ABSTRACT

Purpose - This paper investigates the relationship between franchising propensity and financial performance of franchising organisations and explores literature on possible intervening and moderating factors on the relationship.

Methodology - This is a critical review of theoretical and empirical literature on franchising propensity and financial performance.

Findings - Literature reveals that most studies on franchising focus on the antecedents of franchising but very few examine the consequences moreover, the studies are anchored on either agency theory or resource scarcity theory. Studies examining the relationship between franchising and performance provide conflicting results. Some studies indicate that increasing the number of franchised units result to superior performance while other studies find no significant difference between franchising and running company owned units. The effect of franchising on capital structure of the franchisor has been examined by a few studies with no conclusive results. Furthermore, prior studies indicate that the relationship between franchising and performance is influenced by firm characteristics. There is a dearth of studies examining franchising in sectors other than the restaurant industry moreover there is need to use time series data to observe the consequences of franchising over time.

Implications: This review of literature mainly consists of studies carried out in developed economies which have superior business models and access to finance. Developing economies are mostly supported by small and medium enterprises and lack the skills and resources similar to advanced economies. Therefore, although developing economies stand to benefit more from the franchising model, there are few studies carried out in developing economies. Therefore, the findings of this study may vary in the developing economies.

Value: This study has presented a new dimension that may explain the inconsistent findings from prior studies and contribute to the discussion of franchising and firm performance. The relationship between franchising and firm performance may be moderated by firm characteristics and mediated by capital structure.

1 PhD student University of Nairobi, School of Business, Department of Finance and Accounting
2 Lecturer University of Nairobi, School of Business, Department of Finance and Accounting
3 Senior Lecturer University of Nairobi, School of Business, Department of Finance and Accounting
Introduction

Franchising is an important growth strategy especially for firms seeking entry into new markets. It provides an opportunity for entrepreneurs to set up businesses or expand existing ventures while basing on the experience of the owner of the business model in exchange for a fee. Franchising involves a binding agreement between two autonomous firms, the franchisor and franchisee, whereby the latter pays the former, to sell his products and or the right to use his trademark at a given place for a specified duration (Lafontaine, 1992).

A franchise contract involves sharing intangible capital between independent firms, that is trademark and goodwill, whose value is maintained by their use. Franchising tend to exist where efficient scales of operation are distinct between the production of a good and the generation of goodwill attached to it. Thus, the profit seeking franchisor is faced with the dilemma of maximizing returns on his intangible assets while relying on quasi rents earned by franchisees in heterogeneous markets (Caves & Murphy, 1976). In return for the services provided by franchisors, franchisees are expected to pay either or all of the following fees: Initial franchise fees, royalties and advertising levies (Hing, 1996).

Several studies have examined the motive to franchise and based their discussions on two main theories: resource scarcity and agency theory. Franchising addresses agency problem by providing franchisees strong incentives through a direct claim to residual profits of the unit. Furthermore, franchisees lay significant capital on the line thus reducing the likelihood of shirking (Aliouche and Schlentrich, 2009). Garg, (2005) noted that franchising allows for rapid growth of an organization as franchisees are motivated more than hired managers in company owned units thus reducing monitoring cost. Resource scarcity theory suggests that firms turn to franchising to obtain scarce resources, that is, capital and managerial skills, for rapid expansion (Oxenfeldt and Kelly, 1969). Firms franchise when the need to achieve economies of scale drives the firm to develop at a rate that surpasses internally generated capital (Alon et al., 2015).

A few studies have examined the effects of franchising on the capital structure of the franchisor. Jiang (2009) contends that franchising has a positive relationship with capital structure because as the franchisor imposes debt limits on franchisees, it increases its debt capacity and tax benefit opportunity. Norton (1995) examined whether franchising provides cheaper capital compared to traditional financing. Although the study did not explain the link between franchising and capital structure, Norton contends that franchising is a capital structure issue since franchise organizations have similar characteristics which influence cost of capital and hence capital structure including: intangible capital, asymmetric information, growth opportunities and asset specificity.

Franchising Propensity

Franchising propensity refers to the proportion of retail stores that a company operates as franchises in relation to the total number of retail stores (Madanoglu, Lee, & Castrogiovanni, 2013). The proportion of outlets franchised varies from one organization to another. In agency theory perspective, firms increase the proportion of units franchised in order to minimize monitoring costs (Rubin, 1978). Vazquez (2007) argued that monitoring cost increases with geographic dispersion due to growth in travel expenses and number of monitoring personnel required. In addition, dispersion leads firms to unfamiliar territories where the franchisor may have limited local market knowledge. Thus, franchising propensity increases with geographic dispersion. Similarly, Shane (1996) contends that franchising reduces moral hazard and adverse
selection problem as independent entrepreneurs are motivated by becoming part owners and sharing in the enterprise profits. Therefore, firms increase the proportion of franchised outlets to reduce moral hazard and adverse selection.

