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The pricing of franchise rights

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Abstract

Franchise contracts typically contain two forms of payment from franchisee to franchisor: the initial franchise fee and the ongoing royalty payment. Economic analysis and empirical examination yield two different predictions about how these payments should relate to one another. In this study using system level data, we find a positive relationship between the initial franchise fee and royalty rate when controlling for average outlet sales. This is consistent with the argument that the initial franchise fee is not a vehicle for extracting the surplus downstream rents left after royalty payments. Implications for franchise research and practice are discussed, as is the importance of regulatory changes that may make sales data available through franchise disclosure requirements. © 2001 by New York University. All rights reserved.

1. Introduction

Franchising is the dominant method of distribution in a wide range of product (e.g., automobiles) and service (e.g., fast food) industries. Thousands of individuals purchase franchise rights each year (Bond, 1997). Despite this major role, major questions remain unsettled with respect to the strategies that franchisors employ to derive economic benefits from the rights they grant to their franchisees to become members of their systems. The price of those franchise rights is typically separated into two components: an initial lump sum franchise fee and an ongoing royalty payment (Dant & Berger, 1996). The rationale with respect to how franchisors set these prices, and the resulting association between the prices

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for these two components, is one of the core theoretical and empirical issues in literature of this field.

Some researchers see these two payment methods as the twin parts of a mechanism to insure that franchisees receive no more than a normal profit on their investment in a franchise. By systematically adjusting the franchise fee and the royalty rate, the franchisor can provide just the right incentive for the franchisee to work industriously, but not obtain excess profits (Blair & Kaserman, 1982). In this view, the two payment types should be negatively correlated with each across different franchise systems.

Others, however, predict a positive relationship. Both price components could reflect the level of investment that the franchisor invests in building its brand and in training its franchisees to support this brand properly. If this is correct, we should see a positive relationship in the relationship across franchise systems (Lafontaine & Shaw, 1999).

Empirical investigation of this controversy has been problematic. The relationship needs to be tested at the franchise system level (Sen, 1993), but data on the necessary measures are seldom available at this level. Sources of secondary data at this level to the time of this research excluded the key information necessary to evaluate the franchise payment question directly.

In research leading to this article, we test the relationship between the two components of franchise prices with firm level primary data and demonstrate the value of a more detailed data set for franchise research. We begin with a brief review of the two theoretical perspectives, and specify the competing hypotheses. We then report upon an empirical test of those hypotheses, discuss the results in light of franchise theory and practice, and the need for data of the type we have gathered.

2. Components of franchisor prices

In addition to statutes and regulations specific to franchising (Federal Trade Commission, 1979), franchise contracts are also subject to regulation by many state securities laws. This is because the purchase of a franchise is, in essence, a financial investment in a business system. In return for this investment, the franchisee receives the right to future profits derived from the use of the franchisor's trademark along with the various forms of franchisor support designed to help deliver those profits. For its part, the franchisor enters into the franchise relationship seeking to exploit the value of its trademark and its own investments. At issue is the nature of the price for those rights.

If the future demand generated by the franchisor's trademark were known with certainty by both franchisor and franchisee, it would be possible to find a single, lump-sum payment that would satisfy both parties' interests (Blair & Kaserman, 1982). In other words, at a given level of demand and average costs, a profit stream could be estimated and the franchise priced (the lump sum fee) at the value of that stream minus the required normal return. Alternatively, the franchisor could auction the rights to competing, prospective franchisees with the expectation that the most efficient of them would bid up the price to reflect a normal return after minimizing operating costs (Caves & Murphy, 1976).

Unfortunately, the future stream cannot be known because expected demand for the