05_Shane_ch03.qxd 11/2/04 4:36 PM Page 43

3

The Disadvantages of Franchising

There is no such thing as a free lunch—not even at a franchised restaurant or fast food operation. The advantages of franchising described in the last chapter come at a cost. By comparing the costs of franchising described in this chapter with the benefits of franchising described in the last chapter, you can better decide whether franchising is worthwhile for your business. This will also help you figure out how to compete with other firms that use franchising.

Franchising creates four types of disadvantages for companies. Because franchising is based on written contracts between independent companies, it suffers from goal conflict between franchisors and franchisees that sometimes spills over into legal disputes. Franchising also creates several transaction cost problems, most notably free riding (discussed later in this chapter), that do not exist within company-owned chains. Franchising makes certain types of innovation and change difficult to execute because of the lack of control that franchisors have over the actions of their franchisees. Finally, under certain conditions, franchising might generate lower financial returns than company ownership of outlets.

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 44

Goal Conflict Between Franchisors and Franchisees

Franchising suffers from an inherent goal conflict between franchisors and franchisees. Because franchisors make money from royalties on gross sales, they seek to maximize the level of sales generated across all of their franchised outlets. In contrast, franchisees are compensated from profits on the outlets that they own and thus seek to maximize the level of profits at their outlets. Strategies that maximize system-wide sales and strategies that maximize profits at individual outlets are not the same, leading franchisors and franchisees to want to adopt different strategies.

Maximizing Sales versus Maximizing Profits

One effect of the franchisor's desire to maximize sales and the franchisee's desire to maximize profit is a conflict over whether to adopt high-volume, low-margin business strategies. In general, maximizing sales tends to occur at lower prices and at higher quantities than maximizing profits. Thus, franchisees tend to prefer strategies that involve selling a lower quantity at a higher price than their franchisors would like.[1]

This conflict manifests itself in disagreements between franchisors and franchisees over the product mix for the business. Take, for example, auto-repair franchises. Brake work might be a high-margin item, but it occurs at relatively low volume because of the relatively small number of customers that need their brakes repaired. In contrast, an oil change might be a much higher-volume item because of the need to change engine oil frequently. However, this activity might have a very narrow profit margin for the company providing the service. Franchisors in the auto-repair business would prefer to have their franchisees emphasize oil changes, while the franchisees would try hard to spend most of their time repairing brakes.

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 45

A related conflict occurs when franchisors try to encourage sales at outlets in their chains. A common way to increase sales is by offering customers a coupon to generate interest in the system's products. Franchisors almost always see the provision of coupons as a good idea because it increases sales and, hence, franchisor royalties. However, the use of coupons often increases costs along with sales because the company must provide the additional free or discounted items. The increase in sales and costs that comes from the use of coupons frequently means that the higher level of sales occurs at a lower profit per unit, leading the franchisee's profit to suffer. As a result, franchisees frequently oppose the use of coupons to increase sales that franchisors try to get them to adopt.

Conflict over Outlet Concentration

Franchisors and franchisees often disagree over the right level of outlet concentration in an area. Franchisors want to establish more outlets of a chain in a given geographic area than franchisees would like to see. Because it is often difficult to increase sales without adding additional units—think coffee shops here—chain operators might want to add an additional unit that would increase overall sales, even if the increased sales comes at the expense of profits generated at existing units. Because franchisors make their money from royalties on gross sales and bear relatively few costs from adding outlets, they tend to want to add outlets up to the point at which the maximum number of customers is served. The franchisor might even want to add outlets that are unprofitable if they add to the reputation of the system and enhance overall sales. This means that the franchisor would like to add outlets as long as the additional royalties from sales are greater than the costs of supervising the franchisees.

Franchisees do not want as many outlets in the system as franchisors would have. Franchisees are compensated from profits net of royalties and other costs. Therefore, they try to maximize outlet-level profits. Franchisees do not want to establish additional outlets if the

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 46

new units will cannibalize some of their sales and, therefore, adversely affect their profits. As Figure 3.1 shows, the difference in franchisor and franchisee compensation generates a fundamental conflict between franchisors and franchisees over the desired number of outlets in a given market. As the figure demonstrates, the number of outlets in the market increases the revenues of the system, but at a declining marginal rate; whereas the costs of additional outlets increase at a constant rate. Franchisees want to have the number of outlets that corresponds to the maximum gap between revenues and costs, while the franchisors want the number of outlets with the highest level of revenue.

