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Brands Across Borders: Determining Factors in Choosing Franchising or Management Contracts for Entering International Markets

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Abstract
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Keywords
marketing, promotion, marketing research, brand management, franchise, international

Disciplines
Hospitality Administration and Management | Marketing

Comments

Brands across Borders

Determining Factors in Choosing Franchising or Management Contracts for Entering International Markets

Should hotel companies expand internationally through management contracts or franchising? It depends on a company's core competencies—as well as the resources available in the market itself.

BY CHEKITAN S. DEV, M. KRISHNA ERRAMILLI, AND SANJEEV AGARWAL

Contractual arrangements such as franchises and management contracts have long been popular means by which hotel companies enter international markets.[1] This study examines the factors that hotels consider in making the choice between expanding via franchises or with management contracts. The study takes into consideration a firm's resources and skills, as well as some environmental factors that influence this choice.[2]

[1] John H. Dunning, *Explaining International Production* (London: Unwin Hyman Ltd., 1988), pp. 242–265.

[2] Farok J. Contractor and Sumit K. Kundu, "Modal Choice in a World of Alliances: Analyzing Organizational Forms in the International Hotel Sector," *Journal of International Business Studies*, Vol. 29, No. 2 (1998), pp. 325–358.

Theoretical Background

Traditional international business theories (such as industrial organization and transaction cost) are based on the idea that firms enter international markets to exploit competitive advantages that they have developed (that is, transaction-specific assets, such as machinery, process know-how, or trade secrets). The danger that firms face in arranging international contracts is that they may be unable to suitably price their transaction-specific assets. Moreover, there is a danger that the potential contract partners may steal their transaction-specific assets, once they are disclosed in the process of justifying the price being asked. Thus, some firms choose to maintain equity in their projects, because ownership affords a higher degree of control over technology, assets, and operations. Avoiding contracts or franchises altogether, however, entails a substantial capital investment, which typically constrains the company's ability to expand rapidly. Because of the limitations of equity-based expansion, hotel firms are attracted to franchising and management contracts despite potential technology-transfer concerns.

The above argument seems not to apply to the hotel industry. The choice of using franchising or management contracts for hotel companies' expansion is difficult to explain using traditional international-business theories, because the hotel firms' concern is not the possible *dissipation* of transaction-specific assets or knowledge, but the *transfer* of technology and deployment of transaction-specific assets or knowledge. That transfer is essential to maintaining consistency of brand image and operations. Therefore, hotel firms are less concerned about control and more concerned about the effectiveness of their transfer of assets and knowledge. To address this issue, we adopt a novel framework based on an organizational-capabilities perspective, an approach that focuses on the transfer of one firm's competencies to another.

> Hotel companies' choice of using franchising or management contracts for international expansion seems to hinge on the nature of technology transfer.

Organizational Capabilities

The organizational-capabilities perspective has emerged from a growing emphasis in strategic-management research on the resource-based view of a firm's performance. This resource-based view exemplifies a shift in research emphasis away from structural features of industries, such as size and degree of concentration (a common approach in industrial-organization theory) toward features that create competitive advantages for individual firms. In this view, a firm's superior performance is a consequence of that firm's distinctive capabilities rather than being a function of the structural properties of the industry to which the firm belongs.

Resources and Capabilities

The capabilities-based approach regards every firm as a bundle of resources. Those resources comprise all of a firm's assets, organizational processes, attributes, information, and expertise that enable the firm to conceive and implement strategies efficiently and effectively.[3] Firm resources can be generally classified into three categories: **(1)** physical (e.g., plant, equipment, location, brands, patents, and trademarks), **(2)** human (e.g., the skills and knowledge of individual employees), and **(3)** organizational (e.g., culture, routines, and rituals).[4] Note that capabilities develop as firms combine resources to create what are known as higher-order competencies.[5]

In the context of hotel firms, we determined that there are 22 resources that might drive a hotel firm's competitive advantage.[6] These 22 resources could be combined into five higher-order capabilities that support a firm's competitive advantage. We named those five capabilities as follows: **(1)** organizational competence, **(2)** quality competence, **(3)** customer competence, **(4)** entry competence, and **(5)** physical competence. Organizational competence captures skills and capabilities that enable the hotel to compete effectively, such as corporate culture, empowerment, operating policies and procedures, and reservation systems. Quality competence includes skills and capabilities needed to build high-quality service and to ensure customer satisfaction. Customer competence encompasses a variety of

[3] Jay Barney, "Firm Resources and Sustained Competitive Advantage," *Journal of Management*, Vol. 17, March 1991, pp. 99–120.

[4] *Ibid.*

[5] Anoop Madhok, "Cost, Value, and Foreign Market Entry Mode: The Transaction and the Firm," *Strategic Management Journal*, Vol. 18 (1997), pp. 39–61.

[6] In addition to our industry knowledge and communications with hotel managers, we drew from: Gaylen N. Chandler and Steven H. Hanks, "Market Attractiveness, Resource-based Capabilities, Venture Strategies, and Venture Performance," *Journal of Business Venturing*, Vol. 9, July 1994, pp. 331–349.

capabilities that help the hotel create its brand reputation, establish a customer base, and build customer loyalty. Entry competence taps the hotel's abilities to find good locations and to time its entry into a certain market. Once a firm finds a prime location, that location is not available to competitors, thus locking in the competitive edge resulting from this capability. Finally, physical competence captures the hotel's capabilities to design and build physical facilities that are of desirable quality, comfort, and ambience.

