Ekonomi, İşletme ve Maliye Araştırmaları Dergisi
Cilt 3, Sayı 3, 2021
s. 243-262

STRATEGIC AND CONTRACTUAL DYNAMICS IN FRANCHISE SYSTEMS: AN ANALYSIS ON SPANISH FOOD AND BEVERAGE INDUSTRY

Gönderim Tarihi: *23.09.2021*

Kabul Tarihi: *26.11.2021*

Araştırma Makalesi/ Research Article

Doi: https://doi.org/10.38009/ekimad.999517

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Abstract

This study aims to address strategic and contractual dynamics of franchising, in consideration of arguments of transaction cost theory and agency theory. By using pooled cross-sectional data on a sample of Spanish food and beverage franchise systems of year 2021, gathered from Guia de Franquicias manual, exploratory analyses on the effect of franchisors' age and total size on their proportion of franchised units are conducted as a first step. Furthermore, the effects of characteristics of a franchise system - its age, total size, origin country and proportion of franchised units, on its franchising contract's financial determinants – level of initial investment, entry fee, royalty rate and advertising rate, are hypothesized and analyzed. Proportion of franchised units' correlations with both age and total size characteristics are found to be inverse U-shaped. By applying multiple regression method, it is shown that none of franchising characteristics, age, total size, being foreign and its proportion of franchised units, play a significant role on level of royalty rates, but their effects on rates are significant, except total size. Moreover, it is proven that being a foreign franchisor also has a positive effect on the levels of initial investment and entry fee.

Keywords: *Franchising, Entrepreneurship, Firm Organization, Transaction Costs, Services Industry*

JEL Classification: *D23, L22, L25, L26, L83*

FRANCHISE SİSTEMLERİNDE STRATEJİ VE SÖZLEŞME DİNAMİKLERİ: İSPANYA GIDA VE İÇECEK SEKTÖRÜ ÜZERİNE BİR ANALİZ

Öz

Bu çalışma, işlem maliyeti teorisi ve vekalet teorisi argümanlarını dikkate alarak, franchising sisteminin stratejik ve sözleşme dinamiklerini ele almayı amaçlamaktadır. Guia de Franquicias yayınından yararlanılarak elde edilen 2021 yılı İspanyol yiyecek ve içecek franchise sistemlerinin verisetine ilişkin havuzlanmış kesit verileri kullanılmış; ilk olarak franchise veren şirketlerin yaşının ve sistem büyüklüğünün verilen franchise oranı üzerindeki etkisine ilişkin keşif analizi uygulanmıştır. Sonrasında, franchise sistemlerinin yaş, sistem büyüklüğü, menşe ülkesi ve franchise verilen birimlerin oranı gibi karakteristiklerinin bir franchising sözleşmesinin finansal etmenleri – ilk yatırım bedeli, franchise bedeli, ciro payı, reklam payı – üzerindeki etkileri analiz edilmiştir. Verilen franchise birimleri oranının hem yaş hem de sistem büyüklüğü karakteristikleriyle korelasyonunun ters-U şeklinde olduğu bulunmuştur. Son olarak, çoklu regresyon yöntemi uygulanmasıyla yaş, sistem büyüklüğü, menşe ülkesi ve franchise verilen birimlerin oranı karakteristiklerinin ciro payı üzerinde etkisi olmadığı, ancak sistem büyüklüğü hariç her birinin reklam payı üzerinde rol oynadığı gösterilmiştir. Ayrıca, yabancı franchisor firma olmanın ilk yatırım bedeli ve franchise bedeli üzerinde olumlu etkisi olduğu görülmüştür.

Keywords: *Franchising, Girişimcilik, Yönetim Organizasyon, İşlem Maliyeti, Hizmet Sektörü*

JEL Sınıflandırması: *D23, L22, L25, L26, L83*

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1. Introduction

The decision process of businesses about choosing between in-firm and market place for their organizational transactions, has been an important research question since Coase (1937). The majority of research on this subject has assumed that transactions should be managed either by contracting or by internal organization. Nevertheless, research on franchising, licensing and sharecropping observe that the entrepreneur uses both markets and internal hierarchy for similar transactions (Norton, 1988a).

The franchising system can be summarized as a company (franchisor) selling to another company (franchisee) the rights to market a good or service under its own brand and also the right to use its own business model. In terms of sales volume, franchising is very crucial in sectors such as restaurants (67% of sales takes place through franchising), food retail (55%), printing and copying (71%) and hospitality (39%). Moreover, franchising is seen as a key growth strategy especially in the USA and Europe; it is estimated that 780000 American franchise businesses created 9 million jobs and contributed approximately $541 billion, which is 3% of the GDP of the United States (International Trade Administration, 2016).

Two characteristics of franchising distinguish itself from other forms of organizations as strategic alliances and equity joint ventures. One of them is that this system finds its place in business models that involve service activity that needs to be carried out especially in close proximity to customers. In this context, spaces designed with the same concept offer the same service to their customers in different locations. Second, franchising contracts regulate responsibility, decision-making processes and profit sharing between a central principal (franchisor) and a decentralized agent (franchisee). The franchisor establishes and implements performance standards that applies to the entire franchise chain, manages the brand image, and administrates essential activities, such as purchasing (Caves and Murphy, 1976). The primary source of the franchisor's income consists of the royalty rate, which depends on the level of sales. Meanwhile, the franchisee establishes the sales location and manages daily activities such as working hours and personnel management. Franchisee’s profit is what is left over after paying royalties and other expenses.

