FRANCHISES WITHOUT BORDERS

Stephen Spinelli took a fresh look at franchising and found that franchisers can be entrepreneurs if they know how to manage an alliance relationship.
Most of us think about entrepreneurs as people who start a new business. But that is far from the only way to be entrepreneurial. My research has looked at franchising as a growth option for the expansion-minded entrepreneur. In fact, franchising, as a strategic partnership model, can help build a high-impact firm.

To arrive at this conclusion, I explored a large franchise company through interviews and observations of the franchiser senior management, their 30 largest multiple unit franchisees, a group of franchisee leaders, and a series of interactive meetings between franchiser senior management and the franchisee leaders. Three other researchers and I sorted and analysed all the data – then we also checked our conclusions against some of the mainstream research about entrepreneurship.

We reached a startling conclusion. Our findings indicate that franchising (as an inter-organisational form) adjusted traditional managerial roles and that the real power of franchising comes to life when it leverages significantly different partner skill sets.

Why a franchise?
The definition of a franchise in the Oxford dictionary doesn’t really denote much vitality: “an authorisation granted by a government or company to an individual or group enabling them to carry out specified commercial activities”. A franchise is formed as a result of two legally independent parties signing a contract (in franchising this is often called a license agreement). This contract calls for a transfer of the business format from the franchiser to the franchisee in exchange for shared rents of the operating outlets. In point of fact, when a vibrant franchise chain exists, it allows an individual possessing a requisite amount of buy-in capital the chance to hop on board a fast-moving commercial train. The franchiser provides the concept, building and operational designs, easy-to-order materials and supplies, and of course promotional considerations.

There are four core reasons to franchise. First, it allows an entrepreneur access to human and financial capital. It also provides short-term growth to meet market competition. A franchise also makes it easier to monitor costs of company-operated units. Lastly, franchising helps you achieve minimum scale efficiency.

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But, underlying each of these obvious reasons to franchise is one other factor that should not be overlooked or underestimated: the franchiser and franchisee are both motivated by profit. There is an intuitively reasoned and theoretically supported expectation by each party in a franchise that profit can be achieved at greater levels or with more certainty (ergo, less risk) through a franchise relationship than as an independent start-up. In such a relationship, a “virtuous cycle” is created as enhanced profits through franchising encourage yet further growth.

Coordination between the franchiser and the franchisee is dependent on the nature of power and dependence between the parties. The ability of either party to achieve its profit potential is dramatically dependent upon their relative bargaining power in the coordination of inter-organisational strategy. While bargaining power is clearly bounded by the characteristics of the contract, the boundaries are not rigid. Indeed, much of the litigation we studied tied to franchising occurred when the parties were by and large inflexible.

So, when a franchise works best, what is the role of each player? How should a franchiser and franchisee behave in a dynamic setting? Let’s summarize the role of each player using three lenses, three ways (or theories) to look at a franchise operation.

As an agency Traditionally, franchising has been driven primarily by agency theory, with the franchiser playing the role of principal and the franchisee in the operating unit acting as agent. However, the phenomenon of the multiple-unit franchise owner obviates the traditional single operator view. By extension, then, this view transforms franchising into a “team” effort; the team is organised under the owner or monitor who holds the right to profits generated by the activity. When a franchise is viewed in this way, it becomes essential for there to be a firm-and-fair monitor to assure that the franchisee is utilizing resources properly and reporting sales accurately (so as to assess proper franchise fees).

Agency theory explains the limits of a firm’s growth occurring when the principal cannot efficiently monitor the activity of each of his agents. In short, the franchise can grow only as fast as
the agent wants it to grow or can make it grow – unless the franchiser can exert a high level of personal control.

Transaction cost economics Further impacting a franchise is the concept of transaction cost economics. A franchise is, in effect, a hybrid organisation; neither the franchiser nor the franchisee fully owns the operating unit. Thus, it’s a kind of strategic alliance because the partners are typically bound by contract. Clearly the parties to the contract believe there is the potential for a market advantage. The franchiser adds value with primarily centralized functions that foster economies of scale. The franchisee adds value through local entrepreneurial intensity. Viewing a franchise this way, one can see that success or failure primarily comes down to the comparative costs of planning, adapting and monitoring.

When the emphasis in a franchise relationship dwells on transaction costs, there is a constant struggle between the “ideal” costs defined by the franchiser and the real costs incurred by the franchisee. If a franchise costs more to operate than the franchiser thinks it should, then problems are bound to occur in the relationship. Therefore, within the bounds of rational calculation, the franchisee and franchiser are compelled to negotiate the relationship in reaction to real or perceived market dynamics. In a transaction cost perspective, the license agreement in franchising is seen as a complex monitoring guide.

Relational exchange theory This theory suggests that the norms that govern commercial exchange behaviour in discrete transactions are markedly different from those in a relational exchange. Think of it this way. Franchise actors cooperate to create a surplus (or potential profit) and can find themselves in conflict over the division of that surplus unless there is a continuum of communications tied to how well the franchise is doing, overall. In other words, the transactions for a day, week, or month are one thing; the shared perspective of the parties entwined in the franchise are yet another. *How is the business doing?* That’s what is emphasized in the regular inter-party negotiations, over and above the numerical reports tied to transactions. And the shared perceptions, if they align, define a successful franchise.

Another way?

After examining the data collected from our research of live franchise operations as well as the accumulated relevant literature, our research team arrived at four key findings.

- A franchise works best when each of the two parties brings a high number of unique skills and competencies.
- The clearer the definition of the value brought to the franchise by each partner, the higher the resulting performance.
- Formalizing organisational structure to work through any discrepancies in success perceptions will result in higher performance.
- Jointly devising the form and structure of the allocation roles and responsibilities will enhance franchise operations.

A franchise, thus, is both a special entrepreneurial opportunity and a kind of strategic alliance. In this light, a franchise is strengthened when the partners involved understand that they need to work constantly on their alliance relationship. Such relationships are inevitably hard work; but when carefully structured, such a strategic alliance can present opportunities (and value) to both large and small entrepreneurs.

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