Toward a Strategic Model of the Franchise Form of Business Organization

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Abstract

As an organizational form, franchising has evolved to the point where it now accounts for 38% of all retail sales in the U.S. This unqualified success of the franchise form can be attributed to its inherent strategic advantages. The most central of these strategic advantages is economies of scale. But scale, and the ensuing spatial preemption, are only attained through the acquisition of external financial resources and managerial agents. Once attained, scale economies and the enforcement of quality standards can lead to internal growth through an integrated low-cost and differentiation-based competitive advantage. (92 words)

Introduction

Business franchising is a particularly American invention. It is part of the history of entrepreneurship in America as practiced by the likes of McCormick, Singer, Ford, and Kroc (Dicke, 1992). As amazingly successful as its creators, franchising accounts for 38% of all U.S. retail trade and generates approximately $1 trillion in annual sales (Trutko, Trutko & Kostecka, 1993). Yet, a theory of franchising has never been part of the mainstream of management thought; particularly in the classroom. A few textbooks focus on the "how to" of franchising; but the "why" of franchising, that is a theoretical discourse on "why" the franchise business organization has been so successful, is largely lacking. The purpose of this paper is to address the "why" of franchising by presenting a strategic model of the franchise form of business organization.

As a form of business organization, franchising is an evolved and complex phenomenon. Still, its success can be explained in terms of the linkage of extant theories. A comprehensive model of the franchise needs to incorporate theoretical development of external and internal growth, the acquisition of financial resource and managerial talent, spatial preemption and economies of scale, low-cost and differentiation-based competitive advantage, and the management of standards and quality. The focus of the strategic model of the franchise form is the progenitor, or franchiser, for whom the franchise is potentially most rewarding. For despite its great success, the franchise may have little economic advantage for the franchisee.

This work is organized into four sections. First, a typology of franchising is reviewed and franchising is defined. Second, franchising is modeled in terms of business growth through the acquisition of external resources. The third section incorporates internal growth into the model through the consideration of low-cost and differentiation-based competitive advantage. Fourth and last, the full model of the competitive advantage of franchising is offered along with a discussion of the role of quality in franchise success.

Franchising

Franchising Typology

Given the diversity of franchising companies, it is not surprising that a number of typologies of franchising have been put forth (e.g., Carney & Gedajlovic, 1991; Combs & Castrogiovanni, 1994; Hoffman & Preble, 1991; Pintel & Diamond, 1987; Stornholm & Scheuing, 1994). The mostly widely accepted typology distinguishes between those franchises that focus on product and those franchises that focus on format (Combs & Castrogiovanni, 1994; Kostecka, 1986). The product-format franchise dichotomy might be termed an evolutionary typology of franchising since the product franchise preceded the format franchise by 80 years (Dicke, 1992). Product franchising grew out of the complexities surrounding the distribution of specialized consumer products such as Singer's sewing machine and Ford's automobile. Even today the technology of the sewing machine and automobile are complex, and these relatively expensive products pose problems in the areas of financing, training, and maintenance. Hence, the automobile dealership remains representative of the product franchise. The product franchise can also be found in areas such as soft drink bottling and major appliance retailing. In terms of absolute sales volume the product franchise remains the most important category, however in terms of relative sales volume and number of business establishments the product franchise is reported to be in decline (Trutko et al., 1993).

By comparison, the business format franchise arose out of the need for standardization. It owes its start to the increase in travel that accompanied the expansion of the railroads and later the interstate highway system. Travelers had no readily available means of evaluating the quality of such travelers' necessities as filling stations, diners, and lodging establishments. By the 1920s, oil companies had begun to respond to travelers' needs for a standard of service and quality. They were followed by A & W Root Beer in 1925, Howard Johnson's in 1935, and others; but the growth of the business format franchise is really a post second world war development, as typified by Ray Kroc's first McDonalds in 1955.