Effects of Capabilities on Choice

An understanding of how the capabilities-based approach might help a hotel firm's brand managers choose between a franchise arrangement and a management contract can develop by analyzing the factors that distinguish franchising from management contracting. Chief among those factors is the extent of technology transfer. A franchise arrangement means that the entering firm relies heavily on the franchisee's capabilities, while under a management contract the entering firm provides most of the day-to-day managerial and technical support from within its own ranks and resources. This means that franchising requires a firm to transfer resources and expertise across firm boundaries (i.e., from the firm to the franchisee), whereas management contracts involve the transfer of such assets within the firm (i.e., from the firm to its own managers who are assigned to work at the foreign location). This difference suggests that if we can understand the factors that influence the effective transfer of a firm's resources, we can understand better how firms might choose between franchising and management contracts. Let us consider how four factors affect such external and internal transfers.

Factors Affecting the Transfer of Resources and Capabilities

As we said, the capabilities-based perspective defines the value of a resource or capability in terms of its contribution to a firm's competitive advantage.[7] Obviously, when a hotel firm enters another country, it must transfer its resources and capabilities to its foreign operations. At the same time, however, the firm wants to ensure that the transfer of such assets does not diminish the firm's ability to generate the desired competitive advantage. The question is, under what conditions is it optimal or justified to transfer assets via a franchising arrangement or a management contract?

According to the capabilities-based approach, resources or capabilities do not need to be transferred within a firm unless the resource or capability being transferred is in some way unique to, or ideally suited to, that particular firm's practices and is therefore difficult to imitate or reproduce.[8] When a particular resource or capability that a foreign hotel hopes to transfer is irreproducible, the host-country collaborator is unable to absorb or replicate it and perform the needed activities without losing its competitive advantage to a considerable degree. Under such circumstances, the hotel transfers the resource or capability internally to preserve the value of the asset.

Some capabilities are more difficult to reproduce than others. Among the factors often cited as preventing one firm from replicating another firm's resources and capabilities are specific historical conditions, complex social interactions, and the tacit (intangible) nature of the know-how involved.[9] It is widely acknowledged that transferring tacit knowledge is difficult because it is complex; it is acquired through trial and error; it is taught and learned by demonstration, observation, imitation, practice, and feedback; and it is continuously evolving. In other words, the less obvious the know-how, the greater the difficulty in reproducing and transferring that expertise.

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[7] David J. Collis and Cynthia A. Montgomery, "Competing on Resources: Strategy in the 1990s," *Harvard Business Review*, July–August 1995, pp. 118–128; and Madhok, pp. 39–61.

[8] See: Madhok, pp. 39–61, who uses the term "imperfect imitability."

[9] See: Barney, pp. 99–120; Yao-Su Hu, "The International Transferability of the Firm's Advantages," *California Management Review*, Vol. 37, No. 4 (1995), pp. 73–88; Bruce Kogut and Udo Zander, "Knowledge of the Firm and the Evolutionary Theory of the Multinational Corporation," *Journal of International Business Studies*, Vol. 24, No. 4 (1993), pp. 625–646; and David J. Teece, "Capturing Value from Knowledge Assets: The New Economy, Markets for Know-how, and Intangible Assets," *California Management Review*, Vol. 40, No. 3 (1998), pp. 55–79.

EXHIBIT 1

Variables used in the study

Y1 *Non-equity (low investment) entry mode* (MODE)
Takes value of 0 for franchising and 1 for management contracts

Y2 *INIMITABILITY (irreproducibility) of competitive advantage (INIMIT)* a ***= 0.76***
Six-item scale based on the following question: Indicate the degree to which you agree or disagree with the following statements concerning your hotel's competitive advantage in this market.
(a) It is difficult for our competitors to imitate us.
(b) Our services are unique, and nobody but our company can offer them.
(c) It took us years to build our brand reputation—nobody can easily copy it.
(d) Our advantages are embodied in the company and not in individuals—nobody can copy us by stealing our employees away from us.
(e) We pre-empt our competitors by building our properties in prime locations.
(f) Nobody can copy our corporate routines, processes, and culture.

X1*Organizational competence (ORGCOMP)* a ***= 0.87***
Six-item scale based on the following question: Indicate the degree to which your parent company has competitive advantage in the following areas.
(a) Company culture
(b) Employee empowerment
(c) Information-technology system
(d) Operating policies and procedures
(e) Quality of reservation system
(f) Establishing a chain operation

X2 *Quality competence (QUALCOMP)* a ***= 0.92***
Six-item scale based on the following question: Indicate the degree to which your parent company has competitive advantage in the following areas.
(a) Quality of guest-contact staff
(b) Quality of managerial staff
(c) Ensuring service quality
(d) Ensuring customer satisfaction
(e) Teamwork among employees
(f) Providing appropriate services

X3 *Customer competence (CUSTCOMP)* a ***= 0.83***
Three-item scale based on the following question: Indicate the degree to which your parent company has competitive advantage in the following areas.
(a) Creating brand reputation
(b) Creating customer base
(c) Creating repeat business

X4 *Entry competence (ENTRCOMP)* a ***= 0.77***
Two-item scale based on the following question: Indicate the degree to which your parent company has competitive advantage in the following areas.
(a) Finding good locations
(b) Knowing the right time to enter

X5 *Physical competence (PHYSCOMP)* a ***= 0.93***
Four-item scale based on the following question: Indicate the degree to which your parent company has competitive advantage in the following areas.
(a) Décor and design of physical properties
(b) Ambience and atmosphere of properties
(c) Comfort of physical facilities
(d) Quality of physical facilities

X6 *Availability of managerial staff in host country (MGTAVAIL)*
Single-item scale based on responses to the following statement:
- Availability of qualified managerial staff in the host country.