This study takes the structural and strategic dynamics of franchising into spotlight, while taking transaction cost approach and agency theory into consideration, and tests the hypotheses on whether several franchise characteristics (age, size, origin country, proportion of franchised units) have effects on financial determinants of a franchise contract - initial investment level, entry fees, royalty rate and advertising rate. Benefiting from pooled cross-sectional data on a sample of Spanish food and beverage franchise systems of year 2021, exploratory analyses on franchising characteristics are conducted as a first step, then the relationship between contract determinants and franchise characteristics are empirically tested as a second step.

The remainder of this paper can be drawn up as follows: In the second section, a brief literature on the theoretical background of franchising is summarized. In the third section, the variables used in this research are defined, moreover some exploratory analyses are conducted. Methodology used to test the hypotheses and the results of the analysis are discussed in the fourth section. The final section represents conclusions and implications from the research.

2. Theoretical Background

Although the United States is considered to be the birthplace of franchising, this business system actually has a long history, stretching back even to ancient China (Seid and Thomas, 2010). Franchising has become a crucial expansion strategy for businesses. In particular, by offering lower monitoring costs to manage geographically dispersed units, the franchising system puts itself in an advantageous position among chain growth strategies (Norton, 1988b; Roh and Kwag, 1997; Dant et al., 2011). From the respective of global markets, franchising increases the value and income of the business, thanks to its capabilities for being able to bring local culture, tradition and values to the forefront (Contractor and Kundu, 1998; Aliouche and Schlentrich, 2009). For instance, Merrilees (2014) claims that franchising can be used as an entry tool into a new country, regardless of the company's original business format. In a similar manner, Ghantous et al. (2018) state that that capabilities are important in managing distant internal relationships and internationalization. During periods of economic growth, the ownership option gives a chance for a steady income, whereas the franchising option provides stable franchise income to the business, with items such as royalty rates and other fees, offered by long contracts of 15-20 years (Morrison and Macmillan, 2000; Andrew et al., 2007). Thus, a diversification strategy by using both ownership and franchising options most likely brings consistently high financial performance, and helps managers and financial executives to make more efficient strategic decisions on firm expansion and resource allocation.

Shane (2005) sums up the benefits of the franchising system in three points: (i) Franchising furnishes a more efficient mechanism for selecting motivated and qualified individuals with strong motivation to make higher profits, (ii) franchising provides an effective mechanism to access the financial and human resources that a business needs for rapid growth, and (iii) franchising provides a profitable business model by boosts returns on invested capital at a lower risk level, in relative terms. These three advantages enabled the franchising system to become a dominant business model for retail entrepreneurship in the United States and many other countries, especially in the services sector (Carney and Gedajlovic, 1991; Altinay, 2006). Nevertheless, there are some disadvantages of the franchising system, as well. Andrew et al. (2007) summarizes these disadvantages as follows: (i) loss of total operational control, (ii) decrease in operating income, (iii) possibility of conflicts with its franchisees, and (iv) decrease in the property value. The disadvantages in question fade, if the franchisor owns the property, rather than opting for franchising, which indicates that franchising and ownership compensate each other's admonition. For this reason, the franchisor needs to determine franchised and company-owned unit proportions in order to maximize its benefits; which leads to a strategy of diversification.

Understandably, franchising, which plays an important role in strategic decision-making processes, naturally attracts the attention of researchers from many different fields. From entrepreneurship perspective, franchising is an important option in terms of owning and running a business (Shane and Hoy, 1996). For marketing academicians, franchising is an essential distribution channel (Kaufmann and Rangan, 1990). From economics perspective, franchising system is a valuable field for studying contract structures (Lafontaine, 1992). From management and organization perspective, franchising is one of the most crucial forms of

organization to analyze (Combs and Ketchen, 1999). As a consequence, franchising is becoming a focus point for more research also because it contributes to different academic fields. For instance, Dnes (1996) and Lafontaine and Slade (1997), examine the economics literature on franchising and reveal the importance of agency theory for the franchising system. In another aspect, Elango and Fried (1997) deal with issues such as the place of the franchising systems in society, the reasons for businesses to take part in the franchising systems, and the management styles of the franchising systems. Combs and Ketchen (2003) apply meta-analysis on franchising related studies.

The hot research topic related to franchising is the ownership, that is, the organizational structure of the franchising systems. While the focus of early research has generally been on whether the franchising system or the ownership system should be preferred (Oxenfeldt and Kelly, 1968; Caves and Murphy, 1976; Rubin, 1978), later studies switched the focus on the integration of the two systems, and how these two options should be allocated within a franchising system (Bradach, 1997, Ehrmann et al. 2013, Meiseberg 2013, Perdreau et al. 2015). Consequently, transaction cost analysis and agency theory have become the most important tools for comparative analyses on the alignment of interests and auditing/monitoring costs (Brickley and Dark, 1987).

Both theories share similarities among various dimensions, such as assuming the existence of opportunism and self-interest is a common (Williamson, 1988; Eisenhardt, 1989). Focusing on these behavioral features, both approaches try to solve the puzzle of optimal incentive systems and governance mechanisms, in order to reach economic efficiency. The theories assume economic efficiency is reached when the transaction/agency cost is at the lowest level. Whenever the optimal proportions of franchised and company-owned units in a franchising system are analyzed by using these two theories, the assumptions are generally based on differences in geographical dispersion, total size, and potential revenue levels (Lafontaine, 1992). Thus, it may be interesting research setting that applies both approaches on the same set of observations, by looking from different angles.