On the contrary, as franchising propensity increases, free riding behavior by franchisees, who may avoid incurring costs to maintain the standards and quality of the franchise, increases. Such franchisees rely on the effort of the franchisor and other franchisees or the goodwill of the franchise brand (Shane, 1998). Thus, franchise organizations that invest significantly in the franchise brand may operate company owned units to minimize opportunism by franchisees (Vazquez, 2007). Sorensen and Sørensen (2001) contend that franchising organizations maintain company owned units in order to facilitate and enforce standards while the franchised units are useful for exploratory learning and experimentation. Oxenfeldt and Kelly (1969) argued that companies tend to franchise some of their chain stores in order to access sparse resources including: managerial resources, capital and local market knowledge, which is useful for rapid business expansion. They further argued that as firms gain access to these resources, they tend to buy back the franchised units in order increase the proportion of company owned units. Galini and Lutz (1992) demonstrated that the proportion of retail stores owned by a company acts as a signal of the firm’s profitability as new franchisees have minimal information about the product and its prospects of success.

**Financial Performance of Franchises**

Financial performance is the extent to which financial objectives are being attained. It is the practice of assessing the results of a firm’s operations and policies in monetary terms (Thappa & Imsunungsang, 2017). Studies evaluating franchising and firm performance have measured performance in several ways: Survival of the franchise (Bates 1998; Shane 1998), growth of franchise (Catrogiovanni & Justes 2002) and financial performance measures such as sales growth, return on assets and return on equity, economic value added and market value added (Aliouche & Schlenrich, 2009). Franchise system survival is the continuous existence of the franchise chain while franchise system growth refers to increase in number of outlets of the chain. Lafontaine and Shaw (1998) measured survival using a dummy variable and giving a value of one, if the firm remains in existence for five or more years. Similarly, Bates (1998) measured survival by assessing firms that remained active beyond a stated period. Shane (1998) on the other hand measured survival by the number of franchise firms that exited by being delisted from franchisor records. Catrogiovanni and Justes (2002) and Lafontaine and Shaw (1998) measured franchisor growth using percentage change in the number of outlets in the franchise chain.

Several studies have used traditional financial measures to assess the performance of franchises. Hsu and Jang (2009) measured financial performance using return on equity (ROE), return on assets (ROA) and Tobin’s Q. Aliouche and Schlenrich (2009) used economic value added (EVA), market value added (MVA), shareholder return and ROE contending that the traditional financial measures (ROE and ROA), lack a direct relation with shareholder value and do not indicate the opportunity cost of capital applied. Madanoglu, Lee and Castrogiovanni (2013) responded to the subject of whether franchising is superior by comparing risk adjusted returns (Sharpe ratio, the Jensen’s index, Sortino ratio, Treynors ratio and upside potential ratio) of franchising versus non franchising restaurants. These measures are deemed to be better in assessing risk as they are market based and not affected by accounting policy manipulation of the
Risk adjusted return measures adjusts for risk by measuring the level of stock return per unit of risk undertaken. However, market based measures can only be applied for public listed firms. These firms tend to be established and mature in the market thus may not find the advantages brought about by franchising as critical as new expanding firms (Aliouche & Schlentrich, 2009; Hsu & Jang, 2009).

**Franchising Organizations**

Franchising organizations can be classified into various forms; two most popular forms are: business format and product distribution franchising (Aliouche & Schlentrich, 2009). Hoffman and Preble (1991) described another franchising form, conversion franchising. Business format franchising entails a business agreement between a franchisor, the owner of the business and franchisee, an entrepreneur, whereby the franchisor provides rights to the franchisee, for a specified duration of time, to run their business using a similar brand and format for promoting, administering and managing the business (Aliouche & Schlentrich, 2009). Business format franchising is commonly used in quick service restaurants such as Steers, Debonairs, Burger King and McDonalds. Product distribution franchising, in contrast, is a more restricted business agreement, whereby the franchisor grants the franchisee the right to use its trademark, but does not offer a system of operating its business (Aliouche & Schlentrich, 2009; Hoffman & Preble, 1991). Product distribution franchising is applied in firms such as Coca Cola and its bottling companies. Conversion franchising on the other hand involves establishment of a franchise through adoption of an existing autonomous going concern into a franchise. This type of franchising is applied where an independent firm is facing intense competition (Hoffman & Preble, 1991).

Franchising organizations have two features that differentiate them from other forms of organizations such as strategic alliances and equity joint ventures. First is that franchising normally occur in businesses where there is a distinguished service element that has to be carried out near customers implying that service outlets must be replicated and spread out geographically. Secondly, franchise contracts usually reflect a unique allotment of decision rights, duties and profits between the franchisees and franchisor. The franchisor determines and implements standards of performance, nominates the franchisees, consents on location of outlets, manages the image of the brand, and supervises activities such as purchasing to obtain economies of scale (Caves & Murphy, 1976).

