

2010

Important Questions about Franchising: What We Know and What We Should Know

Arturs Kalnins

Cornell University, atk23@cornell.edu

Follow this and additional works at: <http://scholarship.sha.cornell.edu/articles>

 Part of the [Hospitality Administration and Management Commons](#)

Recommended Citation

Kalnins, A. (2010). *Important questions about franchising: What we know and what we should know* [Electronic version]. Retrieved [insert date], from Cornell University, School of Hospitality Administration site: <http://scholarship.sha.cornell.edu/articles/347>.

This Article or Chapter is brought to you for free and open access by the School of Hotel Administration Collection at The Scholarly Commons. It has been accepted for inclusion in Articles and Chapters by an authorized administrator of The Scholarly Commons. For more information, please contact hlmdigital@cornell.edu.

Important Questions about Franchising: What We Know and What We Should Know

Abstract

[Excerpt] In Chapter 39, Ramon Diaz-Bernardo presented an excellent and thorough review of academic work on franchising. This is the most complete review, of which I am aware, of the various literatures that make predictions about the phenomenon. Diaz-Bernardo added additional value in two ways: First, he described the theoretical bases in a language that can be easily understood by applied academics and practitioners alike. Second, he illustrated all the main points with interview quotes from practitioners. The design of this literature review is novel in this regard and is worthy of emulation.

Keywords

hospitality management, hospitality industry, franchising

Disciplines

Hospitality Administration and Management

Comments

Required Publisher Statement

© SAGE. Final version published as: Kalnins, A. (2010). Commentary: Important questions about franchising: What we know and what we should know. In C. Enz (Ed.), *The Cornell School of Hotel Administration handbook of applied hospitality strategy* (pp. 646-654). Los Angeles, CA: SAGE. Reprinted with permission. All rights reserved.

Important Questions about Franchising: What We Know and What We Should Know

Arturs Kalnins

In Chapter 39, Ramon Diaz-Bernardo presented an excellent and thorough review of academic work on franchising. This is the most complete review, of which I am aware, of the various literatures that make predictions about the phenomenon. Diaz-Bernardo added additional value in two ways: First, he described the theoretical bases in a language that can be easily understood by applied academics and practitioners alike. Second, he illustrated all the main points with interview quotes from practitioners. The design of this literature review is novel in this regard and is worthy of emulation.

The success of the franchising form of organization is beyond doubt. I will not repeat the many anecdotes and statistics discussed by Diaz-Bernardo (in Chapter 39) to support this claim. Instead, I will summarize the different sections of his chapter and emphasize those aspects I believe are most important, as well as fill in some gaps and perspectives that I feel have been insufficiently emphasized. My own emphasis will be on implications for research possibilities for the applied academic. When relevant, I also provide advice for the practitioner, either an actual franchisee or franchisor, or an individual considering either role. I reiterate that Diaz-Bernardo's is the most complete and satisfying review of franchising theory that I have read and that the individual points I make should not be construed as criticism of his work.

Diaz-Bernardo usefully categorized the work on franchising into topical areas that he referred to as "Franchising and Society," "Creating Franchise Relationships," and "Managing a Franchise System." In this commentary, I focus on the first two of these topics, and then add a discussion of international franchising.

Franchising and Society: Do Franchisee Ventures Outlast Those of Independent Owners?

The "Franchising and Society" section deals with the important big-picture question of whether franchising improves societal welfare. While we know franchising is a ubiquitous organizational form, suggesting the answer of "yes" to this question, nailing down the answer with a more precise analysis

has proved to be difficult. While franchise trade groups often tout data that support the idea of the benefits of franchising, purely academic work has found mixed results at best.

