

Franchising and firm financial performance among U.S. restaurants

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Abstract

Franchising has attracted the attention of retailing and entrepreneurship scholars in the past three decades, but evidence pertaining to how franchising affects financial performance is mixed and inconclusive. Thus, the question remains as to whether franchising firms exhibit better financial performance than non-franchising firms in the same industry. In order to find an answer to this question, our study compares the risk-adjusted financial performance of franchising versus non-franchising restaurant firms over the 1995–2008 interval, using five different performance measures: the Sharpe Ratio, the Treynor Ratio, the Jensen Index, the Sortino Ratio, and the Upside Potential Ratio. For each measure, the results revealed that franchising restaurant firms outperformed their non-franchising counterparts. Thus, we provide very robust evidence that franchising is superior on average in the restaurant industry, which can help explain the increasing popularity of franchising as a business form.

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Introduction

The unprecedented growth of franchising businesses in recent decades sparked considerable research interest (cf. Bürkle and Posselt 2008; Combs, Ketchen, and Hoover 2004; Lafontaine 1992; Norton 1988; Oxenfeldt and Kelly 1968; Rubin 1978; Windsperger and Dant 2006). Early franchising research sought to understand why an increasing number of firms adopt franchising, along with the characteristics of franchising firms (e.g., Caves and Murphy 1976; Norton 1988). For example, a number of researchers (e.g., Carney and Gedajlovic 1991; Castrogiovanni, Combs, and Justis 2006) have examined resource scarcity and agency arguments as to why firms franchise. Others have considered alternative reasons for franchising such as innovation (Bradach 1997) and risk spreading (Lafontaine and Bhattacharyya 1995).

Surprisingly little research has dealt with the ultimate effects of franchising on firm financial performance, however. Two major challenges have hindered research in this area (Combs, Ketchen, and Hoover 2004; Combs, Michael, and Castrogiovanni 2004). First, a large majority of franchising firms

are privately held companies, which severely limits the availability of performance data. Second, some researchers maintain that franchising must be performance enhancing or else it would not be so prevalent. Still, franchising and non-franchising firms often coexist within the same industry, and so it is not clear whether either form of business is superior to the other.

We set out to address this deficiency. Our central research question was, “Does franchising result in better risk-adjusted financial performance?” More precisely, our purpose was to investigate whether franchising restaurant firms outperformed non-franchising restaurant firms during the period of 1995–2008. To achieve this purpose, we examined a sample of publicly listed restaurant firms from a capital markets perspective using five different risk-adjusted financial performance measures.

Prior studies have not considered both risk and return while also controlling for industry. Some (e.g., Aliouche and Schlentrich 2009; Hsu and Jang 2009) controlled for industry but did not account for risk. Others (e.g., Spinelli, Birley, and Leleux 2003; Aliouche and Schlentrich 2007) adjusted for risk but did not account for difference across industries. We thus contribute to the franchising literature by considering risk and return simultaneously, using individual firm level data (cf. Sorenson and Sorenson 2001). In addition, we contribute by examining both traditional risk-adjusted financial performance (the Sharpe

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Ratio, the Treynor Ratio, and the Jensen Index) and alternative conceptualizations based on semi-variance (the Sortino Ratio and the Upside Potential Ratio). As shown below, our findings were consistent in all cases, which gives us considerable confidence in our conclusions.

Franchising and financial performance

Considerable research has assessed consequences of franchising that could lead to better performance among franchising firms (cf. Aliouche and Schlenrich 2007). Mechanisms through which franchising can enhance financial performance have been explained by drawing on resource scarcity theory (Oxenfeldt and Kelly 1968), agency theory (Lafontaine 1992), risk sharing theory (Martin 1988), and others (e.g., Bradach 1997). For recent reviews, see Combs and Ketchen (2003), Combs, Michael, and Castrogiovanni (2004), and Gillis and Castrogiovanni (2010). Research, however, has been inconclusive as to whether such consequences of franchising ultimately result in superior financial performance over non-franchising firms.

