

Strategic Debt in Vertical Relations: Evidence from Franchising[☆]

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Abstract

In this paper, we examine the strategic use of debt in franchise organizations. We focus on both the franchisee's and the franchisor's capital structures. The primary goal of this study is to examine whether franchisors impose limits on franchisees' debt levels to be able to increase their own leverage. We find that the franchisor's leverage is significantly related to the maximum leverage allowed for the franchisee. As the franchisor sets an upper limit on the franchisee's debt ratio, the franchisor can raise more debt and therefore seizes tax benefits, since interest payments are tax deductible. We find that this effect is stronger in chains with larger fractions of franchised outlets.

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Introduction

Why do firms franchise? Although this fundamental question has been the subject of considerable theoretical and empirical investigation, little consensus has been reached (Combs and Ketchen 2003; Combs, Michael, and Castrogiovanni 2004; Dant 1995). In general, the reasons for franchising are based on the resource-based view and organizational economics (Combs and Ketchen 1999a,b). The resource-based view suggests that firms use franchising to relieve financial and managerial constraints in order to enhance growth. Oxenfeldt and Kelly (1968) argue that financial constraints induce franchising, since the partial financing by franchisees limits the financing needs of franchisors. However, this view has been refuted by Rubin (1978) and Norton (1995), arguing that franchisee capital is not less expensive than capital from passive sources such as lenders and stockholders. In organizational economics, transaction costs (Williamson 1983) and agency costs (Jensen and Meckling 1976) present motives for franchising. Combs and Ketchen (2003) and Combs, Michael, and Castrogiovanni (2004) argue that the two theories

are complementary in explaining franchising structures. In this paper, we introduce a new specific element in the trade-off of costs and benefits of franchising, which is related both to organizational economics and resource scarcity: firms benefit from franchising by being able to increase their debt ratio.

A common practice in the franchising business model is that franchisors impose a lower boundary on the franchisees' personal capital required in the initial total investment. For example, McDonald's requires a minimum of 100,000 dollars of equity investment, which is about 20 percent of the initial total investment, and Subway Restaurants requires franchisees to fund about 43 percent of the total initial investment with their personal capital. Clearly, the equity required by franchisors is an important variable in the contract offered to franchisees. Because of the vertical relation between the franchisor and the franchisee, opportunities for the franchisor may arise to strategically use the debt structures to enhance firm value.

De Fraja and Piga (2004) model financing decisions in vertical relations and argue that the upstream party imposes a limit on the downstream party's debt level in order to avoid bankruptcy risk and to secure profits. In this paper, we follow their reasoning. We suggest that organizations using the franchising structure benefit from the opportunity of setting the franchisees' capital structure in such a way that the franchisor can bear more debt. The higher debt ratio of the franchisor increases value because of the tax deductibility of interest payments (Modigliani and Miller 1963; Graham 2000). Based on the model of De

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Fraja and Piga (2004), we predict that lower maximum leverage for franchisees induces more leverage for franchisors. In addition, we predict that this effect is stronger when more outlets are franchised. In other words, we propose that the strategic use of the franchisee's maximum debt level may affect the franchisor's capital structure, which will ultimately affect firm value.

We empirically test our propositions with data from the Bond's Franchise Guide and COMPUSTAT. We construct a model in which we first estimate the determinants of the maximum debt ratio that is allowed for franchisees. We find that the maximum debt ratio depends on the size of the outlets, on the age of the franchise firm, on arrangements between the franchisor and the franchisee (such as cooperative advertising), and on the type of industry. We then compare the predicted maximum debt ratio, based on firm and industry determinants, with the actual maximum debt ratio. We use the deviation as an explanatory variable in the leverage regression for the franchisor, because this variable measures the constraints on franchisee debt that cannot be explained by firm and industry characteristics.

