To Main Proceedings Document

THE DYNAMICS OF FRANCHISING AGREEMENTS

Begoña López

Begoña González-Busto

Yolanda Álvarez

University of Oviedo, Spain

Departamento de Administración de Empresas y Contabilidad

Facultad de Ciencias Económicas y Empresariales

Avenida del Cristo, s/n

33071 Oviedo, Spain

e-mail: blopez@econo.uniovi.es; bbusto@econo.uniovi.es; yalvarez@econo.uniovi.es

Abstract

A franchise company is a hybrid or plural form, typically set by both company-owned units and franchised units, where the latter receive an entire business format. The importance of franchising is well documented. In this sense, it is estimated that more than a third of retail sales occurred through franchised chains in the U.S. in 1997 –this is the country where franchising is more developed, although the use of this contractual arrangement is increasing all over the world.

We explore the reasons that explain franchise chains growth and how franchising firms choose the extent of company ownership. There is an extensive literature that has addressed these topics, but a dynamic approach has received little attention. Therefore, we build a dynamic model including contractual and system variables such as fees, royalties, investment, chain size or trade name recognition. These variables have been commonly included in empirical tests conducted in this field, since they are periodically published in professional yearbooks. Through this model, we go on to analyze the dynamic behavior of a chain and how its ownership structure evolves over time as a result of the interaction of variables mentioned above.

1. Growth and vertical integration in franchise organizations

In franchised chains, individual outlets are managed by company managers or by franchisees who own the outlet. The same business concept is exploited through both contracts and firms. Although the incentives they receive are very different, patrons observe a high level of uniformity among them. The design of the outlet, the operating system and the service are identical.

Uniformity is important as it enhances the value of the brand name. It guarantees the patron the same service in every location and this reduces his searching costs because he can take advantage of his previous consumer experiences (Rubin, 1978).

Franchisees are independent operators that acquire the right to clone the complete business format and the right to use the trademark in a particular period and location and under certain conditions. In return, they have to pay a fixed up-front fee and on-going royalties and advertising fees.

Royalties and advertising fees, that are usually calculated as a constant percentage of the franchised unit's sales, and up-front franchise fees, which are paid only once at the beginning of the contract, are the main sources of revenues to franchisors. Both concepts, the royalty rate and franchise fee, fixed by a franchisor at a point in time are identical for all members of the chain. There is also much persistence, over time, in franchise contract terms within firms (Lafontaine and Shaw, 1999).

Franchisees differ from independent owners in several aspects. They are supplied managerial inputs and a marketable product or service by the franchisor (Williams, 1999). For example, the franchisor usually assists the franchisees in the start-up of the business, advising them when selecting a location, negotiating a lease, financing, building and equipping. He also trains franchisee and his employees and gives ongoing services. These include advertising campaigns, group buying, training updates, research and development and marketing strategies.

Globally considered, company-owned outlets preserve the uniformity of the system and the franchisees its innovativeness. Franchisees are motivated by revenues and are conducted by persuasion, not hierarchy like company managers are. They investigate adaptations to markets or put pressure on the franchisor for specific solutions (Bradach, 1998).

Dual distribution provides synergies in the chain. Franchises are businesses based on intangible assets. These are difficult to commercialize given that to a large extent they are specific to the organization, which develops them. Moreover, they have features in common with public goods. These characteristics stimulate business development for the organization itself, as these intangible assets tend to be surplus. This is an explanation of the important business growth in franchising.

Franchisor performs operations for which costs are expected to fall for a substantial level of output (Rubin, 1978). On the other hand, franchisees will be responsible for areas where there are not such returns to scale, like daily management of the outlet.

