Resources Constraints in Franchising: A Comparative Study
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Abstract

Many theories discussing about the motivations for franchising, one of the most popular theories is explored from the perspective of resource constraint. Oxenfeldt and Kelly first put forward this kind of argument; they argue that franchising is advantageous to a franchisor in the early stage because of lacking some kind of resources including capital, management talent, knowledge of local market conditions and human resource. They also suggest that franchisors will buy back the profitable outlets as franchisors got enough resources based on the organisational lifecycle theory. However, in this research, the author uses two contrast industries, which are product based (convenience store) and service based (estate agency) to be a comparative study. In addition, various ownership patterns are also highlighted in either industry. By a cross case and within case study, the findings suggest that there are many conflict points against this theory, such as constraints on capital, management talent and buying back franchisees.

Keywords: franchising, ownership pattern, resources constraints

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INTRODUCTION

During the past four decades, franchising has blossomed into a major business form. Today, over one-third of all retail sales in the US are through franchised outlets and approximately 20 percent of US gross national product results from franchise operations. According to Tikoo (1996), by 2005, franchising will account for nearly 50 percent of US retail sales. However, the majority of research in franchising has focused on domestic franchising activity, especially within the US market (Forward and Fulop, 1993). Being a developing country like Taiwan, by the means of inward and outward internationalisation, franchising has already played an important role as in other industrialised countries. According to the '2000 Taiwan Chain Store Almanac', there are over 343 franchisors in Taiwan. One of the reasons for quick expansion in franchising could be explained from the perspective of resource constraint (Oxenfeldt and Kelly, 1968-69). In this paper, the aims are threefold: the first is to examine the existing theories from two contrast industries (retail and service sectors) to see whether resource constraint theory could be applied to different sectors. Second, based on the difference of ownership patterns, three different patterns were compared, pure company ownership, plural system and pure franchising. Third, a qualitative research was carried out to contrast previous researches, which were largely focus on quantitative research. Based on these differences, the author tries to offer different kind of viewpoints, which are different from the previous research.

LITERATURE REVIEW

Oxenfeldt and Kelly (1968-69) suggest that franchisors use franchising to obtain access to some resources which franchisees own. Underlying this resource constraint argument is the assumption that retailers prefer to own their outlets; this is only because the option is unavailable to them that they choose to franchise. They suggest that the resources provided by franchisees might include financial capital, human capital, or management talent. Similarly, Norton (1988) emphasized the franchisor’s need for human capital and managerial talent as a reason for franchising, while Minkler (1990) focuses on the franchisee’s capacity to provide local market expertise. Therefore, we can conclude that the resource constraints could be from financial capital, human capital, management talent and local market expertise.

As far as the source of capital is concerned, several researchers (e.g., Brickley and Dark, 1987; Norton, 1995; Rubin, 1990) do not think that capital scarcity should be considered as a potential explanation of the decision to franchise because franchisees are a costly source of capital, although the capital scarcity hypothesis was among the early explanations offered for franchising (Oxenfeldt and Kelly, 1968-69). Their arguments are mainly from two perspectives. When a firm needs funds, it is more efficient to obtain capital from passive investors such as lenders and stockholders who, by investing in an entire chain, diversify their risk among the outlets. Unable to similarly diversify, rational franchisees will demand a greater return on their capital (Norton, 1995; Rubin, 1990). Unless there are imperfections in debt and equity markets that might increase the cost of capital from passive investors, using franchisee capital to overcome capital scarcity would be inefficient and irrational (Combs and Ketchen, 1999). However, Lafontaine (1992) pointed out that franchising might be a less expensive source of capital if there are incentive issues at the outlet level. She argues that if managers lack incentives to exert effort, investors with a portfolio of shares from all outlets are likely to demand higher rates of return, even if their investment is less risky, than they would on the capital invested in a single store that they manage themselves. Hence, capital may be more efficiently obtained from franchisees than from investors (Lafontaine and Kaufmann, 1994).

