

# The franchising business model: an entrepreneurial growth alternative

William Gillis · Gary J. Castrogiovanni

Published online: 25 May 2010  
© Springer Science+Business Media, LLC 2010

**Abstract** The franchising business model is widely and increasingly used by entrepreneurs seeking growth through geographic expansion. Thus, continued research efforts are needed to help entrepreneurs make wise choices as to whether the franchising business model is appropriate for them. To help promote such research, we reviewed the literature on reasons for franchising and outcomes of franchising. Based on that review, we drew conclusions as to future research directions likely to be fruitful. Specifically, we recommend that researchers (a) continue adding theoretical diversity to franchising research, (b) build large-scale, longitudinal databases, (c) test or control for implicit and explicit assumptions, (d) pay more attention to micro-level considerations within franchise networks, and (e) compare franchising with alternative business models suitable for geographic expansion.

**Keywords** Franchising · Business models · Growth · Geographic expansion · Resource scarcity · Agency

Franchising is commonly defined as a business relationship grounded in a licensing agreement between two independent firms. While franchising has two primary forms, product distribution (such as soft drink distributors) and business format franchising (such as fast food restaurants), it is business format franchising that is the dominant form of franchising studied by researchers over the past 40 years (Alon 2001; Shane 1998a). Business format franchising is defined as a continuing relationship between two parties that provides a full set of services and in which

---

W. Gillis  
Department of Management, Mitchell College of Business, University of South Alabama,  
Mobile, AL 36688-0002, USA  
e-mail: gillis@usouthal.edu

G. J. Castrogiovanni (✉)  
College of Business, Florida Atlantic University, 777 Glades Road, Boca Raton, FL 33431, USA  
e-mail: castrogi@fau.edu

one party, the franchisee, sells goods or services supplied by or approved by the other party, the franchisor (U.S. SBA 2002, MP-26: 2).

Since the seminal work on franchising by Oxenfeldt and Kelly (1969), there have been major advances in franchising theory and research. This research has taken different forms depending on the researcher's discipline. Marketing researchers focus on the channels of distribution and the effects of the brand, management and strategy researchers focus on the organizational form implications and the issues of managing independent franchisees versus employee managers of company owned outlets, and economists focus on whether and how it is better to franchise or use company owned outlets for growth. Generally, researchers have been hampered by the fact that franchisors are primarily privately owned, which limits data availability.

Entrepreneurs increasingly choose the franchise business model in businesses with significant service components that must be provided in local markets (Combs et al. 2004b). Moreover, the average proportion of outlets franchised within franchising chains has tended to increase as well (Combs et al. 2009). Franchising scholars thus must assist in this process by providing evidence needed for entrepreneurs to make informed franchising choices. Our purpose here is to stimulate and guide further research in this area. In that effort, we focus on three research questions: (a) Why do firms franchise? (b) How does franchising affect firm performance? and (c) What directions will prove most fruitful for future research in this area?

These three questions are addressed in the following sections. First, we summarize research to date on reasons for franchising. Then, we review literature on franchising outcomes. Finally, we draw conclusions for future directions of franchising research.

## Reasons for franchising

Alternative theoretical perspectives investigate reasons for franchising and the resulting consequences. Resource scarcity and agency theories have dominated the literature, but others have emerged recently. This literature is reviewed below. First, research on resource scarcity and agency theory is examined and findings associated with those two dominant perspectives are synthesized. Then, more recent theoretical developments are examined.

### Resource scarcity theory

Oxenfeldt and Kelly (1969) theorized that younger and smaller firms would use franchising as a means to expand rapidly and thereby overcome the three scarce resources of managerial skills, local market knowledge, and financial capital. As firms grew in size and matured, they would franchise less, open new stores as company-owned outlets and eventually attempt to become primarily company-owned by buying back more profitable franchises, while also allowing contracts to expire without being renewed for many of the others.

Resource scarcity theorists assumed that scale economies are important determinants of network survival, franchisees cost-effectively provide capital and other resources, and company-owned outlets are more profitable than franchises

(Oxenfeldt and Kelly 1969). The first assumption explains why firms adopt franchising even if it tends to be less profitable. That is, this assumption leads to the conclusion that firms initially franchise to reach minimum efficient scale (Shane 1996). The second assumption explains why franchisors choose franchising over other methods of raising capital and other resources. A firm can more quickly expand using franchisees' capital and local knowledge, than by raising capital to build outlets and then hiring and training its own set of managers. If franchisees provide a competitive source of capital, then firms can grow more quickly using franchising because capital costs are absorbed by the franchisee, not franchisor (Norton 1995). The third assumption, that company-owned outlets are more profitable than franchised outlets, leads to a key prediction of resource scarcity—that once economies of scale are reached and resource scarcities alleviated, the firm will move toward company ownership. As markets become saturated, growth becomes less of a priority and firms focus on improving profitability. Buying back the more lucrative franchises and only opening new company-owned stores enhances profitability (Oxenfeldt and Kelly 1969).

Resource scarcity theory provides a rationale for the decision to initiate franchising. By franchising early in its lifecycle, a firm initiates franchising to overcome three scarce resource constraints of managerial expertise, local market knowledge, and capital (Mahoney 2005; Thompson 1994). By franchising, small firms overcome this lack of managerial expertise by attracting a wider pool of qualified managers that self-select into the franchise system (Shane 1996). The second resource constraint franchising helps resolve is the lack of local market knowledge. Franchising provides a means of overcoming this disadvantage because franchisees provide the local market knowledge a franchisor lacks (Minkler 1992). The third scarce resource is capital funding. Resource scarcity posits that small or young firms might not have easy access to capital markets. Franchisees furnish growth capital by their investment in new outlets.

There is limited data on franchise initiation. First, censoring is one problem. Firms that do not initiate franchising as a growth option are not represented in most samples of franchisors. A second problem is that the limited surveys on franchisor initiation (Lafontaine 1992a; Dant 1995) are retrospective, leading to possible bias in that founders might try to justify their decision to franchise (to both themselves and the researcher) rather than giving the real reason or reasons for franchising. These limitations mean that any conclusions drawn from surveying franchisors about initiation intentions are tentative at best. Overall, firms appear to initiate franchising for a multitude of reasons. As noted by Norton (1988a) and Dant (1995) there could be more than one reason for a firm to initiate franchising. Lafontaine (1992b) surveyed over 100 founders and found that over 50% cited raising capital as a reason for franchising. In a survey of franchisor CEOs and founders, Dant (1995) identified seven reasons from the literature on why firms initiated franchising. These included resource scarcity reasons of access to capital, access to managerial talent, access to local market knowledge, and the need to gain economies of scale in production, promotion, and co-ordination. Dant (1995) hypothesized these reasons might not apply after a firm has begun franchising because over half of the founders surveyed were unhappy with the results of the franchising system but nevertheless continued to franchise.

A second resource scarcity prediction is that a firm will franchise more heavily during the early part of its lifecycle to overcome the scarcity of resources. Essentially, if a firm is young, small, or growing fast, then it franchises more. As the firm ages and matures, franchising should diminish. The three ways researchers have tended to measure this pattern of franchising are with the variables of franchisor age, size, and growth rate. Additionally, special attention has been paid to a single resource: capital scarcity. Resource scarcity predicts that firms' propensity to franchise will increase with capital scarcity. A summary of the correlations found in a meta-analysis for these three effects along with the effects of the capital scarcity hypothesis are summarized in Table 1.