As far as the franchisee is the residual claimant on the proceeds of the firm, franchisor's monitoring costs are reduced (Jensen and Meckling, 1976). While this incentive reduces insufficient effort problems, it creates incentives for hold-up and free-riding. Franchisee can free-ride off brand reputation and franchisor could appropriate quasi-rents of the other. Although literature sustains that firms vary the degree of vertical integration or the fees charged to franchisees in order to motivate them, evidence has been found that they do not change those parameters over time (Lafontaine and Shaw, 1999). In this paper we study the dynamics of this pattern. We explore the reasons that explain franchise chains growth and how franchising firms choose the extent of company ownership. There is an extensive literature that has addressed these topics, but a dynamic approach has received little attention.

Most of the franchisors purposely choose between operating outlets themselves and franchising them (Brickley and Dark, 1987; Lafontaine, 1991). About 90 percent of firms involved in franchising wish to expand the number of outlets in their systems (Brickley and Dark, 1987; Lafontaine, 1992; Love, 1986). This is due to the fact that franchisor revenue growth comes almost exclusively from opening new outlets rather than from increasing sales at existing outlets (Norton, 1988, Sen 1998). Emerson (1982) reports that restaurants reach its maximum sales in a three months average.

The optimal rate of outlet growth for franchisors is greater than for franchisees because franchisors are compensated from system revenues, and franchisee compensation is linked to outlet revenues (Zeller *et al.*, 1980).

If a system relies on franchising for its expansion, it faces the problem of encroachment with its existing franchisees as it opens more units in a particular area (Vincent, 1998). Franchisees usually have an exclusive area guaranteed in order to prevent these conflicts and encourage specific investments in their potential local markets. Exclusive territories grant a minimum distance with other outlets, allowing to fulfil a twofold objective. First, it limits intrabrand competition, although it cannot completely eliminate it (Schmidt, 1994). Besides, it avoids cannibalization between closely located outlets. In this sense, in order to contain this cannibalization, a proper percentage of integration could control this competition because the franchisor can fix its own prices but not the franchisees' ones.

A high level of growth discourages new franchisees because of legal conflicts with existing franchisees (Hunt, 1973) and the decline in sales. Opening company outlets may overcome the problem of finding a franchisee for a developed area.

Franchisor produce certain corporate resources, such as marketing, purchasing, and training for company managers and for the franchisees that choose to adopt them. These market forces put pressure on the chain operator to be competitive. Besides, the company units provide a stable base of demand for services, which enables the chain (and its franchisees) to take advantage of economies of scale in critical areas such as purchasing (Bradach, 1998, p. 129). A fixed percentage of company outlets can motivate the franchisor to maintain the value of the trademark. A sufficient number of owned stores could make profitable its investments in the chain even if only the company establishments existed.

As far as the franchisor does not use authority but persuasion with franchisees, he does not impose the adoption of new products to them. A chain's franchisees decide independently whether to implement an adaptation but they can destroy a launch if they not adhere to it. At any point in time, only a portion of the franchise units might have adopted an adaptation, which is why advertisements often say that a product is available at "participating locations" (Bradach, 1998, p. 152). This can be another motivation to maintain a certain percentage of company units where decisions are made in a centralized fashion. Implementing ideas in these units, the chain operator can reach a critical mass of outlets adhered and persuade franchisees to adopt the idea with actual results.

There is a similar problem with advertising fees. Advertising can be considered a form of systemwide adaptation because it affects the uniform identity of every unit (Bradach, 1998, p. 153). Advertising is closely related to the establishment of the franchisor's brand name, which is critical to the success of the franchise (Mathewson and Winter, 1985; Norton, 1988; Rubin, 1978; Sen, 1993; Sen, 1995). Many franchisors with strong brand names have high promotional expenditures (Norton, 1988). It should be pointed out that the chain operator usually applies the same fixed percentage to establish its advertising budget for company units than the one required to franchisees (Bradach, 1998, p. 205).

For these decisions it is usually applied a voting scheme based on majority decision (votes are apportioned on the basis of units). The mix determines advertising decisions. Evidence exists that chain operators sometimes shift the mix of units in their chain to obtain control of these decisions (Bradach, 1998, p.154).