Another important issue of resource constraint is on the concept of buying back of franchisees. This is based on the logic of organisational lifecycle which suggests that young or small franchisors use franchising to access resources needed for growth. Lafontaine (1992) observes that firms use franchising as a mechanism to grow faster. This implies that franchising allows franchisors to overcome some types of constraint on their growth. However, as the firm grows, the firm may buy back franchisees in accordance with the franchising contract. This may occur owing to the release of scarce resource, to maintain service quality and provide a quick/ flexible response to meet changing circumstances. Such repurchases provide the franchisor with...
additional control and by repurchasing the largest and most profitable franchisees first, the firm captures additional rents previously allocated to the franchisee. Therefore, the large, profitable franchisees and those outlets in urban or higher population densities will be transformed into company owned outlets. The only franchisees remaining are those in less profitable or rural areas (Oxenfeldt and Kelly, 1968-69). Thomas, O’Hara and Musgrave (1990) also make the same suggestion that high unit sales cause the franchisor to convert a franchised unit into a company owned unit. However, Anderson (1984) concludes that although the percentage of units owned by franchisors has systematically increased over the period of ten years, there is no evidence that comprehensive ownership and/or performance differentials have emerged that favour company-owned establishments. Therefore, we cannot say that company owned outlets have a better performance than franchised outlets.

In addition, Porter (1985) suggests that the concept of product life cycle is simply a useful descriptive tool with too many variations to be generalised. This kind of interpretation is consistent with some authors who recommend examining configurations of resource exchange rather than life cycle stage analysis (Connor, 1991; Norton, 1988). Further, there is a limitation on the life cycle first forwarded by Oxenfeldt and Kelly (1968-69), that is franchising is too early in its own stage to reliably forecast its future trends. Therefore, the argument of the life cycle may change afterwards.

As far as ownership pattern is concerned, aside from company ownership, Tikoo (1996) suggests there are two systems in the franchise organisations which are the fully franchised system and the mixed system. A fully franchised system allows a firm access to franchisee capital and labour. In addition, this allows the transfer of business risk to its franchisees, reduces monitoring costs, generates promotion efficiencies, and focuses its efforts on specializing in national promotion and product development (Tikoo, 1996). This approach happens when the franchisor is young. In order to expand quickly, they prefer to lower the standardisation to sell the franchise, even though this may damage its brand value. The second system is the mixed system. There are three ways to establish it. First, a firm can start by franchising all locations, then take over some of the stores later. This way allows a firm to gain the initial benefits of franchising and this approach is related to the life cycle of a franchise first put forward by Oxenfeldt and Kelly (1968-69), which has mentioned previously. The second method is by initially opening only company-owned stores, then franchising some new locations at a later stage. This is suitable for a firm willing to grow gradually and steadily. One of the advantages is that the franchisor can pre-test the business know-how or product mixes in the company-owned outlets in order to prevent potential conflict with franchisees afterwards. Third, a firm can establish franchised and company-owned outlets simultaneously. This option provides a means to combine the advantages of the other two options (Tikoo, 1996). In practice, Dahlstrom and Nygaard (1994) took petrol service station as an example to analyse ownership structures. They suggest that ownership pattern comes in three forms: corporate ownership and operation; corporate ownership but management by franchisee; and ownership and operations by franchisee. Ownership patterns can vary from industry to industry; even in the same industry, there may be different structures.

Based on the above literature, we can see that different kinds of arguments were presented regarding resource constraints. Also, various ownership patterns appear in different industries. In this research, Convenience Store (CVS) is a plural system (see Appendix1) including regular chain (RC)- corporate ownership and operation; and franchise chain (FC1 and FC2)-corporate ownership but management by franchisee whereas Estate Agency (EA) is a pure franchise system, which is owned and operated by franchisee.
study several contexts within the case (Mukherjee et al., 2000). In this research, the case is based on the company (brand) level; so, there are eight cases were researched. Two different sectors, convenience store and estate agency which typify retail and service industries were compared. In addition, other subcategories were also compared such as RC Regular Chain (RC) vs. Franchise Chain (FC); Single vs. Multi-unit franchisee; Local vs. International system; Internal vs. External franchisee original and transferred franchises. Here, regular chain means company-owned chain. The great advantage of the case study over other methods is that it attempts to be comprehensive, and involves describing and analyzing the full richness and variety of events and issues in the organizations. The sample frame is composed of eight national/international franchise brands in the Taiwanese retail market. Four of them are from the convenience store industry and the other four are from the estate agency industry. For each franchise system, 3 interviews in each head office and 10 franchisees from each system should be selected. The reason to choose the number is to minimize the bias from just one or two interviews. As to which ones to be selected, it is based on stratified (national/international brand and personal network) and random purposeful (phone lists and street visits) sampling methods. However, owing to the difficulties of access, 84 interviews were conducted (see Appendix 1.), in other words, the successful rate- 82% was achieved. Regarding the analysis, cross case and within case analysis were adopted to compare the collection of cases and to uncover the implications of interviewees.