According to resource scarcity, a firm's age should be negatively associated with its propensity to franchise. A firm's age could be measured in two ways: (1) age since franchise initiation or (2) age since founding. Although these can be highly related, firms could have very different franchising patterns and yet be very similar on one of these dimensions (Carney and Gedajlovic 1991). For instance, two firms may have been franchising for 5 years, but one may have been in existence 30 years and the other only 6 years. Regardless of measure, however, the results have not supported a relationship between age and propensity to franchise. For instance, Alon (2001) found no support for the relationship. A recent meta-analysis of firm's propensity to franchise and age revealed no linear relationship (Combs and Ketchen 2003). In fact, recent studies have found that firms franchise more, not less over time. For instance, Castrogiovanni et al. (2006a) found that firms continued to

**Table 1** Resource scarcity variables influencing firms' propensity to franchise (PF)

Variable	Prediction (effect on PF)	Effect on PF / most likely explanation for non-finding	Sample studies
Age	Negative—when firms are young, they need franchising to overcome scale economies, so as they age, firms need to franchise less	No effect ( $r=.04, p>.05$ ) / Non-linear explanation lies elsewhere (See Lafontaine and Shaw 2005)	Lafontaine and Shaw (2005) Castrogiovanni et al. (2006a)
System Size	Negative—when firms are small, franchising allows them to overcome scale economies, so as firms become bigger, they should need to franchise less	Positive ( $r=.20, p<.05$ ) / explanation lies elsewhere	Alon (2001) Contractor and Kundu (1998)
Growth Rate	Positive—as firms become large, their growth rate slows down, and they need to franchise less because economies of scale have been achieved.	No effect ( $r=-.02, p>.05$ ) / no relationship	Michael (2000a) Martin and Justis (1993) Shane (1998a)
Capital Scarcity	Positive—when it is difficult to raise capital through other means, franchisees provide an inexpensive form of capital	No effect ( $r=-.06, p>.05$ ) / poor measures or no relationship	Martin and Justis (1993) Combs and Ketchen (1999b) Norton (1995)

When correlation are reported, they are taken from the meta-analysis by Combs and Ketchen (2003). The explanations for non-findings are derived from analysis

increase the franchised proportion of their outlets even 60 years after franchise initiation. Lafontaine and Shaw (2005) found that the percentage of franchised outlets rises dramatically for the first 7 to 8 years and then stabilizes with not much change thereafter. These results suggest that a relationship exists between proportion franchised and age, but that it is not linear. Castrogiovanni et al. (2006a) hypothesized and found, for example, a cubic pattern whereby franchisors increased the franchised proportion of their outlets during the first 10 years of their franchising effort, decreased the proportion slightly for roughly the next 10 years, and then increased it slightly thereafter (cf. Lafontaine and Shaw 2005).

The second variable used to study franchising patterns is franchise system size. System size is usually measured as number of outlets (Alon 2001) or total sales (Contractor and Kundu 1998). System size is posited to be negatively associated with firms' propensity to franchise because as a firm grows it should be able to obtain sufficient capital and other resources on its own. There are mixed results based on different samples. In opposition to resource scarcity reasoning, Alon (2001) found that larger systems franchised more. In support of resource scarcity, Castrogiovanni et al. (2006b) found that the bigger the firm (in total number of outlets) the less its propensity to franchise. They also noted that this trend was not linear, but curvilinear in that much of the reduction in propensity to franchise occurred while systems were relatively small and that as they became larger, the percentage changes decreased. Consistent with resource scarcity, Shane (1998a) also hypothesized and found a curvilinear relationship, an inverse U-shaped relationship between system size and the proportion of franchised outlets.

Overall, these divergent studies suggest that either the relationship between system size and a firm's propensity to franchise is more complicated than resource scarcity suggests or that system size is not a good proxy for the resource scarcity hypothesis. This latter view is supported by a recent meta-analysis that found a linear relationship opposite that predicted by resource scarcity (Combs and Ketchen 2003). The effect size between system size and proportion of franchising was significant and positive ( $r = .20, p < .05$ ). This suggests that some of the measures might be poor proxies for resource scarcity or that other explanations exist for the relationship between firm size and propensity to franchise. Perhaps, as franchising systems grow and develop resources to select, hire, train, and motivate franchisees, franchisors recognize that utilizing and exploiting these resources may result in a competitive advantage (Combs et al. 2004b), thus leading them to continue or even increase their use of franchising as they grow.

The third variable studied by resource scarcity researchers interested in a firm's pattern of franchising is growth rate. Growth rate can be measured as the percent change in outlets (Michael 2000b) or as an increase in sales (Roh 2001). Resource scarcity posits that growth rate is positively related to a firm's proportion of franchising because growth rate is usually higher when a firm is young, small, and attempting to achieve scale economies. Once again, the empirical evidence is mixed. Michael (2000b) found a negative relationship between growth rate and the percentage of franchising; suggesting that firms franchised less when they had a high growth rate. In support of resource scarcity, Lafontaine (1992a) found a positive relationship between growth rate and a firm's franchising proportion, suggesting that franchising allowed a firm to grow faster. As a meta-analysis found no linear

relationship, these conflicting results suggested the possibility of a non-linear relationship (Combs and Ketchen 2003).

Shane (1998a) posited an inverse U-shaped relationship between growth rate and the propensity to franchise that more accurately reflected the resource scarcity prediction on growth rate. He hypothesized that franchising might free up firms to franchise more often when they were growing at a fast rate, but that over time as that growth rate slowed, firms might then franchise less. However, he found no evidence for this relationship. Thus, meta-analysis revealed no linear relationship and Shane found no non-linear relationship, which suggests there is most likely no overall relationship between a firm's growth rate and its propensity to franchise.

In summary, there is little support for the resource scarcity hypotheses that firms franchised less as they age and grow in size, and that they franchise more when they are growing fast. A recent longitudinal study of 23 franchising industries over 17 years suggests that franchisors increase their propensity to franchise for about 7 years and then retain that proportion of franchising (Lafontaine and Shaw 2005). A recent meta-analysis by Combs and Ketchen (2003) of 44 studies found not only no support for the resource scarcity hypothesis, and in fact found that the evidence regarding two of its predictions (age and size) are in the opposite direction (see Table 1). These findings suggest that as franchising firms grow in age and size, they franchise more not less, contrary to the resource scarcity argument.

In addition to the general resource scarcity variables (i.e. age, size and growth) one specific resource scarcity variable—capital—has been singled out for special attention. Oxenfeldt and Kelly (1969) hypothesized that franchisors would be able to use franchisees as an easily available and cost-effective source of capital. Rubin (1978) challenged the notion that franchisees are a cost effective source of capital. He noted that because franchisees will most likely own only one or two outlets, the franchisee's investment is more concentrated and thus much riskier than an investment in the entire chain. Therefore, a risk-averse franchisee should prefer investing in some form of shares in all outlets rather than confining an investment to only one outlet. This suggests that franchisees should require a higher rate of return on capital if forced to invest in one outlet. The counter argument is that because the alternative—passive investors in stock and bond markets—do not know which firms have given full disclosure or which will continue to act in investors' best interests over time, passive investors might actually be a more expensive form of capital than franchisees (Martin and Justis 1993). Further, because franchisees possess privately held information concerning their managerial abilities, they may be able to provide a lower cost of capital than passive investors (Combs and Ketchen 1999b). Norton (1988b) posited that it was actually the bundling of both financial and human capital that makes franchising attractive as a means of growth. Because a franchisor lacks several forms of capital (financial and human) the best method of acquiring these resources is by bundling them together in a franchise system.

The capital scarcity argument for franchising has also received mixed results (Combs and Ketchen 2003). While some researchers found support for the hypothesis that firms confronting capital scarcity franchise more, others have not. For instance, Martin and Justis (1993) found that young firms' propensity to franchise increased directly with interest rates, suggesting that when other sources of financing are harder to obtain, firms turn to franchising. In contrast, Minkler and

Park (1994) found that increases in the real interest rates were positively associated with company ownership. Other researchers used capital requirement measures such as outlet size, finding support in the opposite direction (Lafontaine 1992a). Studies measuring actual slack capital also point in opposite directions (Combs and Ketchen 1999a; Dant et al. 1998). When combining all types of capital measures, meta-analysis also found no support for the capital scarcity-propensity to franchise relationship (Combs and Ketchen 2003). In essence, while capital scarcity may help firms initiate franchising (Dant 1995), many firms continue franchising well past the necessity of capital requirements.

The final prediction of resource scarcity is that, in the extreme, a firm reverts back primarily to full company ownership as it matures. As mentioned above, it does not appear that franchising has followed such a lifecycle pattern (Combs et al. 2004b). Lafontaine and Shaw (2005) examined franchising patterns of over 1,000 franchisors from 1980 through 1997, and found no significant change in the proportion of company ownership after firms had franchised for 8 years. Castrogiovanni et al. (2006a) likewise found that franchising persists, in their longitudinal analysis of over 100 firms. Consequently, franchising appears to be a permanent organizational form adopted by some organizations.

