper, we used variables that should help us distinguish between different types of countries from a franchising point of view. In total we have 14 variables. The variables include three types: demographic, economic, and cultural. A short description of each of the variables and its corresponding measure follows.

Growth Domestic Product per capita purchasing power parity [GDPPC (PPP)] = the value of all final goods and services produced within a nation in 2006 divided by

population as of 7/1/2006. The nation's purchasing power parity (PPP) exchange rates is the sum value of all goods and services produced in the country valued at prices prevailing in the United States. This is the measure most economists prefer when looking at per-capita welfare and when comparing living conditions or use of resources across countries. We used the CIA World Fact Book (2006).

Gini = measures economic inequality, which assesses the extent to which the distribution of income among households within a country deviates from a perfectly equal distribution. If income were distributed with perfect equality, the index would be zero; if income were distributed with perfect inequality, the index would be 1. We used the CIA World Fact Book (2006).

Service % of the economy = the percentage distribution of the labor force in the service sector. Economies with a strong service orientation are more likely to attract franchising since most franchises are in the service sector (Alon, 2005, 2006).

Corruption Perception Index (CPI) = The definition of corruption is "the abuse of entrusted power for private gain" that means the degree to which corruption is perceived to exist among public officials and politicians. A higher score means less (perceived) corruption. The scores are between 0 and 10. We used Transparency International (2006).

Population = the number of inhabitants a nation had at 2006. Larger societies have more demand for all sort of products, including ones offered by franchising. Source: CIA World Fact Book 2006.

Ease of doing business index = is a world bank's index. A high score on the ease of doing business index means the regulatory environment is conducive to the operation of business. That indicates better, usually simpler, regulations for businesses and stronger protections of property rights. This index uses 10 topics, made up of a variety of indicators like: Starting a business - Procedures, time, cost and minimum capital to open a new business and Dealing with licenses - Procedures, time and cost of business inspections and licensing.

% upper- middle class = We used Senauer and Goetz 2004 method to calculate the percentage of upper – middle class. The size of the emerging middle class is estimated with a cut-off level of $6,000 GNI per capita. We used the World Bank data in for GNI per capita, converted into US dollars using purchasing power parity (PPP) and the percentage shares of income or consumption by 10 percent of the population (see Senauer and Goetz 2004 for a more detailed explanation). Currie and Alon (2005) underscored the importance of income distribution in franchising.

Urbanization = the percentage of the urban population out of the total population. The source is World Population Prospects the United Nations Population Division.

Economic Freedom = We used in our paper the Index of Economic Freedom of The Heritage Foundation.[1]

Political risk = ddescribes the risks companies and investors face due to the exercise of political power. These include potential losses from nationalization, regulatory changes, potential risk of a government or government agency not honoring a contract and also

[1]See http://www.heritage.org/Index/countries.cfm for a more detailed explanation.

include potential losses due to riots, civil-war and terrorism.[2]

Culture uses four culture variables that were primarily estimated using variables from the House, et al. (2004) GLOBE study of 62 societies, which has been called "probably the most sophisticated project undertaken in international business research" (Leung, 2006: 881). We used four out of the nine culture dimensions in the GLOBE study. The four culture dimensions are equivalent to the ones Hofstede (1980, 1983) has and are more up Power Distance Index, Gender Egalitarianism, Uncertainty Avoidance, and Individualism/Collectivism.

Analyses

We clustered the 56 countries using the 14 variables described above. We used a squared Euclidean distances in the cluster process. The main problem with this method is that if the variables are measured in units that are not comparable, the procedure will give more weight to variables with large variances. Therefore, we standardize the variables so they measured on the same scale. All the variable scores during the statistical process were normalized with a mean of 50 and a standard deviation of 10. In a squared Euclidean distance one places progressively greater weight on objects that are further apart. For example, a cluster with China and India is formed mainly because the population of those countries is so much larger than the population of the other countries in the sample.

[2] See http://www.prsgroup.com/PRS_Methodology.aspx for a more detailed explanation.