Unlike the product franchise, business format franchise tends to view the good or service as less important than the preparation and presentation of the good and service. For example, consumers are often presented with a choice of unfamiliar dining establishments that offer hamburgers of unknown quality. But, franchises are successful because many consumers prefer to choose a hamburger of known and consistent quality. So consumers are told that McDonalds always makes its Big Macs the same way, so that they taste the same in Seattle, Beijing, and Moscow, and the consumer is pleased because there is no surprise. The business format franchise accounts for all of the present growth in franchising (Trutko et al., 1993).

Franchising Defined

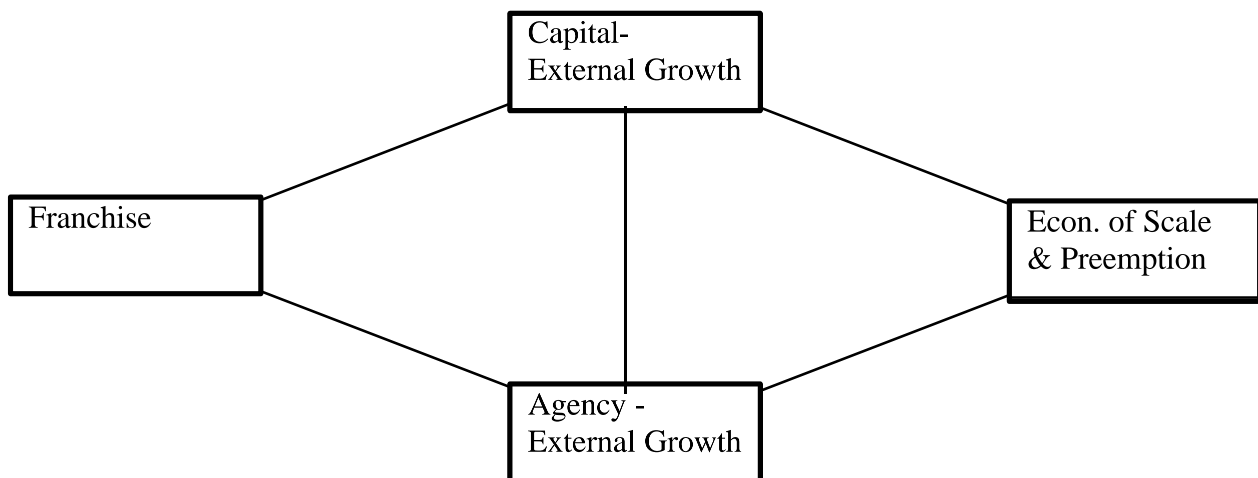
General Motors, American Express, and McDonalds are all companies that employ franchising in their day-to-day operations. This diversity among franchisers suggests that

franchising must be defined with broad brush strokes. Thus broadly defined, franchising may be considered a contractual arrangement in which a franchisee owns and operates a business employing the franchiser's brand name; wherein the franchisee commonly purchases various goods from the franchiser, often for resale. In turn, the franchiser receives fees and royalties for the use of his/her brand name and typically provides non-branded inputs such as operating systems and training. In addition, the contractual arrangement grants the franchiser the right to set and enforce uniform quality standards upon the franchisee (based on Milgrom & Roberts, 1992). The model developed in this paper may be applied to both the product and the business format forms of franchise; however, the principal focus of the paper is on the business format franchise.

External Growth Model

Firms may grow through the employment of both externally and internally generated resources. External growth is fueled through the control and acquisition of resources in the firm's environment, while internal growth is largely generated through the more efficient use of the firm's assets (Pfeffer & Salancik, 1978). There are four prevalent explanations for the existence and success of the franchise and all may be said to focus on external growth: 1) the ability to raise scarce capital as the result of capital market imperfections, 2) managerial motivation within the context of agency theory, 3) spatial preemption, a form of first mover advantage, and 4) economies of scale[1]. The literature has held some of these factors to be competing explanations. For example, Carney and Gedajlovic (1991) and Martin and Justis (1993) are among those who present resource scarcity and agency as alternative explanations of franchising. In contrast, Castrogiovanni, Bennett, and Combs (1995: 53) conclude "franchisers generally are concerned with both administrative efficiency and resource scarcity, though their concern over one relative to the other may vary somewhat with their particular circumstances." This broader perspective suggests that these four explanations are complementary and integral components in a model of the franchise's external competitive advantage as depicted in Figure 1.