**Research Problem**

Franchising is acclaimed for improving firm performance as it eliminates agency problems experienced by businesses due to separation of ownership and management (Shane 1996; Aliouche and Schlentrich, 2009; Garg, 2005). The franchisor who is the business owner provides the business idea, the managerial and technical experience while the franchisee who is the entrepreneur provides capital, local market knowledge and invests his time running the business. Studies indicate that franchising system addresses agency problems by providing great incentives for the franchisees to perform well as they have rights to the residual profits of the unit and having put capital at risk, it reduces the likelihood of shirking (Aliouche & Schlentrich, 2009). Garg (2005) also noted that franchising allows for rapid growth of an organization as franchisees are more incentivized than managers in company owned units, thereby requiring less monitoring cost. Therefore, even as the franchise firm becomes bigger, it continues to increase competitiveness from the savings on agency related monitoring costs.
Several studies carried out to assess the relationship between franchising and firm performance focus on proportion of company owned units in relation to franchised units. On one extreme, some of the studies contend that operating franchises results to superior performance compared to company owned units (Madanoglu, Lee & Castrogiovanni 2013; Perdreau, Nadant, & Cliquet, 2009) while on the other extreme, studies show that there is no major difference in performance between the two organizational forms (Sorenson & Sørensen, 2001; Kosová, Lafontaine & Perrigot, 2013). However, Bracker & Pearson (1986) and Scott Jr (1995) argue that a mix of the two organizational forms is more beneficial to the organization.

The decision to franchise has been linked to capital structure by a number of studies with no conclusive evidence. Oxenfeldt and Kelly (1969) posited that firms franchise so as to access capital and managerial resources from franchisees. Norton (1995) consent that franchising is a capital structure issue but failed to explain the relation between capital cost and the existence of franchising. Rubin (1978) disputed the capital cost incentive arguing that funds from franchisees tend to be more costly compared to passive investors in capital markets as they cannot diversify risk. Jong, Jiang and Verwijmeren (2009) applied an empirical approach and found the link between franchisee capital structure and the franchisor. Their study concluded that franchising organizations set debt limits for the franchisees enabling them to increase leverage thus gaining more tax benefit. Furthermore, the tax benefit increases with the franchising propensity.

The performance of franchising organizations may be influenced by firm characteristics such as size, age, brand name value, location, royalty rate and entrepreneurial orientation. Gikonyo, Berndt and Wadawi (2014) posited that the critical success factors for franchising restaurants include strong brand, convenient location, stable pricing and ambience. Empirical studies indicate a positive relationship between firm characteristics and performance including location of the franchised units (Fenwick & Strombom, 1998); entrepreneurial orientation (Dada & Watson, 2013); pioneering advantage (Bordonaba Juste, Lucia- Palacios & Polo- Redondo, 2009); franchising propensity (Sorenson & Sørensen 2001; Bracker & Pearson 1986).

Gillis and Castrogiovanni (2012) pointed out that there is a dearth of studies examining the relationship between franchising and firm performance particularly focusing outside the restaurant industry. Moreover, Combs, Michael and Castrogiovanni (2004) highlight that the relationship between franchising and firm performance is largely dependent on other factors and that extant evidence is inconsistent with theory. Therefore, this paper seeks to contribute to this debate by examining the relationship between franchising propensity and firm performance. The study aims to explore literature examining the effects of intervening and moderating factors in the relationship between franchising propensity and firm performance.

**Research Objectives**

i. To determine the relationship between franchising propensity and financial performance of franchise organizations

ii. To determine the intervening factors in the relationship between franchising propensity and financial performance in franchise organizations

iii. To determine the moderating factors in the relationship between franchising propensity and financial performance of franchise organizations

iv. To determine the relationship among franchising propensity, possible interveners, possible moderators and financial performance of franchise organizations
Theoretical Review

Agency Theory

Agency relationship refers to situations where one party, the principal delegates authority to another party, the agent. Each party is construed to be self-interested and possess differing goals, thus agency problems emerge forcing the principal to set mechanisms that ensure the agents’ acts are in the principals’ utmost interests (Jensen & Meckling, 1976). In a franchising system, the principal is the franchisor while the agent is the franchisee. Franchising is favored over company ownership as it addresses agency problems by providing strong incentives for the franchisee to do their best through entitling them to the residual profits of the unit (Rubin, 1978). Franchising alleviates monitoring costs which normally increase with the number of franchised units, geographic dispersion and incidences of foreign outlets (Norton, 1988).