### Agency theory

Agency theory in franchising research is concerned with resolving the agency problem that arises when the goals of the principal (franchisor) and the agent (franchisee or manager) conflict under conditions wherein it is difficult or expensive for the principal to monitor the agent's behavior (Eisenhardt 1989). Individuals are assumed to be self-interested, boundedly rational, and generally risk averse (Eisenhardt 1989). However, the principal and agent might have different risk preferences. Principals are assumed to be risk neutral because they can diversify and spread their risk among different opportunities while agents are assumed to be risk averse because they cannot spread their risk. Both parties are self-interested, which leads to goal conflict. Information asymmetry between principal and agent is also assumed, which means each party knows more information than is shared. For instance, agents might know more about local market conditions (Minkler 1990; Combs and Ketchen 1999a), or principals might know more about operating routines and overall market demand (Mathewson and Winter 1985). Information is assumed to be a purchasable commodity meaning that principals can learn about agent behavior by monitoring, though this monitoring comes at a cost. The central unit of analysis is the contract between principal and agent (Eisenhardt 1989).

Eisenhardt (1989: 60) noted that “the focus of the principal-agent literature is on determining the optimal contract, behavior versus outcome, between the principal and the agent.” In franchising, the contract between principal and agent is structured differently depending on whether the agent is a franchisee or an employee-manager. Franchisees are given the incentive of a residual claim on all profits after expenses, including a royalty percentage paid to the franchisor. Managers are usually paid a salary with a small bonus tied into outlet performance.

In franchising, risk neutral franchisors (principals) contract with risk averse franchisees or managers (agents) to perform some duties, such as operating a store in



accordance with a standardized system of operating routines. The franchisor has a valuable strategic asset that includes its brand name and operating system (Caves and Murphy 1976). The question for the franchisor is whether to choose to expand using company-owned outlets, franchisees, or some combination. According to agency theory, this choice results from the tradeoffs of using different franchisees or employee managers as agents. Agency theory suggests that as monitoring costs increase, the principal is more likely to attempt to align incentives through the offer of residual claims to the agent via franchising. Franchisors trade off a loss of some profit (residual claims) in return for motivated franchisees. However, the more firms franchise, the more likely that some franchisees will take advantage of the established reputation of the franchise system and provide a lower quality service (Michael 2000a). Because of this potential for free riding behavior, franchisors with valuable inputs might want to franchise less.

There are two predictions related to franchising that come from agency theory. The first is that firms will expand with company-owned outlets if monitoring costs are low and will expand using franchising, a second-best contract, in response to rising agency costs associated with incomplete information. Second, by franchising, firms introduce opportunities for free riding by both parties, which potentially limits firms' propensity to franchise and the benefits accrued from franchising. The literature on each of these areas is reviewed below, with an emphasis on how each prediction affects firms' propensity to franchise. A summary of the empirical literature on firms' propensity to franchise is presented in Table 2.

The first prediction means that in the case of complete or near complete information, the principal wants to contract for behavior (Eisenhardt 1989). Employee-managers contracts are preferred when the principal can obtain near complete information about the activities of these managers by easily monitoring outlets using direct observation. Therefore, the principal opens company-owned outlets to retain all of the profits after paying monitoring costs—the expenses incurred observing, understanding, and redirecting agents' actions (Alchian and Demsetz 1972; Jensen and Meckling 1976).

There are two principal-agent problems in company-owned outlets, moral hazard and adverse selection. Moral hazard refers to lack of effort or misdirected effort on the part of the agent (Eisenhardt 1989). Shirking, the kind of moral hazard most prevalent with employee-managers, occurs when the agent (in this case, manager) withholds effort when the principal is not watching (Brickley and Dark 1987). Because company-owned outlet managers are compensated primarily by salary, they are more likely to shirk. Principals hire monitors (middle managers) to watch the managers of company-owned outlets and thus minimize shirking (Jensen and Meckling 1976). Adverse selection occurs when agents (in this case, employee-managers) have an incentive to misrepresent their true abilities, and the principal is not in a position to determine who presents themselves honestly (Eisenhardt 1989). For instance, firms may hire employee-managers who are unqualified if the job requires an understanding of the industry that applicants falsely claim to possess. In the hierarchical governance structure of a company-owned outlet, this adverse selection is handled via screening in the selection process, via termination, or by re-training post-hire. If firms can keep these monitoring costs down, they will choose to open only company-owned outlets.



**Table 2** Agency theory variables influencing firms' propensity to franchise (PF)

Variable	Prediction on firms' propensity to franchise	Effect on propensity to franchise / most likely explanation for non-finding	Sample studies
Geographical Dispersion	Positive—firms franchise more the farther outlets are located from headquarters.	Positive ( $r=.24, p<.05$ )	Alon (2001) Brickley and Dark (1987) Lafontaine (1992a)
Local Managerial Expertise	Positive—firms franchise more the more important local managerial expertise is to running the outlet	Positive (with some measures) ( $r=.09, p<.05$ ) / other measures do not accurately capture effect	Dant et al. (1998) Michael (1996)
Inefficient Outlet Size	Positive—firms franchise more the smaller an outlet is because it is more expensive to monitor than larger outlets.	Positive ( $r=.09; p<.05$ )	Lafontaine (1992a) Thompson (1992)
Non-repeat, Mobile Customers	Negative—firms franchise less because potential free riding by franchisees would negatively impact system quality	No effect found (not included in meta-analysis)	Brickley and Dark (1987) Minkler (1990)
Valuable Franchisor Inputs	Negative—firms franchise less because they do not want free riding on valuable brand name or operating system	Negative ( $r=-.18; p<.05$ )	Combs and Ketchen (1999b) Lafontaine and Shaw (2005)
Royalty Rate	Positive—firms franchise more because a higher royalty rate obtains larger revenue stream with more franchised outlets	Negative ( $r=-.07; p<.05$ ) / Royalty measures actually depict the price of the franchise.	Norton (1988b) Lafontaine (1992a) Scott (1995) Sen (1993)

Correlations and explanations for non-findings are taken from the meta-analysis by Combs and Ketchen (2003)

When principals select an outcome-based contract such as franchising, they are using a second best contract. The franchisees are incentivized with a potential profit stream after paying an up front franchise fee, an ongoing royalty, and all other operating costs (Klein 1995). Franchisors use franchising to reduce the costs of monitoring and adverse selection (Brickley and Dark 1987; Shane 1996). Franchisees are incentivized by becoming residual claimants (Fama and Jensen 1983). Thus, when monitoring costs increase, making franchisees residual claimants converts them into acting like principals. As owners, they are motivated to maximize income and profits, thereby minimizing any desire to shirk. Adverse selection is reduced because only the competent would purchase a franchise since they could lose their upfront investment as a result of their own incompetence, in addition to forfeiting income opportunities from alternative employment. The empirical evidence regarding monitoring costs and adverse selection on firms' propensity to franchise is reviewed below.

*Effects of monitoring costs (moral hazard) on propensity to franchise* The costs of monitoring company-owned outlets increase for three reasons: (1) geographical dispersion, (2) importance of local managerial expertise, and (3) inefficient outlet size. Each of these factors raises monitoring costs and thus induces firms to franchise more (see Table 2).

The first factor that increases monitoring costs under company ownership and thereby encourages franchising is geographical dispersion (Rubin 1978). When outlets are located far away from headquarters, it becomes more expensive to monitor managers' activities. For instance, an outlet located in that city or personnel from headquarters needs either a monitoring team to be located in that city or personnel from headquarters to travel there regularly for monitoring (Carney and Gedajlovic 1991). Either option increases costs as more outlets are located away from headquarters. As these costs rise, franchisors find it more attractive to franchise outlets. A number of authors have investigated and found support for this hypothesis. Brickley and Dark (1987) tested the hypothesis that corporate-owned stores would be located closer to corporate and regional headquarters than franchisee owned stores. Using a sample of 36 firms in 9 industries they found that this was indeed the case. Fladmoe-Lindquist and Jacque (1995) found that foreign expansion was more likely through franchising than company ownership. Meta-analysis supports the positive relationship between a firm's geographical dispersion and propensity to franchise ( $r=.24$ ,  $p<.05$ ), suggesting that the farther an outlet is opened from headquarters, the more likely it is to be franchised (Combs and Ketchen 2003).