X7*Availability of investment partners in host country (PRTNAVAIL)* a ***= 0.82***
Two-item scale based on responses to the following statements:
(a) Availability of qualified local investment partners to parent company
(b) Availability of trustworthy local investment partners to parent company

X8 *Attractiveness of host country's business environment (BUSENV)* a ***= 0.81***
Three-item scale asking respondent to rate the business conditions in the host country on the following factors:
(a) Political stability
(b) General business conditions
(c) Quality of infrastructure

Another way to look at resources and capabilities is that these may be embedded in a firm. An embedded capability is deeply entrenched in company-specific routines and practices, characterizing complex social interactions and team relationships within an organization. The knowledge embodied in such a capability, in turn, can be transferred only through intimate social interactions. Furthermore, the transfer of such embedded knowledge requires the transfer of the established routines and organizational processes through which the knowledge is applied.[10]

Franchising or Management Contracts?

A firm typically possesses a mix of reproducible competencies (i.e., entry, physical, and customer competencies) and irreproducible competencies (i.e., quality and organizational competencies). If a firm possesses irreproducible resources and capabilities that are key to achieving a competitive edge in the marketplace, the firm is likely to choose management contracts over franchising to reduce technology transfer. On the other hand, reproducible competencies are not expected to influence the choice between franchising and management contracts.

We must point out that firms can enjoy a sustainable competitive advantage even if their capabilities are completely reproducible. Maintaining irreproducible capabilities is only one approach to sustaining a firm's competitive advantage. Instead of embedding their resources, for instance, firms can protect their know-how and resources through legal means, such as copyrights, trademarks, patents, and licenses. Accordingly, it should be no surprise that companies that expand via franchising show a great deal of concern for the presence and enforcement of intellectual-property laws in the host markets, as discussed below. In short, there is more to the concept of sustainability than the degree to which competitors or contract partners can reproduce a firm's embedded capability.

[10] See: Alice Lam, "Embedded Firms, Embedded Knowledge: Problems of Collaboration and Knowledge Transfer in Global Cooperative Ventures," *Organization Studies*, Vol. 18, No. 6 (1997), pp. 973–996; and Madhok, pp. 39–61.

With the above considerations in mind, we can see that in most cases a hotel firm that expands by transfering irreproducible competencies would clearly favor management contracts for that expansion. Any attempted transfer of such capabilities within the context of a franchising arrangement may lead to a serious loss of competitive advantage for the firm. Moreover, the influence of these irreproducible capabilities on the choice between franchising and management contracts depends on the strength of the competitive advantage generated by those capabilities. When such capabilities do not generate value for the firm and are difficult to transfer to the host market, for instance, they are not likely to influence the firm's choice. On the other hand, when such capabilities are critical to the firm's competitive advantage, they will dominate the decision-making process. We expect, therefore, that the greater the competitive advantage generated by a firm's irreproducible capabilities, the higher is the firm's probability of choosing a management contract over franchising.

> Transferring irreproducible competencies in a franchise arrangement could lead to a serious loss of competitive advantage.

Other Factors

Several other factors enter into the decision regarding whether to enter a market via franchising or management contracts. Those factors are the availability of management capabilities in the host market, the availability of suitable partners, and the development level of the host country's business environment.

Management availability. In addition to accounting for a host hotel's capacity to reproduce a foreign firm's resources and capabilities, the capabilities-based perspective stresses the role of the supporting infrastructure in facilitating or impeding the transfer of the entering firm's resources and capabilities.[11] For example, even if the en-

[11] See: Hu, pp. 73–88; and Madhok, pp. 39–61.

EXHIBIT 2

Brands represented in the study

ANA	Mandarin Oriental	Peninsula
Caesar Park	Marriott	Regent
Camino Real	Melia	Renaissance
Conrad	Meridien	Ritz-Carlton
Crowne Plaza	Mövenpick	Rockresorts
Disney	Nikko	Shangri-La
Fairmont	Novotel	Sheraton
Four Seasons	Oberoi	Sonesta
Hilton	Okura	Taj
Holiday Inn	Omni	Traders
Hyatt	Pannonia	Westin
Inter-Continental	Pan Pacific	Wyndham
Kempinski		

tering firm's core resources and capabilities could be transferred through franchising, what happens if the local hotel cannot find good management talent? Franchising is not conducive to exploiting the entering firm's advantages if a host country's franchisees lack adequate access to competent managers. Rather than risk destroying the value of its capabilities under such circumstances, the firm may decide to use a management contract in an effort to transfer critical managerial capabilities from its home country to the host market. Thus, we expect that firms will be more likely to choose a management contract over a franchising arrangement when qualified managerial employees are not readily available in the host market.

Availability of partners. Management contracts succeed only if a hotel-management firm can find qualified and trustworthy partners with complementary capabilities—that is, collaborators who can make the necessary capital investments in terms of infrastructure and facilities. These complementary capabilities free up the foreign firm to focus on managing the hotel. Without qualified and trustworthy investment partners, it is much more difficult to establish effective management contracts.[12] Thus, we expect that the ready availability of trustworthy and qualified investment partners in a host market increases the likelihood that an entering firm will choose a management contract over a franchising arrangement.

Business environment. We have noted that effective transfer of resources and capabilities depends not only on the characteristics of an entering firm, but also—sometimes crucially—on the capabilities of the host-country collaborator. Those capabilities, in turn, depend on the general business environment within which the host organization will be operating. Consequently, franchising is more effective and franchisees are more capable in developed countries than in developing ones.[13] For example, the use of franchising in developed nations is promoted by the characteristically robust existence and enforcement of intellectual-property laws. If a high level of development in the local business environment encourages franchising generally, then it stands to reason that franchising becomes more viable in relation to management contracts when the host market's business environment is highly developed.

Summary of Factors

Based on the organizational-capability approach, we expect that **(1)** the presence of irreproducible resources and capabilities favors management contracts over franchising; **(2)** the availability of management resources in the host market favors franchising arrangements over management contracts; **(3)** the availability of qualified local investment partners in the host market favors management contracts over franchising; and **(4)** a highly developed business environment favors franchising arrangements over management contracts.