Aliouche and Schlentrich (2009) supported agency theory perspective arguing that franchising reduces agency problems as franchisees invest substantial capital and time thus reducing the likelihood of shirking and adverse selection. Similarly, Garg (2005) contends that franchising allows for rapid growth of an organization as franchisees are more incentivized than managers in company owned units hence require less monitoring cost. Thus, even as the franchise firm becomes bigger, it continues to increase competitiveness from the savings on agency related monitoring costs. Shane (1996) examined agency theory by determining the implications of hybrid organizational forms, comprised of franchised and company owned units, on their growth and survival. He contends that hybrid form provides a way to overcome moral hazard and adverse selection thus enhancing growth and performance of the organization. Similarly, Lafontaine (1992) provided empirical evidence supporting the agency theoretical assumptions of franchising, that is, firms franchise more when monitoring cost and incentive problems are higher downstream. Shane (1998) however argued that franchising creates opportunities for free riding due to misaligned incentives between the franchisor and franchisee. The franchisee benefits from the outlet profit while the franchisor benefits from royalties made from system-wide sales. This misaligned incentives cause franchisees to maximize the profits of the outlets at the expense of system-wide sales. In summary, agency theory provides a link between franchising and performance by highlighting the agency related incentives to franchising.

Resource scarcity theory

Resource scarcity theory as propounded by Oxenfeldt and Kelly (1969) argues that firms prefer company ownership to franchising but resort to franchising in order to leverage on capital, managerial skills and local market knowledge from franchisees. Firms opt to franchise when the desire to achieve economies of scale forces them to grow at a rate that surpasses internally generated capital (Alon et al., 2015). Franchisees provide cheaper capital to the franchisor than other investors while the franchisee benefits from the managerial skills ability of the franchisor thereby increasing the chances of success (Caves & Murphy 1976; Diaz-Bernardo, 2012). Oxenfeldt and Kelly (1969) argued that as firms mature, they cease franchising and become primarily company owned because company ownership is presumed to be profitable to franchising. Hunt (1973) and Dant and Kaufmann (2003) empirically examined resource scarcity theory and found evidence of conversion of franchised outlets to company owned outlets as the franchisor matures and obtains increased access to resources. However Lafontaine and Kaufmann (1994) observed that although resource scarcity plays a role in determining the percentage of company owned units, the proportion tends to be small. Thus, Castrogiovanni,
Combs and Justis (2006) argued that resource scarcity theory explains growth through franchising in the early years of a firm’s operation, whereas agency theory explains the use of franchising in the later years of a firm’s life cycle.

Resource scarcity theory has however been met with significant theoretical opposition. Rubin (1978) argues that capital provided by a franchisee is more costly compared to that provided by passive investors that is, stock holders and bondholders, as franchisees cannot diversify their risk among outlets in the chain since the franchisor determines their geographic location. However, Combs and Ketchen (1999) oppose this argument stating that passive investors face a challenge of adverse selection since they are not able to adequately evaluate the quality of investors and only rely on publicly available information. In addition, Lafontaine and Kaufmann (1994) argued that selling shares, as opposed to franchising, leads to loss of strategic control as the investors will influence the company’s strategic direction.

**Signaling theory**

Gallini and Lutz (1992) suggested that new franchisees face the problem of information asymmetry as franchisors have better information about their products. Therefore, to encourage new franchisees to sign up, the franchisor operates some company owned units in order to signal their expectation of good performance. Similarly, Dant and Kaufmann (2003) hypothesized that franchisors run company-owned units to overcome credibility hurdle when seeking to attract franchisees. Moreover, they proposed that franchisors require high royalties from franchisees to signal the high value they peg on their product. Dant and Kaufmann (2003) evaluated empirically the propositions of signaling theory and found that the larger, older and more resource flush systems appear the more likely for the company to run company owned units than franchised units. These results support the resource scarcity theory rather than the signaling theory. Gallini and Lutz (1992) argued that signaling theory complements agency and resource scarcity theory as it seeks to solve franchisor’s dilemma with franchisee at the commencement of the contract prior to the agency concerns.

**Capital Structure Irrelevancy Theory**

The debate on relevance of capital structure to firm value was instigated by Modigliani and Miller in 1958. They examined whether strategic use of debt has implications on firm value and concluded that capital structure is irrelevant to the value of the firm. This theory was however criticized for its simplicity and assumption of zero taxes. Modigliani and Miller refined their theory in 1963 by relaxing the tax assumption and found that the value of the firm increases with increase in leverage. They therefore concluded that a firm should maximize its value by maximum use of leverage. Although this theory has been criticized immensely, Modigliani and Miller made a significant contribution to finance theory by explaining the relevance of leverage to firm value.