The Bates (1995) study, mentioned in Diaz-Bernardo's chapter (Chapter 39), has gained much attention in the academic and public policy sectors from its finding that franchising may actually decrease the survival period of a business, relative to independent ownership. Bates (1995) raised an important issue. Statistics that suggest benefits of franchising inappropriately conflate all franchisees into one category: small "mom and pop" owners of one establishment of a possibly little known brand name and publicly traded franchisee corporations that own and operate hundreds of units of the most well-known brands. Obviously, the business outlets of the large, experienced, and munificent franchisee corporations will likely outperform the establishments of independents. Once Bates (1995) controlled for number of outlets owned by a franchisee, franchising adds no residual benefit; in fact, it appears to be a detriment. Thus, franchising per se may not be a relevant "success factor" for entrepreneurs looking to open their very first business. Their survival rate is likely to be much closer to that of similar independents. Confounding the issue further, the beginning entrepreneur will be very unlikely to gain the rights to open a top franchise such as McDonalds or Wendy's. McDonald's, for example, only accepts 1% to 2% of their applicants as franchisees. It hardly would be surprising if a McDonald's survived longer than a franchised outlet of a little known brand name. No study, to my knowledge, has controlled for the effect of chain size or brand familiarity in a study of the benefits of franchising versus independent ownership.

Further, many comparisons of franchised and independent business survival rates are apples and oranges comparisons in a different dimension, because franchised businesses are more likely to be transferred to other owners or to company management without changing the name. Many studies do not count this as a "failure," even though the original franchisee may have lost almost all of their initial investment. Independent businesses are far less likely to remain intact, operating under the same name, after an ownership change. For example, Thompson (1971) stated that franchisors with highly visible business outlets, such as restaurants, will typically not permit failure of an outlet, at least soon after it has opened. To keep any potentially viable units open, franchisors will try to transfer ownership whenever a franchisee wants to sell the unit or operates the unit poorly, as well as when company managers cannot be monitored effectively.

A related issue exists in the lodging industry that also calls into question the validity of franchised versus independent survival comparisons. As noted in a quote from former Choice Hotels and Marriott executive Joe Lavin in Chapter 39, the lodging franchisor provides mostly marketing services. If

hotel franchisees are unsatisfied with the performance of a particular hotel chain in this regard, they can fairly easily switch to another brand without necessarily incurring substantial remodeling or contracting costs. They may also continue to operate their hotels as independents. Thus, unlike a fast-food franchisee, the lodging franchisee need not worry so much about the survival or failure of the entire venture based on the choice of the franchising organizational form. If a hotel is built in a good location, the initial choice of franchised or independent status can often be changed if it did not prove optimal.

The implications for academics as well as practitioners are reasonably clear. Academics need to better define the concept of survival and to seek a subset of franchised operations that appear most similar to independent businesses. Entrepreneurs considering franchising should not believe they are necessarily improving their odds of success or at least of survival by franchising. Rather, they should attempt to understand which organizational design, franchising, or independent business is best for them given their goals, strengths, and weaknesses as businesspeople. Diaz-Bernardo discussed this issue thoroughly in the "micro" section of the "Creating Franchise Relationships" section of Chapter 39.

Creating Franchise Relationships: Why Does Franchising Exist at All?

In Chapter 39, Diaz-Bernardo articulated the many benefits of franchising, from the point of view of a brand owner, but I would like to begin my discussion from a different perspective and point out benefits of not franchising—that is, company owning or at least operating all outlets. The main benefit, often overlooked in discussions of franchising, is that company-owned outlets have the potential to make more money for the brand owner. Company-owned units do not have to be more profitable to be preferable for the company. Even if the franchisee-owned restaurants were more efficient and have higher margins, as noted by Joe Lavin in Diaz-Bernardo's chapter (Chapter 39), the fact that the company only gets a sales royalty from the franchisees means that the company still ends up with less money. Kaufmann and Lafontaine (1994) found that even after paying the royalty to the franchisor, giving the franchisee a \$72K salary, and compensating them for their cost of capital, a McDonald's restaurant with average sales yielded \$85K in rents that went to the franchisee in 1989. These rents would all be potential profit for the franchisor if the unit were company owned.

Consistent with the greater profitability, franchisor executives clearly articulate a preference for company-owned units. McDonald's President Fred Turner discovered the profit potential of company-owned stores in the late 1960s, increasing company-owned units from 9% to 33% between 1967 and 1976. While profit margins were lower at McDonald's company-owned restaurants, consistent with Joe

Lavin's observations at Marriott, the company-owned units brought in 70% of revenues in 1993 (Love, 1986).

Some executives seem to only grudgingly accept the necessity of franchisees because the franchisee capital helps them grow. Ray Kroc, founder and the first CEO of McDonald's, had the following to say about this matter: "If I felt that if we could finance the things and grow rapidly enough, I would darn near be in favor of never selling another franchise" (Love, 1986, p. 202).