Those fees are usually deposited in a national promotion fund, which is used by franchisors for preserving the chain's brand name strength (Justis and Judd, 1989). Franchisor collects these fees because he is specialized in activities where there are significant economies of scale such as the coordination of national promotional campaigns (Rubin, 1978).

Growth not only increases the value of the franchise through the market representation – number of outlets– (Baucus *et al.*, 1993; Sen, 1993), but also generates more funds for advertising. Besides, it can reduce the effects of spatial competition because it expands demand (Kaufmann and Rangan, 1990).

Finally, growth also alters the cost structure of the chain. Thus, monitoring costs usually increase with the size of the system, up to a point where density reduces them. Also training costs should increase until the franchisor can reach economies of scale.

Related to the decision of whether to grow through owned or franchised outlets, "the organizational resources required to add franchise units by adding a new franchisee were somewhat less than those required to add company units. The cost advantage of the franchise source of growth came from the fact that some franchisees required little assistance and therefore consumed few resources. Moreover, most franchisees made decisions (for example, selecting vendors) and undertook activities (for example, hiring staff) that in the company arrangement would have required the involvement of existing managers" (Bradach, 1998, p. 72). Multi-unit franchising overcomes even better growth constraints, because chain operator selects only well-performing operators to add units. Besides, these experienced agents need less assistance in the start up of new outlets and enhance uniformity in the chain (Franquicias Hoy, 2000).

2. Basic loop structure

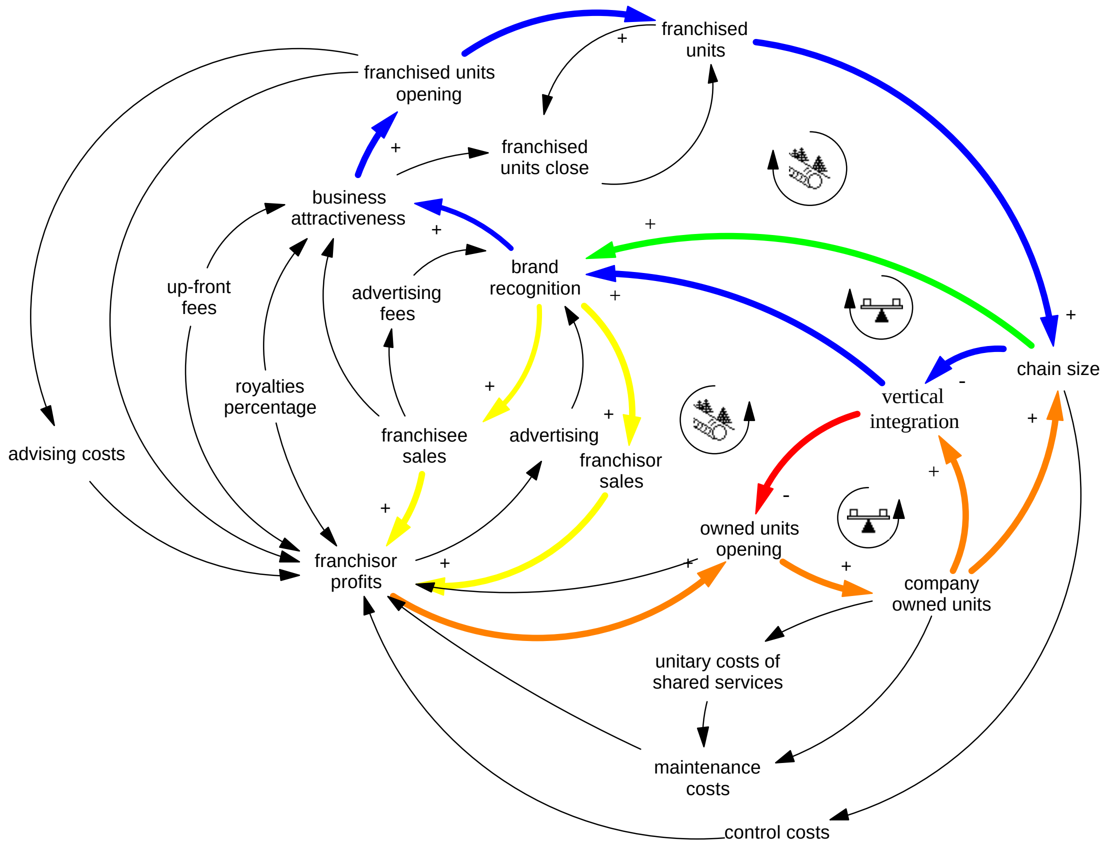
Based on the theoretical framework previously outlined, we go on to describe the simplified causal loop structure used as a reference to build the model, and which reflects the main relationships considered.

