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Franchising as a plural system: A risk-based explanation☆

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Abstract

Empirical studies show that most franchise systems consist of both franchisee-owned and franchisor-owned units. We contribute a new theory that explains why such a mixture exists, using a model that focuses on the franchisor's optimal risk allocation. The costs of risk and controlling franchised units explain the varying fraction of franchisee-owned to total selling units, and the incentive to franchise decreases with an increasing fraction of franchisee-owned to total selling units, as well as with decreasing costs of control. Our explanation for these plural systems is consistent with the ownership redirection hypothesis.

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Introduction

When buying at an outlet, most customers do not know whether it is a franchisee- or franchisor-owned branch. According to franchisors and franchisees, this situation marks a success, because it indicates that the franchisor has successfully transferred its brand name to the franchisee. A naïve assumption might suggest a system containing uniform outlets uses either a pure franchise system or a pure company-owned system, depending on which form proves superior in the particular conditions. However, franchise systems usually contain some company-owned outlets; that is, franchise systems generally are plural systems rather than pure franchise systems. Bradach (1997) reports that of the 100 largest U.S. restaurant chains, 74 employ plural systems, 22 are systems with exclusively system leader-owned units, and only 4 represent pure franchise systems.

This article contributes a new explanation for the existence of plural systems that specifically considers the fraction of franchisee-owned outlets versus the fraction directly operated by the franchisor. Several existing theoretical and empirical studies address the ownership patterns of franchise systems, mostly by examining changes in ownership patterns as franchise systems mature (Dant and Kaufmann 2003; Dant et al. 1992; Dant et al. 1996; Hunt 1973; Lafontaine 1993; Lafontaine and Kaufmann 1994; Lafontaine and Shaw 1999) on the basis of various theoretical backgrounds and concepts, such as the resource acquisition (Caves and Murphy 1976; Norton 1988; Oxenfeldt and Kelly 1968) and signaling (Gallini and Lutz 1992; Lafontaine 1993) theories of franchising.

However, no previous studies attempt to determine the percentage of franchisees in the system by taking into account the franchisor's risk considerations. We examine how franchisor risk and related costs develop when outlets convert from franchisee- to franchisor-owned units or vice versa and base our findings primarily on the franchisor's risk assessments, which have been largely ignored in the literature thus far,[1] even though risk assessments play significant roles in explaining unit-level decisions. According to agency theory, the franchisor's goal conflict consists of stimulating a selling incentive versus allocating risk efficiently, which prompts fixed transfer payments and sales shares (Lafontaine 1992; Lal 1990). In this sense, the typical

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[1] For an exception, see Martin (1988), who explicitly discusses the franchisor's risk assessments but does not consider the fraction of franchised units.

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Nomenclature

$E\{\}$	expected value of the whole business from the point of view of the franchisor
F	fixed sum
N	number of units transferred to franchisee-owned units
$\bar{N}$	sum of franchisor-owned units and franchisee-owned units
r	franchisor's degree of risk aversion
r_P	(Potential) franchisee's degree of risk aversion
R	risk premium
$U(\,)$	utility
$V(\,)$	cost function
x	fraction of franchised units

Greek letters

μ	expected value of each franchisee-owned or franchisor-owned unit
μ_P	expected value of an independently operating unit
σ^2	profit variance of each franchisee
σ_P^2	profit variance of each independent entrepreneur
Φ	profit of the franchisor
Φ_{CE}	certainty equivalent of the franchisor

assumption that franchisees are more risk averse than franchisors appears plausible because of the common relative proportions of size by the two parties.

We focus on the risk reduction the franchisor can achieve when it substitutes a franchisor-owned with a franchisee-owned unit, which it does as long as its costs of control remain sufficiently low. This conceptualization may seem counterintuitive at first, because risk is shifted to the more risk-averse franchisee, which should increase the cost of risk for the whole system. However, from solely the franchisor's perspective, increasing the percentage of franchisee-owned units decreases its risk and thereby reduces the costs associated with financing, in that the franchisor substitutes part of the variable income it earns from its franchisor-owned units to fixed income it obtains from franchisee-owned units. If the franchisor minimizes the costs associated with risk taking and control of the system, the preferred system structure will include both franchisor- and franchisee-owned units, and the fraction of franchisee-owned units should depend on the costs the franchisor incurs to take risks and control the system.

We organize the remainder of this article as follows: In the next section, we provide a brief overview of extant literature that attempts to explain the existence of plural systems. Then, we examine whether it is possible to make a definitive statement about the optimal fraction of franchisee-owned units, or the optimal ratio of franchisee-owned to the total number of outlets. Subsequently, we develop a new approach that explains the combinations of franchisee- and franchisor-owned outlets in one system. Finally, we clarify why such risk transfer within the framework of a franchising system affects the fraction of franchisee-owned units and argue that it strongly supports the introduction of a plural system.

Explaining plural systems

Different lines of argument attempt to explain why a franchisor may maintain at least a fraction of franchisor-owned units in a system, but no previous research addresses the size of this fraction.

Ownership redirection

According to one research stream, franchise systems exist because of the franchisor's need for capital (Caves and Murphy 1976; Dant and Kaufmann 2003; Dant et al. 1992; Dant et al. 1996; Kaufmann and Lafontaine 1994; Norton 1988; Oxenfeldt and Kelly 1968). Therefore, the typical life cycle of a system takes the following form: The franchisor starts its own outlet, then recruits franchisees to expand the system with the help of franchisee capital, because the only way to achieve further growth of the system is to include franchisees. If the system grow large enough and the franchisor has gathered sufficient capital, this process may reverse, at which point the franchisor prefers to own all further units and may even attempt to regain ownership of existing franchisee-owned outlets. Thus, in the case of successful systems run by financially strong franchisors, we expect a declining fraction of franchisee-owned units, though the scale of such ownership redirection remains empirically unclear (Dant et al. 1996). A recent study by Dant and Kaufmann (2003) also supports the resource acquisition theory of franchising, which implies a tendency toward ownership redirection.

Quality of the business idea and experiences

The franchisor tests the business idea before licensing it; therefore, in early-stage systems, the fraction of franchisee-owned to total units is 0 but may rapidly increase thereafter. If the franchisor prefers to avoid the burden of operating multiple branches, it disposes of them during the course of the system's development, so that the fraction of franchisor-owned units may drop to 0. However, franchise systems generally maintain at least a few corporate outlets, which enable the franchisor to keep track of the market developments that its franchisees confront, better understand necessary adjustments in the system, and detect opportunistic behavior by franchisees with regard to market information by verifying any such information through its own units. Thus, the franchisor achieves a position in which it may ascribe success or failure to stochastic influences versus the franchisee's efforts, if the various outlets have had similar experiences. Dutta et al. (1995) develop a similar argument to explain the coexistence of sales representatives and house accounts.

Signaling by means of company outlets

The franchisor may set up its own outlets and make their results readily accessible to potential franchisees to recruit them