International Franchising Success Factors: Front End Risk Management

Bill Merrilees, Lorelle Frazer, Griffith Business School and Services Industries Research Centre

Abstract

Australia has been coined the 'franchise capital of the world' (Walker 2004, p.36) because it has over three times the number of systems per capita than the United States. The Australian franchising sector is described by *BRW* as 'booming' (Walker 2004, p.36). International franchising has potential to contribute to Australia's export performance, but requires a thorough understanding of what capabilities are needed. A case research approach of leading systems has been used in the research, with an immediate focus on the front end considerations of what approaches can contribute to success. Two *types* of international franchising strategy are proposed.

Introduction

The contribution of the franchising sector to the Australian economy is widely acknowledged and its importance is recognised by government agencies (Department of State Development 2000). Growth in franchising via international expansion is healthy for the sector and the economy and thus needs to be encouraged. However, whilst we have some idea of the magnitude of franchising exports (Frazer and Weaven 2004), little is known about how franchisors plan and implement their expansion strategy. In contrast, it appears that many franchisors are reacting to approaches made by overseas investors rather than proactively developing international expansion strategies (Frazer and Weaven 2004).

The mode of entry literature is particularly relevant. Different competing theories have emerged over time to explain why a particular mode (exporting, foreign investment, franchising, licensing, joint venture, among others) was chosen. The Scandinavian stages model of entry suggests a sequential pattern of entry into successive foreign markets, with increasing degrees of commitment. For example, exporting is an early stage mode of entry, with limited commitment, whereas foreign investment is a later stage mode with a much greater commitment (investment) of resources. Other theories include transaction cost theory, agency theory (discussed below) and Dunning's eclectic theory (see Buckley and Casson, 1998). Most of these theories help shape the international franchising literature, discussed in more depth below. However in the broader mode of entry literature, franchising is positioned in the middle, with a medium level of risks, but only a medium level of control in the new foreign market. Another sub-field of international marketing literature concerns the "born global" debate. The main point of this literature is that some firms do not go through all of the sequences of the Scandinavian stages theory, but quickly skip to more serious commitment quite early on in the life of the company, thus the name born global (see Rennie 1993).

The international franchising literature is growing, although most of it focuses on particular issues rather than a strategic approach in a comprehensive way. The growth of international franchising throughout the globe is shown in Preble (1995) and Koiranen (1998). The first issue considered is whether a franchise system should be taken internationally or not. Sashi

and Karuppur (2002) argue that franchising is more relevant than other modes if there is political and economic uncertainty, a strong brand name, cultural distance and high investment costs for non-franchise options, while franchising is discouraged if the product entails high technical knowledge.

Doherty and Quinn (1999) provide another perspective on the international franchising decision. They note that resource availability and agency theory are the two main competing theories. The resource argument is based on franchising being a low cost, low risk method of international expansion. Agency theory applies when the two parties have an interdependent and cooperative relationship, but rationally might pursue different, possibly contradictory goals. Special issues covered by agency theory include information asymmetry, intangible assets, moral hazard (agents operating in self-interest against the objectives of the principals), monitoring costs and free-rider problems (agents benefiting from the brand without fully contributing to annual costs). Doherty and Quinn (1999) used agency theory to predict a preference for culturally proximate markets to reduce risk. Use of local franchisees reduced risks when little was otherwise known about local operating conditions while fees and royalty payments reduced moral hazard. Joint ventures were applicable when risks were acute (such as Russia). Notwithstanding the contribution from agency theory, there are some areas in which its role is uncertain. Doherty and Quinn note that it is still hard to control standards in master/area franchising. Also, the role of power and agent satisfaction has not been explored much, nor has the degree of adaptation been well studied. The role of control and support policies is given in Quinn (1999).

Much of the previous empirical studies have been very narrow, focusing on just one or two variables, including scale of the franchisor (Alon and McKee, 1999), scale and experience (Huszagh and Huszagh, 1992), and a general propensity to internationalise (Kedia, Ackerman, Bush and Justis, 1994). Much of the preceding research favours the resource rather than the agency theory, but this might reflect the type of survey designed. A slightly broader approach is by Beilock, Wilkinson and Zlateva (1998) in their study of Bulgaria, though some key determinants were left ambiguous in their likely impact. In what seems to be the most sophisticated quantitative study in the field, Contractor and Kandu (1998) found that both environment and internal factors had a role. In particular international franchising was more likely: the higher the per-capita GDP of the foreign market, the more important branding and other intangible assets were and the greater the size of the franchisor.