2.1. Transaction Cost Approach

Transaction cost theory (Williamson, 1985) argues that planning, adaptation, and monitoring costs play an essential role in business management structure choice. According to the transaction cost theory, the choice of contract type, as a safeguarding mechanism, depends on the transaction specific investments and uncertainty (Jiang et. al, 2011). Two behavioral characteristics are the main pillars of the transaction cost view: (i) Bounded rationality – which can be summarized as the inability to be able to predict all possible future situations, and (ii) opportunism – that is the tendency to behave based on self-interest. Transaction cost approach assumes the investment in a transaction-specific asset as a hostage within interorganizational relationships. The effectiveness of interorganizational understandings depends on the appropriate usage of hostages to limit opportunism, rather than to encourage it.

As an approach that is particularly used to explain the differences in the franchising system, early research on transaction cost approach tried to measure the impact of investments on the franchised outlets' vertical integration (Klein, 1980; Williamson, 1985; Dnes, 1992; Dahlstrom

et al., 1995; Berkovitz, 1999). Because of the hostage effect of the investment on outlets, the risk of opportunism that the franchisor faces will be lower, and that will enable a lower level of vertical integration. According to transaction cost analysis, differences in asset specifications, frequency of transactions and uncertainty determine who owns the outlets in a franchising system.

Meanwhile, a higher brand value will lead to a pressure for higher degree of vertical integration (Minkler and Park, 1994). A research conducted by Lafontaine and Shaw (2005) shows that brand equity has a significant effect on the ratio of company-owned outlets to franchise outlets. The paper demonstrates that the proportion of company-owned outlets follows a stable line throughout the organizational life cycle. The reason of this stable rate is level of investment in brand equity. Higher brand equity leads to a greater control by the franchisor, because the franchisor wants to protect itself against the risk of being harmed by the franchisee's opportunism, making brand equity and level of control being positively correlated. The main point here is to take precautions against the risk of opportunism by creating contractual guarantees. Thus, transaction cost theory contributes to franchising paradigm as part of the structure of franchising contracts.

Most of the contract clauses in franchise agreements can be interpreted as ex-ante protection measures. Thanks to this approach, the contract cannot be seen as a discretionary use of authority by the franchisor. Instead, the contract is considered as a composite monitoring/auditing arrangement in which both parties give pledges to facilitate centralized control and avoid externality costs.

2.2. Agency Cost Theory

Agency theory, which is also a view on contract theory as transaction cost approach, is a framework that examines the optimal organizational agreement necessary to obtain maximum performance from agents, especially in situations where the principal is unable to measure the agent's performance accurately and the principal and agent have different level of risk tolerances (Eisenhardt, 1989). Because both principal and agent are self-interested and have different goals, the principal should use her/his own resources in a way that best protects the principal's interests (Jensen and Meckling, 1976).

To be more precise, principals' and agents' differences in goals, together with the situations of incomplete information and uncertainty, lead to a three acclaimed agency problems for the management of the organization. The first problem is defined as moral hazard, which can be explained by the difficulty level a principal faces, in order to ensure that the agents put their maximum effort. The other problem is known as adverse selection that makes measuring agents' quality level problematic for the principal (Levinthal, 1988). And the last one is hold-up problem that occurs when at least one party acts opportunistically, in order to renegotiate the contract over a relationship based investment (Williamson, 1985).

Amid service and retail sectors, where franchising is occasionally preferred business model, the franchisor acts as a principal and transfers the authority to the representatives, the managers of the franchised outlets. With the franchising business model, principals' need to monitor outlet managers' work levels decreases, because franchisees have to make substantial investments to

their franchised units (Rubin, 1978; Norton, 1988a). Expected profit levels from these investments depend on franchisees' motivation levels and efforts (Klein, 1995). Hence, agency theory perspective assumes that the strategy for choosing between corporate ownership and franchising depends on the characteristics of the franchising company (Brickley and Dark, 1987; Norton 1988a; Brickley et al., 1991; Lafontaine, 1992; Dahlstrom and Nygaard, 1994; Shane, 1998; Alon, 2001).

According to research based on the agency theory, market-based systems, such as franchising, are more efficient than mechanisms relying on hierarchical governance, in situations when sub-optimal performance and adverse selection may occur (Jensen and Meckling, 1976; Rubin, 1978; Brickley and Dark, 1987; Eisenhardt, 1989). In contrast, initiatives based on internal hierarchy are more effective in managing hold-up and free-riding problems (Klein et al., 1978; Brickley and Dark, 1987; Brickley et al., 1991). Buchan (2014) underlines that although monitoring is an effective approach to manage and control the costs of the agency problem, incentive alignment, which is based on a franchise business format, may be even more crucial in order to make the franchising business model to perform better. Agency theorists explain this dilemma as follows: When monitoring costs are lower, company-owned outlets are much more preferable than franchised outlets. These conditions are generally valid when the outlets are geographically close to each other. But if monitoring costs increase due to higher level of opportunism and uncertainty, franchised outlets will be more preferable and efficient, as they will create stronger incentives for the outlet managers. Dogru (2017) defines the principal-agent relationship and agency issues in two dimensions: Vertical and horizontal. Vertical dimension is a typical principal-agent relationship, in which the franchisor depends on the franchisee's effort to maximize profits. Whereas a franchisee choose to follow the free riding path among other franchisees, in the horizontal dimension.