Norton (1995) introduced the debate on whether franchising is a capital structure issue. He examined the motive of franchising; whether it was as a result of failure of conventional sources of capital to provide funds for new entrepreneurs. Although Norton failed to provide the connection between capital cost and the decision to franchise, he concluded that franchising is a capital structure issue as franchise firms have common characteristics that influence capital costs and therefore affect capital structure including: growth opportunities, intangible capital, asset specificity and asymmetric information. Jong, Jiang and Verwijmeren (2009) examined whether
strategic use of debt influence franchising decisions by focusing on the franchisees’ and franchisors’ capital structures. They posited that franchisors set debt limits for franchisees in order to increase leverage and gain tax benefits. Findings indicated that franchisor’s debt proportion is inversely related to the maximum debt proportion allowed for the franchisees suggesting that as the franchisor sets a ceiling on the franchisees’ debt in order to raise their debt thereby gaining tax benefits. Moreover, the study found that this effect is robust in organizations with larger proportions of franchised outlets.

**Relationship between Franchising Propensity and Financial Performance**

A substantial body of literature focuses on the benefits of aligning incentives of the entrepreneur, who manages the franchise, with the franchising organization to explain performance. Literature suggests that firms franchise in order to reduce agency problems that arise with managing units that are dispersed geographically (Rubin, 1978; Shane, 1998). Without close monitoring, managers may engage in activities that undermine the performance of their units (Jensen & Meckling, 1976). Franchising is deemed to reduce monitoring costs which increases with geographical dispersion between units (Norton, 1988). Franchisees work hard to maximize the performance of their units as they obtain residual profits and risk losing their capital should the unit underperform. Consequently, firms that opt to franchise should outperform those that run company owned units, when in the event of high risk of moral hazard (Shane, 1996). Similarly, resource scarcity theorists posit that franchising provides cheaper capital and managerial resources which enable franchising firms to achieve economies of scale. Thus, franchising is deemed to be important for rapid growth of new businesses and to permit exploitation of marginal locations (Oxenfeldt & Kelly, 1969). As a result of the agency related incentives, reduced monitoring cost and access to resources, franchising is alleged to improve the profitability (Shane, 1996; Hsu & Jang, 2009; Aliouche and Schlentrich, 2005). However, some studies dispute the superior performance argument of franchising organizations indicating that there is no difference in performance between franchising and non-franchising organizations (Bracker & Pearson, 1986; Scott Jr, 1995).

**Relationship between Franchising Propensity, Capital Structure and Financial Performance**

Norton (1995) posits that the franchising decision is linked to financing decision issue as franchise organizations have common characteristics that influence capital costs thus affecting capital structure including: growth opportunities, asset specificity, asymmetric information and intangible capital. Jiang (2009) contends that tactical use of franchisee capital structure influences the franchisor’s capital structure and ultimately the firm value. He posits that firms franchise in order to benefit from franchisees reduced operational risk as a result of limiting their debt level thus enhancing the franchisors debt capacity, tax advantage and profitability. Similarly, Rubin (1978) contends that capital market argument does not explain the motive to franchise. He argues that capital provided by a franchisee is more costly compared to that provided by passive investors that is, stock holders and bondholders, as franchisees cannot diversify their risk among outlets in the chain since the franchisee determines their geographic location. However Rubin posits that comparative advantage of franchising organizations is from agency related incentives that creates wealth compared to other forms of organizational; that is lower monitoring and managerial costs.
Furthermore, Jong, Jiang and Verwijmeren (2009), link the motive to franchise to the tax benefit derived from cheaper franchisee capital. They contend that franchisors limit the level of franchisees debt thus increasing their capacity to borrow and hence deriving tax benefit which increase with franchising propensity. Similarly, Jong and Jiang (2013) contend that standard capital structure theories apply in franchising organizations as the franchisor’s leverage is affected by firm specific characteristics such as liquidity, tangibility and past growth. Moreover, they argue that the franchisor’s debt level is adjusted based on the franchisee’s debt level.

**Relationship between Franchising Propensity, Firm Characteristics and Financial Performance**

A number of firm characteristics have been examined when studying the relationship between franchising propensity and performance. These include: size of the franchise, age of the franchise, royalty fees, start up costs, location, brand name value, entrepreneurial orientation, pioneering advantage and stage in the firm’s life cycle (Rho, 2002; Barthélémy, 2008; Fenwick & Strombom, 1998; Dada & Watson, 2013; Perdreau, Nadant & Cliquet, 2009). Studies suggest that franchising assists small firms with limited access to capital to grow faster. Capital obtained from franchisees provides an alternative method of financing new ventures for small firms which are unable to access funds from the capital markets (Oxenfeldt & Kelly, 1969; Cave & Murphy, 1976). Consequently, Rho (2002) hypothesizes an inverse relationship between firm size and proportion of franchised outlets. Similarly, Shane (1998) contends that the proportion of franchised units is significantly different between large and small firms. On the contrary, Bates (1995) contends that independent startups tend to have better survival prospects and more profitable than those of franchises.

