How Do Franchise Ownership Structure and Strategic Investment Emphasis Influence Stock Returns and Risks?

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Abstract

Franchisors seek to maximize firm value by managing investments both in tangible and intangible assets and in the mix of company and franchised outlets, yet little is known about how investors respond to shifts in these strategic decisions. Our goal is to assess the impact of these decisions on shareholder value within franchise systems through panel-data models. Specifically, we provide evidence on how investors in publicly traded franchises evaluate both the ownership structure and the strategic investment emphasis between intangible assets (e.g., brand) and tangible assets (e.g., plant and property). We find that an increase in the proportion of franchised units is negatively associated both with stock returns and idiosyncratic risk. In contrast, an increase in the emphasis on strategic investments in intangible assets is positively associated both with stock returns and idiosyncratic risk. Moreover, strategic investment emphasis moderates the strength of the effect of franchise ownership structure when firms franchise internationally. Overall, this research provides a novel empirical examination of franchising economics and has managerial implications for franchised channel structure.

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Introduction

Franchising is an important method of distribution in the US. Many franchisors start as small retail entrepreneurs, but once successful, typically contemplate an initial public offering (IPO) of their equity. In recent years, a growing number of franchise systems have completed IPOs. For example, franchise firms such as Hilton Worldwide, RE/MAX, and Noodles & Company did so in 2013 while Habit Restaurants, El Pollo Loco, and Papa Murphy’s followed suit in 2014 (Daley 2014). One of the key concerns identified by the researchers and practitioners for publicly traded companies is the impact of marketing strategy on stock price and the growth of, and risk to, cash flows (Hanssens, Rust, and Srivastava 2009; Srinivasan and Hanssens 2009). Marketing strategy in publicly held franchise systems is comprised of a myriad of decisions. In this paper we focus on two important decisions made by franchisors, which combine and interact, to achieve superior financial performance: the franchisor’s mix of company-owned and franchised units and the strategic investment emphasis. Specifically, a franchisor has to decide whether to expand the business by focusing on company-owned units or by attracting new franchisees and on the relative emphasis on investments in tangible (e.g., investments in plant and equipment) and intangible assets (e.g., investments in the brand name).

Research on mix of company-owned and franchised units, also known as the plural form (Bradach 1997), derives from theoretical explanations as to why and when a franchisor seeking to expand would decide to franchise instead of operating as a company-owned chain. Central among those explanations have been the efficient acquisition of capital argument (Caves and Murphy 1976; Oxenfeldt and Kelly 1968), and the solution to agency problems argument (Bergen, Dutta, and Walker 1992; Brickley and Dark 1987; Lafontaine 1992; Rubin 1978), with the latter including the information asymmetry explanation (Heide 1994, 2003). While the different explanations spawned a
long-standing debate (Dant, Paswan, and Kaufman 1996), each explanation contains the implicit underlying objective of an efficiency effect that likely enhances the franchiseor’s performance. 

Franchising researchers have been increasingly urged to adopt insights from broader areas such as the firm’s economic value (e.g., the operating return on assets) and the firm’s accounting value (e.g., net income, earnings per share) to evaluate the performance of dual distribution (Dant, Grünhagen, and Windsperger 2011; Kaufmann, Gordon, and Owens 2000). Some researchers have focused on specific financial outcomes of the decision to franchise. For example, Aliouche and Schletrich (2008) calculate the net present value (NPV) generated by a company-owned unit compared to a franchised unit. In addition, Spinelli, Birley, and Leleux (2003) find that franchise portfolios outperform the Standard and Poor’s 500 Index (S&P 500) in terms of total stock returns. Even when studying the indicators of financial performance, however, marketing researchers have concentrated on the linkage between a firm’s strategic marketing initiatives and the level of shareholder value and have typically ignored the effects of franchisors’ strategies on firm risk, a key metric for publicly traded companies (for exception see Aliouche, Ken, and Schletrich 2012). 1 Taken together, the current literature leaves us with an incomplete picture of the joint impact of franchisors’ strategies on both stock returns and risks.