A second factor that increases monitoring costs and induces firms to franchise more is when local managerial expertise rises in importance. Managerial expertise is the ability, talent, and understanding of local market conditions that is needed to manage an outlet. As this expertise becomes more important, franchisors find it increasingly problematic to monitor managers' behavior, and therefore firms consider it more advantageous to contract with franchisees (Lafontaine 1992a). One reason it becomes problematic is that if the local manager has the expertise, it is difficult for the franchisor who does not have the local expertise, to effectively evaluate the quality of local managers' actions. For instance, in real estate services, the franchisor can provide training, management, and marketing support, but will be

unfamiliar with the best route through neighborhoods, the intricacies of the local schools, or whether neighborhood price values are trending up or down. These market variables require experience and judgment that only a local real estate agent can provide. However, if operating routines are more standardized and easy to observe, then managerial expertise becomes less important and franchisors are more likely to open company-owned outlets (Combs and Ketchen 1999b). Therefore, agency theory posits that as managerial expertise becomes more important, firms' propensity to franchise increases. Meta analysis found support for the local managerial expertise-propensity to franchise relationship ( $r=.09$ ;  $p<.05$ ) (Combs and Ketchen 2003).

A third monitoring cost variable that increases monitoring costs and induces franchising is outlet size. Outlet size is measured by the average outlet startup costs or outlet sales (Alon 2001; Caves and Murphy 1976). A smaller outlet size increases the franchisor's monitoring costs because scale economies make monitoring larger outlets marginally less expensive (Lafontaine 1992a). Thompson (1992) and Combs and Castrogiovanni (1994) found that smaller establishment size is positively related to franchising and these results were supported by meta-analysis ( $r=.09$ ,  $p<.05$ ) (Combs and Ketchen 2003).

*Effects of adverse selection on propensity to franchise* As young firms grow they overcome adverse selection problems through franchising (Shane 1996; Norton 1988a). When firms are young and growing fast, they have an entrepreneurial capacity problem (Mahoney 2005; Thompson 1994). In essence, Penrose (1959) posited that the capacity of existing management is a key constraint to expansion. Because management needs to be concerned with running the firm's current operations, these concerns hampered its ability to initiate new operations. A key decision variable for young entrepreneurs is where to allocate their time. If that time is spent finding and evaluating employee-managers, it cannot be spent on other critical functions. By franchising, firms could overcome this constraint because franchisor-entrepreneurs hire qualified franchisees, who self select into the system. Consequently, franchising firms can grow more quickly because franchisor-entrepreneurs can allocate more of their time to other critical areas (Norton 1988a).

In franchising, qualified individuals signal their capabilities by buying outlets. Franchisees invest, which they would not do if they did not have the confidence that they could succeed. Thus, in the aggregate, more qualified individuals will see value in buying franchises. Franchising reduces the cost to the young franchisor of determining whether hired outlet managers have the necessary capabilities and qualifications, which reduces the cost of firm growth. Finally, franchisees are motivated to learn as much and as quickly as possible about the system in which they have invested, which reduces the cost of assimilation into the organization (Norton 1988b; Shane 1996).

Thompson (1994) adds that franchisors must create a structure in which to assimilate franchisees, and that this structure might require a steady stream of franchisees to remain efficient. Thus, franchising might not only help promote growth, but actually require it to remain efficient. The results generally support the idea that expansion through franchising is positively associated with firm growth. Shane (1996) found that expansion through franchising is positively associated with

firm growth among new franchisors, suggesting that firms could overcome managerial limits to expansion through franchising. Thompson (1994) also found support for firms circumventing the Penrose constraint on organizational growth through franchising. Once a decision to franchise had been taken, firms' growth rate was three times greater than expansion via company-ownership. These studies thus imply that firms use franchising to avoid adverse selection.

Generally, in situations where it is difficult or expensive to monitor agents' behavior, principals should use more franchising. Franchising reduces adverse selection by allowing firms to hire motivated franchisees, especially early on when firms are growing fast. However, franchising also introduces the problem of franchisee free riding.

*Free riding: the cost of franchising* Once firms begin franchising, a different moral hazard is introduced. Franchisee free riding refers to situations in which the franchisee offers lower quality products or services to customers because the outlet does not depend on repeat business. For instance, a franchised fast food restaurant on an interstate might deliver poor service to customers because there is less likelihood that customers will frequent that same restaurant again, regardless of service quality. The chain as a whole suffers some loss to brand image but the local franchisee capitalizes on the difference in the cost of quality offered versus that of providing quality that meets the chain's standards. Franchisee free riding could be a serious problem for the franchisor because although the customer is not likely to visit the same outlet, the customer associates the lower quality service with the entire chain (Brickley and Dark 1987). Thus, the individual franchisee gains the one-time sale, but the system loses the customer. Over time, and especially as more franchisees free ride, the entire chain suffers because these actions tarnish the chain's brand image and reputation (Brickley and Dark 1987; Michael 2000a).

There are three solutions to franchisee free riding according to agency theory. First, the franchisor can increase monitoring. However, this negates a major benefit of franchising—minimizing monitoring costs. Second, franchisors can accept the increased risk of free riding. However, the danger with this approach is that the free riding of franchisees will drive down the firm's reputation and quality such that there is less market for new franchisees and ultimately system survival is impacted (Brickley and Dark 1987). In a multi-industry study Michael (2000a) found that the higher the percentage a firm franchised, the lower the quality rating of that firm, suggesting that lower system quality is a byproduct of franchisee free riding that cannot be contracted away. A third approach to minimize franchisee free riding and the effects of lower quality is to franchise less.

Firms can franchise less in two ways: (1) selectively or (2) system-wide. First, the franchisor can open company-owned outlets in locations where free riding opportunities are high. The agency prediction here is that in locations where customers are not likely to frequent the same outlet, these outlets should be company-owned to avoid free riding. However, Brickley and Dark (1987) found no support for less franchising of outlets located near freeways where free riding opportunities should be highest. Others also found no reduction in franchising by franchisors facing free riding in certain geographical areas (i.e. Brickley et al. 1991).

A second way to franchise less is to grow system-wide via company-owned outlets. Firms might decide to franchise less when they have a valuable input such as a brand image. When firms have unique operating routines or an established brand name, demand for the service may be high enough that individual agent effort becomes less important in determining outlet success (Combs and Ketchen 1999b). When franchisees can obtain a steady profit stream with less effort, free riding opportunities are introduced. The empirical evidence supports this negative relationship between valuable franchisor inputs and less franchising. Combs and Ketchen (1999b) found through a survey that the more specific knowledge firms had, the less likely they would expand through franchising. Lafontaine and Shaw (2005) found that companies with strong brand images used more company ownership. These results are supported by meta-analysis that found support ( $r = -.18$ ,  $p < .05$ ) for the relationship between valuable franchisor inputs and firms' propensity to franchise (Combs and Ketchen 2003).

The potential for franchisee free riding does not appear to deter franchising. Firms continue to open franchise outlets in spite of rising free riding opportunities by franchisees. This suggests that monitoring cost avoidance overrides free riding concerns. Because a franchisee is difficult to terminate (Bradach 1997), the entire chain suffers from the actions of any franchisees or managers who free ride. By using franchised outlets, franchisors appear to accept lower quality (Michael 2000a).

In general, the potential for free riding effects on firms' propensity to franchise appears minimal. Firms franchise less when they possess valuable assets such as a brand image or operating routine, but ignore selective opportunities to franchise less in certain locations where free riding opportunities might be higher. So, while free riding is a cost to the franchisor (Michael 2000a), the overall effect of free riding concerns on firms' propensity to franchise may be minor.

### Resource scarcity and agency theory synthesis

Empirical results support the notion that franchising versus company ownership reflects a tradeoff among agency costs. Agency considerations relate to the differences in goals desired by agents (managers or franchisees) and their principals (franchisors). Agency theory hypothesizes that franchisors want to minimize their costs by aligning the incentives of principals and agents through monitoring and incentivizing (Alon 2001).