[12] See: Contractor and Kundu, pp. 325–358; and Dunning, pp. 242–265.

[13] Farok J. Contractor and Sumit K. Kundu, "Franchising Versus Company-run Operations: Modal Choice in the Global Hotel Sector," *Journal of International Marketing*, Vol. 6, No. 2 (1998), pp. 28–53.

Testing the Model

To test our expectations, we developed a questionnaire that measured the above-mentioned variables (see Exhibit 1). The questionnaire was pre-tested on a sample of 30 hotel general managers who attended an executive-education program at Cornell University. The questionnaire was modified based on their feedback and mailed to managers of 530 hotels belonging to the Global Hoteliers Club. We sent two follow-up reminders at two-week intervals with copies of the original questionnaire. We received 201 usable responses, for a response rate of 39 percent.

Response-bias test. We later faxed a one-page form to 38 non-respondents (hotels that did not respond even after the two reminders) to gain some particulars about those hotel operations. Eleven hotels responded. We compared information provided by these 11 hotels with similar data from the late respondents. Also, the background information sent by early respondents was compared with that of late respondents.[14] Taking these results together, we can safely allay fears of non-response bias.

Because of our interest in firms that choose franchising and management contracting without any equity participation, we asked the respondents—managers of the local hotels—to indicate the description that best fit the foreign hotel firm's involvement in their property. Based on those responses, arrangements other than pure franchising and pure management contracts were removed from the analysis, resulting in a final sample of 139 observations. Exhibit 2 lists some of the well-known brands that were represented in this study.

Exhibit 3 summarizes the sample's salient characteristics. As we indicated, the vast majority of the questionnaires were completed by general managers of the hotels surveyed, which helped ensure the quality of the data. Because 46 countries are represented in the sample, we are confident that a diversity of environments is represented. Note that franchising accounted for just over one-quarter of the observations. The survey

[14] Scott J. Armstrong and Terry S. Overton, "Estimating Non-response in Mailed Surveys," *Journal of Marketing Research,* Vol. 14, August 1977, pp. 396–402.

EXHIBIT 3

Salient characteristics of sample hotels (*N* = 139)

Location of hotel

City center	63.3%
Suburban	9.4%
Airport	4.3%
Resort	21.6%
Other	1.4%

Positioning of hotel*

Luxury or 5-Star	38.1%
Upscale or 5-Star	30.9%
First Class or 4-Star	27.3%
Other	3.6%

Mean number of hotels in chain = 351.6

Mean percentage of international revenues for parent = 57.4%

Mean number of rooms per hotel property = 359.2

Mean number of employees per hotel property = 420.4

Number of countries represented in sample = 46

Countries most frequently represented

China	10.8%
Australia	10.1%
Singapore	5.8%
USA	5.0%
Thailand	5.0%
Indonesia	4.3%
Canada	3.6%
Germany	3.6%

Level of economic development in host market

Developing countries	55%
Developed countries	45%

*Hotel positioning was determined by respondents' self reports.

EXHIBIT 4

Logistic-regression results

Variable	*Model 1*	*Model 2*
Intercept	1.503[d]	2.069[d]
Main effects		
Organizational competence *(X1, ORGCOMP)*	0.593[c]	0.633[b]
Quality competence *(X2, QUALCOMP)*	0.417[a]	0.923[b]
Customer competence *(X3, CUSTCOMP)*	0.269	0.604[b]
Entry competence *(X4, ENTRCOMP)*	-0.227	0.037
Physical competence *(X5, PHYSCOMP)*	-0.216	-0.408
Availability of managers *(X6, MGMTAVAIL)*	-0.531[b]	-0.625[b]
Availability of partners *(X7, PRTNRAVAIL)*	0.364[a]	0.797[c]
Development of business environment *(X8, BUSENV)*	-0.578[b]	-0.308
Interaction effects		
ORGCOMP x BUSENV	–	0.653[c]
PHYSCOMP x HTLREPUTE	–	-0.896[d]
QUALCOMP x HTLSIZE	–	2.200[d]
QUALCOMP x SRVCSENS	–	1.270[d]
Model statistics		
Model Chi-square	31.25 (p = 0.005)	58.4 (p = 0.000)
Classification rate	78.4%	85.6%

Notes: Dependent variable is Y1, MODE (0 = franchising, 1 = management contract); N = 139; One-tail p-value: a = 0.10, b = 0.05, c = 0.01, d = 0.001.

also measured the following control factors: **(1)** the size of the hotel firm serving the foreign market, **(2)** the international experience of the hotel firm, **(3)** the size of the subsidiary hotel property, **(4)** the reputation of the hotel firm in the host market, and **(5)** the level of service sensitivity of the hotel's target audience.[15]

Measurement of Capabilities

To determine whether the five capabilities identified earlier were indeed independent, we asked survey respondents to rate the extent to which the foreign firm enjoyed a competitive advantage in each of the 22 resources on a Likert-type scale anchored by 1 (no advantage) and 5 (great advantage). The responses were subjected to factor analysis. The results confirmed the existence of the five overarching competencies that we expected to find.

In keeping with the capabilities-based perspective, we needed to validate which of the five competencies are difficult to reproduce. First, we measured the extent to which collaborator firms believe that they can copy or imitate the foreign firm's overall competitive advantage in the host market. This measure is not specific to individual capabilities, but represents a global measure of the difficulty of copying the competitive advantage in question, as perceived by the respondent. Although this question targets imitation by competitors, it can be equally effective in characterizing imitation by host-country collaborators, because the underlying causes of irreproducibility are identical.