Figure 1
External Growth of the Franchise



Financial Resources

Franchising may be the least expensive way for a franchiser to raise capital (Oxenfeldt & Kelly, 1968). Facing constraints on the ability to raise growth capital, the franchiser is able to turn to a non-traditional source of capital, the franchisee. Since the franchisee effectively pays the franchiser for the privilege of expanding the franchise, while the franchiser adds another unit without tying up capital, incurring debt or lease obligation, and diluting equity, there is no alternative arrangement that will result in a lower cost of capital (Caves & Murphy, 1976). This explanation, despite its face validity, relies on the assumption of capital market imperfections and is not without its critics (Norton, 1988a; Rubin, 1978). Empirical support for the capital acquisition argument is offered by Kauffman and Dant (1996) and Carney and Gedajlovic (1991). The probity of capital acquisition is more obvious in the context of agency and spatial preemption (Lafontaine, 1992).

Agency

Reliance on the franchisee for capital also results in the recruitment of an owner-manager whose motivation is aligned with that of the franchiser. Edith Penrose, in her classic *The Theory of the Growth of the Firm* (1958), points out that the growth of firms is limited by managerial talent. A firm can grow no faster than its ability to indoctrinate its managers into the firm's culture and routines. The problem is one of agency (Alchian & Demsetz, 1972; Jensen & Meckling, 1976). For hired management, a thorough indoctrination into the firm's culture reduces the manager's incentive to shirk and thus reduces the firm's monitoring costs. But indoctrination takes time and is a less than perfect substitute for ownership. A franchisee, as owner and manager, has his/her wealth invested in the success of the franchise and has no incentive to shirk; thus the franchiser has minimal monitoring costs. In addition, the alignment of the franchiser and franchisee's motivation means the time the franchiser must spend on indoctrination is reduced to training in the franchiser's systems and routines. In support of this argument, Norton (1988a) finds that franchising is significantly correlated with agency incentives; while Carney and Gedajlovic (1991) find that both agency considerations and capital acquisition contribute to the growth of franchises.

Spatial Preemption and Economies of Scale

The monitoring problem of agency is increased by the spatial dispersion of the firm's locations (Norton, 1988b). That is, as a firm's locations become geographically dispersed, the costs of monitoring managers and enforcing quality standards increase. The franchise, through the alignment of franchiser and franchisee interests, serves to reduce the travel and bureaucratic costs associated with monitoring the performance of dispersed locations. In support of this argument, both Brickley and Dark (1987) and Lafontaine (1992) found that franchise locations

close to headquarters were more likely to be company owned and managed than more distant locations.

The need for spatial preemption, and the accompanying rapid growth, is particularly important when the franchiser has an innovative retail concept (Carney & Gedajlovic, 1991). Locations are dispersed as the franchiser attempts to capitalize on his/her first mover advantage by preempting the most desirable locations and saturating the market for her/his type of business (Julian & Castrogiovanni, 1995; Lillis, Narayana, & Gilman, 1976). Thus, high growth and preemptive strategies are most important for young franchises and this assumption is supported by the findings of Martin and Justis (1993). Eaton and Lipsey (1979) offer a parallel conception with their argument that firms increase entry barriers through the process of market saturation and the concurrent attainment of economies of scale.