Although several feedback loops can be detected on Figure 1, next we describe and pay special attention to those underlined on the diagram, as they are those which better contribute to understand the dynamics of the integration adjustment process and chain growth.

First of all, a positive feedback loop can be detected, associated with the interrelations between franchised units, chain size, brand recognition and business attractiveness. Thus, the greater the business attractiveness, more potential franchisees wish to join the franchise chain. As franchised units increase and, therefore, chain size, brand recognition is positively influenced, as well as business attractiveness. This positive feedback loop is critical for the chain growth. However, the increase of franchised units indirectly generates a negative effect, reflected on the following negative feedback loop.

As the number of franchised units increases, due to a great brand recognition and a high business attractiveness, the degree of vertical integration on the chain starts to decrease, damaging brand recognition as the chain uniformity decreases.

Figure 1: Basic loop structure



In order to counteract this negative effect, that can restrain chain growth, the franchisor tries to maintain the degree of vertical integration to a desired level. This behavior is shown through another negative feedback loop that connects the decision of opening new owned units and the degree of vertical integration. Thus, as vertical integration increases above a desired level, the franchisor decides to open new units of his own in order to preserve chain uniformity.

Finally, another positive feedback loop shows the interrelations between the degree of the chain vertical integration, brand recognition, the chain sales, the franchisor profits and the opening of owned units. Thus, as franchisor profits increase, due to both franchisee and franchisor sales rise, new owned units can be opened, increasing the degree of vertical integration, as well as the chain size. Vertical integration has a positive effect on brand recognition, as it increases chain uniformity, giving rise to an increase in sales.

3. Model structure

The basic loop structure, described in the previous section, was converted into a flow diagram –see Figures 2 and 3.

Figure 2 shows the three main levels of the model: franchised units, company owned units and, finally, franchisor profits. The first level –franchised units– inflow depends on business attractiveness for potential franchisees. The decision of opening new owned units depends on the vertical integration policy followed by the chain franchisor. The decision of closing both, franchisor and franchisees units is respectively related to franchisor profits and franchisees incomes[1]. The total incomes –the franchisor profits inflow– are obtained by adding those obtained from the up-front fee paid by franchisees who join the chain, from royalties and, finally, from the franchisor sales. The costs incurred by the franchisor –outflow of the franchisor profits level– include those related to the opening of owned units, advising costs –costs of training and advising new franchisees before opening their units–, owned units maintenance costs –subjected to economies of scale– and control costs –that positively depends on the degree of vertical integration[2].

Figure 2: Flow diagram (I)

