Why do entrepreneurs use franchising as a financial tool? An agency explanation

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ABSTRACT

When and why one type of entrepreneur (franchisor) attracts to its ventures another type of entrepreneur (franchisees) instead of passive investors is a central concern in entrepreneurship literature. Based on the informativeness principle of the principal–agent model, we claim that franchisees are not such an expensive financial tool as has been argued in the literature because their compensation (return) is more efficiently designed: it directly depends on variables which are under franchisees’ control. We therefore link agency and financial explanations for franchising. Most of our findings show that, once the agency argument is controlled for, the higher the cost of alternative funds for the franchisor (estimated through different variables), the more the franchisor will rely on expansion through franchising as opposed to company-ownership. We interpret this as a clue that franchising is also used as a financial capital source.

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Keywords: Entrepreneur Franchising Capital cost Informativeness principle Financial argument Agency argument

1. Executive summary

An essential challenge for entrepreneurs is to attract resources to their startup businesses. The entrepreneurship literature recognizes the need to persuade resource providers about the viability and profitability of ventures in order to collect enough resources to support the appropriate level of business growth (Ireland et al., 2003; Michael, 2009). Analyses have been made into how entrepreneurs signal their private information to reduce the distrust of capital providers resulting from their informational disadvantage (Deeds et al., 1997; Janney and Folta, 2003, 2006; Michael, 2009). We develop this research line but, instead of focusing on how to attract funds, we turn to when and why different resource sources are preferable.

The field of study is that of franchising. This has been extensively analyzed in the entrepreneurship literature because it can be considered an entrepreneurial partnership (cooperative arrangement) between two different types of entrepreneur: franchisor and franchisees (Baucus et al., 1996; Kaufmann and Dant, 1999). Franchisors need to attract resources to their businesses and one option is to franchise their establishments, so that it is the franchisees who provide the funds needed to achieve growth. But other options are also possible, such as debt or passive investors, which allow entrepreneurs to open up company-owned establishments. Therefore, the relevant question in this paper is when and why entrepreneurs (franchisors) prefer franchisees’ funds to passive investors’ funds.

The traditional resource scarcity argument offers an initial answer. It establishes that franchising is used to facilitate access to specific scarce resources, such as capital (Ozanne and Hunt, 1971; Caves and Murphy, 1976), management abilities (Oxenfeldt and
Entrepreneurship literature has analyzed this, focusing mainly on how entrepreneurs signal their private
resources, the emphasis should be on carrying out a cost-benefit analysis when deciding between franchising and other conventional formulae. Franchising is neither good nor bad but depends on the relative prices of alternative formulae. Second, the results also show which variables may affect the cost of franchising and other fund sources. They offer clues to entrepreneurs about how to reduce their funding costs: if franchisors want to attract franchisees, they need to act on the variables that make the franchise package attractive, like low initial investment and good brand reputation, but if they want to attract shareholders and lenders, they have to offer good guarantees in the form, for example, of good real backing assets.

2. Introduction

Attracting the most competitive resources to the venture is essential for an entrepreneur’s success (Ireland et al., 2003; Michael, 2009). Entrepreneurship literature has analyzed this, focusing mainly on how entrepreneurs signal their private information to reduce capital providers’ distrust (i.e. how they obtain funds), in both R&D companies (Deeds et al., 1997; Janney and Folta, 2003, 2006) and franchise chains (Michael, 2009). We develop this research line in franchising but, instead of focusing on how to attract funds (e.g. how to solve asymmetric information problems), we turn to when and why different sources of resources are preferable (e.g. when franchisees’ capital becomes more attractive). Franchising has also been extensively analyzed in the entrepreneurship literature, suggesting that it is an entrepreneurial partnership (cooperative arrangement) made up of two different types of entrepreneur: franchisor and franchisees (Baucus et al., 1996; Kaufmann and Dant, 1999). Given that the new venture is launched by the franchisor, they must then attract resources to their business. Norton (1995) argues that franchisors will choose fund providers according to their costs, with franchisees’ capital being just one possible option. However, franchisees, like any entrepreneur, also have a profit motivation (Spinelli and Birley, 1996) and do not participate for free. They will join the venture depending on the rate of return and will expect a risk premium (Phan et al., 1996). The relevant question is therefore when and why entrepreneurs prefer franchisees’ funds to passive investors’ funds.
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