As far as resource constraints are concerned, four are identified for franchisors: financial capital, human resource, managerial talent and local knowledge. In practice, for both the convenience store and estate agency industries, franchisors and franchisees agreed with the constraints on human resource and local knowledge. Both parties believe that franchising can speed business expansion through those who know the local market well, although the degree of importance placed upon this particular constraint is different. For the CVS, local knowledge is not as important as it is for EA. This is because most of the goods are the same in each shop and the shop is reactive to the customer, rather than in EA where salesmen have to locate customers and get access to them. For the CVS, the most important consideration of all is location, whereas the personal network is the most important factor for the EA industry. Consequently the franchisors had different views on this point:

“We don’t need to pay the personnel costs and variable costs of the store. Therefore, the franchisor can easily see the profit level and then focus on the operations. For a company-owned outlet, the franchisor has to pave the way for his future development.” (CVSa) (International) “It is easy to raise the capital to open 100 outlets but it is very difficult to have 100 qualified store managers. Also, one of the advantages of franchising is the cultivation of a trading area. For company-owned employees, they may be rotated at a regular time, so as a result, it is more difficult to build relationships with local residents as franchisees.” (EAb) (Local) In order to reduce the franchisor’s costs, most franchisors in the CVS have tried their best to lower the proportion of company-owned outlets. According to the franchisors’ statements, the ideal percentage is 80-91% Franchise Chain: 20-9% Regular Chain. The main reason for keeping some company-owned outlets is to provide for training and product testing. Take CVSa Taiwan for example, its final objective is to keep 9% company-owned outlets. As to how to best utilize company employees, the franchisor encouraged them to become franchisees or to transfer to other related businesses in the group.

Regarding the other three issues, financial capital and managerial talent, buying back franchisees, each industry has a different viewpoint; so, these issues will be examined separately.

1. Financial capital constraints

Most franchisors in CVS do not think franchisees are the main source of financial capital since if that were true; they would franchise their businesses in the beginning. Furthermore, each CVS has a strong financial background, i.e., they do not need this capital injection from franchisees to expand, because it just takes a tiny part of their business capital. One CVS franchisor said:

“If the brand is not strong enough, it is difficult to expand even though you have enough capital. So, it is related to brand reputation rather than capital scarcity. This is because that even if you can get capital from franchisees, the amount is
limited. Even if you can get the capital from financial institutions, you still cannot be sure that franchisees want to join your system. Therefore, the capital scarcity is not so important, what is the most important of all is whether the brand is strong enough to attract potential franchisees.” (CVSa) (International)

From this comment, we can see that the key issue is whether the brand is strong enough to attract franchisees rather than whether the franchisor has enough financial capital. In other words, if the brand is strong enough, the other potential resource constraints should disappear. For instance, if there were many people wanting to be franchisees, then the financial institutions would be very happy to lend money. Other than the franchisor and franchisee’s capital, one franchisor said that another source of capital is product manufacturers who pay the display cost to the franchisor.

However, for the EA cases, some franchisors and most franchisees thought that the franchisees’ initial fee and royalties provided a certain proportion of the franchisor’s revenue. As a result, if the franchised outlets are below the break-even point, the franchisor has a financial deficit. If this is true, some of the franchisors should have already gone bankrupt, because one franchisor in EA said that the break-even point for the number of outlets should be 140, with this number, franchisors can just offer proper services and supports to franchisees. The implication behind is that other than the franchisees’ initial fee and royalties, the franchisor must have other sources of capital, otherwise he cannot survive. Consequently, we can say that financial capital from franchisees may be important but is not the most important factor of all. The main capital sources should be stockholders and financial institutions.

