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Size, growth rate and risk sharing as the determinants of propensity to franchise in chain restaurants

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Abstract

The purpose of this study is to identify the determinants of selected firms' characteristics that affect the proportion of company ownership and franchising in the chain restaurant industry. Size, growth rate as related to agency cost, brand name capital, and risk sharing arguments are proposed to explain why these financial measures are expected to differentiate the likelihood of franchising. To test these hypotheses, publicly held restaurant companies are examined.

While previous research has focused on a narrow explanation for the existence of franchising, this study incorporates multiple prevailing theories to explain the proportion of franchised units to company-owned units. The study finds evidence that a restaurant's size, growth rate specifically related to monitoring costs, and risk sharing are important factors in determining the incremental use of the franchised units. On the other hand, despite predictions offered by existing literature, brand name capital is not as strong as an indicator of the mix of company-owned units and franchised units in the chain restaurants. © 2002 Elsevier Science Ltd. All rights reserved.

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1. Introduction

Franchising is a popular form of organization in the restaurant industry. A franchisor allows a franchisee to use and promote the franchisor's brand name capital in exchange for a mixture of fixed fee and on-going royalties. Franchising is

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perceived as a powerful expansion vehicle when the franchisor desires to grow under limited managerial resources.

While some restaurants do not engage in franchising, to a large extent, a significant number of chain restaurants are actively involved in franchising as a form of strategic management for the firm. However, it is interesting to recognize that the proportion of company-owned units versus franchised units varies substantially across each individual franchisor. What might explain the mixture of company-owned units versus franchised units?

The purpose of this study is to identify the determinants of selected financial characteristics that affect the proportion of company ownership and franchising in the chain restaurant industry. Motivating this inquiry is the observation that franchising has become an increasingly important and flourishing element in the restaurant industry. In its recent Sixth Annual Chain Restaurant Industry Review and Outlook Report (http://www.ffca.com/res_irev.htm), the Franchise Finance Corporation of America predicts increased use of franchising by restaurants as a result of increased restaurant divestitures by publicly held companies.

Traditional arguments for franchising generally center on specific issues and problems encountered by younger, smaller companies that do not have sufficient capital for rapid expansion (Oxenfeldt and Kelly, 1968–1969; Hunt, 1973; Caves and Murphy, 1976; Martin, 1988; Lundberg, 1994; Manolis et al., 1995; Dant et al., 1998). In this scenario, franchising serves as financing although it is an indirect and non-traditional means of raising capital. In effect, financial resources provided by franchisees are vital for small, immature franchisors.

Another explanation for franchising is the growth rate specifically related to costs of monitoring labor. For example, early stage firms with limited managerial capabilities utilize franchising contracts as a means of relieving resource constraints upon a firm's growth. Growth of the company is accompanied by increases in labor, which require a firm to bear additional costs in monitoring employees. However, the main advantage of a franchising contract is the lower cost of monitoring and governing the actions of employees. Thus, franchising is an efficient form of organization when the marginal cost of monitoring company-owned store managers is greater than the marginal cost of undertaking a franchise agreement (Rubin, 1978; Brickley and Dark, 1987; Brickley et al., 1991).

Additionally, a firm's tendency to franchise is likely to be related to the value of a firm's brand name capital. The primary role of brand name capital is to convey information about consistent quality that the consumer might find costly to obtain otherwise (Caves and Murphy, 1976; Norton, 1988a; Aaker, 1991). Fong (1987) argues that a franchise system makes it possible to distribute brand name capital more efficiently. This leads to the belief that companies engaged in franchising possess identifiable brand names which assure the customer uniform product quality (Brickley and Dark, 1987).

Risk sharing is the fourth explanation for the prevalence of franchising. According to this view, franchising agreements allow for an efficient allocation of risk between the franchisee and franchisor (Lafontaine, 1992; Lafontaine and Bhattacharyya, 1995). The franchisee minimizes the risk of operations by utilizing a franchisor's