4. Results

Using cluster analysis methods on the variables presented in section 3, we received eight different clusters for franchising. Table 1 shows the countries that are included in each cluster. Table 2 shows the non-standardized mean for each variable of each cluster for meaningful comparisons.

Insert Table 2 About Here

Each cluster is different from the other clusters, but how much different? Table 3 helps us to understand in a statistical and visual way the difference between the clusters. The table is a result of normalized variables (mean 50, s.d 10): the higher the score, the greater the difference between the clusters.

Insert Table 3 About Here

As can be seen in table 2, the biggest difference exists between clusters three and eight. Cluster three contains Australia, Austria, Canada, Denmark, Finland, France, Netherlands, Sweden and Switzerland. Cluster eight contains China and India. The difference is quite clear between the clusters and it is well presented in table 2.

4. Conclusions and Discussions

From our data and empirical research we received eight different clusters (see table 1) of host countries regarding to franchising. As mentioned earlier, we used a squared Euclidean distance in our empirical tests, which gives greater weight in formulating the clusters to objects that are further apart. According to the method, we named the eight clusters by the main characteristic of the countries in the cluster, and provided some

descriptive explanation for each of the clusters (as per table 2).

Group 1: The Modernizing Islamic Nations

Group 1 includes some of the modernizing Islamic states: Albania, Egypt, Georgia, Kazakhstan, and Indonesia. Interestingly, these states are from geographically diverse areas. Their average GDP per capita is considered "developing" with about $5,400 PPP GDP per capita. The economies, however, are becoming increasingly liberal, service-based, and only mildly politically risky. With a population of about 68 million people and urbanization rates reaching about half of the population, these markets provide a large "emerging" market for international franchisors. But for franchisors from Western countries, a challenge exists in understanding and operation within the cultures of these countries, which are relatively more power distant and more collectivistic.

Group 2: Latin European PIGS and Newly Industrialized

Group 2 includes a diverse group of developed and "emerged" markets, both static and dynamic. The PIGS (Portugal, Italy, Greece, Spain) are the static EU powers, while Slovenia, Hungary and Poland are the "emerging" and dynamic EU powers. Korea, Taiwan and Israel are the newly industrialized countries in the group from Asia and the Middle East, respectively. Costa Rica is the Latin equivalent. The PPP GDP per capita for this group is around$23 thousand, which is "developed" in economic terms. These economies are service driven, and relatively politically safe. Income is more equitably distributed compared to group 1.

Group 3: Middle Powers

The Middle Powers, a term borrowed from political science, include the "developed" countries that are not super powers, but that have a strong regional and economic influence. They include mostly European countries, such as Denmark, Finland, France, Sweden, Switzerland, Netherlands, Austria, but also others, such as Australia and Canada who have started to diverge from their original Anglo-inspired origins. These countries all have high incomes, with relatively low income inequality. They are free, service oriented and safe, and doing business there is relatively easy. Because large portion of the population can afford products and services offered by franchising, these markets are good candidates for franchising development.

Group 4: Anglo Saxon Inspired

The Anglo inspired countries are mostly ex-colonies of Great Britain: Hong Kong, Ireland, New Zealand, Singapore and the USA, but also include Japan whose culture and development were largely influence by the USA after WWII. This set of countries is quintessential for global franchising development, including the following characteristics: service oriented, large populations with high incomes, politically stable, urbanized. The consumers in these countries are relatively rich and willing to engage in franchising-based consumption. Franchising has thrived in these environments.

Group 5: Emerging Latin Markets

With the exception of Namibia, these countries reside in Latin America and include Brazil, Argentina, Mexico and Bolivia. While these countries are mostly "developing"

and "emerging" their PPP GDP per capita, on average, is above $9,000, but their income is unequally distributed, political risk exists, economic freedom is limited, and doing business there is not easy. Thus, while the potential is high, global franchising was slow in gaining a footing.

