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

Manuel Gonzalez-Diaz [a,1], Vanesa Solis-Rodriguez [b,*]

[a] University of Oviedo, Business Administration Department, Avda. del Cristo, s/n, Oviedo, 33006, Spain
[b] University of León, Business Administration Department, Campus de Vegazana s/n, León, 24071, Spain

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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.

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

* Corresponding author. Tel.: +34 987291000x5527; fax: +34 987291454.
E-mail addresses: mgdiaz@uniovi.es (M. Gonzalez-Diaz), vasolr@unileon.es (V. Solis-Rodriguez).
[1] Tel./fax: +34 985102807.

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Kelly, 1969; Norton, 1988) or local information (Minkler, 1990, 1992). However, this argument did not initially consider the relative prices of alternative funds but just their scarcity. It was therefore highly criticized, in contrast to the agency argument, which is the one most supported by academics. However, franchisors' opinions seem to support the former argument because they mention access to capital as the main reason for adopting franchising (Dant, 1995). So, are franchisees really such a costly way of financing as Rubin (1978) states or can they provide cheaper capital than passive investors?

A link between the financial and agency arguments provides an answer, in that the motivational and selection advantage of franchising might result in less expensive capital for the franchisor (Lafontaine, 1992; Martin and Justis, 1993; Shane, 1996a; Combs and Ketchen, 1999; Combs, Michael and Castrogiovanni, 2004).

We add the informativeness principle (Holmstrom, 1979) of principal–agent model to show another link between agency and financial arguments and to rationalize the advantage of franchising in terms of capital costs. This principle states that an agent (franchisee or shareholder) demands lower compensation if this depends on variables which are under his/her control (i.e. they depend on his/her effort) because of a perception of lower variability or risk. Considering financing via franchising vs. other alternatives, we claim that “passive” investors, such as lenders or minority shareholders, will demand a higher return on capital because their compensation will depend on variables that are not directly related to their effort: they have very little influence over decision-making in the outlet; do not have good information about the efforts made by the agents managing the outlets, or about their abilities; and do not control financial risks because, if the franchisor bankrupts, they cannot differentiate their investment from that of the franchisor (which would be possible in franchising). In sum, the franchisee disadvantage in terms of exogenous risk allocation (Rubin, 1978) may be compensated for not only by the motivational and selection advantages of franchising, but also by greater direct control over the investment, which leads the franchisee to request a lower return for capital.

We also consider that, when chains have financial partners among their shareholders, such as private equity or financial firms, franchising is less likely to be adopted because these partners provide enough funds for expansion. Finally, we consider that the franchisor's capacity to attract franchisees also depends on the franchise package appeal, estimated through franchisor experience and initial investment.

Based on a panel data consisting of Spanish franchise chains operating in Spain during the period 1996–2005, we estimate a partial adjustment model finding that, once the agency argument is controlled for, upward changes in the franchisor's cost of debt and reductions in the asset backing and liquidity ratios (as proxies for the prices of alternative sources of capital) increase the chain's propensity to franchise. We also observe that franchisors with financial partners as shareholders franchise fewer establishments than chains without this type of shareholder. Additionally, franchisors with lower initial investment and higher experience seem to franchise more outlets than other chains.

We consider that these findings mainly support our hypothesis that franchising is not as expensive as financial tool as has been claimed. We suggest that the disadvantage in terms of exogenous risk allocation may be compensated for by both the motivational and selection advantages of franchising and greater direct control over the investment. Franchisees therefore perceive lower variability so they also accept a lower return. Additionally, it also seems that making the business attractive for franchisees in terms of investments and guarantees helps increase the proportion of franchisees, which suggests that franchisors do not always find as many franchisees as they want.

Entrepreneurs may draw some interesting lessons from these results. First, if we accept that entrepreneurs consider franchising to be just an alternative source of financial 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.