The desire to capitalize on a franchise's first mover advantage leads to rapid growth, the end result of which may be the attainment of economies of scale (Hoffman & Preble, 1991; Martin, 1988). Economies of scale have been attained when the average unit cost of a given activity or product can be shown to decrease as the quantity produced increases (Shepherd, 1990). Caves and Murphy (1976) stress the efficacy of the franchise as the ability to centrally coordinate the activities associated with scale while decentralizing the benefits associated with scale. Thus, the franchise is an organizational form that can realize economies of scale in any activity that may be centrally organized and Table 1 lists the areas in which researchers have noted economies of scale in the franchise.

Table 1
Franchise Activities Subject to Economies of Scale

Activity	Source
National Brand Names (Advertising)	Caves and Murphy, 1976;
	Mathewson and Winter, 1985
	Litz and Stewart, 1998
Distribution	McGuire, 1971;
	Stephenson and House, 1971
Information Systems	Oxenfeldt and Kelly, 1968
Risk Management	Martin, 1988
Training	Mendelsohn, 1985
Quantity Discounts	Pilling, 1991

Internal Growth Model

While it is the quest for economies of scale that drives external growth, it is the attainment of economies of scale that forms the basis for internal growth. The realization of economies of scale results in a relative competitive advantage for the franchise (Martin & Justis, 1993). These economies of scale arise when a firm is able to realize a savings in any one, or a combination, of two actions; the amortization of fixed costs and an increase in bargaining power.

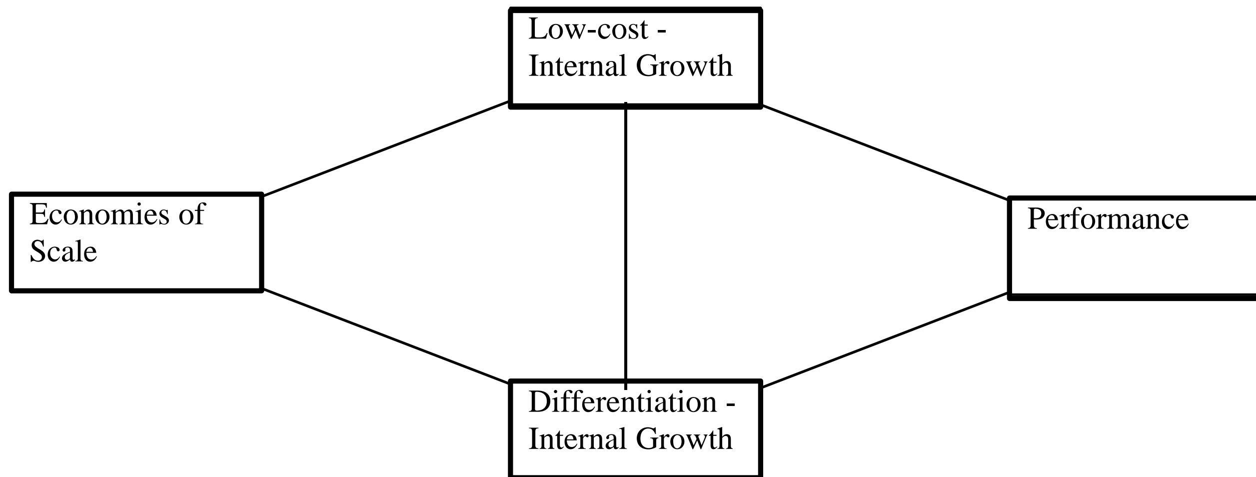
The ability to amortize fixed costs is a function of the degree of specialization in the franchise organization and often the number of locations in the franchise system. Like economies of scale, specialization is a function of size (Blau, 1970; Williamson, 1979) and thus specialization and scale appear to be highly correlated in the franchise. Table 1 represents not just franchise activities subject to scale but each activity is also most economically controlled through the franchiser's specialized staff. For example, information system software that tracks a customer's product preferences can only be created by specialized assets and that software can be best amortized across a large number of physical locations.

By comparison, the bargaining power that results from economies of scale is primarily a function of volume. The more the firm buys from a supplier, the greater a firm's ability to negotiate larger discounts. Thus, economies of scale derived from increased bargaining power are associated with reduced costs while scale economies derived form specialization may be associated with an increase in customer focus.