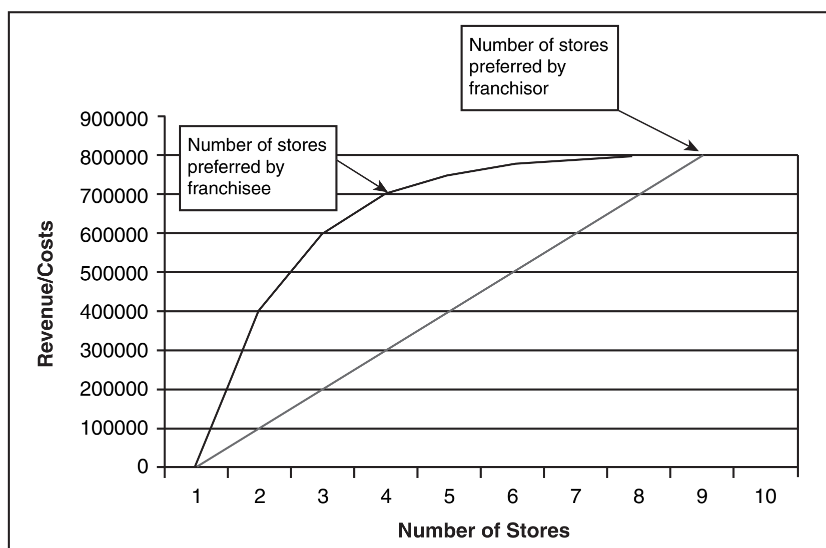

FIGURE 3.1 Franchisor and Franchisee Desired Levels of Outlet Concentration

The conflict between franchisors and franchisees over the concentration of outlets in a particular geographic market is often a major source of legal disputes between franchisors and franchisees, with many franchisees suing their franchisors over the establishment of new locations near their existing outlets. To reassure franchisees that they will not add outlets in a given geographic area,

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 47

franchisors often grant franchisees exclusive territories, which are the subject of a more detailed discussion in Chapter 7, "Territorial Strategies."

Litigation between franchisors and franchisees and the adoption of policies to minimize the threat of litigation do not occur only when franchisors add new outlets. They also come from any effort by franchisors to deliver its product to end customers. For example, Pepsi® ended up in several disputes with its franchisees when it decided to offer its fast food products through supermarkets and other delivery mechanisms that competed with its outlets.

Regulators have also gotten involved in the issue of managing the problem of outlet concentration. As we will discuss in greater detail in Chapter 10, "The Legal and Institutional Environment for Franchising," some state governments, including Iowa's, have established laws to protect franchisees by precluding franchisors from establishing new outlets closer than 3 miles from any existing ones.

All of this makes litigation a much more prominent aspect of running a franchise system than is the case with a chain of company-owned outlets. In fact, conflict over outlet concentration and the level of litigation that surrounds it is one reason why some companies, such as Starbucks, are reluctant to franchise. When making the decision to franchise, you should consider the inevitable conflict that you will encounter with franchisees over outlet concentration if you choose to franchise.

Conflict over Collective Action

Franchising also has important disadvantages when a company wants to rely on collective action across outlets. Companies that own all of their own outlets do not care whether a particular outlet is advantaged or disadvantaged by a policy that the company adopts. Because the company will consolidate its financial statements across all outlets, its management is indifferent as to whether costs and revenues

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 48

are balanced across outlets or whether some revenues are generated in one outlet as a result of costs incurred in another.

This is not so with franchised outlets. No franchisee is willing to undertake actions that would benefit the rest of the franchised chain but would harm his or her business. Therefore, policies undertaken in franchise systems need to ensure that they match costs and revenues at the outlet level. Because franchisees are independent companies, with their own shareholders and own financial statements, costs cannot be incurred in one location to support revenues generated in another location.