Bradach (1998) quoted a similar opinion from a franchisor executive: "We use franchisees to fill the gap between our targeted objectives for new units in a market and our ability to add company units" (p. 75).

These quotes illustrate two points. First, these franchisors seem to prefer company management. Second, they are not able to grow sufficiently rapidly without franchising. So what holds most brand owners back from the company ownership model? Understanding the theories articulated by Diaz-Bernardo in Chapter 39 is crucial to formulate a credible answer. The resource scarcity theory is implicit in the quote from Ray Kroc. Something makes financial resources unavailable to a company trying to grow through ownership alone. The main alternative explanation is based on agency theory—franchisees, because of ownership, will work harder than will company managers. On top of these explanations, Diaz-Bernardo also added an explanation for the benefits of the "plural form"—that is, the case where franchised and company owned (or operated) locations exist within the same chain. After briefly reviewing these explanations, I wish to focus on an alternative—information scarcity—that receives less attention in Diaz-Bernardo's chapter. I finish this section with a discussion of possibilities for future research.

Resource Scarcity

Franchising often arises because of resource scarcity, as discussed by Diaz-Bernardo. The resource in question is usually financial capital (Caves & Murphy, 1976; Oxenfeldt & Kelly, 1968; Ozanne & Hunt, 1971). However, information constraints are also important and are often underemphasized in the literature (see, for example, Minkler, 1992). According to the capital constraint hypothesis, franchisors require financial capital in their early stages and sell franchises to raise capital. As the franchisor matures, the capital constraints are relaxed, and company ownership is possible. As evidenced by the examples of the previous section, many franchisor executives describe motivations consistent with this explanation for franchising. Two academic studies find results consistent with the capital scarcity hypothesis. Combs and Ketchen (1999) found that variables indicating a lack of capital

are associated with a chain's reliance on franchising. Shane (1996) examined growth of 138 franchisor firms that began franchising in 1983. He found that proportion of units franchised is significantly and positively correlated with growth in units of the franchise system (in number of units) as well as with survival of the franchisor. However, one of the main implications of the capital scarcity hypothesis—the idea that the franchisor will more likely own future units themselves, once they have sufficient capital—has received little support, as noted by Diaz-Bernardo in Chapter 39 (see, for example, Dant, Kaufmann, & Paswan, 1992; Dant, Paswan, & Kaufmann, 1996).

In fact, the capital scarcity argument has often been discounted by academics—despite persistent claims from practitioners such as the previous quotes. Rubin (1978) articulated the standard argument against resource constraints as a motivation for franchising: risk-averse small investors should prefer owning shares from many franchised business outlets, thus diversifying their portfolio, than having all their capital invested in a single unit. And, as Diaz-Bernardo (in Chapter 39) pointed out, the franchisor actually provides financing to franchisees within some chains. At least for this subset, capital constraints do not explain franchising. However, Lafontaine (1992) argued that franchisees might serve as a less expensive source of capital if agency problems also exist, as discussed in more detail next. If company-owned unit managers are more likely to shirk than are franchisees, investors with a portfolio of shares from all units are likely to demand higher rates of return, even if their investment is less risky, than they would on the capital invested in a single store that they manage themselves. Hence, she argues that capital may well be more efficiently obtained from franchisees than from investors.

Agency Theory

Diaz-Bernardo discussed thoroughly the concept of agency theory in Chapter 39. Ownership separates from control in many business situations resulting in what are known as agency problems. The most well-known example is that of publicly owned firms run by full-time managers with little or no ownership stakes. Often this separation results in managers taking too many perquisites, because any potential reduction in their salaries is unlikely to fully reflect the cost of the "perqs" (Jensen & Meckling, 1976). This dilemma exists for geographically dispersed firms, even if privately held. Subsidiaries may be located distantly from headquarters (HQ) where the owners cannot monitor effectively. Local managers will be likely to shirk in such locations, because like perquisite taking the managers do not bear the full cost of this activity.