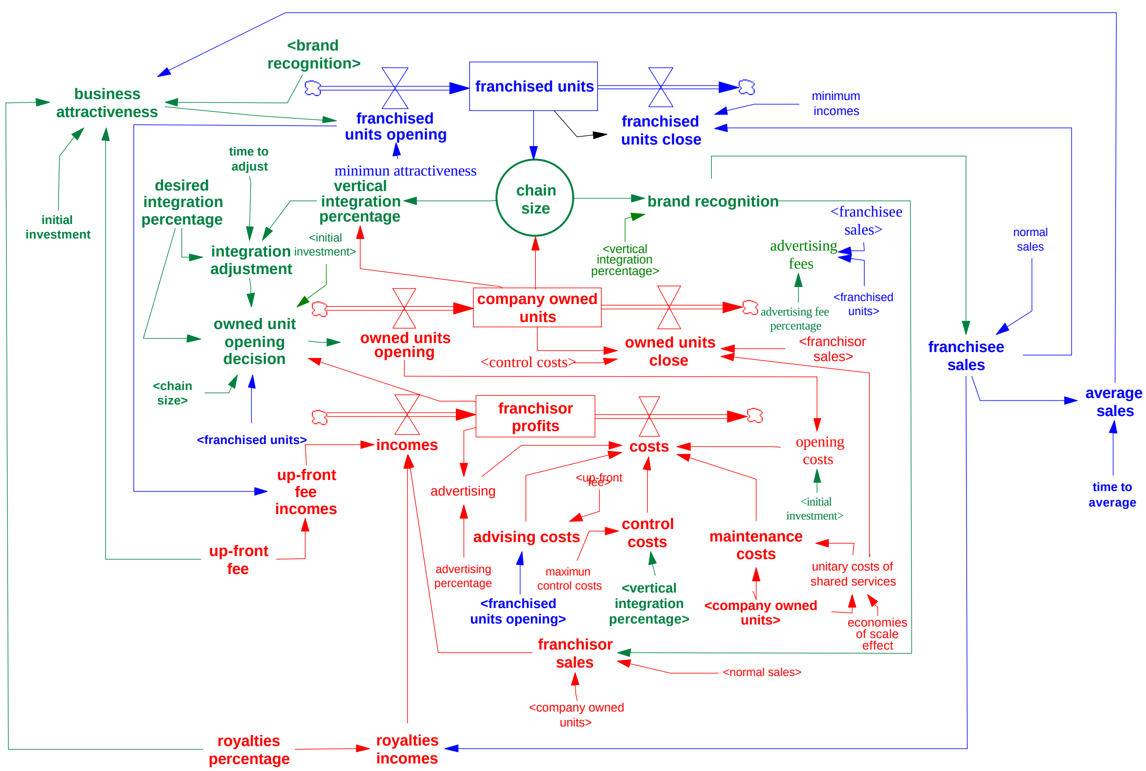
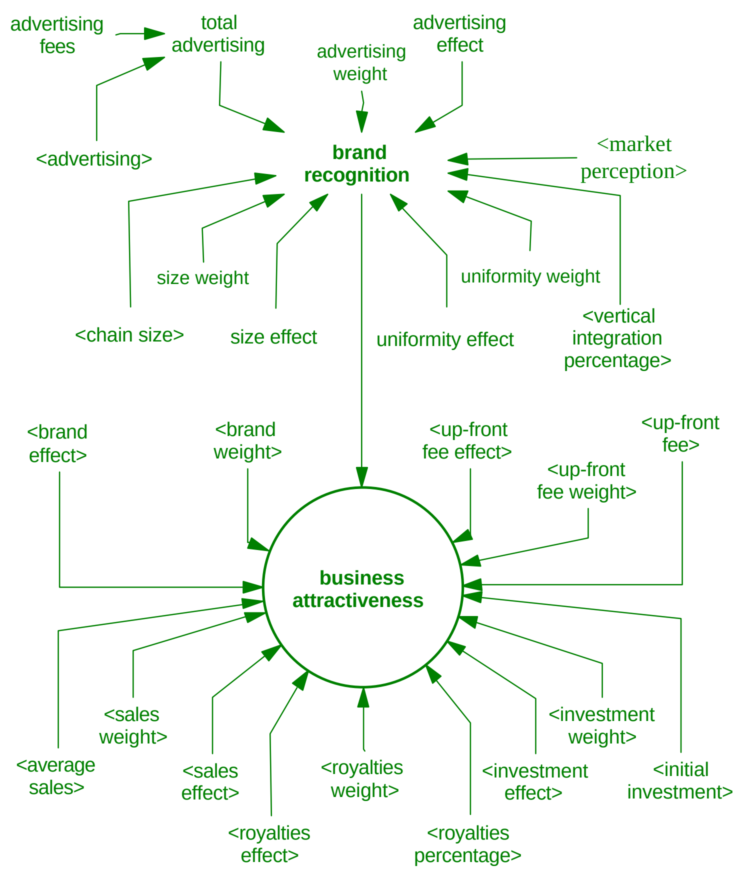