Take, for example, a warranty system for a chain of franchised auto-repair shops. Any warranty work performed by franchisees must be made equal to the amount of warranty claims made against a franchisee, or the franchisor and franchisees will end up in conflict. Franchisees do not want to have to perform more free warranty work than they are responsible for because of claims made against them. Because the customers are likely to have repair work under a warranty done somewhere other than the original shop where the claim was generated, the franchisor needs to compensate the franchisees doing the repairs, or they will not want a system-wide warranty policy. In particular, new franchisees will likely rebel against a system-wide warranty policy unless they are compensated for repair work. New franchisees will be the most adversely affected by the failure to compensate for repairs done under warranty because they will often be performing repairs under warranty for claims made against other franchisees without anyone else yet having to perform repairs on their work.[2]

Obsolescing Bargain

A final area of conflict between franchisors and franchisees lies in the temporal nature of the contributions of the two parties to the franchise system. Over time, the value to franchisees of the services and assets provided by the franchisor tends to shrink. While franchisees

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 49

derive on-going value from the franchisor's effort to build the system brand name and from lower cost inputs that come from the exploitation of scale economies, much of the value that the franchisor provides to the franchisee dissipates over time. For instance, franchisees benefit from franchisor training and set-up assistance, but the value of these things declines after the franchisee has learned how to operate the outlet. The source of conflict lies in the fact that the royalty rate paid to the franchisor remains constant over time. Therefore, over time, franchisees begin to think that the royalties that they pay are too high, given the value that they derive from the system.

Stop! Don't Do It!

1. Don't franchise if you want a high density of outlets in a particular geographic area.
2. Don't franchise if your business depends heavily on collective action by operators of the different outlets.

Transaction Cost Problems

Because franchising involves the delivery of a product or service to end customers by a set of legally independent entities, it faces several transaction cost problems that are not present with chains of outlets owned by a single company. These include: free riding, hold-up, under-investment, and loss of intellectual property.

Free Riding

Franchisors develop a brand name and system for delivering a product or service to end customers; the delivery of the actual product or service is undertaken by legally independent entities—their franchisees. The fact that the franchisees are legally independent creates an important externality. Franchisees jointly use the brand name of the system. As a result, the cost of any one franchisee's actions to degrade the brand

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 50

name is not borne completely by the degrading franchisee. Rather, it is borne by the entire chain. In contrast, any benefits that come from degrading the brand name—say, not paying the cost of ensuring an adequate level of customer satisfaction—is captured by the underinvesting franchisee. This externality creates an incentive for franchisees to free ride off the efforts of other franchisees.

Take, for instance, the case of oil change franchisees that do not replace oil filters, but merely clean them. If customers go to a franchisee that doesn't change oil filters properly, they develop a perception that the chain is of low quality and might stop frequenting the franchise system. The cost of the decreased demand that results is borne by all of franchisees in the system, proportional to the number of customers that they serve. However, the money saved by not replacing oil filters is captured by the single franchisee that does not replace the filters.

The incentive to free-ride is a disadvantage of franchising because it raises the cost of franchising. To combat free riding, franchisors must write quality standards into contracts and conduct audits to ensure that franchisees meet those standards. They also need to limit franchisee discretion by carefully specifying what franchisees can and cannot do. Take, for example, restaurant chefs. If franchisees have scripted menus and have to buy defined supplies directly from the franchisor, monitoring their behavior is easier. Scripted menus and set supplies reduce the opportunity for the chefs to make choices about ingredients that allow the substitution of inferior quality ingredients that degrade the brand name.

However, controlling the behavior of your franchisees is not easy. You aren't going to be able to anticipate everything that they could do; this makes it hard to write a complete contract that covers all possible contingencies. And whatever you don't write into the contract won't be covered.

Moreover, as a franchisor, you are limited in your control over franchisees. As will be discussed in greater detail in later chapters, you are limited in what you can dictate to your franchisees. For

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 51

instance, you are not permitted to specify the prices at which products can be sold to end customers—you can only suggest prices.[3]

Franchisors often control franchisee free riding by designating suppliers. By dictating that franchisees use a certain source of supply, franchisors can minimize the potential for franchisee free riding by eliminating the option of substituting a lower-cost source of supply for the one recommended by the franchisor. If only some franchisees do this, the degradation of quality that results is borne by all outlets in the system, while the benefits of free riding are garnered by only those who substitute for cheaper supplies. Thus, those who substitute for lower-cost supplies gain at the expense of the rest of the system.