We find evidence supporting our primary prediction that the franchisor's capital structure is interrelated with the franchisee's capital structure. More specifically, we find that the franchisor's leverage is positively related to the deviation of the franchisee's leverage. That is, as the franchisor sets a higher requirement for the franchisee's equity component than expected (lower maximum leverage), the franchisor is able to raise more debt. This evidence is in line with our proposition that the strategic use of the franchisee's capital structure affects the franchisor's decision of financing. Obviously, our argument is an addition to the array of motives for franchising, which currently prevail in theory (Combs and Ketchen 2003; Combs, Michael, and Castrogiovanni 2004). Furthermore, we also find that the effect becomes stronger when the fraction of franchised units versus wholly-owned units in a franchising chain increases.

Our analysis primarily contributes to the franchising literature by demonstrating important consequences of debt financing in franchising that previous research has not examined. Particularly, our work complements the earlier work of Oxenfeldt and Kelly (1968), Rubin (1978) and Norton (1995), whereas these authors specifically emphasize the costs and constraints in financing, ignoring the strategic use of debt financing.

Literature review and hypotheses

The resource-based view is one of the main theories explaining why organizations franchise. It suggests that franchising is used by franchisors to access scarce financial and managerial resources to relieve constraints on growth (Oxenfeldt and Kelly 1968). Much of the debate on the resource scarcity explanation has focused on capital provided by franchisees to franchisors. Several researchers have questioned whether franchisee capital is less expensive than the capital from passive investors such as stockholders and debtholders (Norton 1995; Rubin 1978). More specifically, Rubin (1978) argues that the capital scarcity argument for franchising cannot be relevant because franchisees will face greater undiversified investment risks as they place substan-

tial personal wealth in a limited number of outlets, and therefore they will demand a risk premium to compensate for this risk. Passive investors do not have this problem, which leads to lower financing costs.

The second theoretical perspective on franchising is organizational economics (Combs and Ketchen 1999a,b). The first stream of research in this literature is transaction costs, where asset specificity influences a firm's propensity to franchise. For example, if two firms cooperate and both invest in specific assets, franchising structure may be the optimal structure (Williamson 1983). The second stream of research is agency theory, where agency problems of monitoring are reduced in a franchising setting, while new agency problems may arise (Combs and Ketchen 1999a,b). Although capital structure considerations in franchising are typically related to the resource-based view, both agency theory and transaction cost economics are directly related to firm's capital structure decisions. It should be noted that resource scarcity and organizational economics are often presented as rival, while in fact these theories can be complementary (Combs and Ketchen 2003; Combs, Michael, and Castrogiovanni 2004).

Our paper differs from previous analyses, because we test a specific model for the capital structure decisions in a franchising setting. In the remainder of this section, we will first investigate the relation between the franchisee's and the franchisor's capital structure and then illustrate how the franchisee's maximum debt ratio is related to the reasons for the franchisor to choose a franchising structure.

The strategic link between the franchisor's and the franchisee's leverage

A stylized fact in franchising is that franchisors usually require their franchisees to put up a specific amount of personal wealth in the total initial investment, and in turn leave the franchisees limited space for debt financing. This phenomenon was explained by Williamson (1989) from the perspective of one-sided moral hazard: equity financing is used as a device against quality cheating by franchisees. He argues that the franchisee can damage the brand image by not maintaining the agreed quality level when quality is non-contractable. As a result, franchisors will require the franchisee to finance a specific investment through their personal resources. The franchisor can punish a cheating franchisee by an early termination of the contract. If the franchisee is allowed to borrow too much debt, this cost of termination goes to the debt lender instead of to the franchisee.

De Fraja and Piga (2004) present a principal-agent model for a setting with two parties in a vertical relationship. The principal (i.e., the franchisor) wants to impose a limit on the borrowing of the agent (i.e., the franchisee), because – even though the agent may prefer to finance with debt – the debt financing increases the probability of bankruptcy, which reduces the value of the cooperation for the principal. Thus, debt financing can increase the agent's bankruptcy risks and therefore reduces the principal's expected value. Consequently, the principal has to impose a limit on the agent's use of debt financing. In this respect, the theory of De Fraja and Piga (2004) builds on Williamson's (1989) one-sided moral hazard model.

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