We subjected the data to a regression analysis in which the five competencies were entered as explanatory variables of reproducibility. The results suggest that organizational competence and quality competence are the largest contributors

[15] For further discussion of the implications of these variables, see: M. Krishna Erramilli and C.P. Rao, "Service Firms' International Entry-mode Choice: A Modified Transaction-cost-analysis Approach," *Journal of Marketing*, Vol. 5, July 1993, pp. 19–38; Hubert Gatignon and Erin Anderson, "The Multinational Corporations' Degree of Control over Foreign Subsidiaries: An Empirical Test of a Transaction Cost Explanation," *Journal of Law, Economics, and Organization*, Vol. 4, No. 2 (1988), pp. 305–336; Contractor and Kundu (*JIM* 1998), pp. 28–53; and Contractor and Kundu (*JIBS* 1998), pp. 325–358.

to the irreproducibility of a firm's competitive advantages. This implies that the greater the competitive advantage generated from organizational competence or quality competence, the more difficult it is to reproduce a hotel's overall competitive advantage. On the other hand, customer competence, entry competence, and physical competence do not appear to contribute in the same way to a hotel's competitive advantage. Based on this evidence, we confirm our expectation that organizational competence and quality competence represent capabilities that are difficult to reproduce.

Testing the Effect of Competencies on Choice

We used a logistic regression model to test whether the five competencies influenced the choice between franchising and management contracts in the way predicted by organizational-capabilities perspective. The test included three external control variables—namely, the availability of management capabilities in a host market, the availability of investment partners in a host market, and the development level of the host country's business environment—and five internal control variables, those being **(1)** the size of the foreign entrant, **(2)**international experience of the foreign entrant, **(3)** host-property size, **(4)** host-property's reputation, and **(5)** service sensitivity of the target audience. The results of the logistic regression are shown in Exhibit 4 and summarized in Exhibit 5.

The key findings that are depicted in Exhibit 6 (overleaf) are all of the statistically significant main or direct effects we found. The results suggest that the two irreproducible capabilities in the study—organizational competence and quality competence—influence the choice between franchising and management contracting. The likelihood of choosing a management contract over a franchising arrangement increases with the contribution to the firm's competitive advantage from these two capabilities. Again, as expected, the three other capabilities—customer competence, entry competence, and physical competence (which are relatively reproducible)—have no significant effect on the choice between franchising and management contracts. Taken together, these results strongly support the conten-

EXHIBIT 5

Summary of results

(A) ***Irreproducible capabilities:*** These are the hotel's capabilities that cannot be easily imitated or transferred to other firms without substantial loss in their advantage-generating value. Examples: *organizational competence and quality competence*	**1.** The more important these capabilities are to the hotel firm's competitive advantage, the greater is its preference to employ management contracts over franchising. **2.** The preference for management contracts becomes stronger when the hotel firm's competitive advantage is derived from *quality competence* especially as the hotel grows larger, and when the hotel operates in a service-sensitive market.
(B) ***Relatively easy-to-reproduce capabilities:*** These are the hotel's capabilities that can be codified and transferred to other firms without substantial loss to their advantage-generating value. Examples: *customer competence, entry competence,* and *physical competence.*	**1.** As these capabilities can be transferred equally well via either management contracts or franchising, their transfer does not by itself distinguish between the two choices. **2.** Some of these capabilities could distinguish between the two choices in the presence of other factors. For example, physical-competence favors franchising, provided the hotel has a strong brand reputation in the host market.
(C) ***Availability of managerial talent in host country:*** This is the availability of competent and qualified managers in the host country.	The greater the availability of such external management capabilities, the greater the hotel's preference to employ franchising over management contracts. Conversely, management contracts become a necessity in countries with scarce hotel-management skills.
(D) ***Level of development of the host country:*** The more developed the host country is, the greater is the availability of supporting infrastructure, and the stronger are the laws to protect intellectual property.	The more developed the host market is, the stronger the hotel's preference to employ franchising over management contracts.
(E) ***Availability of investment partners in the host country:*** This is the availability of qualified and trustworthy investment partners in the host country.	The greater the availability of investment partners, the easier it becomes for a hotel to employ management contracts.

EXHIBIT 6

Franchising versus management contracts: Significant effects

Company and market characteristics that...	...Favor franchising	...Favor management contracts
Ease of host-country partners reproducing the hotel's advantage-generating capabilities?	Easy	Difficult
Extent of quality competence?	Low	High
Extent of customer competence?	Low	High
Availability of managerial talent in the host country	Abundant	Scarce
Host country's economic development	Highly developed	Developing
Availability of qualified and trustworthy investment partners in the host country	Scarce	Abundant

tion that irreproducibility is a key factor in choosing management contracts over franchising.

The results also indicate that the likelihood of choosing a management contract over a franchising arrangement increases as managerial talent becomes scarcer and investment collaborators become more abundant in the host country. In addition, the results suggest that franchising is preferred as the host-country business environment becomes increasingly developed.

It is interesting to note that there was no direct effect arising from any of the internal control factors. This shows that the contract-versus-franchise choice does not depend on the size of the hotel firm, international experience of the hotel firm, size of the local property, reputation of the local property, or the service sensitivity of the target market.

Testing Contingent or Combined Effects

It is possible that the competencies may have complex interactive effects with internal or external control variables in determining the choice between franchising and management contracts.[16] In other words, it is important to understand how competencies affect the choice of business model in conjunction with other factors.

First, in considering the possible joint effects, we examined the interaction of organizational competence and the level of development in a host market. This particular joint effect allows us to test whether a hotel firm serving developed markets might prefer franchising even when its capabilities are difficult to reproduce.

Second, we tested the likely joint effect of the foreign entrant's reputation and physical competence. This addresses the question of whether hotel firms with easily reproduced capabilities like physical competence may choose management contracts when their brand reputation is strong.