Unfortunately, antitrust laws hold that franchisors can dictate suppliers only when the supply is central to the product or brand of the company. For instance, KFC® can dictate to its franchisees who will be the supplier of the 11 herbs and spices in its chicken, but not who will be the supplier of plastic utensils. In addition to the fact that this arrangement increases the potential for franchisees to free-ride, there is another cost to franchisors. For supplies that are subject to volume discounts, such as the plastic utensils at KFC, there might be a significant cost savings in choosing one supplier. Therefore, centralized purchasing might have significant benefits to companies, which are lost if franchisors cannot dictate suppliers.[4]

The incentive to free-ride also leads franchisees to underinvest in advertising, compared to what the managers of a company-owned chain would invest on a per-outlet basis. Because advertising is an important mechanism to get customers into outlets, underinvesting in advertising leads to a lower level of sales in franchised chains than would be the case if free riding on advertising did not occur.

So why do franchisees underinvest in advertising? That question is best answered by looking at an example. Suppose you have opened a new subway sandwich franchise called Scott's Super Subs. As long as there is only one location in the media market, the franchisee of that location would have an incentive to advertise. The ads would

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 52

generate increased demand for the subs and, therefore, enhance the performance of the outlet.

However, what if there was more than one franchised outlet in the media market? Then each of the franchisees has an incentive to underinvest in advertising. Regardless of who paid for the ad, customers would be attracted to the outlets. And they would probably go to the outlet nearest to them. Each of the franchisees would have an incentive to free-ride and save on the cost of the ad. If the other franchisees in town paid for the ad, the franchisee that didn't pay for it would still get additional customers.

To combat this problem, you, as a franchisor, need to write contracts with all of your franchisees to ensure that they make minimum advertising payments to support the development of the brand. Not only are these contracts difficult to write, but they are also costly to enforce. You need to write down in the franchise contract the conditions that the franchisee has to meet to comply with the advertising requirements. Given the cost of lawyers, the amount of money that this takes is not trivial.

Moreover, you need to reserve the right to terminate the franchisees if they don't comply with the terms, to ensure that the contract has teeth. That, of course, makes your franchisees concerned that you will use the efforts to control franchisee behavior as a way to take advantage of them, causing you more expense to reassure the franchisees that you will act in good faith.

Sometimes the threat of free riding means that companies simply give up on the idea of franchising altogether and replace franchisees with salaried managers. Because the operators of company-owned outlets do not get to keep any savings from failing to keep bathrooms clean or provide replacement auto filters, or underinvesting in advertising, or engaging in any of the other ways in which franchisees free ride, company-owned outlet managers do not have any reason to engage in this behavior. Without a reason, they do not do it—and the problem is avoided.

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 53

Hold-up

The previous section mentioned the concern of franchisees that franchisors will use the threat of termination to take advantage of them. This problem is a real one and is not to be taken lightly. Franchisors replace franchisees fairly regularly. In fact, the International Franchise Association conducted a study that showed that approximately 16 percent of all franchise outlets turn over every year. Moreover, as Table 3.1 shows, this turnover rate ranges from 10 percent to 51 percent across different industries.[5]

TABLE 3.1 Average Annual Outlet Turnover Rates for Selected Industries

Industry	Average Turnover Rate
Baked goods	50.5%
Printing and copying	19.4%
Fast food	19.0%
Maintenance services	16.2%
Services	16.1%
Retail food	15.9%
Education related	15.7%
Business services	14.4%
Travel	14.2%
Auto repair	13.4%
Building and construction	12.4%
Lodging	12.3%
Child related	12.1%
Personnel services	12.1%
Real estate	11.9%
Restaurants	11.1%
Retail	10.7%
Sports and recreation	10.4%
Overall	**16.0%**

Source: Adapted from data contained in the IFA Educational Foundation's *The Profile of Franchising* (Washington, D.C.: IFA, 1998).