Figure 3 shows those variables that define both, brand recognition and business attractiveness for franchisees. Brand recognition on the market is caused by the delayed effects of advertising –financed through the advertising fees charged to franchisees and direct investments of the franchisor–, as well as the effect of the chain size and uniformity.

Brand recognition on the market determines business attractiveness for potential franchisees, along with the initial investment required to open a unit –that amounts the cost of beginning operations, including equipment, inventory, rent, working capital, and other miscellaneous costs–, the percentage of royalties charged, the up-front fee to be paid when joining the chain and, finally, the expected sales[3].

Of all these factors, empirical evidence exits about brand recognition being the most valuable of all for potential franchisees (Withane, 1991; Peterson and Dant, 1990).

Figure 3: Flow diagram (II)

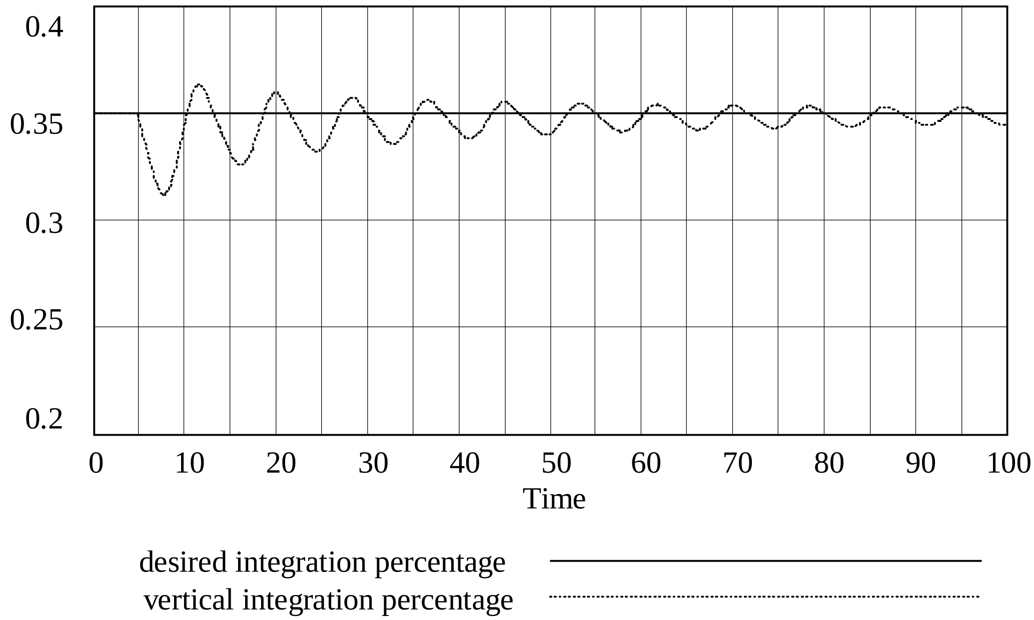


4. Analysing the dynamic behavior of vertical integration

Empirical evidence shows that the average degree of vertical integration in franchise chains in the service sector takes a value of approximately 35%. Therefore, this was the value assigned to the constant variable "desired integration percentage" and taken into account when establishing initial values for the levels "franchised units" and "company owned units". Thus, the degree of vertical integration matches its desired value at the starting point of the simulation.