Barthélemy (2008) contends that franchises with a tacit business practice and a valuable brand name perform better with a lower percentage of franchised units. Company owned outlets enhance tacitness which is necessary for knowledge and a business to maintain its value. However, it is difficult to convey tacit business practices to franchisees. Thus company owned stores enhance their performance in the short run while shielding their business from imitation in the long run. Dada and Watson (2013) suggest that entrepreneurial orientation of franchising organization is germane to its performance. Entrepreneurial orientation which has three dimensions, risk taking, pro-activeness and innovativeness, is hypothesized to have a positive relationship with performance. On the contrary, Sorenson and Sørensen (2001) contends that the right mix between franchised and company owned units is critical to performance in order to enhance organizational learning and standardization.

**Relationship between Franchising Propensity, Capital Structure and, Firm characteristics and Financial Performance**

Vazquez (2007) contends that there are some unseen factors that influence both the percentage of units franchised and the performance outcome analyzed. Therefore, the performance implication of franchised units is hinged upon the chosen proportion and the factors that influence it. Vazquez examined the relationship between percentage of units franchised and performance by first examining the effects of size, age, monitoring cost and growth rate on the percentage of franchised outlet and then the correlation between proportion of franchised units on growth and percentage of discontinued outlets. He argues that as firms expands and become geographically dispersed, monitoring cost increases and franchising become more attractive, thus hypothesizing that the percentage of units franchised is positively related to geographic dispersion. He posited
that system size and age are inversely related to percentage of units franchised while system growth rate is positively related to the percentage of units franchised.

Similarly, Shane (1996) contends that franchising enhances growth and survival of the organization. He proposes that the relationship between franchising and performance is influenced by the age of the firms, pricing variables (franchise fees, royalties and start up cost), industry growth rate and number of company owned outlets. He also contended that franchising enables entrepreneurs to surmount managerial limitations to firm growth providing a means by which internal managerial capacity can be leveraged to produce more rapid growth. However, he posited that franchising is a high risk venture as over three quarter of new franchises fail in the first ten years and prior managerial experience does not translate to successful management of a franchise.

**Empirical Literature Review**

**Franchising Propensity and Financial Performance**

Aliouche and Schlenreich (2009) examined twenty four franchising and seventeen non-franchising public restaurant companies based on the four financial performance measures: market value added, return on equity, economic value added and shareholder’s return. Results showed that franchisors have a higher propensity to generate economic and market value. However, their results are insignificant due to the relatively small sample size, narrow focus on public restaurant firms and the use of mature firms which may not benefit significantly from franchising benefits.

Hsu and Jang (2009) sought to establish whether franchising influences the financial performance of companies in restaurant industry by investigating the profitability and intangible value of franchising and non-franchising restaurants. They sampled 100 publicly held restaurant firms and regressed return on equity, return on assets and Tobin’s Q ratio against the proportion of franchised restaurants. Results indicated that franchise firms had a notably higher profitability than non-franchise firms. Secondly, they found the existence of an optimal franchise proportion implying that franchisors in the restaurant industry can maximize their profits and intangible value by attaining a certain mix of franchised verses company owned units. This study focused on publicly listed companies which tend to be mature and have access to funds thus may not depend on franchising to raise capital.

Financial performance has also been measured using risk adjusted returns. Madanoglu, Lee and Castrogiovanni (2013) addressed the subject of whether franchising is preferable by comparing risk adjusted returns of franchising versus non franchising restaurants. They surveyed 102 publicly traded firms in the US restaurant industry with 54 being franchising and 48 non-franchising firms. The study considered risk adjusted returns including: Jensen’s index, Sharpe ratio, Sortino ratio, Treynors ratio and the upside potential ratio. Results showed that all franchising firms performed better than the non-franchising firms. The study was however not able to clarify whether more franchising is better among franchising firms.

Thomas, O’Hara, and Musgrave (2003) examined the consequences of ownership structure and investment on the performance of franchise organizations. Using pooled time series cross sectional analysis for ten years for ten franchised business activities across industries, they observed declining relative franchise performance in response to higher company ownership. Secondly, the study observed that relying on capital from the franchisees does not improve the
relative performance of the company owned establishment. This finding is contrary to the popular belief that franchisors profit by relying on capital from franchisees.

Franchising Propensity, Capital Structure and Financial Performance

Jong, Jiang and Verwijmeren (2009) contend that tactical use of franchisee capital structure influences the capital structure of the franchisor and ultimately the firm value and franchising propensity. They posit that firms franchise in order to benefit from franchisees reduced operational risk as a result of limiting their debt level thus enhancing the franchisors debt capacity and tax advantage. They examined 97 listed franchise chains based in North America from 2001 to 2006. Findings supported the prediction that franchisee’s lower leverage induced franchisor’s higher leverage and vice versa. Thus as franchisees put more equity in the initial investment, franchisors bears more debt and gains more tax benefit. This effect was observed to increase with a rise in franchising propensity.