To manage these agency problems, firms develop governance structures, such as corporate boards, to supervise top managers. Because explicit supervision of managers by institutions, such as

corporate boards, is difficult and incomplete at best, these institutions are supplemented with explicit incentive alignment mechanisms, such as stock options and performance-based bonuses for the managers. Franchising presents geographically dispersed firms with a similar set of governance mechanisms. The firms have the option of "company-owning" retail or service outlets or manufacturing facilities and creating an organization that monitors them effectively. Alternatively, as franchisors, firms allow the local manager to actually own the local operation, giving the manager incentives to maximize profits. In fact, agency theory provides sufficient conditions for franchising with sales royalty payments to emerge as an optimal arrangement for two parties (the franchisor and franchisee) who lack the ability to monitor each other's behavior perfectly (Mathewson & Winter, 1985).

Similar to Joe Lavin's statement in Chapter 39 about performance of franchised versus company-managed locations, profit data of fast-food restaurants have been found to be consistent with the view that substantial agency costs exist for company-owned restaurants. Shelton (1967) examined the profitability of 22 restaurants that experienced a transfer from franchisee ownership to company ownership or vice versa. In 19 cases, the restaurant was less profitable under company ownership than under franchisee ownership. On average, the profit margin under franchisee ownership was 9.5%, and under company management it was only 1.8%. Because locations of the units in this study remained constant, while only ownership changed, this finding compellingly suggests that agency costs substantially influence the performance of company-owned restaurants.

Franchisor executives, such as Mr. Dangelo in Diaz-Bernardo's Chapter 39, also recognize that company ownership presents problems relative to franchising other than slower growth. In contrast to his boss, Ray Kroc, in the quote given earlier, Fred Turner, the president and CEO of McDonald's in the 1960s, seemed to recognize benefits to franchising. He stated, "Running a McDonald's is a three-hundred-sixty-three-days-a-year business and an owner-operator, with his personal interests and incentives, can inherently do a better job than a chain manager" (Love, 1986, p. 291).¹

I believe that the basic capital scarcity and agency theory arguments have face validity and have the support of academic research, particularly when considered jointly, as per Lafontaine's (1992) argument. However, there remains academic work to be done. In this regard, Ketchen, Combs, and Upson (in Chapter 42) provided a valuable approach for future research. They recognized that not all franchisors are alike in regards to their needs: Some may lack hands-on managerial skills while others lack capital. The former group may rely on franchising primarily due to the agency theory while the latter due to capital scarcity. In Chapter 42, Ketchen et al. used cluster analysis to identify four distinct

¹ McDonald's are typically closed on Thanksgiving and Christmas.

groups based on a sample of 94 restaurant franchisors. While I view their specific group designations and conclusions as exploratory due to their small data set and the cross-sectional nature of their data, their approach of identifying franchisors with different sets of skills and needs is worthy of imitation. Once we can clearly understand the different needs of franchisors, we will not only be better able to identify the relevant theories but we will also be able to link these theories to levels of performance.

The Plural Form

Diaz-Bernardo also spent some time discussing the benefits of the "plural form"—that is, company-owning and franchising units simultaneously. His discussion is largely based on the path-breaking work of Bradach (1998), who presented case-based evidence that franchisors benefit from the simultaneous presence of both types of organization. The franchisors can learn from franchisees how to best operate their company units. Their employees at company stores often make the best future franchisees. The franchisors can use company stores to train franchised unit managers and to conduct market tests of new concepts and products. In addition, ex-franchisees may become valuable top management members of the franchisor's corporate team.

While these plural form arguments seem logically persuasive, it remains unclear, then, why so many chains franchise 100% of their units. For every major chain that uses the plural form, it is easy to name one, or more than one, that is 100% franchised. While McDonald's, Burger King, and Wendy's use the plural form, Subway, Dairy Queen, and Dunkin' Donuts do not. In the lodging sector, most midscale and economy chains do not have company-owned or company-managed hotels. Chains that are 100% franchised include the Wyndham International brands (Super 8, Ramada, and Day's Inn) and the Choice brands (Comfort, Quality, and Sleep Inns). Within the midscale and economy tiers, only Motel 6 and La Quinta have significant numbers of both company-owned and franchised properties under their brand name. An important research question, then, for the applied academic, is to understand under what circumstances, or for what type for franchisors or business formulas, the plural form makes the most sense. The cluster analysis approach of Ketchen et al. in Chapter 42 could prove very useful here.