The high rate of turnover of franchised outlets is important because it raises the fear that franchisees have of termination by opportunistic franchisors seeking to take advantage of them. Franchisees have to make investments in assets that are highly specific to the franchise system that they are entering, whether those investments are in signs, distinctive buildings, proprietary machines, or other things. In fact, one study showed that the average franchisee has to invest approximately $144,000 in assets that are specific to the franchise system in just the first year after buying an outlet.[6]

These large investments in assets that are specific to the franchise system, combined with the right of franchisors to terminate franchisees, creates the opportunity for franchisors to engage in something called *hold-up*. Hold-up occurs when one party takes advantage of another party's investment in specific assets to extract money from the second party. For example, suppose that an eye-care franchise has specially designed equipment for making its brand of eye glasses. The franchisor could opportunistically renegotiate with the franchisees to get them to pay additional royalties by threatening to terminate the franchisees or by refusing to approve the sale of the franchisee's outlet to another franchisee. Once the franchise agreements were terminated, the franchisees would be precluded from using the equipment specific to the franchise system. As long as the cost of replacing the equipment was more than cost of the additional royalties that the franchisees would have to pay the franchisor, the franchisees would likely consent to pay the additional royalties.

Although threatening termination is a common way for franchisors to hold up franchisees, it is not the only way that franchisors act opportunistically to appropriate some of the returns to the franchisee's investment in the system. Take, for example, the case of Fotomat®, a film-distribution franchisor. Having discovered that it earned much higher profits from company-owned outlets than it had expected and that it had sold its franchises at too low a fee, Fotomat established company-owned outlets near the locations of its franchised

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 55

outlets and ended the film pickup and delivery services it had offered its franchisees. This set of actions cut the level of profits at the franchised outlets and allowed Fotomat to buy them back at a discount.[7]

Consider another example, this one of a car-rental franchise that had set up an outlet just outside of a major airport. The franchisor and franchisee agreed that the franchisee would pay 5 percent of sales as royalties in return for the use of the brand name and participation in the national reservation system. The franchisor then opportunistically sought a royalty rate increase to 7 percent of sales by threatening to add another franchise on the other side of the airport.[8] Because the franchisee realized that his sales would be cut almost in half by the establishment of another franchise near the same airport, he accepted the royalty rate increase.

Under Investment

Another disadvantage with franchising is that it can lead to underinvestment by franchisees. In comparison to a large retail chain that can raise money through financial markets, such as Starbucks, the individual purchasers of franchises, who invest a large portion of their net worth in a single outlet, tend to be undiversified. This lack of diversification leads them to view investment in the development of the outlet as riskier than the diversified owners view the same investment. As a result, franchisees are less willing to make those investments or are willing to make them only for a higher rate of return than diversified corporations, leading to underinvestment in outlets through franchising.[9]

Loss of Intellectual Property

In many retail businesses, the heart of the business's competitive advantage lies in its intellectual property. This intellectual property could be the firm's method of operations, as is the case with Merry Maids® cleaning service, or it could be the firm's equipment, as is the

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 56

case with East Coast Original Frozen Custard®'s frozen dessert machines. Regardless of the form that the intellectual property takes, an intellectual property–based competitive advantage makes franchising problematic.

The first issue is that of disclosure. To franchise, the franchisor must provide the franchisee with the intellectual property that provides the competitive advantage to the business. Unless the intellectual property is patented, efforts to transfer this type of competitive advantage to franchisees are problematic. To get potential franchisees to buy your intellectual property, you need to show them why that intellectual property is valuable. However, your efforts to convince the franchisee of the value of your intellectual property demonstrate what that intellectual property does, thereby allowing them to imitate your intellectual property without paying for it. [10]

The second issue concerns trade secrecy, which is difficult to maintain through franchising. For trade secrets to be preserved, efforts must be taken to keep the secrets secret. The best way to do this is not to put the secret into the public domain. Unfortunately, this is not possible in franchising. Franchisees need to gain access to many of your company's trade secrets to operate their outlets. Therefore, as a franchisor, you have to rely on nondisclosure agreements to preserve your trade secrets. However, the use of nondisclosure agreements to control behavior faces strong limitations when the secret is being given to hundreds, if not thousands, of franchisees. The more people who have access to information, the greater is the likelihood that the information will leak out, even if you sign nondisclosure agreements with the recipients.