Jong and Jiang (2013) examined factors influencing franchisors and franchisees’ capital structure choice and how those choices are interrelated. They empirically examined whether specific characteristics of outlet affected franchisee’s capital structure choice; the applicability of standard capital structure theories in franchising firms and lastly the relationship between franchisee capital structure and the franchisor. Ordinary least squares regression was applied on 122 Dutch franchising firms. The finding indicated that outlet specific characteristics such as outlet size, hard type franchising, non-food retailing industry may affect franchisee’s optimal capital structure significantly. Secondly, the study found that firm specific characteristics such as liquidity, tangibility and past growth significantly affects franchisor’s leverage and growth opportunity. Thirdly they observed that that the franchisors leverage is altered depending on the franchisee’s leverage. Although these studies explain the link between franchising and capital structure, they fail to include the effect of tangibility. As franchising propensity increases, it is expected that tangibility declines the thus affecting the ability to raise debt finance.

Franchising Propensity, Firm Characteristics and Financial Performance

Various firm characteristics have been examined when studying the relationship between franchising and firm performance. These include: size of the franchise, age of the franchise, proportion of outlets franchised, brand name value, royalty rate, startup costs, entrepreneurial orientation and stage in a firm’s life cycle. Perdreau, Nadant and Cliquet (2009) posited that an organizational form influences performance both independently and jointly with firm characteristics. They suggested that the firm’s stage in the life cycle and human capital assets are the characteristics that influence performance. They examined panel data of forty one Franchising organizations publicly listed in European markets for the period 1998 to 2007. Results indicated that franchising propensity units have a positive effect on performance for oldest and youngest firms with high human capital value.

Dada and Watson (2013) sought to understand the extent to which entrepreneurial orientation is germane to franchised firms. Entrepreneurial orientation describes how firms operate capturing three core dimensions, risk taking, pro-activeness and innovativeness. The study applied a cross sectional research design using mail questionnaire survey to collect data from a sample of 70 franchisors operating in the UK. The hypothesis in the study was tested using path model. Results showed that for franchise organizations, entrepreneurial orientation is positively related to performance. This study used data from a cross section of industries which increases
generalizability. It also controlled for firm size and age which are significantly variant across industries.

Bordonaba-Juste, Lucia- Palaciosa and Polo- Redondo (2009) examined whether long term survival of franchises is related to pioneering advantage. They examined 188 franchise firms operating in restoration and fashion retailing sector for a period of eight years using cox proportional hazard time regression model to determine survival. Results provided evidence of pioneering advantage, that is, early entry approach leads to lower risk of failure. Additional variables found to influence survival include previous experience and dual distribution. Fenwick and Strombom (1998) carried out an empirical investigation on the determinants of franchisee performance. The study analyzed forty two franchisees of a New Zealand franchise chain using stepwise multiple regression analysis. They established that the key determinant to franchise performance is the location of the franchisee. Location with a single large population centre and micro location within a mall were observed to have positive relation with performance. The results of this study are however not generalisable as only one franchise system was examined.

**Franchising Propensity, Capital Structure, Firm Characteristics and Financial Performance**

Combs (2003) carried out a meta-analytic study to determine why firms employ franchising as an entrepreneurial approach. They examined the two widely applied theoretical justifications: resource scarcity and agency theory. Examining resource scarcity theory, they hypothesized that firm age and size are inversely related to the adoption of franchising while rate of growth and capital scarcity are positively related to the adoption of franchising. Secondly, examining agency theory, they hypothesized that geographic dispersion, local managerial knowledge and royalty rate have a positive relationship with franchising while valuable franchisor input, franchising fee and outlet size are inversely related to the adoption of franchising. Using a meta-analytic approach, the study used 44 studies that examined the use of franchising and measured at least one of the hypotheses. Results indicate that the adoption of franchising is in line with agency theory propositions but there was no empirical support for franchising and resource scarcity theory.

Asare, Kang and Alejandro (2010) examined franchising performance literature and determined nine drivers of performance that is, size, age, brand, royalties, start-up costs, area agreement, franchise fees, assistance and proportion of franchised outlets. Using a meta-analysis approach, studies were examined to determine the key franchise performance drivers. These factors were categorized into strategic factors and contextual factors. Contextual factors are those that cannot be easily manipulated by the franchisor in the short term such as age, size and brand reputation while strategic are those that can be easily controlled such as franchise fees, startup cost and royalty rate. Results revealed a significant positive relationship between franchise performance and several drivers: brand reputation, age and size. However the findings indicate a negative relationship between startup cost and franchise performance.