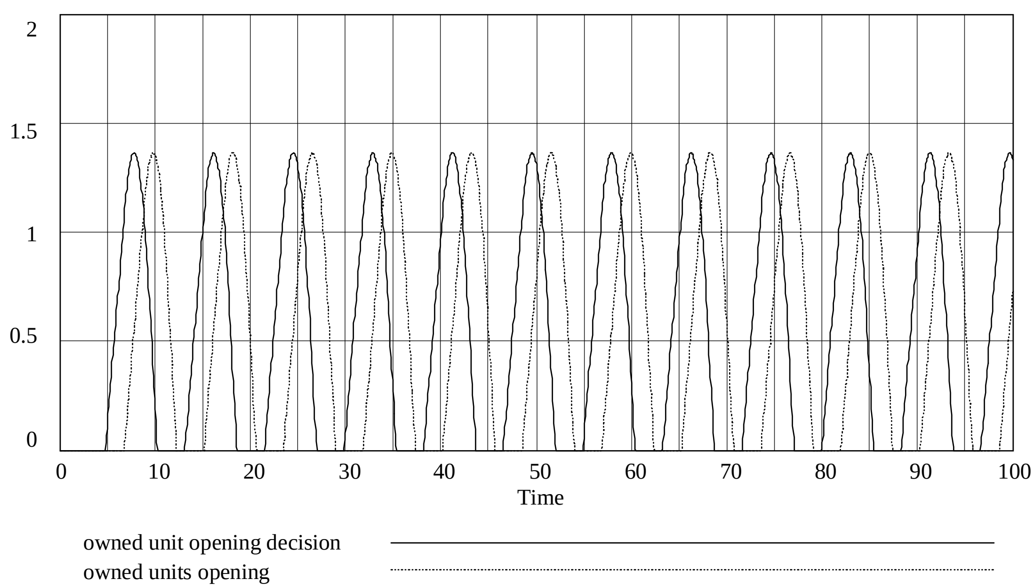
As shown in Figure 4, the percentage of vertical integration oscillates around the desired value, but not fitting equilibrium.

Figure 4: Evolution of the vertical integration percentage and the desired integration percentage



This behavior can be explained based on the existing delays concerning the detection of a decrease in the degree of vertical integration, and the decision and action of opening a new unit –see Figure 5.

Figure 5: Evolution of owned unit-opening decision and owned units opening



5. Conclusions

A rapid growth is a key issue for franchise firms –specially for those operating in the service sector– because in the long term increasing returns exists, as it happens for new industries based on intangible assets and knowledge (Arthur, 1996). Thus, a rapid initial growth allows the firm to increase brand recognition –as it increases market presence and generates more funds for advertising– that, in turn, expands the demand, generating positive feedback. Besides, growth is critical for the franchisor as his revenues almost exclusively come from opening new units or outlets.

However, this rapid growth through franchised units can damage chain uniformity and, therefore, brand name. This fact explains the franchisor interest on controlling the extent of company ownership.

In short, both, rapid growing (Shane and Spell, 1998) and an appropriate degree of vertical integration, are fundamental for the franchise chain survival. Through the dynamic model built –described on sections 3 and 4–, we try to demonstrate the difficulty of trying to simultaneously handle both goals.

Based on the results of the simulation, it is demonstrated that franchisor cannot reach the optimal degree of vertical integration due to the existing delays between the increase of franchised units and the opening of company owned units.

Due to the preliminary nature of this work, our further research will focus on reducing model limitations. In this sense, the nature of the integration decision must be reconsidered, including a control on delays, in order to demonstrate if this new policy reduces vertical integration fluctuations observed in the present model.

6. References

Arthur, W. B. (1996). Increasing Returns and the New World of Business, *Harvard Business Review,* july-august, 100-109.

Baucus, D., M. Baucus and S. Human (1993). Choosing a Franchise: How Base Fees and Royalties Relate to the Value of the Franchise, *Journal of Small Business Management*, vol. 31, 91-104.