Furthermore, trade secrets often work best when the knowledge underlying them is tacit and hard to write down. However, franchising requires the codification of operations in operating manuals given to franchisees. Although most franchisors require franchisees to return the system's operating manual if they leave the system, the fact that the operations have been written down in the manual and the

manual has been given to others makes it very difficult for franchisors to ensure that trade secrets contained in the operating manual are kept secret.

Take, for example, the difficulty that East Coast Original Frozen Custard has in protecting its proprietary custard and yogurt mixes, which are its primary competitive advantage. The chemical composition of these mixes is what gives the company's product its distinctive flavor. The company's franchise agreement bars franchisees from conducting analysis of the mixes to determine their chemical composition. However, this legal barrier is relatively weak; by operating an East Coast Custard franchise, people would have the opportunity to figure out the composition of the mixes and create duplicative products.

Stop! Don't Do It!

1. Don't franchise when the threat of free riding on quality or advertising is high; you are better off with company-owned outlets under these conditions.
2. Don't franchise when the threat of franchisor hold-up through adding nearby outlets or other means is high; you will have difficulty getting franchisees.
3. Don't franchise when your key competitive advantages are trade secrets that are easily imitated.

Innovation and Change

Franchising is not the most effective organizational form if a business needs to engage in certain types of innovation and change. Specifically, it tends to be ineffective when organizations need to change their structure frequently. In addition, franchising is problematic when an organization wants to test particular innovations to the system, as well as to transfer those innovations from one outlet to another.

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 58

Making Changes to Structure

Franchising is a poor choice of an organizational arrangement if you want to have the flexibility to change organizational structure regularly. To change organizational structure, franchisors must change their contracts with franchisees—and contracts with franchisees are difficult to alter. Unlike internal organizational structure and employment relationships that are used to manage the relationships between outlets in a company-owned chain, which can be changed at will, relationships between franchised outlets are set out in formal contracts that are governed by contract laws. Changing these relationships means renegotiating legal agreements. Not only does this effort incur substantial legal costs, but most franchisees also are unwilling to accept changes to organizational arrangements unless these changes benefit them. As a result, a franchisor that has discovered that it provides franchisees with, say, too many services might not be able to change the contractual provisions regarding services provided to franchisees.

Moreover, as will be described in greater detail in Chapter 10, in many states, any material change in the franchise relationship requires changes in franchise documents filed with state regulators.[11] Thus, changing the franchise relationship requires regulatory review as well as the administrative costs of making the changes to all documents provided to franchisees.

As a franchisor, you also cannot make changes to your system in a piecemeal fashion. Unlike with company-owned stores, where managers or entrepreneurs can give some outlets the best support and training and starve others of resources, in franchising, outlets have to be treated equally. Franchise discrimination laws make it difficult to treat new franchisees differently from existing franchisees. This makes it very difficult to establish new provisions in franchise contracts. Without the option of providing new terms to new franchisees, franchisors must get all of their franchisees to accept a change to alter their structures.

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 59

Franchising is very ineffective in business settings in which developments that could not be foreseen at the time of the writing of the original franchise contracts have a powerful effect on an industry, for many of the same reasons as those discussed earlier. The most notable example of this lies in information technology. Many franchisors have had difficulty requiring franchisees to adopt computers to provide point-of-sale information. Their contracts—written before the widespread adoption of computers—do not have any language about technology use. In contrast to the case with company-owned locations, franchisors cannot force their franchisees to adopt this technology if it was not foreseen and written into the agreements.[12]

Similarly, franchising inhibits efforts to examine the potential of future product offerings. Take, for example, an ice cream shop. A franchisor might consider offering cookies as a way to increase sales. To sell cookies, the outlet would need space set aside for baking and the installation of an oven. The allocation of this space and the expenses of installing an oven are worthwhile only if the ice cream shop actually sells cookies. If not, the space and equipment are wasted.