Many studies in the literature claim that controlling contract problems influence the effect of franchisor characteristics on the preference between company-ownership and franchising to be linear across franchising systems (Lafontaine and Kaufmann, 1994). Despite this argument, in the United States, proportion of franchised units differ among franchise systems, with an average of 80% of their units franchised, and owning only 20% (International Franchise Association, 2021). According to another view, the effect of these strategies may be curvilinear (Shane, 1998; Bai and Tao, 2001; Lafontaine and Shaw, 2005). In order to overcome the problems caused by the conflicting demands of the franchisor and franchisee parties, the franchisor balances the marginal cost and benefit by using the ownership/franchise ratio in the system (Norton, 1988a). This may cause the ratio in question to be curvilinear.

Moreover, franchising contract determinants may also be influenced by similar marginal cost and benefits of the system, depending on the level of monitoring costs to the franchisor. As a result, different characteristics of a franchising system may have a different influence level on the proportion of franchised and company-owned outlets, and on the financial determinants of a franchising contract. Xie et al. (2016) study the issue of how different contracts affect the decisions and profitability of a franchising system, and its members with three different types of contracts involving the franchise fee, they come up with a conclusion that the franchise fee with centralized service requirement contract can maximize the channel profit. Choi et al.

(2019) analyze the franchising contracts with the involvement of the profit-sharing royalty and derive the optimal contract types.

By taking the arguments of transaction cost approach and agency theory into account, this study aims to test these arguments, by using the data from Spanish food and beverage franchising industry. Although the two paradigms have several similarities as noted above, transaction cost theory focuses on the transactions between agents, making the size and experience crucial, whereas agency theory puts a significant role on the limitation of possible divergence of interests between principal and agents. Hence, by applying both angles of contract theory, the effects of characteristics of a franchise system - its age, total size, origin country and proportion of franchised units, on its franchising contract's financial determinants – level of initial investment, entry fee, royalty rate and advertising rate, are hypothesized and analyzed.

3. Data and Descriptive Statistics

3.1. Data

Data is gathered from "Guia de Franquicias y Oportunidades de Negocio" publication of Emprendedores. The guide is an annual publication that provides information on the number of company-owned and franchised outlets, the industry of the franchise systems, company age, the minimum investment level necessary to open an outlet, franchise fee, royalty rate, advertising rate, country founded, etc. The publisher, Emprendedores, is a leading Spanish economic magazine, especially focusing on new business ideas and opportunities, notifying entrepreneurs and other market actors with latest developments.

This study focuses on franchises in Spanish food & beverage industry. Franchising is a very commonly used business model applied in food & beverage industry for a long time, thus this industry is chosen as the focus of this study, in order to keep it industry-specific, and to prevent potential inter-industry variability.

The publication consists 206 food and beverage franchises based in Spain. Seven businesses have yet to establish a franchised unit, thus these businesses are taken out of the dataset. As a result, the dataset is consisted of 199 observations.

3.2.Variables

The variables used in this study can be listed as below:

Age: Number of years between the year franchising company has been established and the publication year of the guide

TotalSize: Total number of outlets in the franchising company's system

FranchisedUnits: The total number of outlets franchised by the company

CompanyUnits: The total number of outlets that belong to the company itself

Franchise: Fraction between the number of franchised outlets and the size of the franchise system as a percentage

Foreign: Dummy variable measuring the origin country of the franchising company. It takes the value of "0" if the origin country is Spain, and "1" if the company is from outside Spain.

InitialInvestment: The amount of investment necessary for the franchisee to open an outlet. It is measured in euros.

EntryFee: The amount of fee that the franchisee must pay to the franchisor to enter the franchise system, in order to be a franchisee. It is measured in euros.

RoyaltyRate: The fixed percentage of gross sales, that franchisees must pay to the franchisors for being a part of the franchising system

AdvertisingRate: The fixed percentage of gross sales, that franchisees must pay to franchisors for advertising expenses

3.3. Descriptive Statistics

Table 1 and 2 demonstrate detailed descriptive statistics for the main variables of interest for the overall sample of 199 observations. Prior to a detailed analysis of cumulative statistics, a brief summary of individual statistics should be discussed: In terms of total number of outlets, Telepizza reaches the highest number by 644, McDonald's follow Telepizza with 542 units. However, the brand that has the highest number of franchised units is different, it is 100 Montaditos. 100 Montaditos franchises 100% of its units, while Telepizza franchises 71% of its units, and Mcdonald's franchises 85%. Majority of the brands with high number of units prefer franchising model more than owning the units. Therefore, one can suggest that in order to have a high number of outlets, thus a high market power, the strategy chosen is franchising a higher number of units.

We can observe that majority of the companies in our dataset is Spanish (86.5% - 172 brands), and just 13.5% are foreign, with 27 brands. Nonetheless, foreign brands prefer franchising 74% on average, whereas local brands choose 64% of their units to be franchised. As a result, we can claim that there are other relevant factors, other than geographical dispersion factor solely, to be taken into account during the process of choosing the type of business organization. In fact, Combs and Castrogiovanni (1994) argue that larger companies have higher number of franchised units because those companies utilize franchising more in the beginning, and this leads to greater growth. Our data supports this claim, because foreign companies have an average size of 88, meanwhile local companies have 38 units on average. This fact also contradicts with resource-scarcity view, which claims that as franchise systems mature and accumulate more resources, their need for franchising will inevitably decrease. The average proportion of franchised units is 65.9%. Apart from Combs and Castrogiovanni's (1994) argument, the reason of this high level of franchising may be because companies' preference of having a certain level of company-owned outlets, and franchising beyond this level.