One EA franchisor said that:
“Franchisees can supply financial resource, but you have to bear in mind ‘water that bears the boat is the same that swallows it’. In other words, franchise system can help the franchisor expanding quickly but it also can lead to failure as well.” (EAb) (Local)

In this context, this means that franchisees are just like water and the franchisor typifies the boat. If the water (franchisee) is unstable, the boat has a high risk of sinking. In other words, if the franchisor only cares about the number of outlets rather than the quality of franchisees, then the risk of failure will be very high. For example, franchisees may damage the brand and that kind of financial loss is far greater than income lost from franchisees’ initial fee and royalties. This also means that franchisors should do extensive screening work before awarding the franchise.

2. Managerial talent constraints

As far as managerial talent is concerned, the CVS do not think that potential franchisees need skills initially. What they preferred were those without previous related working experience; like a blank sheet of paper, which the franchisor can influence through training. In general, training takes one to two months before producing a qualified franchisee. Since all the operations are the same for all franchisees, it is easier for the franchisor to apply managerial standardisation and keep a uniform service quality by training from scratch. The premise is that the franchisors can give franchisees a guarantee of annual gross margins. Taking CVSa Taiwan for example, the guaranteed annual gross margin is NT$ 2 million dollars (£40,000). In theory, what franchisees need to do is just follow the franchisor’s policy without any personal input in terms of creative thinking. However, this does not always work out that way in practice because once a franchisee has become a multi-unit franchisee; he/she must have developed some level of managerial talent. Just as one CVS franchisee said:

“As far as managerial talent is concerned, it varies with experience and time as a franchisee. In the beginning, when you joined the system, you did not need to have any experience. However, when you have become familiar with the operations and want to be a multi-unit franchisee, you must have acquired that kind of talent in order to manage different stores.” (CVSa) (Franchisee 5)

This indicates that from the franchisors’ viewpoint, what they need is simply a person who can manage a store rather than one with his/her own ideas on store operations. However, franchisees are inclined to think that if they have developed managerial talent, then they would like to apply to be a multi-unit franchisee after a period of time. During this period of time, both parties will evaluate each other.
If the franchisor finds the franchisee’s performance is not good enough, then such an application will be rejected; in contrast, franchisees will be evaluating the franchisors’ performance to see whether it is worth being there or to become a multi-unit franchisee.

Within EA, knowledge is more professional; as a result, franchisors like to hire those with practical experience so that they do not need to closely supervise franchisees. In fact, only those with experience show the willingness to become franchisees. An EA franchisor stated:

“…We will never consider those without industrial experience to be franchisees. This is because if he/she didn’t have experience, we dare to say he/she must have a lot of money ready to be burned, and likely, the outlet will be closed within a very short time.” (EAc) (Local)

Another EA franchisee also said:

“If the franchisee joins the system when the market is good, then he/she can survive and gain the experience. However, if the market is not good, the franchisee will find it difficult to survive unless he/she has a rich personal network. In other words, if somebody without industrial experience wants to be a franchisee in a recession, the failure rate is 99.99%.” (EAa) (Franchisee 6)

From both viewpoints, we can see that managerial talent is considered necessary to run an estate agency. However, there was one exception among the interviews. One franchisee did not have any relevant experience before becoming a franchisee, but the economy was good at that time and he ran the store via ‘learning on the job’ to accumulate experience and knowledge. He now owns four units and also the brand has become the leading brand in that area. This confirms that aside from managerial talent, the external environment plays an important role as well.

Apart from financial capital, human resource, managerial talent and local knowledge, there is another important issue highlighted in resource constraint theory, concerning the buying back of franchisees as the franchisor got enough resources. This kind of statement is related to the retail life cycle. The following section will explore whether this is applicable to the Taiwanese retail market.