Resource scarcity predicts that firms initiate franchising to overcome economies of scale early in the lifecycle and then abandon it at the later stages. However, meta-analyses do not support many of the predictions of resource scarcity. Franchising may be initiated by resource scarcity considerations, but the pattern of franchising and a redirection toward ownership of franchised outlets is not supported.

In reconciling these two theories there are three approaches. Rubin (1978) takes the position that these two theories are in direct opposition to each other. Shane (1998b) takes the position that agency theory explains so much of the relationship that resource scarcity is not needed. Others (Carney and Gedajlovic 1991; Combs and Ketchen 1999a) take the position that these theories are complementary in that their variance explained is additive. Based upon the results of the meta-analysis

(Combs and Ketchen 2003), and our review of the literature, a fourth position is most probable—resource scarcity seems to play a role in the initial decision to franchise, but agency theory better explains the pattern of franchising once the firm has reached its minimum efficient scale (cf. Castrogiovanni et al. 2006a). Still, agency theory does not completely explain the long-term pattern. Indeed, extant research explains only a small proportion of firms' propensity to franchise (Combs and Ketchen 2003).

Specifically, there are three unresolved issues that agency theory does not explain. First, agency theory does not explain why a firm would be 100% franchised. If firms franchise in response to rising monitoring costs, then some outlets (such as those located close to headquarters) should remain company-owned. Yet, Minkler (1992) pointed out that in some companies even outlets close to headquarters will be franchised. A second agency theory shortcoming is a failure to account for the coexistence in the same geographic area of franchised and company owned firms. Agency theory simply posits that in any area, only one form (either franchised or company-owned outlets) should exist because monitoring costs should be about the same for all outlets in the area. Thus, how firms choose their propensity to franchise, including the co-location of franchised and company-owned outlets is not well understood. Finally, agency theory offers no explanation for multi-unit franchising, which exists when franchisors give multiple outlets to the same franchisee. This practice is not universal, but may be used as an incentive to reward franchisees who have performed exceptionally well (Bradach 1997). Agency theory suggests that franchisors should not offer multi-unit franchising because franchisees in charge of multiple locations can no longer devote full attention to a single outlet, eliminating the advantage of having the residual claimant to watch day-to-day activities (Kaufmann and Dant 1996).

### Recent theoretical developments

Other theoretical perspectives addressing the relationship between antecedents to franchising and a firm's propensity to franchise include organizational learning (Darr et al. 1995; Sorenson and Sørensen 2001), search cost theory (Minkler 1990, 1992), signaling theory (Gallini and Lutz 1992), and institutional theory (Combs et al. 2009). These theories have unique perspectives on a firm's propensity to franchise. Although these theories have not been investigated as extensively as resource scarcity or agency theory, there is limited support for each.

*Organizational learning* Organizational learning in franchising research is concerned with how organizations gain knowledge and transfer that knowledge throughout the franchise system. Organizational knowledge consists of two types—information (knowing what something is) and know-how (the procedures on how to do something) (Kogut and Zander 1992).

In franchising, researchers interested in organizational learning focus on the determinants and consequences of interfirm and intrafirm knowledge transfer (Darr et al. 1995; Sorenson and Sørensen 2001). Darr et al. (1995) found that while franchisees transfer knowledge across outlets owned by the same franchisee, this knowledge did not transfer as readily to other franchisees. In addition, this

knowledge deteriorated more quickly over time in outlets owned by single unit franchisees than in those outlets owned by multi-unit franchisees suggesting that there are two advantages—knowledge transfer and knowledge retention, associated with allowing multi-unit franchisees. A more hierarchical governance structure, as provided by many multi-unit franchisees, may help franchisees retain knowledge passed down from franchisors (Bradach 1997).

Knowledge transfer can be achieved by franchisors using a balance of exploration and exploitation (March 1991; Sorenson and Sørensen 2001). Managers of company-owned units exploit existing routines while franchisees explore new routines and ideas. Ideally, successful ideas are passed up to the franchisor, incorporated by headquarters, and passed down for replication in all company-owned and franchised outlets. However, as franchisees are independent firms, they need to be convinced that new routines are worthwhile (Bradach 1997). Although organizational learning suggests that firms use a mix of company-owned and franchised outlets, it does not predict the optimal balance.

Sorenson and Sørensen (2001) found initial indications of a positive relationship between organizational learning and firms' propensity to franchise in that firms that expanded through franchising had higher sales growth. Sorenson and Sørensen (2001) suggested that this provided an alternative explanation to agency theory for the link between geographical expansion and franchising. Instead of franchising in remote geographical areas to minimize monitoring costs, franchisors might use franchised outlets to expand and explore for new ideas in those markets so that these innovations could be transferred throughout the chain. This theory explains why company-owned and franchised outlets might be located in the same geographical area.

*Search cost theory* Search cost theory also provides an explanation for the existence of outlets at similar locations that are both company-owned and franchised (Minkler 1990). Search costs are those expenses that a franchisor incurs in finding out about local market conditions (Minkler 1990). By outsourcing information search costs, decision-making authority on marketing, and other local variations onto franchisees, franchisors capitalize on franchisees' ability to learn about and act on local opportunities (Dnes 1996; Minkler 1992). Similar to agency theory, distant outlets are more likely to be franchised but the reasoning relies on the importance of local market knowledge and the franchisors inability to acquire it. Thus, search cost theory predicts markets are entered first via franchising. After firms acquire local market knowledge from their franchisees, they open company-owned stores. In this way, franchised and company-owned outlets come to co-exist in each market.

By analyzing a restaurant chain's franchising pattern in one city, Minkler (1990) found support for search cost. There was no difference in distance from headquarters between company-owned and franchised outlets, and franchised stores were interspersed among company-owned outlets (Minkler 1990). If reducing monitoring costs was the overriding decision on where to franchise, a different pattern would have emerged, but it appears that, in contradiction to agency theory, companies use a mix of franchising and company ownership in the same geographic locations. Overall, search cost appears to be an alternative explanation for some inconsistencies between agency theory predictions and the observed reality of the co-location of franchised and company-owned outlets.



*Signaling theory* Signaling theory explains the mix of company owned and franchised outlets as a reflection of the franchisors' signaling of business quality (Gallini and Lutz 1992). It assumes that franchisors have a superior business model and want to convey that information to franchisees via two means—the opening of company-owned stores and a high royalty rate (Gallini and Lutz 1992). Franchised outlets are assumed to be more profitable than company-owned outlets, so firms operate company-owned units only to signal a high quality operation to potential franchisees. Firms charge a high royalty rate as a signal to potential franchisees that they have a quality system that can demand a premium price. The two predictions of this theory are: (1) that firms open company outlets in new locations before franchised outlets, and (2) that as a firm's reputation improves over time, it should need to use less signaling. Thus, signaling theory posits that as franchising firms' age and their brand image improves they franchise more and open less company-owned outlets (Gallini and Lutz 1992). Unless franchisors can signal a high quality operation via other means (reputation or high royalty rate), firms will need to operate some percentage of company-owned outlets.

Signaling theory has received mixed empirical support. Scott (1995) provided some evidence for signaling theory in a study of over 1,000 survey responses across 47 industries. He found that firm age was positively associated with percent franchised, suggesting that as firms' signaled better quality, they franchised more, not less. However, Dant and Kaufmann (2003) found the opposite—that aging franchisors trended toward more company-owned outlets. Lafontaine (1993) also found no support for signaling theory's predictions in her analysis of 125 franchise systems. She found that firms with brand names did not use royalty rate, franchise fee, or proportional company ownership to signal to prospective franchisees about the quality of the franchise system. Thus, while signaling theory provides an explanation for the co-location of franchisees and company-owned outlets, few studies directly support this explanation.

*Institutional theory* Combs et al. (2009) obtained evidence that both external and internal institutional pressures influence firms' propensities to franchise, based on a sample of 1,300 franchisors active during 1980 through 2000. Moreover, they found that responsiveness to internal institutional pressures declines as economic reasons to franchise increase. Among external pressures, they found a general trend toward increased use of franchising, suggesting that the franchising business model itself may be increasingly institutionalized. In their analysis, several resource scarcity and agency variables were incorporated for control purposes. The effects of the institutional theory variables were greater than those of the resource scarcity or agency variables, suggesting that institutional theory may prove to be at least as important in explaining propensity to franchise as the two perspectives that have dominated the literature to date.