Group 6: Gateways to the Muslim World

Group 6 consists of only 3 countries: Malaysia, Qatar, and Kuwait. All of these are Muslim countries, with a high level of economic development, a PPP GDP per capita approaching $22 thousand, and relatively stable political system. The challenge for franchisors is that a small part of their economy is based in services, and that large adaptation may be needed to adjust to the local culture.

Group 7: Untapped Developing Countries

This group of countries consist of mostly developing countries from around the world: Latin America (Colombia, Ecuador, El Salvador, Guatemala, Venezuela), MENA (Iran, Morocco, Turkey), Africa (Nigeria, Zambia, Zimbabwe), Asia (Philippines, Thailand), and Eastern Europe (Russia). While these countries level of development is low with a GDP per capita below $6 thousand, on average, these countries suffer from lack of economic freedom, low level of service economy, high political risk, and difficulties in doing business. Great potential is, thus, mired by franchising underdevelopment.

Group 8: The Biggest Emerging Markets

Group 8 consists of the world's most populous nations: China and India. While the level

of economic development is low, the emergence of these countries' economies is undisputable. Given their large populations, the multinational company cannot ignore these markets in their global product portfolio, despite difficulties in doing business there.

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Table 1	
Country	Cluster
Albania	1
Egypt	
Georgia	
Indonesia	
Kazakhstan	
Costa Rica	2
Greece	
Hungary	
Israel	
Italy	
Poland	
Portugal	
Slovenia	
South Korea	
Spain	
Taiwan	
Australia	3
Austria	
Canada	
Denmark	
Finland	
France	
Netherlands	
Sweden	
Switzerland	
England	4
Hong Kong	
Ireland	
Japan	
New Zealand	
Singapore	
United States	
Argentina	5
Bolivia	
Brazil	
Mexico	
Namibia	
Kuwait	6
Malaysia	
Qatar	
Colombia	7
Ecuador	
El Salvador	
Guatemala	
Iran	
Morocco	
Nigeria	
Philippines	
Russia	
Thailand	
Turkey	
Venezuela	
Zambia	
Zimbabwe	
China	8
India	

Table 2: Clusters mean

	1	2	3	4	5	6	7	8
GDPPC (PPP)$	5,400	22,727	33,733	35,471	9,080	21,933	5,964	5,750
GINI (between 0 & 100)	33.08	35.24	29.46	40.97	58.18	46.10	48.57	38.25
Economic Freedom	1.62	2.42	3.00	3.21	2.18	2.42	1.68	1.48
Service % of the	51.24	65.45	70.42	71.43	57.70	39.17	54.38	50.35
Political risk	66.25	75.68	85.39	83.64	69.20	75.83	59.21	64.75
CPI	2.74	5.36	8.81	8.31	3.26	5.27	2.90	3.30
Ease of doing business	111.80	49.55	18.00	6.14	82.60	34.00	97.00	103.50
Urbanization	48.20	68.40	77.44	81.83	67.80	82.33	57.57	32.50
Population	67.66	22.95	18.70	72.69	70.04	9.40	43.40	1225.80
GE	3.04	3.65	3.19	3.52	2.89	3.23	3.55	3.24
PD	5.05	5.28	4.71	5.02	5.20	5.01	5.57	5.26
UA	3.99	3.75	4.91	4.51	3.80	4.33	3.70	4.55
CII	5.70	5.32	4.06	4.68	5.28	5.34	5.75	4.55
% upper- middle	0.32	0.89	0.95	0.94	0.44	0.59	0.33	0.33

Table 3: Distances between cluster centers

Clusters	1	2	3	4	5	6	7	8
1	0							
2	39.7	0						
3	62.7	39.9	0					
4	61.6	30.2	20.1	0				
5	30.3	37.1	58.5	52.1	0			
6	37.2	30.5	43.7	39.2	32.3	0		
7	26.4	36.7	69.1	61.2	26.8	39.9	0	
8	52.8	67.5	83.9	80.6	61.1	66.7	57.4	0