In total, the average size of the companies in our dataset is 45 units, ranging from 2 to 644 units. Moreover, the average number of units owned by the franchisor company is only around 12, ranging from 0 to 196. These statistics show us there is a a great diversity in the food and beverage franchises in Spain, and there is a high tendency towards franchising among the companies.

Another interesting fact is that although average age of Spanish franchising companies are around 12 years, there are Spanish companies that are established in 1960s and 1970s. This shows us that although there are many new companies who have just started franchising, this type of business model is already a well-known concept in Spanish market. Average age of foreign franchising companies are around 21, higher than the local companies, though. This may be explained by foreign companies, such as McDonald's, Pizza Hut, Dunkin' Donuts, KFC, enter different markets after gaining significant experience at home market, supporting the argument claimed by Windsperger (2014).

There are big differences between foreign and local franchising companies in terms of financial conditions. Initial investment ranges from 0 to one million euros, with an average 171000 euros (Average of foreign franchising initial investment is 300000 euros, whereas it is around 150700 euros for local franchising companies). Entry fee's range is from 0 to 80000 euros, and its average is around 20000 euros. There is a gap between foreign and local franchises in terms of entry fee, as initial investment. Average entry fee of a foreign franchise is around 30600 euros, and average entry fee of a local franchise is around 18200 euros. Royalty rate differs from 0% to 8% (3.9% on average), and advertising rate from 0% to 6% (1.5% on average). Although average royalty rate of foreign and local companies do not differ much, 4.2% for foreign companies and 3.9% for local companies, advertising rate of foreign franchises (3.2%) is much higher than local ones (1.3%). This difference can be explained by foreign franchises' big budgets on their branding strategies.

Table 1: Summary Statistics

	N	Minimum	Maximum	Sum	Mean	Std. Deviation
CompanyUnits	199	0	196	2352	11.82	27.386
FranchisedUnits	199	1	470	6572	33.03	70.598
TotalSize	199	2	644	8924	44.84	83.320
Franchise	199	.052	1.000	131.234	.65947	.265972
Age	199	1	59	2420	12.16	11.330
InitialInvestment	199	0	1000000	34029660	171003.32	156374.973
EntryFee	199	0	80000	3957004	19884.44	13861.411
RoyaltyRate	199	0.0	8.0	783.0	3.935	1.7917
AdvertisingRate	199	0.0	6.0	306.5	1.540	1.5918

Table 2: Summary Statistics by Franchisor's Origin Country

Foreign		Company Units	Franchised Units	Total Size	Franchise	Initial Investment	Entry Fee	Royalty Rate	Advertising Rate	Age
0	Minimum	0	1	2	.063	0	0	0.0	0.0	1
	Maximum	196	470	644	1.000	750000	80000	8.0	6.0	49
	Sum	1850	4698	6548	111.271	25919660	3130004	669.5	220.5	1858
	Mean	10.76	27.31	38.07	.64692	150695.70	18197.70	3.892	1.282	10.80
	N	172	172	172	172	172	172	172	172	172
1	Minimum	0	3	5	.052	40000	0	0.0	0.0	3
	Maximum	145	461	542	1.000	1000000	80000	8.0	6.0	59
	Sum	502	1874	2376	19.963	8110000	827000	113.5	86.0	562
	Mean	18.59	69.41	88.00	.73938	300370.37	30629.63	4.204	3.185	20.81
	N	27	27	27	27	27	27	27	27	27
Total	Minimum	0	1	2	.052	0	0	0.0	0.0	1
	Maximum	196	470	644	1.000	1000000	80000	8.0	6.0	59
	Sum	2352	6572	8924	131.234	34029660	3957004	783.0	306.5	2420
	Mean	11.82	33.03	44.84	.65947	171003.32	19884.44	3.935	1.540	12.16
	N	199	199	199	199	199	199	199	199	199

4. Empirical Analysis

4.1. Correlations

Next step is checking correlations between the proportion of franchised units of a company and its age, and also the company's total number of units. I believe that these correlations are important, because age and size are important determinants on experience, reputation and cost structures. As a support to my claim, a number of researchers have investigated the relationship between the rate of franchised units and franchisor's level of establishment (Gallini and Lutz, 1992; Lafontaine 1992; Scott 1995). For instance, Gallini and Lutz (1992) show that more established companies have a lower company-owned share. Moreover, they argue that a big franchise system means high experience in controlling the franchisees against free riding. The authors explain these results as an evidence supporting the influences of signaling and reputation, supporting the claims above.

However, contradicting to the literature, both the relationships between the proportion of franchised units and its age, and the proportion of franchised units and its total size can be defined by an inverse U-shape, as shown in Figure 1 and Figure 2. Although this correlation is not strong between level of franchised units and company total size, the non-linear relationship between the proportion of franchised units and age is significant even in an Ordinary Least Squares (OLS) regression (β of Age is 0.926 and β of Age^2 is -0.819). This can be explained by the fact that as companies become more established and access scarce resources easier, such as capital (Caves and Murphy, 1976), human resources (Norton, 1988a), or information in local level (Lafontaine, 1995; Prendergast, 2002), franchisors manage to reduce their dependence on franchising, and begin to increase share of company-owned units over time.