Third, we tested the joint effect of quality competence and the level of service sensitivity of the market. This allows us to address whether firms that position themselves as those that cater to service-sensitive target markets prefer to choose management contracts more than do those that cater to price-sensitive target markets, especially when those firms have strong quality competence.

Finally, we tested the joint effect of quality competence and hotel size (i.e., the size of the local hotel property itself) to determine whether firms with high quality competence are inclined to choose contracts or franchising according to the size of the hotel property. We thought that the resultant problems of monitoring and controlling employees represent such a management challenge that the firm might sacrifice value and

[16] For discussions of interaction effects, see: Sanjeev Agarwal and Sridhar N. Ramaswami, "Choice of Foreign Market Entry Mode: Impact of Ownership, Location, and Internalization Factors," *Journal of International Business Studies,* Vol. 23, No. 1 (1992), pp. 1–27; and Eramilli and Rao, pp. 19–38.

switch to franchising when host-country hotel properties are large.

To test for the interaction effects that we just outlined, we used logistic regression similar to the first test, except this time the regression equation included the four interaction terms as well. The results of the second regression equation that are presented in Exhibit 4 reveal strong interaction effects. Although these can be interpreted in more than one way, we offer the following interpretations in view of the questions raised earlier.

First, although foreign entrants seem to prefer franchising when the host business environment is highly developed, the preference switches to management contracts when organizational competence, an irreproducible capability, makes an increasingly greater contribution to their competitive advantage. The probability of choosing management contracts is extremely high in poorly developed markets, and drops dramatically in favor of franchising in highly developed markets, but only when organization competence is not important to competitive advantage. When organization competence is important, management contracts continue to be strongly favored regardless of the market conditions. Graphically, this can be represented as shown in Exhibit 7.

Second, while physical competence alone may not influence the selection of franchising (because it is reproducible), it can become a powerful predictor in conjunction with strong brand reputation. When physical competence is an important source of competitive advantage, franchising is strongly favored (and the probability of choosing a management contract drops) only when the reputation of the brand is also strong in the host market. If the brand is weak, on the other hand, the probability of using a management contract actually increases, as shown in Exhibit 8.

Third, a firm's preference for using a management contract becomes stronger with the rising importance of quality competence in large hotels. Generally speaking, when quality competence (an irreproducible capability) is an important source of competitive advantage, the tendency to choose a management contract becomes stronger as the hotel increases in size. However, when quality is not an important source of competitive advantage, management contracts