Newby and Smith (1999) contrasted the risk and return of franchised and independent units in the real estate and commercial printing industries in Australia, with mixed results. Franchised real estate agencies had a lower level of profitability compared to non-franchised firms ($p \leq .05$), but exactly the opposite outcome was obtained for commercial printing firms.

Roh (2002) argued that franchising reduces the variability of operating cash flows because royalties received from a unit exhibit less variance over time than the revenue and profit of that unit. Moreover, a firm-owned unit requires a fixed capital investment by the firm, which increases the firm's leverage and thus its level of risk. Therefore, Roh (2002) maintained that publicly traded restaurants with a higher proportion of franchised units would have lower variation in operating cash flows, and thus a more favorable risk-return tradeoff.

Michael (2002) provided indirect evidence of a positive franchising – performance effect. Firms that franchised early gained market share quickly, which in turn led to better financial performance. Later, Michael (2003) explained that franchising facilitates rapid growth by enabling greater resource access (cf. Shane 1996), which enables firms to gain first mover advantages.

Spinelli, Birley, and Leleux (2003) hypothesized that a portfolio of 91 franchising stocks would outperform the Standard and Poor's 500 Index over the ten-year period between 1990 and 1999, but their hypotheses received mixed support. For the period January 1990 through January 1991, there was no statistically significant difference between the performance of franchising firms and the index. During the period January 1991 through July 1997, however, franchising firms enjoyed their greatest comparative advantage in total return to shareholders. Then, during the remainder of the study period, the index outperformed the stock of the franchising firms. Spinelli et al. did not report the mean difference between two index returns for the full period (1990–1999).

In two related studies of franchising restaurant firms, Combs, Ketchen, and Hoover (2004), Combs, Michael, and Castrogiovanni (2004) and Ketchen, Combs, and Upson (2006)

found that the franchising effect is nonlinear. Combs, Ketchen, and Hoover (2004) and Combs, Michael, and Castrogiovanni (2004) identified three strategic groups among the 65 franchising firms that they examined, and Ketchen, Combs, and Upson (2006) identified four strategic groups among 94 franchising firms. Both studies considered three performance variables – (a) return on assets, (b) sales growth, and (c) market-to-book value – and found that some strategic groups outperformed others.

Aliouche and Schlenrich (2007) investigated risk and return performance of franchising firms compared to major stock market indices such as CRSP and S&P 500, using the Sharpe ratio and the Jensen Index. They found that franchising firms outperformed the benchmark indices on average throughout over the years 1990–2005. Examining five-year sub-periods, however, they found that the indices outperformed franchising firms in 1995–2000.

Aliouche and Schlenrich (2009) used *t*-tests to compare 24 franchising and 17 non-franchising restaurant firms along four performance dimensions – market value added, economic value added, return on equity, and shareholder returns. Their findings indicated that at the descriptive level franchising firms had better financial performance but none of these mean differences were significant at the .05 level. This could have been due, however, to the relatively small sample size and lack of control variables.

Hsu and Jang (2009) examined 82 franchising and non-franchising restaurant firms over the 1996–2005 interval with regard to three performance variables – return on assets, return on equity, and Tobin's Q. In *t*-test comparisons, the franchising firms exhibited better results than the non-franchising firms along all three variables. However, after controlling for return on assets, firm size, debt leverage and advertising expense, the difference in Tobin's Q between franchising and non-franchising firms was not significant.

As these studies show, research as to whether franchising has a generally positive, neutral, or negative effect on firm financial performance has been extremely limited, and the overall findings have been mixed. Our sense is that, on balance, the literature seems to lean slightly toward a positive effect. Moreover, Combs, Michael, and Castrogiovanni (2009) found that franchising firms have tended to utilize franchising more and more extensively over time, which suggests that their experience indicates a net benefit of franchising vis-à-vis firm ownership. Thus, we hypothesize an overall positive effect as follows:

H1. Franchising firms will achieve greater risk-adjusted financial performance than non-franchising firms in the same industry.

Methods

Sample

Our study focuses on financial performance from a capital markets perspective, which restricts our sample to publicly traded firms. We focused on the restaurant industry because it is one of the few industries that allows for comparison of publicly traded franchising and non-franchising firms. We started our

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