Some of the previous research has used case studies. Connell (1999) compares two American hotel chains in their internationalisation process. He found that the use of standardisation is slower and more difficult to use than a more adaptable approach. Another interesting case study of a single franchise system is given in Quinn (1998). The more detailed analysis coming from this type of analysis is very relevant to the method used in the current project. Quinn made various conclusions that were helpful. Complex motivation for internationalisation was found, useful for us to consider from the outset. A lack of importance of culture was found, but may be unique to the chosen company. Nonetheless this perspective helped focus our interview questions. It was also discovered that commitment to internationalisation progressed from reactive to proactive over time.

Research Design

A case study approach was deemed appropriate because of the limited understanding we have of the key decisions involved with international franchising. A multiple rather than single case study design will be used as there is a great deal of variation in franchise systems and a single case design would not enable this diversity to be captured. Moreover, the evidence from multiple case studies is considered to be more compelling (Yin 2003), resulting in a rigorous study. The sample of franchisors selected for the case study analysis was *purposefully* to obtain information-rich cases (Patton 2002). Our aim was to gather an indepth understanding of international franchising practices rather than make empirical generalisations. The use of a multiple case design enabled careful selection of cases that produced similar results (literal replication) as well as cases that predict contrasting results, but for reasons expected (theoretical replication) (Carson et al. 2001). A diversity of experiences was seen as an essential ingredient in case research and theoretical saturation (convergent interviewing) was the eventual aim (Lincoln & Guba 1985).

To assist this process we set up an industry advisory panel (including Austrade) to make sure that we were addressing the relevant issues as well as nominating good candidates for the cases. Design of the interview protocol is critical and would be based on "how" and "why" questions and probes relating to the key international decisions, built around the research propositions (Yin 2003). Some of the guiding propositions were fairly broad, but poignant and included the:

- choice between joint venture and master franchise
- role of the contract
- choice of the country market
- use of control methods and whether these differ between domestic and foreign operations
- use of support mechanisms and whether these differ between domestic and foreign operations.

Ten in-depth cases have been conducted, with two interviewers present at each interview to crosscheck the results. All but two of the franchisors were very experienced in international franchising, expressed in terms of the number of countries entered, the number of overseas franchisees and the percentage of business derived from international operations (generally more than 50 percent from overseas). The remaining two had just commenced international expansion, but were very keen to build this aspect of their business.

Results

Although specific issues could be discussed one by one, it is more helpful to draw out some common themes. The franchisors themselves were impressive; they have started Australian operations in a continental outpost and then enthusiastically, vigorously and rigorously taken this concept and applied it to the wider world. The courage in doing this demands admiration. So the *motivation in going international was broadly comparable*: taking a well-proven concept developed in Australia and thrusting it global. Financial rewards were certainly a factor, but generally not the dominant factor. The view was expressed that financial goals *per se* would not lead to success.

Another common factor was that nearly all systems had gone through a *steep learning curve*; making mistakes and learning quickly. There was virtually no exception to this pattern. It does suggest that there will be much to learn from the ten cases and their often lengthy-experience in international franchising. This is the viewpoint that the researchers take. However a counter-suggestion might be that firms have no choice but to go through a deep end learning curve.

A third common theme was the *vigorous and clear-minded approach to risk management*. Universally there was an understanding that legal action was not only a last resort, but a sign of failure in the relationship. It was always better to get the relationship right rather than get entrenched in protecting the franchisor in the contract. This philosophy was common, but the nuances and methods of achieving risk management were amazingly varied. All of the detailed results can be sub-grouped under the risk management umbrella, in that all of the processes and activities leading up to entry can be linked to risk management in some way – thus the title of the paper.

Mode of entry: was an important consideration and seemed to divide the respondents into a master franchise versus joint venture choice. It was felt that joint venture gave more control to the parent franchisor and suited riskier markets such as China. However one franchisor felt that China was not necessarily riskier, because of their personal contacts in Hong Kong. Notwithstanding, the typical case did use a master franchise model, though not everyone saw that as the first best choice.