EXHIBIT 7

Regression results of market development by organization competence

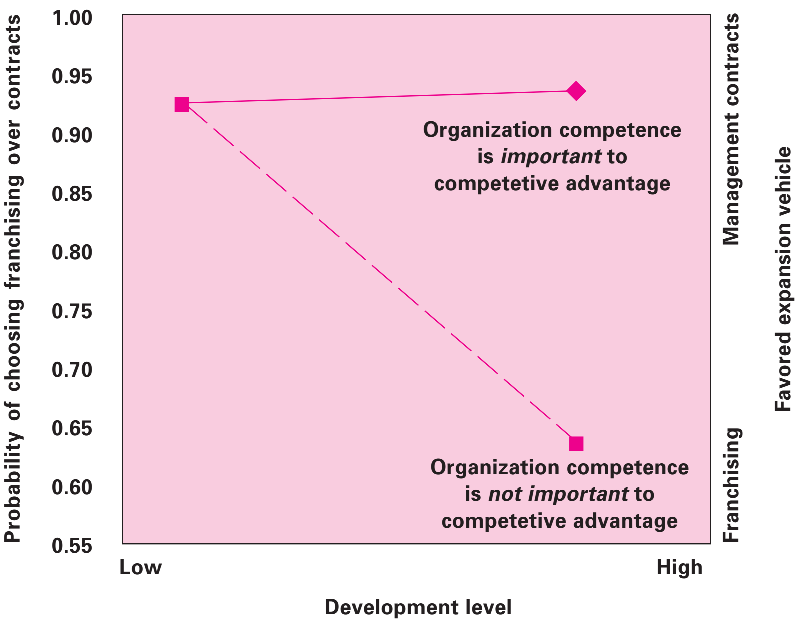


EXHIBIT 8

Regression results of physical competence by brand reputation

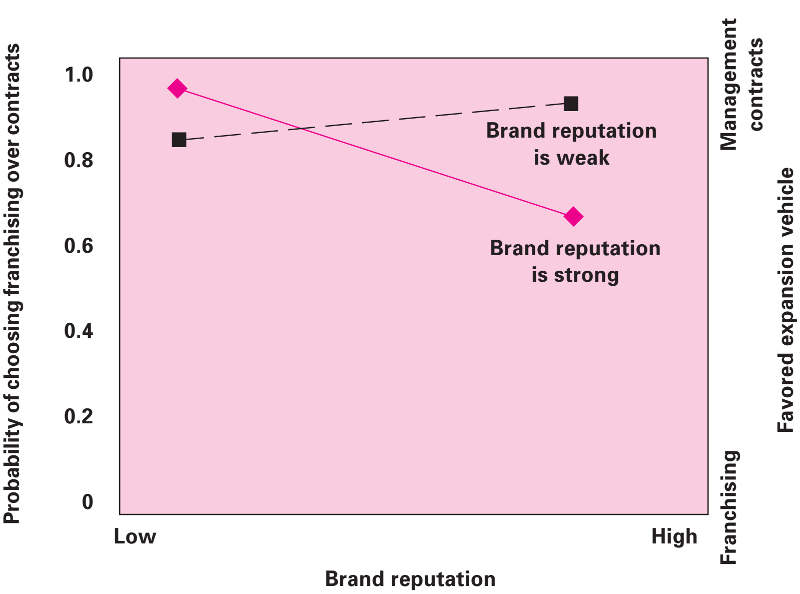


EXHIBIT 9

Regression results of quality competence by hotel size

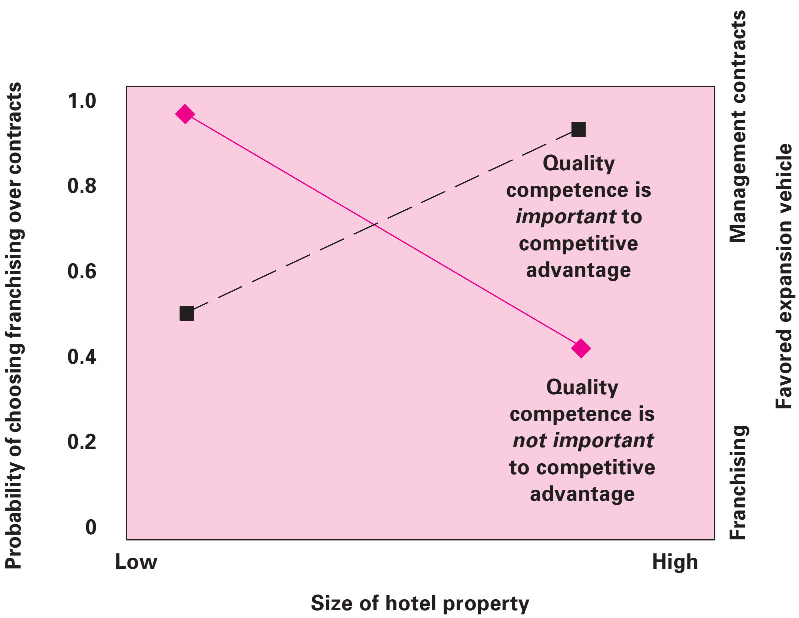
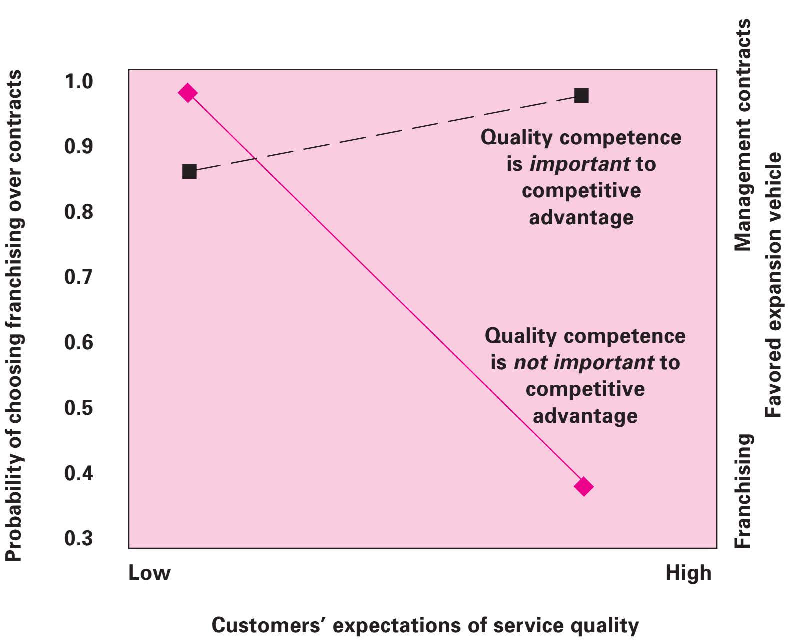


EXHIBIT 10

Regression results of quality competence by service sensitivity



are less preferred and the use of franchising becomes more likely as the hotel size increases (see Exhibit 9).

Finally, the influence of the quality competence on the choice of management contract or franchising becomes stronger when the hotel's market tends to be service sensitive. In markets where customers have low service expectations, the company's quality competence makes no difference. However, when customer-service expectations are high, firms are more likely to choose management contracts if they possess competitive advantages in quality competence, but tilt towards franchising if they don't (perhaps to make use of the franchisee's quality competence). This is depicted in Exhibit 10.

The results of the study also show that, among other things, customer competence—which played a minor role in the results of the main-effect tests—figures prominently in the model that includes interactions among variables. Evidently, the preference for management contracts is stronger when the advantage generated by strong customer expertise is higher.

Managerial Implications

The results should be interpreted with caution. Consider the following two limitations. First, because the data are correlational, we cannot rule out reverse causation, wherein the choice of operating mode may drive capabilities, rather than the other way around. We do, however, report original findings based on robust tests of association between capabilities and operating mode. Second, the results of this study are based on what a sample of well-known hotel firms do. The study results cannot predict, for example, that firms which rely on irreproducible competencies for competitive advantage (and thus choose management contracts) will be more profitable. The results, however, validate expectations based on a sound theoretical model and thus provide a high level of confidence in the theory's application. The recommendations made in this study are normative, then, to the extent that they are in accordance with a theory that is not specific to hotel firms and which was developed independently of this study.

How can managers facing the choice between franchising and management contracts in the course of international expansion use these results? We believe that following the lead of the successful multinational hotel corporations that we surveyed will bode well for those firms that are just beginning their international expansion. Prior to our study, relatively little was known about the criteria that hotel firms might apply in choosing between franchising and management contracts. With this study, we have addressed this gap in the literature by describing a study of 139 hotels based in 46 different countries, using the organizational-capability perspective to explain a hotel firm's choice between a franchise arrangement and a management contract. Once again, Exhibit 4 summarizes those results.