Figure 1: Company Age vs. Franchise % Correlation Graph

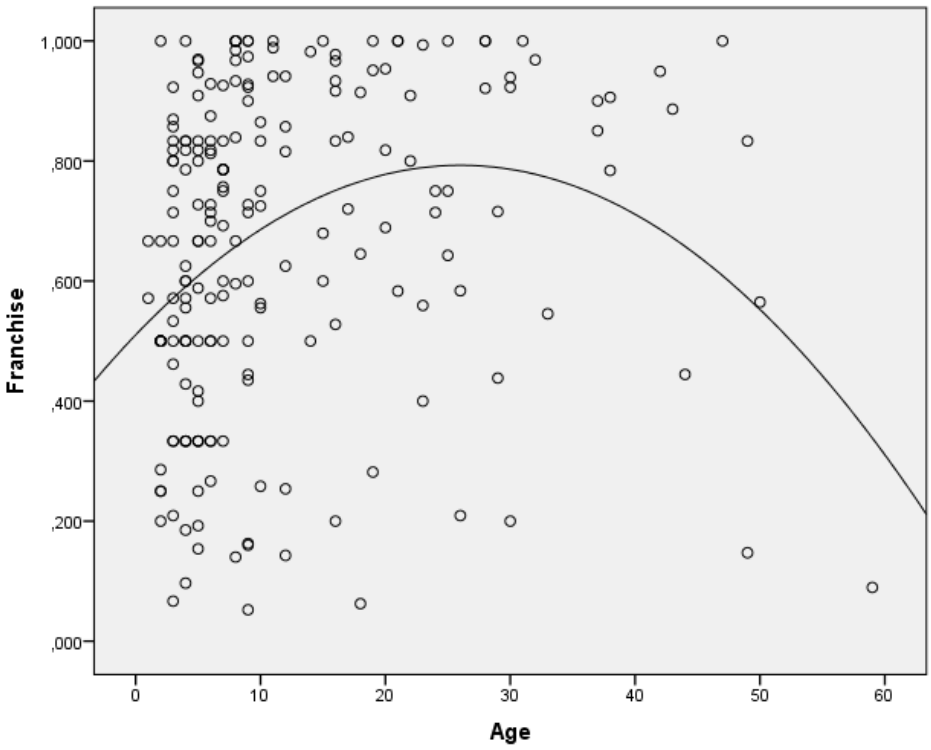
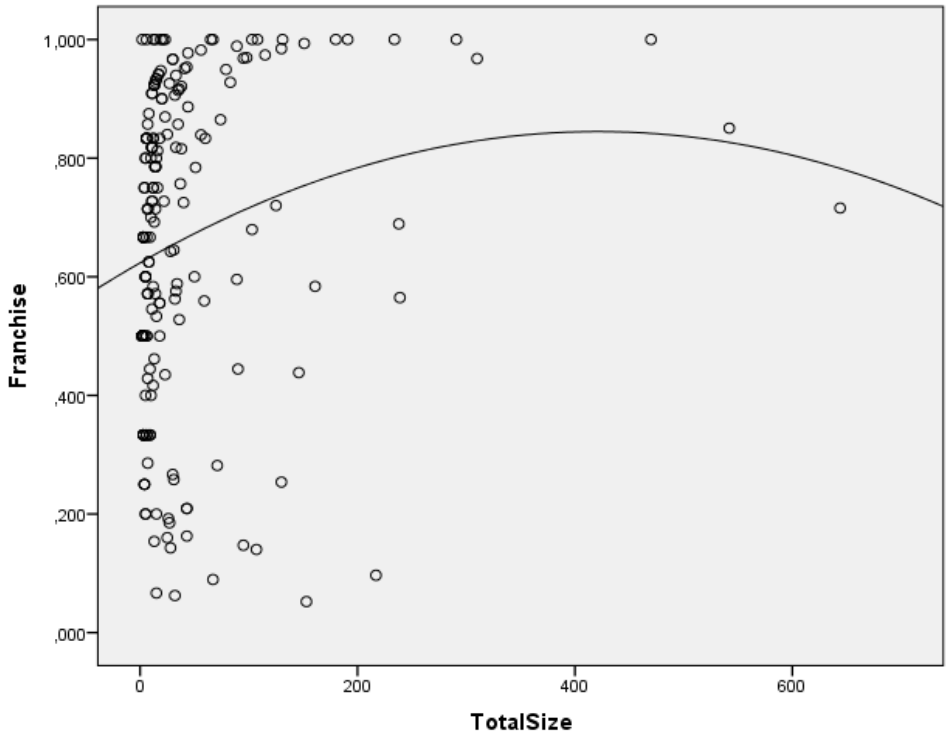


Figure 2: Company Size vs. Franchise % Correlation Graph



Similar correlations are reached even when the distinction of origin country is made (Figure 3 and 4). The only significant difference is that foreign franchising companies keep increasing its

proportion of franchised units as its total number of units increase (Figure 4). Because international brands' intangible assets are well known, they may not need signaling as much as local brands, reducing the necessity for the company-owned outlets (Lafontaine, 1992; Combs et al., 2004).