A second stream of research has focused on the franchiseor’s relative investment in tangible versus intangible assets. In anticipation of an IPO, investment bankers often advise franchisors to use their limited resources to increase their tangible asset value (Continental Franchise Review 1996). The implicit assumption is that a relative emphasis on tangible asset value is viewed favorably by potential investors because it increases the accounting measures of performance, thus leading to a successful IPO (Kaufmann, Gordon, and Owens 2000). At the same time, the inherent benefits of intangible assets in creating sustained competitive advantage especially in brand-sensitive businesses characteristic of franchised companies is well documented (Maze 2014). Investments in brand building not only strengthen customer loyalty, thereby enhancing expected cash flow, but also facilitate growth by augmenting the attractiveness of the system to prospective franchisees. Thus, both in anticipation of an IPO and in managing their ongoing firm value, franchise companies must make tradeoffs in balancing investments in tangible and intangible assets in their effort to create and exploit their profit opportunity and to be rewarded by investors.

Importantly, a complication in assessing the effect of the mix of company-owned and franchised units on financial performance is due to the fact that an emphasis on franchising may have the confounding effect of freeing capital for investments in intangible assets, that is, marketing and brand development initiatives. It is therefore unclear whether any observed enhancement in financial performance is due to a reduction in agency problems or to the strategic redirection of assets toward enhancing the firm’s intellectual property and brand equity. It is critical therefore to include both the mix of unit ownership and the emphasis on tangible and intangible assets in any model of franchiseor performance.

Similarly, the different ways in which the ownership and development costs of real property are handled in a franchise system can complicate the analysis of investments in tangible assets. A franchiseor may choose to minimize investments in tangible assets by having franchisees purchase the real property, develop the unit, and operate the outlet. On the other hand, the franchiseor can increase its investments in tangible assets either by developing real properties and operating them as company-owned outlets or by developing real properties and leasing them to operating franchisees. The latter approach has been a hallmark of McDonald’s investment strategy. When a franchiseor invests in real property for units operated by franchisees, it has the effect of increasing the franchiseor’s tangible assets while creating predictable revenue streams from rent and royalties paid by operating franchisees typically associated with an emphasis on investments in intangible assets. In this complex environment, it is difficult to disentangle investment decisions from organizational form decisions. The bottom line is that it is still unclear which strategy will outperform the other in terms of the firm value. For the above reasons, we simultaneously investigate the effect of relative investment in tangible and intangible assets and the mix of outlet ownership on firm value.

To sum up, it is critical for franchiseors to gain an understanding of how the franchise ownership structure and strategic investment emphasis are perceived and evaluated by the investor community. Yet, such an understanding is largely lacking since most franchising studies take the perspective of an owner-franchiseor and focus solely on growth or sales, completely ignoring the perspective of investors (Dant and Kaufman 2003). Addressing the gaps in extant literature, we aim to answer two main research questions: (1) what are the stock returns and risk implications of changes in company-owned units versus franchised units for a franchiseor? and (2) does a franchiseor’s strategic investment emphasis on tangible assets versus intangible assets differentially influence its stock returns and risk? From a practice perspective, our research sheds light on how investors evaluate franchiseors’ dynamic strategies of ownership structure and strategic assets investment allocation.

The rest of the article is organized as follows. We first establish the focal firm value metrics of abnormal returns, idiosyncratic risk, and systematic risk. Next, franchising and marketing strategy research is integrated to develop hypotheses concerning the effects of on financial performance. Next, we describe our data, measurement, and methodological approach used to test the hypotheses. Finally, we conclude with findings and implications from the research.

**Conceptual Framework and Hypotheses**

Fig. 1 provides our conceptual framework for investigating the effects of ownership strategy of company-owned units versus

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1 It should be noted that Aliouche, Ken, and Schletrich (2012) examine the performance of franchising using a cross-sectional analysis in a single sample period. Our study uses longitudinal panel data analysis to examine the effect of changes in franchisors’ strategies on firm value.
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