Collectively, these theories add some richness to that provided by resource scarcity theory and agency theory. For instance, a theoretical justification for the co-location of franchised and company-owned outlets emerges from each theory. However, each theory differs in how that co-location emerges. Organizational learning and search cost suggests that firms explore new markets with franchisees

and then exploit these markets with company-owned outlets. Signaling theory posits the opposite—company-owned stores are opened first to signal a high quality operation to potential franchisees. While there is limited support for each, they address a key limitation of agency theory—the existence of both franchised and company owned outlets in the same area.

The question remains, therefore, whether agency theory, combined with one or more of the above theories, is a sufficient explanation of firms' propensity to franchise. Agency theory is arguably an incomplete theory based upon the lack of variance explained as well as the inconsistencies in explaining dual distribution and multi-unit franchising. Organizational learning provides an explanation for the collocation and expansion of company owned and franchised outlets, but makes no predictions on how firms arrive at the decision to choose this proportion. Both signaling and search cost theories imply systematic changes in company ownership over time, but in opposite directions (Dant and Kaufmann 2003; Lafontaine and Shaw 2005). Given that firm ownership remains fairly stable over time, both these theories can be rejected as well. Thus, while agency theory provides limited guidance, the addition of these other theories is not sufficient to explain firms' propensity to franchise.

### Franchising outcomes

There is limited knowledge on the firm performance associated with franchising, which underscores the need for a more comprehensive understanding of the link between the antecedents to franchising and the consequence of firm performance. Extant theory has not been directly concerned with performance outcomes because the two dominant theories used in franchising research, resource scarcity and agency theory imply, but do not directly predict superior performance. For instance, agency theory posits that if firms structure the right contract with the correct agent, superior performance will follow. Thus, survivability has been a key performance measure within the franchising literature. Other theories such as signaling and search cost theory also assume that one form, either franchised or company-owned outlets, respectively, is more profitable and that franchise systems are trending toward one form or the other (Dant and Kaufmann 2003). Therefore, researchers using these theories have been concerned with changes in firms' propensity to franchise over time (Lafontaine and Shaw 2005). Overall, theories used to study franchising have not specified how franchising systems develop competitive advantage and thus, researchers have rarely investigated causes of performance differences.

Researchers are also limited by the lack of available public data on franchising firms, because most franchises are privately owned (Shane 2005). Of those that are publicly owned, many are owned by parent companies that also own several similar chains and make public only the aggregate segment data, not the franchisor chain-level data. While researchers are beginning to understand what helps franchise systems survive over time (i.e. Shane 2001), what is less well known is what will differentiate those survivors. The limited extant literature on three types of franchising performance outcomes—growth and survival, financial measures, and subjective measures is reviewed below.

## Growth and survival

Franchise systems are subject to the same liability of newness phenomenon that afflicts other organizational forms (Shane 1996; Stinchcombe 1965). Shane (1996) found that the use of franchising enhances firm growth and survival for new franchisors. He argued that franchising allows firms to grow more quickly, achieve economies of scale, and improve survival rates. However, only 25% of the new franchise systems he studied survived after 10 years, suggesting more would fail without it. Shane (1998b) found that failure was more likely when franchisors (1) permit passive ownership (in which the franchisee is not actively running the outlet), (2) had a complex franchise system (in which the franchisor offers many different services to franchisees), or (3) used master franchising (in which an intermediary is used to recruit, hire, and train franchisees). It seems that these contract items exacerbate agency costs, leading to an increased likelihood of failure. When franchisees were required to (1) initially invest more cash at startup, or (2) have experience in the industry, then the risk of franchisee adverse selection is minimized and the probability of failure decreased.

Hold-up is a post-contractual issue where either party acts opportunistically and attempts to renegotiate a contract after specific investments have been made by the other party (Shane 1998a; Williamson 1985). Agency theory predicts that hold up will have negative impacts on growth and survival because if franchisors engage in hold-up, franchisees may be harder to find and if franchisees engage in hold up, firm performance may suffer in the long run because of increased litigation (Michael 2000a) and increased transaction costs associated with renegotiating the contract (Brickley and Dark 1987; Shane 1998a). The reverse may also be true. If hold up is reduced, then young franchisors have a better chance for survival. Shane and Foo (1999) found if a new franchisor begins franchising in one of 14 states requiring a ‘termination’ clause, survival odds improve. The ‘termination’ clause requires franchisors terminating franchise agreements to show good cause and provide franchisees’ compensation, increasing the cost of termination. Starting a franchise system in one of these states also lowers the cost of attracting qualified franchisees because a signal is sent to prospective franchisees that the contract will not be terminated unless there is justification (Shane and Foo 1999). These results suggest that reducing the threat of hold up can improve franchisor survival.

With a longitudinal data set of almost 3,000 franchise systems, Shane (2001) also found support for the argument that when larger franchise systems manage changes to contract over time better than competitors, then these franchisors are more likely to survive. Specifically, he identified policies that mitigated franchisee free riding and thus increased franchise survival in large franchise systems. Franchisor-initiated services have opposite effects on performance because while they reduce franchisee free riding they also increase the opportunity for franchisor hold up. These services reduce free riding by placing the control of key inputs used by franchisees in the hands of the franchisor. However, these services also make it easier for the franchisor to hold up franchisees because these services require franchisees to make relationship-specific investments in franchisor inputs (Klein and Saft 1985).

Shane (2001) found three types of services related to increased opportunities for franchisor hold up and decreased opportunities for franchisee free riding that lead to

increased system survival. First, training services include franchisor required field training, field operations evaluation, and initial store-opening assistance. Centralized services are common to franchisees and company-owned outlets, such as centralized purchasing, data processing, and inventory control. Communication services are activities such as a telephone hotline, regional and national meetings, or franchisee newsletters. Shane (2001) found that when large franchise systems made these services available, failure rate was lowered. This suggests that reducing the potential for franchisee free riding overrides franchisor hold up concerns, especially among larger franchise systems. The franchisees want franchisor services to bind all franchisees and thus minimize free riding. An alternative explanation is that these training services accomplished their goal and help achieve a standardized product, build better relationships among franchisees and franchisors, and that this improved relationship is what lowered the failure rate.

Thus, agency theory variables relate to franchisor growth and survival. However, while these are important performance indicators, they do not differentiate among the surviving franchising systems. Shane's (2001) analysis does not help determine which systems deliver superior performance, only that they survived. Collectively, these studies illustrate that small contract changes over time impact franchise system survival, but that gaining competitive advantage in franchising might also involve other, relation-specific resources.

### Financial measures

Few studies have investigated the financial performance of franchise systems. In their review Combs et al. (2004b) found only three studies with implications for franchisor financial performance. Using 137 firms from the fast-food restaurant industry, Michael (2003) found that the first firm to franchise in a new market segment builds more outlets than competitors, leading to greater market share and better profitability. In particular, Michael (2003) noted that it was the first firm to franchise, not first to market, that resulted in greater market share and better profitability. This suggests that the first mover advantage proposed by Lieberman and Montgomery (1988) applies to franchising. Franchising allows firms to achieve scale economies more quickly than competitors (Shane 1996), and this gives firms opportunities for increased market share.

In a study involving 152 restaurant chains over 7 years, Sorenson and Sørensen (2001) found that the more geographically dispersed a chain became, the more revenue they could generate when growth occurred through franchising. When firms expanded into multiple regions, they posited that organizations learned more and grew faster through franchised outlets. Finally, in another restaurant industry study, Combs et al. (2004a) separated franchisors into three strategic groups. Franchisors had performance differences related to ROA, sales growth, and market-to-book value based upon which strategic group they were classified. Those that franchised based on a need to fill a resource scarcity exhibit poorer performance than firms that franchised in response to agency-based considerations. One limitation to these studies is that they were all conducted within the restaurant industry, limiting their generalizability to other franchising settings but also highlighting the difficulty obtaining financial data on franchising firms.

## Subjective performance measures

Performance is a multi-faceted, multi-dimensional construct (Combs et al. 2005). In franchising, due to the paucity of hard financial measures, other measures of performance such as innovation, quality, and standardization are used as indicators of superior performance (Combs et al. 2004b). Michael (2000a) found that consumer rated quality is negatively related to the percent franchising in both restaurants and hotel chains, suggesting that franchising inherently decreases quality. These results suggest that to franchise decreases performance due to franchisee free riding (Michael 2000a).