Figure 3: Company Age vs. Franchise % Correlation Graph (by Origin Country)

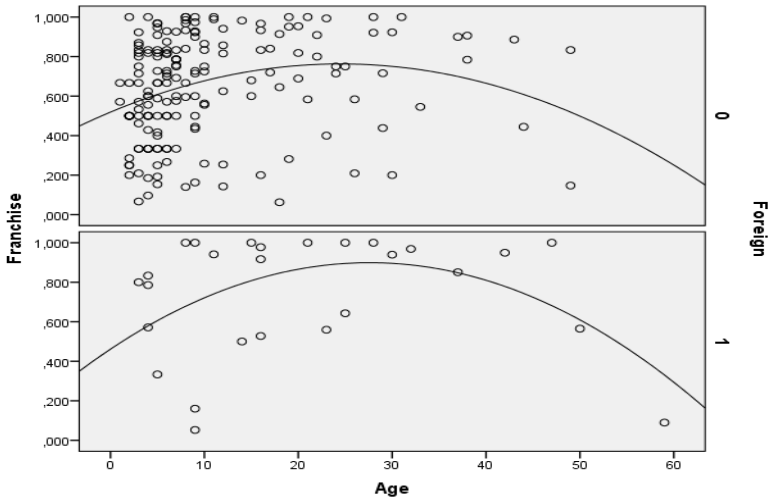
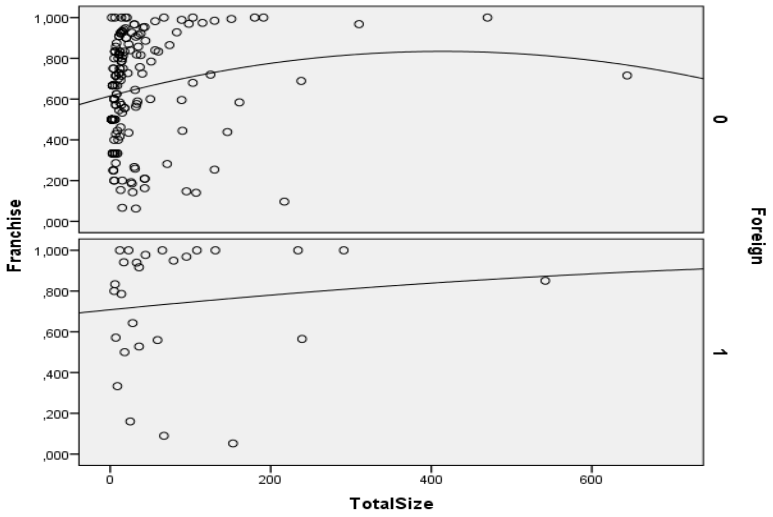


Figure 4: Company Size vs. Franchise % Correlation Graph (by Origin Country)



4.2. Hypothesis Development and Testing

As discussed above, under the assumption of existence of positive transaction costs, pay for performance contracts are often dominated by promotion based compensation contracts. Thus, franchise contract determinants as initial investment expense, entry fee, royalty rate and advertising rate are crucial variables that both the franchisor and the franchisee seriously analyze when deciding to go into business. These determinants are important for the franchisors, because entry fee and royalty rate provide financial growth, meanwhile initial investment expense and advertising rate provide greater protection against free riding, a higher

value of the brand name and a greater advertising power. On the other hand, for franchisees, these factors determine the profit levels.

Having said that, understanding the relationship between each of these financial determinants of a franchise contract and franchising companies' characteristics is crucial, considering franchising business model is based on principal-agent models, which aim optimal sharing of profits, and the terms of the franchise contracts vary across franchising models.

As a result, average characteristics of a franchising company, age, total size, being foreign, and proportion of franchised units, may play an important role in determining the level of initial investment expense, entry fee, royalty rate and advertising rate in a franchise contract. In order to test these claims, I put forward following hypotheses:

Hypothesis 1: A franchising contract determinant, *initial investment expense level*, is positively affected by franchising company's age, total size, being foreign, and proportion of franchised units

Hypothesis 2: A franchising contract determinant, *entry fee level*, is positively affected by franchising company's age, total size, being foreign, and proportion of franchised units

Hypothesis 3: A franchising contract determinant, *royalty rate level*, is positively affected by franchising company's age, total size, being foreign, and proportion of franchised units

Hypothesis 4: A franchising contract determinant, *advertising rate level*, is positively affected by franchising company's age, total size, being foreign, and proportion of franchised units

The analysis of this study is conducted by applying Ordinary Least Squares (OLS) regression, using SPSS 21 statistical analysis package. Using OLS multiple regression is appropriate, considering the cross-sectional nature of the data.

In order to check whether there is a possible multicollinearity between independent variables, variance inflation factor (VIF) analysis has been applied. A rule of thumb assumes that if VIF value is higher than 10, then the multicollinearity is high. We can see on the table that none of the independent variables has a value higher than 2, thus we can assume that no multicollinearity problem exists.

Table 3: VIF Table of Independent Variables

Variable	VIF	1/VIF
Age	1.23	0.815921
TotalSize	1.17	0.857272
Foreign	1.12	0.892688
Franchise	1.04	0.960743
Mean VIF	**1.14**	

Estimation results of hypothesis 1 are as expected for age and being foreign, but not for total size and proportion of franchise units. Higher age and being a foreign company both have a significantly positive effect on the level of required initial investment in a franchise contract.