Differentiation and Low-Cost Based Advantages

Scale economies are potentially a source of competitive advantage. Porter (1985) popularized the concept of competitive advantage based upon either a cost-based advantage or a differentiation-based advantage. Hill (1988) made the argument for competitive advantage based upon both low-cost and differentiation. In his arguments for a simultaneous low-cost and differentiation based advantage, Hill states that economies of scale may be a source of both low-cost and differentiation-based advantages. To illustrate Hill's (1988) argument through a continuation of the previous example, consider that the software that tracks customer preferences increases customer satisfaction and loyalty, thereby differentiating the firm from its competitors. This increased differentiation results in a higher sales volume. An increase in volume allows the firm to bargain aggressively with its suppliers thus decreasing the firm's costs for inputs. The decrease in the cost of inputs contributes to a cost-based competitive advantage. If the power of this modest example is increased by several of the activities contained in Table 1, the franchise exhibits exceptional potential for internal growth through the attainment of a simultaneous cost- and differentiation-based advantage. Figure 2 illustrates the relationship between economies of scale and the internal growth of the franchise.

Figure 2
Internal Growth of the Franchise



The Full Model and Role of Quality

The purpose of external resource acquisition is the timely attainment of economies of scale. A consequence of scale economies is internal growth through low-cost and differentiation-based competitive advantage. Consequently, external and internal growth are linked through economies of scale as represented in Figure 3. In addition to combining Figures 1 and 2, Figure 3 incorporates a feedback loop representing the contractual aspects of the franchise agreement. The contractual arrangement between the franchiser and franchisee grants the franchiser the right to set and enforce uniform quality standards on the franchisee (Milgrom & Roberts 1992). The feedback loop represents this quality monitoring and the effect of quality standards on franchise performance. Not unlike economies of scale, quality may also be associated with the attainment of low-cost and differentiation-based advantages. The feedback loop includes the financial returns to the franchise that are essential to those franchise functions subject to quality, specialization and economies of scale.

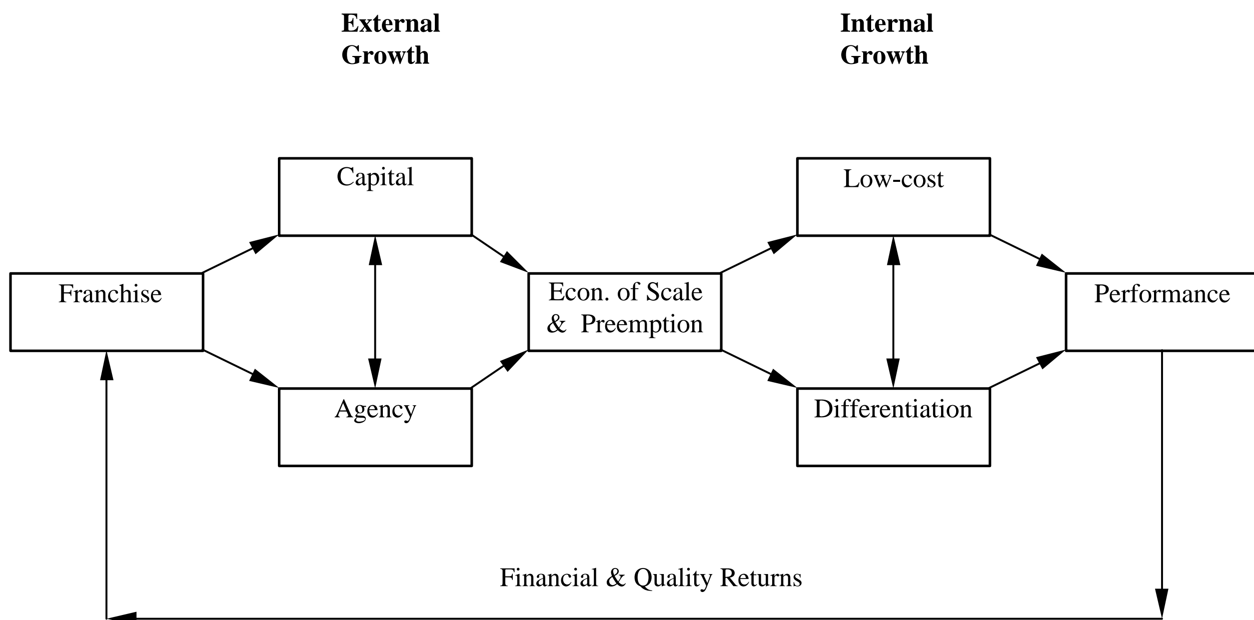
Quality is integral to franchising, but the concept of quality has many dimensions and is best defined within the context of the franchise (Gehani, 1993). The business format franchise arose from the customer's need to rely on an identifiable brand name for products and services of a predictable standard of quality regardless of the geographical location of those products and services (Dicke, 1992). This customer demand for a standard of quality is consistent with Reeves and Bednar's (1994) definition of quality as products or services conforming to a standard that meets or exceeds customer expectations. Thus, it may be argued that quality is an integral and essential component of the franchise operation. Quality is critical to the competitive advantage of the franchise because like most specialized activities it is subject to economies of