Information Scarcity

My final contribution is to address the information theory of franchising. Minkler (1992) articulated the potential role of another scarce resource for franchisors: information constraints. He analyzed a theoretical model that assumes only franchisees can learn supply and demand information in their local areas but that franchisors cannot. Franchising takes place at least initially, based on these

assumptions, because the franchisors need the access to the local information. Minkler's (1992) argument is also consistent with the view that firms are constrained by geographically localized search routines. Academics have tested some aspects of the information constraints hypothesis. In particular, Brickley and Dark (1987) found that company-owned restaurants are more likely to be located near the chains HQ and company-monitoring locations, consistent with the information constraint argument. Baum, Li, and Usher (2000) also made such an argument to explain why wholly owned nursing home chains choose acquisitions close to their existing units. But little else has been tested regarding information scarcity, particularly regarding performance. Do company-owned units perform better in the locations where the company is most likely to have good information? What types of locations are these? Do these include the vicinity of the corporate HQ, monitoring locations, and existing company units? Do franchised units perform best in the vicinity of the franchisee's home location? Does it make sense to intermingle company and franchised outlets so that the company can learn directly from the franchisees? Answering these and other questions about the role of information constraints in franchising would make a substantial contribution to the literature.

Given these theories suggest that the franchisee provides capital and local knowledge, the reader might well wonder what the franchisor brings to the relationship. Diaz-Bernardo (in Chapter 39) discussed several studies that address this question—mostly via surveys of franchisees regarding why they decided to choose that form of entrepreneurship. The two most common answers appear to be the brand name and the "proven business formula." What is not known is exactly how valuable these "proven business formulae" are for the typical franchisee or their scope of applicability.

In other words, much like the franchisee possesses "local" knowledge that is assumed not to be valuable outside a specific geographical area, is there also some limit to the value of the proven business formula? One particular setting where a franchisor's business formula does indeed appear to be of limited value is the case of international franchising. Little evidence exists regarding the geographic limits of the value of franchisors' business formulae. However, my finding (Kalnins 2005) that more than 60% of international fast-food ventures initiated by U.S. franchisors fail within 5 years suggests that some aspect of the business formula is often either inapplicable or at least is not being applied correctly, in foreign markets.

Information in Foreign Markets

More recently, Klonowski, Power, and Linton (in Chapter 41) presented a fascinating case study of a large and successful U.S. franchisor in the casual dining segment. Despite working with a very

professional franchisee in Poland, the arrangement did not yield success in that nation. The problems appeared to be threefold: (1) the business formula that worked so effectively in the United States and elsewhere was less applicable in Poland, (2) the franchisor had insufficient information about the Polish market to apply the business formula, and (3) there were some instances in which the franchisor appeared to be more interested in taking advantage of the franchisee rather than cooperating to build a successful business.

One of the main complaints from the Polish franchisee was that the training its managers received in the United States did not translate to the Polish market. The challenges of purchasing, marketing, and human resources (HR) were so different in a developing nation, whose economy had only been free from state socialism for a decade, than they were in the United States. Another complaint was that the franchisor behaved erratically in regards to site selection, first rejecting a potential high traffic site for the first restaurant and then approving an almost identical and nearby site a year later, without any explanation regarding how the sites possibly differed or why the decision had changed. The franchisee incurred substantial opportunity costs due to this delay. This complaint is particularly salient because one of the franchisor's supposed areas of expertise—a typically crucial part of the business formula—is site selection. While it is very likely that this particular franchisor does possess site selection expertise in the United States, however, there is no reason to believe that this should translate to the Polish market or that of any other emerging economy. Finally, the most troubling aspect of this case study was that the franchisor demanded that the franchisee always buy kitchen equipment from the franchisor, in the United States. While the franchisor claimed this was necessary to maintain quality, the equipment was far more expensive than what the franchisee could have paid for local equivalents. Further, there were few options for repair, leaving the franchisee with a large amount of nonfunctioning equipment.

We have little systematic understanding of the limits of franchisor knowledge and the limits of business formula applicability. Many examples exist of very successful international ventures by U.S. franchisors in foreign markets, and many examples exist, such as the Polish case just given, where the relationship dissolves through animosity and mistrust and results in substantial monetary losses. Very well-known brand names, such as Burger King, Wendy's, and Domino's, have seen both great success and terrible failures (Kalnins, 2005), so even a respected name does not seem to avert failure. Further, given my findings of a 60%+ failure rate of foreign ventures, international franchising does not appear to have the same level of success as the local variety. But we have established few generalities of what makes a successful venture and what predicts a failure. My study found that development commitments

that were too aggressive (e.g., 100 stores in 5 years) predict failure. But that is only one dimension. We need to identify and test other such factors that have some power predicting success or failure in order to move knowledge forward in this exciting and growing realm.