Collectively, these studies reveal three needs in research on franchisor performance. First, studies of franchising performance should include industries other than the restaurant industry. Franchising system survival has been studied in a multi-industry setting, but other studies that investigated performance differences among surviving franchise systems have not. Second, survival and growth are excellent performance measures that apply to all firms and industries, but they do not capture the variance of differing performance levels among survivors. Although much has been learned about what franchise systems can do to enhance growth early in their lifecycle and enhance survivability both early on and as the system becomes large, there is little guidance on what makes a superior system. Third, franchising researchers should use measures (other than survivability) that apply across industries and for both private and public firms because this will help findings from franchising research generalize to other hybrid organizational forms. One way to do this would be to survey franchisors.

## New directions

Recent research suggests that the resource-based view and the relational view may offer additional insights about firms' propensity to franchise and its effects on firm performance. Accordingly, firms' propensity to franchise is initially an organizational form decision, answering the question: Do I want to engage in franchising? After that decision, managers set a target proportion of franchising (Lafontaine and Shaw 2005). The resource-based view might help explain how managers decide on their propensity to franchise because managers want to include within their boundaries those resources and capabilities they view as central to their competitive advantage (Madhok 2002). The relational view might help explain how managers decide their propensity to franchise because it recognizes the importance of interfirm relations. The more managers recognize the importance of relational resources, the more that they will want to capitalize on these investments.

The resource-based view and relational view are also theories of competitive advantage. The resource-based view predicts performance differences by looking inside a firm and determining how resources and capabilities help achieve competitive advantage. The relational view predicts performance differences by looking at how the joint management of interfirm relations is exploited to create relational profits that neither firm could achieve independently. In franchising, there are both internal strategic assets that can be developed and relational strategic

assets that create opportunities for competitive advantage. The use of these theories may enhance our understanding of franchising decisions and firm performance, and resolve some of the gaps in how and why firms franchise the way they do.

Consistent with other recent reviews (e.g., Combs et al. 2004b), we urge researchers to diversify the theoretical perspectives used to study franchising. In particular, we feel that the resource-based and relational views may prove particularly fruitful. Given the data collection difficulties we noted in this review, particularly regarding franchisor performance, development of a large-scale, longitudinal database would be particularly helpful. Researchers might seek support from the International Franchising Association in an effort to survey franchisors annually. Such an annual survey could track certain standard variables such as franchising propensity and performance, or those associated with an integrative model of franchising antecedents and consequences, each year while perhaps alternating over the years inclusion of additional variables associated with a variety of theoretical perspectives, such as those discussed in this review.

Research is also needed which tests the implicit or explicit assumptions of prior studies. Most of the franchising propensity studies reviewed here, for example, overlooked possible differences due to multi-unit franchising. Thus, an outlet was considered to be franchised regardless of whether it was the only outlet or one of many outlets owned by a particular franchisee. Likewise, researchers have tended to ignore whether franchisees operate their own outlets or hire managers to do so. In addition, possible confounds due to co-branding have been ignored. In the case of franchisee-initiated co-branding efforts, for example, such as when a single franchisee co-locates several restaurant franchisees in a food court, agency arguments about franchisee incentives may be problematic because the franchisee will be motivated to optimize across the co-branded businesses rather than maximize the performance of the particular franchise in question.

In addition, greater emphasis should be placed on micro-level research focused within franchise organizations. We noted previously, for example, that Minkler (1990) tested agency propositions associated with distances between specific outlets and firm headquarters. Recently, Castrogiovanni and Kidwell (2010) offered several propositions and related arguments concerning differences in the selection and training of franchisee versus employee managers of outlets in franchised networks. Focusing within organizations, researchers might flesh out the implications of agency theory, resource scarcity, and other theoretical perspectives described here by looking at decisions whether or not to franchise particular outlets as well as performance differences between franchised and company outlets.

Finally, research is needed comparing franchised networks with such close alternatives as wholly-owned chains, business opportunity networks, or distributorship networks. Most of the studies reviewed here focused on plural-form networks, which are those having some combination of franchised and company-owned outlets (Bradach 1997). In many cases, examination of alternatives to franchising can confirm, refute, or clarify conclusions drawn from plural-form franchise networks. Recall, for example, that Michael (2000a) found quality to correlate negatively with the propensity to franchise. If so, we would expect wholly-owned chains to exhibit greater quality than franchised chains, all other things being equal.



In conclusion, we reiterate that franchising is an increasingly common business model available to entrepreneurs seeking growth through geographic expansion. We reviewed the literature on both reasons for franchising and outcomes of franchising—key considerations in decisions by entrepreneurs as to whether the franchising business model is right for them. Much has been learned since Oxenfeldt and Kelly (1969) offered their theoretical perspective more than four decades ago, yet much still needs to be learned. With that in mind, we offered several suggestions to help stimulate and guide future research in this area.

## References

- Alchian, A., & Demsetz, H. (1972). Production, information, and economic organization. *The American Economic Review*, 62(5), 777–795.
- Alon, I. (2001). The use of franchising by U.S.-based retailers. *Journal of Small Business Management*, 39(2), 111.
- Bradach, J. L. (1997). Using the plural form in the management of restaurant chains. *Administrative Science Quarterly*, 42(2), 276–303.
- Brickley, J. A., & Dark, F. H. (1987). The choice of organizational form—the case of franchising. *Journal of Financial Economics*, 18(2), 401–420.
- Brickley, J. A., Dark, F. H., & Weisbach, M. S. (1991). The economic-effects of franchise termination laws. *Journal of Law & Economics*, 34, 101–132.
- Carney, M., & Gedajlovic, E. (1991). Vertical integration in franchise systems: agency theory and resource explanations. *Strategic Management Journal*, 12(8), 607–629.
- Castrogiovanni, G. J., & Kidwell, R. E. (2010). Human resource management practices affecting unit managers in franchise networks. *Human Resource Management*, 49, 225–239.
- Castrogiovanni, G. J., Combs, J. G., & Justis, R. T. (2006a). Shifting imperatives: an integrative view of resource scarcity and agency reasons for franchising. *Entrepreneurship Theory and Practice*, 30(1), 23–40.
- Castrogiovanni, G. J., Combs, J. G., & Justis, R. T. (2006b). Resource scarcity and agency theory predictions concerning the continued use of franchising in multi-outlet networks. *Journal of Small Business Management*, 44(1), 27–44.
- Caves, R. E., & Murphy, W. F. (1976). Franchising: firms, markets, and intangible assets. *Southern Economic Journal*, 42(4), 572–586.
- Combs, J. G., & Castrogiovanni, G. J. (1994). Franchisor strategy: a proposed model and empirical test of franchise versus company ownership. *Journal of Small Business Management*, 32(2), 37–48.
- Combs, J. G., & Ketchen, D. J., Jr. (1999a). Explaining interfirm cooperation and performance: toward a reconciliation of predictions from the resource based view. *Strategic Management Journal*, 20(9), 867–888.
- Combs, J. G., & Ketchen, D. J., Jr. (1999b). Can capital scarcity help agency theory explain franchising? Revisiting the capital scarcity hypothesis. *Academy of Management Journal*, 42(2), 196–207.
- Combs, J. G., & Ketchen, D. J., Jr. (2003). Why do firms use franchising as an entrepreneurial strategy?: A meta-analysis. *Journal of Management*, 29(3), 443–465.
- Combs, J. G., Ketchen, D. J., Jr., & Hoover, V. L. (2004a). A strategic groups approach to the franchising-performance relationship. *Journal of Business Venturing*, 19(6), 877–897.
- Combs, J. G., Michael, S. C., & Castrogiovanni, G. J. (2004b). Franchising: a review and avenues to greater theoretical diversity. *Journal of Management*, 30, 907–931.
- Combs, J. G., Crook, T. R., & Shook, C. L. (2005). The dimensionality of organizational performance and its implications for strategic management research. In D. J. Ketchen Jr. & D. C. Bergh (Eds.), *Research methodology in strategy and management*, Vol. 2 (pp. 259–286). Oxford: Elsevier.
- Combs, J. G., Michael, S. C., & Castrogiovanni, G. J. (2009). Institutional influences on the choice of organizational form: the case of franchising. *Journal of Management*, 35(5), 1268–1290.
- Contractor, F. J., & Kundu, S. K. (1998). Franchising versus company-run operations: modal choice in the global hotel sector. *Journal of International Marketing*, 6(2), 28–53.
- Dant, R. P. (1995). Motivation for franchising: rhetoric versus reality. *International Small Business Journal*, 14(1), 10–32.