Brickley, J. A. and F. H. Dark (1987). The Choice of Organizational Form: The Case of Franchising, *Journal of Financial Economics,* vol. 18, 401-420.

Emerson, R. (1982). *Fast Food: The Endless Shakeout,* Lebhar-Friedman, New York.

Franquicias Hoy (2000). *El multifranquiciado: una figura rentable,* n. 49, march, pp.60-64.

Hunt, S. (1973). The Trend Toward Company-Operated Units in Franchise Chains, *Journal of Retailing,* vol. 49, 3-12.

Jensen, M. C., and W. H. Meckling (1976). Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, *Journal of Financial Economics,* vol. 3, n. 4, October, 305-360.

Kaufmann, P., and V. Kasturi Rangan (1990). A Model for Managing System Conflict During Franchise Expansion, *Journal of Retailing*, vol. 66, n. 2, 155-173.

Lafontaine, F. (1991). How and why Franchisors Do what They Do: A Survey Report. In P. Kaufmann (Ed.), *Franchising: Passport for Growth and World of Opportunity*. Proceedings of the 6th Conference of the Society of Franchising.

Lafontaine, F. and K. L. Shaw (1999). The Dynamics of Franchise Contracting: Evidence from Panel Data, *Journal of Political Economy*, vol. 107, n. 5, 1041-1080.

Love, J. F. (1986). *McDonald's: Behind the Golden Arches*, Bantam Books, New York.

Norton, S. (1988). Franchising, Brand Name Capital, and the Entrepreneurial Capacity Problem, *Strategic Management Journal*, vol. 9, 105-114.

Peterson, A. and R. P. Dant (1990). Perceived Advantages of the Franchise Option From the Franchisee Perspective: Empirical Insights from a Service Franchise, *Journal of Small Business Management*, July, 46-61.

Sen, K. C. (1993). The Use of Initial Fees and Royalties in Business Format Franchising, *Managerial and Decision Economics*, vol. 14, 175-190.

Sen, K. C. (1998). The Use of Franchising as a Growth Strategy by US Restaurant Franchisors, *Journal of Consumer Marketing*, vol. 15, n. 4, 397-407.

Shane, S. A. and C. Spell (1998). Factors for New Franchise Success, *Sloan Management Review*, spring, 43-50.

Vincent, W. S. (1998). Encroachment: Legal Restrictions on Retail Franchise Expansion, *Journal of Business Venturing*, n. 13, 29-41.

Williams, D. L. (1999). Why Do Entrepreneurs Become Franchisees? An Empirical Analysis of Organizational Choice, *Journal of Business Venturing*, vol. 14, n. 1, 103-124.

Withane, S. (1991). Franchising and Franchisee Behavior: An Examination of Opinions, Personal Characteristics, and Motives of Canadian Franchisee Entrepreneurs, *Journal of Small Business Management*, January, 22-29.

Zeller, R., Archabal, D. and Brown, L. (1980). Market Penetration and Locational Conflict in Franchise Systems, *Decision Sciences*, vol. 11, 58-80.

Notes:

[1] It should be pointed out that the decision of closing a franchisee unit should also depend on its profits, rather than on its incomes. However, the model does not reflect franchisees profits, as its goal is to reflect the chain growth and profitability, rather than that of the individual franchisee.

[2] As mentioned on section 2, motivation of independent franchisees and franchisor employees who manage franchisor units is different. The former are more motivated, as they have invested their own capital on the business; thus, the need to control lessens in this case, and increases, and so control costs, when the degree of vertical integration is high. Besides, it should be mentioned that other costs, such as those related to personnel, inventory or raw materials purchasing, are not included in the model.

[3] In both cases –brand recognition and business attractiveness– a weight was given to each factor employed to define them, based on qualitative information obtained from franchising literature. Besides, it should be mentioned that values assigned to most parameters were obtained from information published in professional yearbooks.