However, a franchising company with a bigger size has no significant effect on the initial investment level. Moreover, a higher proportion of franchised units has a significantly negative effect on the level of initial investment. This may be related to the franchising policy of the company: As the company aims to increase the proportion of franchised units, it may prefer to decrease the level of required initial investment, so that the company may attract higher number of entrepreneurs to join its franchising system. (R^2=0.439)

Table 4: Estimation Results of Hypothesis 1

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	183720,207	27196,593		6,755	,000
	Age	4018,300	960,038	,291	4,186	,000
	TotalSize	165,081	127,359	,088	1,296	,196
	Foreign	113020,588	30290,327	,248	3,731	,000
	Franchise	-127860,447	37687,827	-,217	-3,393	,001

a. Dependent Variable: InitialInvestment

Second hypothesis, focusing on company characteristic factors affecting level of entry fees, is also not completely rejected. Both total size and being foreign factors play a significantly positive effect on the level of entry fees. We can explain this outcome by claiming that bigger and foreign franchisor companies, which are generally more established players in the market, expect a premium, thanks to their market strength, thus demand higher entry fees compared to other franchisor companies (R^2=0.426)

Table 5: Estimation Results of Hypothesis 2

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	15980,846	2560,998		6,240	,000
	Age	122,371	90,403	,100	1,354	,177
	TotalSize	25,817	11,993	,155	2,153	,033
	Foreign	9930,217	2852,322	,246	3,481	,001
	Franchise	-135,836	3548,916	-,003	-,038	,970

a. Dependent Variable: EntryFee

Third hypothesis about the effect of company characteristics on level of royalty rates is also rejected. The estimation output on Table 5 and r-squared value shows us that all franchising

company characteristics' effects on the level of royalty rates are insignificant. This situation is similar to what we faced in hypothesis 2: Like the entry fee level, royalty rates is a crucial income item for all type of franchisor companies, therefore franchisors' characteristics shouldn't be expected to play an important role in determining the royalty rate level. (R^2=0.102)

Table 6: Estimation Results of Hypothesis 3

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	4,214	,351		12,023	,000
	Age	,021	,012	,133	1,697	,091
	TotalSize	-7,386E-005	,002	-,003	-,045	,964
	Foreign	,183	,390	,035	,468	,640
	Franchise	-,844	,486	-,125	-1,737	,084

a. Dependent Variable: RoyaltyRate

The estimation outcome of hypothesis 4, regarding level of advertising rates, cannot be completely rejected. The statistical outcomes are as expected, except total size, hence we can claim that all franchisor company characteristics, age, being foreign and the proportion of franchised units, play a positively significant role on the level of royalty rates. Advertising rate level acts like a premium for the franchisor company, as long as its brand value is higher than the market average. In order to keep this level high, the franchisor company should keep its advertising expenses high, resulting with higher level of advertising rate demanded from its franchisees. (R^2=0.391)

Table 7: Estimation Results of Hypothesis 4

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	,195	,264		,739	,461
	Age	,037	,009	,267	4,015	,000
	TotalSize	,002	,001	,119	1,833	,068
	Foreign	1,330	,294	,287	4,519	,000
	Franchise	,921	,366	,154	2,515	,013

a. Dependent Variable: AdvertisingRate

5. Discussion and Conclusion

Franchising became an established organizational form, especially among services industry, in the latest decades. This business model appears to keep on as a permanent feature of modern economies. As a result, it has become an important research topic for researchers from diverse fields of inquiry. In a similar fashion, transaction cost and agency theories have turned into tools to explain the dynamics of franchising: Because franchising leads the company to a dual labor compensation system, the company benefits from hierarchical promotion-based employment system to maximize its profits from company owned units, and uses franchise contracts to reduce the incentive misalignment costs in the remaining units at the same time. The purpose of this research is to offer a better understanding of the dynamics of franchising, factors related to the proportion of franchised units choice, and company characteristics influencing financial determinants of a franchise contract.

By using Spanish food and beverage industry data from Guia de Franquicias y Oportunidades de Negocio review, the analysis shows that Spanish food and beverage franchising companies, which are 12 years old and contain 44 units on average, prefer the proportion of their franchised units (around 66%) to be higher than company-owned units, although they can be considered as young companies, considering their average age. Foreign based companies, thanks to their international franchising experience, have even a higher proportion of franchised units (around 74%), and on average they are older and bigger than the local franchising companies. Foreign franchising companies also demand higher initial investments, entry fees, royalty rates and advertising rates compared to the local franchising companies, because foreign companies enjoy higher brand value and market power.

An interesting outcome has emerged, while analyzing the proportion of franchised units' correlations with two company characteristics, age and total size. Both graphs showing the relationship between the proportion of franchised units, age and total size are inverse U-shaped. To be more precise, the proportion of franchised units increases until a moderate point in terms of age and total size, and starts decreasing after reaching that climax point.

Final analysis is applied to the effects of company characteristics, age, total size, being foreign and its proportion of franchised units, on a franchise contract's financial determinants, which are initial investment level, entry fees, royalty rates and advertising rates. It is shown that none of these characteristics play a significant role on level of royalty rates, but their effects on advertising rates are positively significant, except total size. Moreover, age and being a foreign franchisor play significantly positive roles on level of initial investments. Also, being a foreign company and age factors affect level of entry fees significantly, and in a positive way.

Relatively not a large sample size and focusing on one industry of one country can be counted as the main limitations of this study. Extending the dataset to an inter-industry level, or perhaps to an international level may give us a better insight about the dynamics of franchising. Also, a comparison with only company-owned systems, or analyzing the expansion of franchise systems in a given timeline may be the focal points of possible future studies.

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