- Dant, R. P., & Kaufmann, P. J. (2003). Structural and strategic dynamics in franchising. *Journal of Retailing*, 79(2), 63–75.
- Dant, R. P., Kaufmann, P. J., & Robicheaux, R. A. (1998). Changes in the mix of company-owned and franchised outlets: Ownership redirection revisited. Paper presented at the twelfth annual Society of Franchising, Las Vegas, NV.
- Darr, E. D., Argote, L., & Epple, D. (1995). The acquisition, transfer, and depreciation of knowledge in service organizations: productivity in franchises. *Management Science*, 41(11), 1750–1762.
- Dnes, A. W. (1996). The economic analysis of franchise contracts. *Journal of Institutional and Theoretical Economics*, 152(2), 297–324.
- Eisenhardt, K. M. (1989). Agency theory: an assessment and review. *Academy of Management Review*, 14(1), 57–74.
- Fama, E. F., & Jensen, M. C. (1983). Separation of ownership and control. *Journal of Law & Economics*, 26, 301–325.
- Fladmoe-Lindquist, K., & Jacque, L. L. (1995). Control modes in international service operations: the propensity to franchise. *Management Science*, 41(7), 1238–1249.
- Gallini, N. T., & Lutz, N. A. (1992). Dual distribution and royalty fees in franchising. *Journal of Law, Economics, & Organization*, 8(3), 471–501.
- Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: managerial behavior, agency costs, and ownership structure. *Journal of Financial Economics*, 3(4), 305–360.
- Kaufmann, P. J., & Dant, R. P. (1996). Multi-unit franchising: growth and management issues. *Journal of Business Venturing*, 11(5), 343–358.
- Klein, B. (1995). The economics of franchise contracts. *Journal of Corporate Finance*, 2, 9–37.
- Klein, B., & Saft, L. F. (1985). The law and economics of franchise tying contracts. *Journal of Law & Economics*, 28(2), 345–361.
- Kogut, B., & Zander, U. (1992). Knowledge of the firm, combinative capabilities, and the replication of technology. *Organization Science*, 3(3), 383–397.
- Lafontaine, F. (1992a). Agency theory and franchising: some empirical results. *The Rand Journal of Economics*, 23(2), 263–283.
- Lafontaine, F. (1992b). How and why do franchisors do what they do: A survey report. Paper presented at the Sixth annual proceedings of the society of franchising: International center for franchise studies, University of Nebraska.
- Lafontaine, F. (1993). Contractual arrangements as signaling devices: evidence from franchising. *Journal of Law, Economics, & Organization*, 9(2), 256–289.
- Lafontaine, F., & Shaw, K. L. (2005). Target managerial control: evidence from franchising. *The Rand Journal of Economics*, 36(1), 131–150.
- Lieberman, M. B., & Montgomery, D. B. (1988). First-mover advantages. *Strategic Management Journal*, 9, 41–58.
- Madhok, A. (2002). Reassessing the fundamentals and beyond: Ronald Coase, the transaction cost and resource-based theories of the firm and the institutional structure of production. *Strategic Management Journal*, 23(6), 535–550.
- Mahoney, J. T. (2005). *Economic foundations of strategy*. Thousand Oaks: Sage.
- March, J. G. (1991). Exploration and exploitation in organizational learning. *Organization Science*, 2(1), 71–87.
- Martin, R. E., & Justis, R. T. (1993). Franchising, liquidity constraints and entry. *Applied Economics*, 25(9), 1269–1277.
- Mathewson, G. F., & Winter, R. A. (1985). The economics of franchise contracts. *Journal of Law and Economics*, 28(3), 503–526.
- Michael, S. C. (1996). To franchise or not to franchise: An analysis of decision rights and organizational form shares. *Journal of Business Venturing*, 11, 57–71.
- Michael, S. C. (2000a). The effect of organizational form on quality: the case of franchising. *Journal of Economic Behavior & Organization*, 43(3), 295–318.
- Michael, S. C. (2000b). Investments to create bargaining power: the case of franchising. *Strategic Management Journal*, 21(4), 497–514.
- Michael, S. C. (2003). First mover advantage through franchising. *Journal of Business Venturing*, 18(1), 61–80.
- Minkler, A. P. (1990). An empirical analysis of a firm's decision to franchise. *Economic Letters*, 34(1), 77–82.
- Minkler, A. P. (1992). Why firms franchise—A search cost theory. *Journal of Institutional and Theoretical Economics-Zeitschrift Fur Die Gesamte Staatswissenschaft*, 148, 240–259.

- Minkler, A. P., & Park, T. A. (1994). Asset specificity and vertical integration in franchising. *Review of Industrial Organization*, 9(4), 409–423.
- Norton, S. W. (1988a). Franchising, brand name capital, and the entrepreneurial capacity problem. *Strategic Management Journal*, 9, 105–114.
- Norton, S. W. (1988b). An empirical look at franchising as an organizational form. *Journal of Business*, 61(2), 197–218.
- Norton, S. W. (1995). Is franchising a capital structure issue? *Journal of Corporate Finance*, 2, 75–101.
- Oxenfeldt, M. R., & Kelly, A. O. (1969). Will successful franchise systems ultimately become wholly-owned chains? *Journal of Retailing*, 44(4), 69–87.
- Penrose, E. T. (1959). *The theory of the growth of the firm*. New York: Wiley.
- Roh, Y. S. (2001). Size, growth rate and risk sharing as the determinants of propensity to franchise in the chain restaurants. *International Journal of Hospitality Management*, 21(1), 43–56.
- Rubin, P. H. (1978). The theory of the firm and the structure of the franchise contract. *Journal of Law and Economics*, 21(1), 277–281.
- Scott, F. A. (1995). Franchising vs. company ownership as a decision variable of the firm. *Review of Industrial Organization*, 10(1), 69–81.
- Sen, K. C. (1993). The use of initial fees and royalties in business-format franchising. *Managerial and Decision Economics*, 14, 175–190.
- Shane, S. A. (1996). Hybrid organizational arrangements and their implications for firm growth and survival: a study of new franchisors. *Academy of Management Journal*, 39(1), 216–234.
- Shane, S. A. (1998a). Explaining the distribution of franchised and company-owned outlets in franchise systems. *Journal of Management*, 24(6), 717–739.
- Shane, S. A. (1998b). Making new franchise systems work. *Strategic Management Journal*, 19(7), 697–707.
- Shane, S. A. (2001). Organizational incentives and organizational mortality. *Organization Science*, 12(2), 136–160.
- Shane, S. A. (2005). *From ice cream to the internet: Using franchising to drive the growth and profits of your company*. New York: Pearson Prentice Hall.
- Shane, S. A., & Foo, M.-D. (1999). New firm survival: institutional explanations for new franchisor mortality. *Management Science*, 45(2), 142–158.
- Sorenson, O., & Sørensen, J. B. (2001). Finding the right mix: franchising, organizational learning, and chain performance. *Strategic Management Journal*, 22(6/7), 713–724.
- Stinchcombe, A. (1965). Social structure and organizations. In J. March (Ed.), *Handbook of organizations* (pp. 260–290). Chicago: Rand McNally.
- Thompson, S. R. (1992). Company ownership vs franchising: issues and evidence. *Journal of Economic Studies*, 19(4), 31–42.
- Thompson, S. R. (1994). The franchise life cycle and the Penrose effect. *Journal of Economic Behavior & Organization*, 24(2), 207–218.
- U.S. Small Business Administration (2002). *Evaluating Franchise Opportunities Management and Planning Series MP-26*, 1–10.
- Williamson, O. E. (1985). *The economic institution of capitalism: Firms, markets, relational contracting*. New York: Collier Macmillan.