**Findings**

This paper sought to determine the relationship between franchising and financial performance and to establish the intervening and moderating variables through a review of theoretical and empirical literature. A number of theories have been proposed to explain the reasons for franchising and the reason for maintaining the dual form of company owned and franchised units. Agency theory proposes that firms franchise in order to reduce monitoring cost and to
align incentives of the independent entrepreneur (franchisee) with that of the franchisor (Rubin, 1978; Shane 1996). Thus, firms tend to increase the percentage of units franchised as it diversifies geographically (Norton, 1988). Resource based theory on the other hand contends that firms franchise in order to leverage on capital, managerial skills and local market knowledge of the franchisees. Once economies of scale are achieved, the firm buys back the franchised units to consolidate ownership (Oxenfeldt & Kelly, 1969; Caves & Murphy 1976). Other theories reviewed in the study include signalling theory which explains the existence of dual form that is, company owned and franchised units and capital structure theory which explains the capital cost incentive to franchise.

Empirical review of literature suggests that there is an existing relationship between franchising and performance. Some studies contend that franchising enhances the financial performance of firms (Aliouche & Schlentrich, 2009; Hsu & Jang, 2009; Madanoglu, Lee & Castrogiovanni, 2013) while others show that there is no significant difference in performance between the two organizational forms (Sorenson & Sørensen, 2001; Kosová, Lafontaine & Perrigot, 2013). A few studies indicate that franchising has a relationship with capital structure and hence firm performance. Norton (1995) contends that capital structure of a franchise organization is influenced by operational benefits of franchising; no link between capital structure and cost of capital was established. However, Jong, Jiang and Verwijmeren (2009) contend that the motive to franchise is influenced by strategic use of franchisee’s debt to maximize firm value. Studies also indicate that the relationship between franchising and financial performance is influenced by firm characteristics including: firm size, age of the firm (Asare, Kang, & Alejandro, 2010) location (Fenwick & Strombom, 1998) brand name value and entrepreneurial orientation (Dada & Watson 2013).

**Conclusions**

The detailed review of literature reveals that there is a dearth of studies on the relationship between franchising and financial performance. Most of the earlier studies focused on the antecedents of franchising that is the choice of whether to franchise and the optimal proportion of franchised units; few studies have focused on the consequences of franchising. The two predominant theories on franchising, agency theory and resource based theory, predict positive relationship between franchising and firm performance. Moreover, studies that have examined franchising performance use non financial measures such as growth of outlets and survival. The review of empirical literature has also revealed mixed findings on the relationship between franchising and performance some studies show a positive relationship between franchising and performance while other studies contend that there is no significant difference in performance between franchising and non-franchising firms. This study has therefore presented a new dimension that may explain the inconsistent findings from prior studies and contribute to the discussion of franchising and firm performance. The relationship between franchising and firm performance may be influenced by firm characteristics and mediated by capital structure.

Despite the vast literature on franchising and performance, further studies still need to be conducted. Majority of studies determine the relationship between franchising and performance in the restaurant industry only (Gills & Castrogiovanni, 2012). Although franchising has widely been applied in the restaurant industry, other service industries also franchise and there is need to examine how their choice of organisational form affects performance. Secondly, most of the empirical studies on franchising and performance use cross sectional data to establish
relationship between franchising and performance. There is need to use time series data to observe the consequences of franchising over time. Empirical literature reveals mixed findings on the relationship between franchising and performance and extant evidence tends to contradict theories. Combs, Michael & Castrogiovanni (2004) posits that the relationship between franchising and performance is dependent on other factors. Therefore, there is need to undertake research using both financial and non-financial performance measures incorporating mediating and moderating factors in the relationship. In addition, studies examining the relationship between franchising and capital structure fail to examine the influence of asset tangibility on financial performance of franchise organisations. As the franchising propensity increases it is expected that asset tangibility declines thereby increasing bankruptcy risk and reducing the flexibility of using debt finance. This is expected to impact negatively on financial performance.

It should be noted that this review of literature mainly consists of studies carried out in developed economies which have superior business models and access to finance. Developing economies are mostly supported by small and medium enterprises and lack the skills and resources similar to advanced economies. Therefore, although developing economies stand to benefit more from the franchising model, there are few studies carried out in developing economies and particularly on the consequences of franchising. Thus the findings of this study may vary in the developing economies.

Future research should focus on multi-unit franchising and its relationship with performance. Garg (2005) contends that multi-unit franchising defies agency theory proposition that franchising reduces agency costs as the independent entrepreneur needs to hire managers to run the sub-franchised units. Multi-unit franchising reverses the proposed agency benefits of low monitoring cost and aligning incentives of the franchise owner and the franchisee. Secondly, future research may examine operational risk and business failure among franchising organisations. Michael (1996) contends that franchising exposes the franchisee to business risk by making the franchisee invest in a specific geographical area, that may not be favourable to the franchisee or making requirements for standardization which does not allow for local adaptation. Moreover, Fosu (1989) argues that franchisee may fail due to lack of sufficient support from the franchisor, strenuous competition from outlet of competitive franchisors; high cost of franchise association. Lastly, future research can compare the performance of franchising businesses to alternative organisational forms such as acquisition, joint venture and strategic alliance.

**REFERENCES**