With a company-owned outlet, the firm can design the outlet to sell only ice cream and change it later to experiment with cookie sales. During the time when only ice cream is sold, the design of the outlet is optimal for the products being sold. With franchising, however, the outlet must be initially designed with the oven set-up present, even if this is not optimal before cookies are being sold. It is simply too difficult to introduce changes to the franchise system that are not initially established in the franchise contract.

Product Innovation

Franchising is also a relatively ineffective model for organizations that seek to develop and introduce new products frequently. One problem that franchisors face is a lack of information necessary to develop new

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 60

products and services effectively. Many innovative new products are developed by research and development departments based on information about customer preferences and demand provided by marketing departments. However, because franchisees are independent companies, the quality of the marketing information that they transmit to franchisor headquarters for the purposes of developing new products is much worse than that provided by company-owned outlets. Only company-owned operations provide real-time management-information systems to gather up-to-date data on what is going in the outlets. The legal independence of franchisees, combined with the requirement that franchisees pay royalties on gross sales, makes most franchisees reluctant to provide franchisors with real-time information about their operations. Therefore, the management of a franchised chain has less marketing information to use to develop new products than it would if it operated its own outlets. As a result, companies are much better able to generate new products if they own their outlets than if they franchise them.

Another problem with innovation in franchise organizations is that it is difficult for franchisors to get franchisees to adopt new products that the franchisor developed. Getting franchisees to agree to changes is a slower and more time-consuming process than getting the managers of company-owned outlets to agree to the same changes. This is because franchisors have no direct authority over the behavior of franchisees the way that managers have authority over the behavior of their employees. Employment contracts allow managers to tell their employees what to do even if the employees disagree with them. However, franchising contracts do not allow entrepreneurs and managers to tell franchisees what to do. Therefore, as many franchisors have aptly pointed out, you can tell employees what to do, but you have to sell franchisees to get them to do what you want.[13]

The requirement that franchisors use persuasion rather than command and control to effect change in their organizations makes change slower to accomplish and more likely to fail. Take, for example, Pizza Hut's difficulty of persuading franchisees to accept home

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 61

delivery. Many franchisees simply refused to adopt this innovation when it was first introduced, despite the many hours spent by the management of Pizza Hut to try to persuade them.

The level of knowledge transfer from one franchisee to another is also low in comparison to knowledge transfer between company-owned outlets. Because communication patterns and incentives to work together are very low between companies that are owned by different individuals, franchisees have little reason or opportunity to share information, relative to the managers of outlets in a chain of company-owned outlets. In a study of pizza franchises, for example, professors Eric Darr, Linda Argote, and Dennis Epple found that franchisees were less likely to transfer knowledge about their innovations to other franchisees than the managers of company-owned outlets were to transfer knowledge to other outlets.[14]

Stop! Don't Do It!

1. Don't use franchising if you want the flexibility to change organizational structure frequently.
2. Don't use franchising if frequent new product introduction is important to your business.

Financial Returns

The previous chapter pointed out many of the financial benefits of franchising, but there are also several financial costs to franchising. The first of these costs is that of establishing a franchise system, which estimates suggest can exceed $500,000.[15] The up-front cost of franchising is important because it makes your analysis of whether you should franchise highly dependent on the number of outlets that you plan to have in your system. If you plan to establish a large chain, this up-front cost will be amortized over a large number of units, making its impact on your overall operations trivial. However, if you plan to franchise only a handful of outlets, the benefits of franchising

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 62

might be overwhelmed by the basic cost of setting up the system, leading you to conclude that franchising isn't really worthwhile. Table 3.2 illustrates the effect of franchise system size on the economics of franchising versus company ownership of outlets.

TABLE 3.2 Balancing the Costs and Benefits of Franchising and Company Ownership

	Franchising	Company Ownership
Cost of establishing the system	$500,000	$0
Sales per outlet	$400,000	$350,000
Profits per outlet per year	$0	$35,000
Royalties per outlet per year	$20,000	$0
Capital cost per outlet	$0	$200,000
Up-front fee per outlet	$10,000	$0
Earnings on 5 outlets over 10 years	$550,000	$750,000
Earnings on 10 outlets over 10 years	$1,600,000	$1,500,000

In the hypothetical example in Table 3.2, franchising is much less profitable than company ownership if the chain has only five franchisees because of the high up-front cost to set up the system. On the other hand, franchising is more profitable than company ownership of outlets once the chain has ten outlets because the financial benefits of having the capital costs paid by franchisees and the benefits of receiving the up-front fees (that were discussed in the last chapter) overtake the effects of the up-front cost of setting up the system.