Due diligence of the partner: whether the partner was a joint venture partner or the master franchisor, this was always seen as a critical and difficult decision. Due diligence refers to the checking of the experience, history and credibility of the potential partner. The key issue here was in terms of whether trust could be achieved in the relationship. An interesting phenomenon was the *snowballing effect* of partner selection. Once a reliable partner was selected (especially in Asia) then that partner often recommended the partner for another territory/country. A particularly enlightened franchisor also suggested that it was important that the *partner* as well get *their own* due diligence right, in terms of the quality of the franchise system and the partnership that they were entering into.

Due diligence of the country: An important consideration in planning foreign expansion was what we have coined "due diligence of the country". *Due diligence of the country* requires research into the economic, political and cultural features of a country, to assess whether a particular country was suitability for the company. This is not to say that such due diligence was always thorough and sometimes it was done expeditiously based on network advice. In other words, there were examples that key partners recommended new partners and *that* process determined *which country* was to be entered. This was expressed differently by other franchisors that made it clear that the selection of country depended very much on finding the right partner.

Contract: is assumed to be an important part of risk management in that its aim is to protect the franchisor if something goes wrong. The intellectual property, both the brand and the system, need to be protected and the "territory rights" handed out to a partner need to be protected in case the partner simply sits on it and does not develop the business. The protection here, through explicit clauses about performance expectations, is not necessarily to fix major problems, but to avoid large opportunity costs of not developing the franchise. One franchisor made it clear that they would have the "ability" to go to any length to remedy

problems and made sure that the agreements were registered with local attorneys and authorities.

Pre-contract negotiations: Although the contract was an important tool, it was invariably seen as a last resort measure. One legally orientated franchisor surprised the interviewers with the view that the contract was not as important as the *negotiations* leading up to it. It was important to get the relationship right and even legal documents such as a memorandum of understanding was mainly seen as a tool to get a solid mutual understanding. One quote from a franchisor was "that if the relationship is not strong then there is no point contracting a person in".

Flexible length contracts: typically the contract duration was ten years with an option to renew for another ten years. However there were some creative alternatives that gave more scope to risk management. One franchisor issued a one-year contract in the first instance, which essentially is a *probation* period prior to signing a more normal contract. Another franchisor essentially *subcontracts* for a fixed term period with no option for renewal. Both of these approaches represent risk-averse strategies.

Discussion

The three themes of motivation, a steep learning curve and a profound sense of risk management provide a strategic context for international franchising. Risk management strategies in particular enable us to decipher different tactics and nuances that can create advantages in export capability. The more sophisticated exporters appreciate that joint ventures or even direct franchisor ownership are potentially superior ways of entering foreign markets, but the lack of suitable partners constrains this alternative compared to the more common practice of master franchising.

Although the contract is an essential tool for risk management (protection of the franchisor) and critical for managing future revenue streams, all franchisors saw legal action as a *last resort* if major problems occur. Instead, the key aim was to build a *solid, lasting relationship* and so *due diligence in partner selection* was critical. The case studies unravel a complex and varied pattern of measures that build future success into the process. Among the alternative measures undertaken were:

- probation contract periods;
- caution in selecting partners;
- using networks to identify partners and sometimes countries;
- making sure that the partner has the right personal characteristics and experience;
- negotiations preceding signing contracts;
- visits to and from potential partners;
- training of partners in the system, usually in Australia;
- being explicit about expectations;
- using proper legal advice (even USA franchising law varies by State);
- the getting of Austrade help in some cases.

The results can be further synthesised into two alternative strategic approaches for international franchising, which we label as *relationship-led* and *branding-led*. Relationship-led franchisors use quality relationships as an integrating mechanism, while branding-led franchisors use branding as an integrating mechanism. The difference between the two

approaches is one of degree and emphasis, because both types of franchisors use both relationships and brands. Over time there may be partial (but not complete) convergence; for example, one of the relationship-led franchisors has realized that she neglected branding initially and has now remedied that situation. Nonetheless, there are noticeable differences in tactics and behaviour between the two types of international franchising, to which we now turn.