Conclusion

To summarize, I have built on the excellent review of franchising provided by Diaz-Bernardo (in Chapter 39) in order to highlight possible areas of research for the applied academic. In particular, I have identified opportunities and strategies to further the work on (1) the franchising versus independent ownership debate, (2) the relative importance of capital scarcity versus agency theory in the explanation of franchising, (3) the role of information scarcity in franchising, and finally (4) the scope of applicability of the franchisor's business formula. I believe that international franchising will be the area where the final question can be best explored. I am confident that franchising will continue to grow in importance worldwide as an organizational form. Solid academic research on franchising should not merely keep pace with the phenomenon itself but should actively help to shape its future success.

References

- Bates, T. (1995). Analysis of survival rates among franchise and independent small business start-ups. *Journal of Small Business Management*, 33(2), 26-36.
- Baum, J. A. C, Li, S. X., & Usher, J. M. (2000). Making the next move: How experiential and vicarious learning shape the location of chains' acquisitions. *Administrative Science Quarterly*, 45, 766-801.
- Bradach, J. L. (1998). *Franchise organizations*. Cambridge, MA: Harvard Press.
- Brickley, J. A., & Dark, F. H. (1987). The choice of organizational form: The case of franchising. *Journal of Financial Economics*, 18, 401 -420.
- Caves, R. E., & Murphy, W. E (1976). Franchising: Firms, markets, and intangible assets. *Southern Economic Journal*, 42, 572-586.
- Combs, J. G., & Ketchen, D. J. (1999). Can capital scarcity help agency theory explain franchising? *Academy of Management Journal*, 26, 368-376.
- Dant, R. P., Kaufmann, P. J., & Paswan, A. K. (1992). Ownership redirection in franchised channels. *Journal of Public Policy and Marketing*, 11, 33-44.

- Dant, R. P., Paswan, A. K., & Kaufmann, P. J. (1996). What we know about ownership redirection in franchising: A meta-analysis. *Journal of Retailing*, 72, 429-444.
- Jensen, M., & Meckling, W. (1976). Theory of the firm: Managerial behavior, agency costs, and ownership structure. *The Journal of Financial Economics*, 3, 305-360.
- Kalnins, A. (2005). Overestimation and venture survival: An empirical analysis of development commitments in international master franchising ventures. *Journal of Economics and Management Strategy*, 14, 933-953.
- Kaufmann, P., & Lafontaine, F. (1994). Costs of control: The sources of economic rents for McDonald's franchisees. *Journal of Law and Economics*, 37, 417-452.
- Lafontaine, E. (1992). Agency theory and franchising: Some empirical results. *Rand Journal of Economics*, 23, 263-283.
- Love, J. E. (1986). *McDonalds: Behind the arches*. New York: Bantam Books.
- Mathewson, G. E., & Winter, R. A. (1985). The economics of franchise tying contracts. *Journal of Law and Economics*, 28, 503-526.
- Minkler, A. P. (1992). Why firms franchise: A search cost theory. *Journal of Institutional and Theoretical Economics*, 148, 240-259.
- Oxenfeldt, A. R., & Kelly, A. O. (1968). Will successful franchise systems ultimately become wholly-owned chains? *Journal of Retailing*, 44, 69-83.
- Ozanne, U., & Hunt, S. (1971). *The economic effects of franchising*. Washington, DC: GPO, Select Committee on Small Business, United States Senate, 92 Congress.
- Rubin, P. H. (1978). The theory of the firm and the structure of the franchise contract. *Journal of Law and Economics*, 21, 223-233.
- Shane, S. A. (1996). Hybrid organizational arrangements and their implications for firm growth and survival: A study of new franchisors. *Academy of Management Journal*, 39, 216-234.
- Shelton, J. (1967). Allocative efficiency versus X-efficiency: Comment. *American Economic Review*, 57, 1252-1258.
- Thompson, D. N. (1971). *Franchise operations and antitrust*. Lexington, MA: Heath.