Another cost that you want to consider when evaluating the advantages and disadvantages of franchising is that chains of company-owned outlets tend to generate greater amounts of profit per outlet than franchised ones. Why? Franchisors earn royalties only on gross sales, and the royalty rate is often less than the margins earned by the outlet operator. Take, for example, ABRA Auto Body & Glass, a collision-repair franchise out of Brooklyn Center, Minnesota. The average outlet in this system earns 9.7 percent of sales before taxes, while franchisor royalties are 5 percent of sales.[16] Thus, in this case, the franchisor is taking about one-third of the margins and giving two-thirds to the franchisee.

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 63

Stop! Don't Do It!

1. Don't franchise if you plan to operate a very small chain; the up front costs of setting up the system will not be recouped.
2. Don't forget to consider the relative margins generated by company-ownership of outlets and franchising in calculating the financial returns to franchising.

Questions to Ask Yourself

1. Can I avoid competing with my franchisees through operations at my own outlets?
2. Do I have something (brand name) that will maintain its value to franchisees over time and justify ongoing royalties?
3. Can I control franchisee free riding?
4. Can I reassure franchisees that I will not take advantage of their investments in my system?
5. Can I protect my intellectual property against disclosure to competitors while still licensing it to others?
6. Can I contractually agree to the products and services to be sold and the organizational form of the business for years at a time?
7. How do financial returns from franchising and company ownership compare in my business? Which one is really better for the type and size of operation I am creating?

Summary

This chapter identified the four major disadvantages of franchising: goal conflict between franchisors and franchisees; transaction cost problems, such as free riding, that exist in franchising but not within company-owned chains; the difficulty engaging in innovation and change in franchised organizations; and lower absolute profits from franchising, as compared to company ownership of outlets.

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 64

Franchising suffers from an inherent goal conflict between franchisors and franchisees because franchisors earn royalties on gross sales of their systems, and franchisees make profits net of royalties at individual outlets. Franchisors seek lower prices and higher volume of sales than franchisees. They want a higher level of outlet density in a given geographical area than franchisees. Franchisees are often unwilling to engage in collective actions because they gain only if their particular outlets benefit from a policy. Finally, the value to franchisees of being part of a franchise system declines as they become more experienced, causing conflict with franchisors who maintain their royalty rates at a constant level.

Because franchisors and franchisees are legally independent entities, franchising suffers from several transaction cost problems that are not present with chains owned and operated by a single entity. Franchisees have an incentive to free-ride off the efforts of other franchisees to uphold the brand name of the system. Franchisees worry that franchisors will opportunistically renegotiate the terms of the contract after the franchisees have invested in system-specific assets and appropriate franchisee profits. Franchisees also underinvest in outlets in comparison to the level of diversified shareholders in company-owned chains. Finally, franchising is a poor mode of business for protecting unpatented intellectual property, such as trade secrets.

Franchising is not a very effective form of organization if a business needs to innovate and change frequently. The use of contracts to govern relationships between franchisors and franchisees makes it difficult to change policies or structure, or adopt products or processes that were not known and specified in the agreement at the time that it was signed. Moreover, the lack of information about customer demand at franchised locations, combined with the lack of franchisor authority over franchisees, means that franchisors lack much of the information necessary to innovate and have trouble getting franchisees to adopt franchisor innovations after they have been developed.

Finally, franchising imposes several financial costs on franchisors. The first is the up-front cost associated with establishing a franchise system, which does not make franchising a cost-effective organizational form if a company franchises only a handful of outlets. The second is that franchising generates lower profits per outlet than company ownership, making it possible for firms to earn much more money by operating outlets directly rather than by franchising them.

Now that you understand the major disadvantages of franchising, the next chapter turns to a discussion of what business concepts can be franchised.

05_Shane_ch03.qxd 11/2/04 4:36 PM Page 66