3. Franchisor buying back franchisees

Resource constraint theory argues that as the firm grows, the firm may buy back franchisees in accordance with the franchising contract. The reasons for this action may include the release of scarce resources, maintenance of service quality and quick/flexible response to meeting changing circumstances. Such repurchases provide the firm with additional control and by repurchasing the largest and most profitable franchisees first, the firm captures additional rents previously allocated to the franchisee. Therefore, the large, profitable franchisees and those outlets in urban or higher population densities will be transformed into company owned outlets. The franchisees remaining are then those in less profitable or rural areas. However, in the Taiwanese retail market, this does not appear to work. Rather the franchisor switches the profitable outlets to franchisees. In the CVS industry, franchisors said:

“We will not buy back the profitable franchisees; rather, we will let profitable company-owned outlets to be franchised outlets. When franchisees are profitable, it means that the franchisor also get benefits from it. So, it is unnecessary to buy back the profitable franchisees. Also, it can save the franchisor’s energy with regard to the human resource and capital requirement.” (CVSa) (International)

“No, it is impossible in the Taiwanese CVS industry. This is because the cost of running a company-owned outlet is higher than a franchised outlet. The only reason to buy back the franchisee would be if the franchisee did not want to run it anymore or the franchisee broke the rules, then the franchisor will buy it back to be a RC outlet.” (CVSb) (International)

Based on the above statements, it is very clear that franchisors would only buy back profitable outlets only if the franchisee does not have the desire to run the store anymore or break the rules. This kind of regulation is specified in the contract. Also, owing to the combined ownership (FC1 and FC2), the more franchisees earn, the more franchisors get. So, there is no reason to buy back profitable franchisees. As to the EA industry, as it is a purely franchised system, in the words, both franchisors and franchisees are financial independent with each other, therefore, this option does not arise. During the interviews, when EA franchisees were asked the same question and their reactions were all the same-
such a situation is impossible in Taiwan. If the franchisor stated to buy back the profitable franchisees, then staff would leave the outlet and open another outlet nearby; the franchisor could then not guarantee that the outlet would be as profitable as before. Also, potential franchisees would not join the system because that they would not know when the franchisor wanted to buy them out. This reason is also related to an industrial characteristic, which is that the EA identity is based on personal interactions and networks, rather than in the CVS industry, which is concerned with the distribution of products.

As a result, the idea of buying back franchisees is not applicable to the Taiwanese market. As to why resource constraint theory specifies that the franchisor would like to buy back franchisees to become company-owned outlets, it may only see the visible profits of the store rather than other factors, such as the effect on a franchisee’s efforts and his/her management aspirations. The theory does not specify whether the outlet would be as profitable as when franchisees ran it. So, there may be a risk in the franchisor buying back the profitable outlets. Particularly it would be difficult to keep an acceptable profit level if the industry is based on personal interaction, such as in the Estate Agency industry.

FINDINGS

After a series of discussions on resource constraints, we know why franchisors want to franchise their outlets based on the argument of resource constraints. Appendix 2 offers the detailed comparisons between sectors and ownership patterns. From this appendix, both the CVS and EA industries have some points in common on the constraints of human resources and local knowledge. However, owing to particular industrial characteristics, ownership pattern and the franchisors’ financial backgrounds, there are differences of opinion on the subjects of capital constraints and managerial talent. This research has another important finding concerning the idea of buying back franchisees. Neither franchisees nor franchisors in both industries agree with this concept. In addition, the idea of buying back franchisees needs to be further tested out to see if the outlet could be just as profitable after the franchisor buys it back especially when the sales is closely related to personal network like in the EA case, franchisors can not ensure that employees are still willing to work in this outlet.

SUMMARY AND IMPLICATIONS

This paper provides a different viewpoint on how franchising is applied to a developing country like Taiwan from the perspectives of retail and service sectors. From the previous discussions and findings, this research suggests that the theory of resource constraints may not be wholly applicable to every industrial sector. Also, different ownership pattern allows a firm to adopt different franchise packages to expand its business at different business stage. Interviewees suggest that buying back franchisees cannot guarantee that the sales will increase in the EA case. Also, by a qualitative research, we can get more information about the information of the interactions between franchisors and franchisees. This will help one not only see the surface phenomenon but also realize the internal implication. Finally, the author suggests that franchisors should not only see the resources from franchisees, both parties should ally together to benefit with each other, just like one franchisor cited one Chinese proverb, “fish (franchisee) help water and water (franchisor) help fish”. Only by cooperation with each other, both parties can benefit with each other.
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