scale and like economies of scale, it can lead to both a differentiation and low-cost based competitive advantage.

Reed, Lemak, and Montgomery (1996), writing on the subject of quality, avoid the terms differentiation and low-cost because these terms are derivatives of the economic discipline. Instead, they argue that market advantage and process efficiency are the appropriate concepts for quality management. Semantics aside, differentiation and market advantage and low-cost and process efficiency are very similar, if not identical, concepts. Reed et al. (1996: 178) define market advantage as a condition that occurs “when customers’ needs are being better satisfied than they can be by rival firms’ offerings.” The result of this is “that a firm is generating (supernormal) profits by attracting and retaining these customers longer, and/or the firm is able to charge a premium price for products” (Reed et al., 1996: 178). Market advantage is therefore analogous to differentiation. Process efficiency, being based on the concept of continuous improvement, is seen as the main tool for ensuring compliance to a standard while improving efficiency. Consequently, process efficiency is only a part of the greater low-cost construct which includes other paths to reduced costs, including economies of scale and the resultant bargaining power over suppliers (Reed et al., 1996). Hence, pursuit of a quality standard in itself may result in a differentiation and low-cost based competitive advantage.

It is the central monitoring of the franchiser that ensures quality and performance are realized by the greater franchise organization. However, it is not enough to simply enforce a fixed standard of quality. Only if the franchiser uses feedback from the franchisee to constantly improve the quality of goods and services will a competitive advantage be sustained.

Figure 3
Competitive Advantage of the Franchise – The Full Model



CONCLUSION

That franchising follows accepted theories of strategic competitive advantage is anything but a coincidence. The franchise emerged in the U.S. before the Civil War due to the need to distribute and service complex consumer products invented by entrepreneurs like Singer and McCormick. Today's franchise is the result of more than 150 years of trial and error (Dicke, 1992). During its evolution, the franchise developed a dual approach to growth, employing both external and internal resources to achieve both a differentiation and cost-based competitive advantage. Customer demands also forced the franchise to focus on quality long before quality management techniques were popularized across the business landscape. This emphasis on growth and quality has allowed the businesswomen and men who employ the franchise form of business organization to consolidate many markets within the relatively fragmented retail sector of the economy. The result has been a form of business organization that currently dominates retailing in the U.S. economy.

Endnotes

[1] Risk reduction is sometimes cited as explanation for franchising. Inasmuch as both agency and capital market theories are based upon risk bearing assumptions, a separate consideration of risk would appear to be redundant (c.f. Combs & Castrogiovanni, 1994; Martin 1988).

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