The results provide strong support for the capabilities-based view that irreproducible capabilities, like organizational competence and quality competence, cannot be transferred effectively through franchising.[17] The difficulty of reproducing competencies not only protects a firm from its competitors, but it thwarts its efforts to transfer the needed capabilities to associates and collaborators in the host market, "forcing" it to employ such mechanisms as management contracts.[18]

The main lesson to be learned from our results is that as hotel firms expand internationally they have to focus on two main points in choosing between franchising and management contracts. The first point is for a firm to ascertain the distribution of its key competencies (that is, the firm's competency level in each of the five areas identified in this study). The second point is whether the firm depends for competitive advantage on competencies that are irreproducible (i.e., quality or organization) or on competencies that are reproducible (i.e., entry, physical or customer).

If irreproducible competencies are important for a brand's establishment and survival, it is imperative that the firm expand using management contracts. In this respect, Ritz-Carlton's strategy is noteworthy. As explained in the *Wall Street Journal,* the firm expanded via management contracts from 10 hotels in 1990 to 49 properties at the end of 2001.[19] On the other hand, franchising requires relatively little involvement by the parent company. Therefore, franchising can be suitably used as long as the key aspects of hotel operation can be codified and transferred. For example, it is relatively easy to transfer the physical ambience required for establishing a certain stated quality of construction and for projecting a consistent image for a particular brand. The size, design, layout, and decoration of the building can be standardized and replicated with little difficulty. Moreover, the strategy of selecting appropriate locations to preempt others from taking those locations can still be implemented in many places. Thus, as long as there is no specific knowledge or skill that comes in the form of expert managers, requisite knowledge can be transferred in the form of a franchise arrangement. Note that the transfer of easy-to-reproduce capabilities (e.g., physical competence) does not appear to play a strong direct role here, since those capabilities can be transferred equally effectively by both management contracts and franchise arrangements. This finding suggests, perhaps, that the difference in transfer costs between franchising and management contracts is not large enough to produce unambiguous choices.

The results also corroborate the contention that firms cannot exploit their advantages without the benefit of a whole range of internal and external support capabilities.[20] For instance, franchising is favored in countries that are economically developed (primarily because such countries have better legal systems and protection for both franchisers and franchisees) and that have the greatest availability of professional managers. When the availability of professional managers is scarce, on the other hand, firms have to make up for the shortfall through internal transfers (i.e., by signing management contracts) rather than by selling franchises. In addition to the availability of certain resources in the environment, the effectiveness of those resources is also critical. What we found out about the level of development of a host market suggests that as potential collabora-

[17] Madhok, pp. 39–61.

[18] See: Ashish Arora and Andrea Fosfuri, "Wholly Owned Subsidiary versus Technology Licensing in the Worldwide Chemical Industry," *Journal of International Business Studies*, Vol. 3, No. 4 (2000), pp. 555–572; and Kogut and Zander, pp. 625–646.

[19] See: Binkley, p. A1.

[20] See: Hu, pp. 73–88; and Madhok, pp. 39–61.

tors (e.g., franchisees) with high levels of competence and "absorptive capacity" become more abundant in the host market, entering firms become increasingly comfortable with franchising.[21] Franchising is also favored when the firm has both a high physical competency and a strong brand reputation. The effect of interaction between physical competence and a strong brand reputation sheds some light on the conditions under which clear choices could be made when transferring reproducible capabilities. While the transfer of physical competence does not clearly favor franchising or management contracts by itself, physical competence unambiguously favors franchising when combined with a strong brand.[22]

On the other hand, management contracts become increasingly attractive with greater availability of reliable investment partners in the host market. It is also more attractive for large firms and for those that construct large hotel properties. In addition, the interaction of quality competence and hotel size is interesting in that it underscores the importance of scale effects. Our results suggest that as quality competence (an irreproducible capability) becomes more important as a source of competitive advantage, the firm's desire for an internal arrangement such as a management contract varies with the size of the hotel property. Evidently, the know-how needed to offer quality service becomes increasingly complex (and decreasingly reproducible) as the hotel property expands in size, thus making an arrangement such as a management contract all the more necessary to transfer key capabilities to the host market.[23]

Management contracts are also favored when the firm has a high quality competence and the market that it caters to is service sensitive. The interaction between quality competence and service sensitivity highlights the interplay between internal capabilities and external market requirements, a noted strength of resource-based and capability-based approaches.[24] As a hotel's customers become increasingly service conscious and demand ever higher amenity levels, hotels with a strong quality competence become increasingly committed to internal arrangements like management contracts.

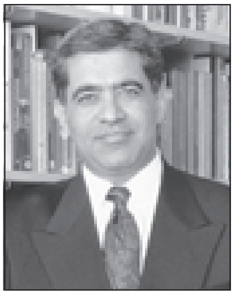
Management contracts are also favored when the firm has a high organizational competence and enters a highly developed market. The results suggest that firms are driven primarily by the transferability of their advantageous capabilities when choosing between franchising and management contracts. When these capabilities are irreproducible, firms not only shun franchise arrangements, but also become strong advocates for management contracts in developed markets (perhaps to gain a bigger share of existing revenue streams). In other words, while external support capabilities are important, the choice appears to be driven primarily by internal capability considerations. ■

[21] Compare: Contractor and Kundu (*JIM* 1998), pp. 28–53; and Karin Fladmoe-Lindquist and Laurent L. Jacque, "Control Modes in International Service Operations: The Propensity to Franchise," *Management Science*, Vol. 41, No. 7 (1995), pp. 1238–1249.

[22] See: Arora and Fosfuri, pp. 555–572; and Kogut and Zander, pp. 625–646.

[23] See: Gatignon and Anderson, pp. 305–336; and Scott A. Shane, "Hybrid Organizational Arrangements and Their Implications for Firm Growth and Survival: A Study of New Franchisors," *Academy of Management Journal*, Vol. 39, No. 1 (1996), pp. 216–234.

[24] Collis and Montgomery, pp. 118–128.



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