The brand-led international franchising strategy still treats relationships as important. However imperfect partner choice can be fixed to some extent with proper training before operations commence. The contract is very important and is usually tightly written for maximum brand and system protection. Probation contracts are more likely with this type of strategy, for additional safeguards. Visits to and from partners are important for quality control. Training is very important before commencement, so it is important to ensure that the right way of doing things is learnt. There is zero tolerance in how the brand is presented overseas. The first outlet has to be exactly right in order for other franchisees to benchmark correctly. In contrast, the relationship-led international franchising strategy pays particular care regards selecting the overseas partner; that is critical. Patience, due diligence of the partner and careful negotiations preceding the contract are important. Choice of the partner will probably determine the choice of the country. Mutual understanding of expectations is more important than the contract, though the contract is still necessary. Visits to and from partners are important for relationship building. There is some (but not a lot of) tolerance in how the brand is presented overseas.

Using the qualitative methods of Yin (2003) we have been able to develop this two-type classification of international franchising strategies, with predictive behavioural differences in terms of the above. Theoretical saturation was achieved for this theory. Future studies need to replicate this qualitatively or apply a quantitative approach to test the theory. The theory lends itself to practical application by current and future franchisors to improve their overseas expansion.

References

Alon, I., McKee, D., 1999. The internationalization of professional business service franchises. The Journal of Consumer Marketing 16 (1), 74-83.

Beilock, R., Wilkinson, K., Zlateva, V., 1998. Franchisor entry and control strategies in difficult and remote business environments: The case of Bulgaria. Management Research News 21 (11), 45-68.

Buckley, P. Casson, M., 1998. Analyzing foreign market entry strategies: extending the internationalization approach. Journal of International Business Studies 29 (3), 539-561.

Carson, D., Gilmore, A., Gronhaug, K., Perry, C., 2001. Qualitative Research in Marketing, Sage Publications, London.

Connell, J., 1999. Diversity in large firm international franchise strategy. The Journal of Consumer Marketing 16 (1), 86-94.

Contractor, F. Kundu, S., 1998. Franchising versus company-run operations: model choice in the Global Hotel Sector. Journal of International Marketing 6 (2), 28-53.

Department of State Development, (2000. Franchising in Queensland. Office of Small Business, Brisbane.

Doherty, A., Quinn, B., 1999. International retail franchising: an agency theory perspective. International Journal of Retail & Distribution Management 27 (6), 224-238.

Frazer, L., Weaven, S., 2004. Franchising Australia 2004. Griffith University, Brisbane.

Giles, S., 2004. Chairman's Message, Franchising and Own Your Own Business Magazine 17 (4), 14-15

Huszagh, S., Huszagh, F., 1992. International franchising in the context of competitive strategy and the theory of the firm. International Marketing Review 9 (5), 5-18.

Kedia, B., Ackerman, D., Bush, D., Justis, R., 1994. Determinants of internationalization of franchise operations by US franchisors. International Marketing Review 11 (4), 56-68.

Koiranen, M., 1998. Spread of franchising: a multinational comparison based on the notions of innovation diffusion. Asia Pacific Journal of Marketing and Logistics, 10 (2), 50-65.

Lincoln, Y., Guba, E.1985. Naturalistic inquiry. Sage, Newbury Park, CA.

Patton, M., 2002. Qualitative research and evaluation methods. 3rd edition, Sage, Thousand Oaks, CA.

Preble, J., 1995. Franchising systems around the globe: a status report. Journal of Small Business Management 33 (2), 80-88.

Quinn, B., 1998. The internationalisation process of a franchise system: an ethnographic study. Asia Pacific Journal of Marketing and Logistics 10 (2), 66-84.

Quinn, B., 1999. Control and support in an international franchise network. International Marketing Review, 16 (4/5), 345-356.

Quinn, B., Alexander, N., 2002. International retail franchising: a conceptual framework, International Journal of Retail & Distribution Management 30 (5), 264-276.

Rennie, M., 1993. Born Global. The Mckinsey Journal, 4, 45-52.

Sashi, C., Karuppur, D., 2002. Franchising in global markets: towards a conceptual framework. International Marketing Review 19 (4/5), 499-524.

Terry, A., 2002. A comparative analysis of franchise regulation in Asia. International Society of Franchising Conference, Orlando: 1-29.

Terry, A., 2004. Andrew Terry on Franchising. Franchising + Own Your Own Business 17 (6), Nov/Dec: 14-15.

Walker, J., 2004. Chain reaction. Business Review Weekly 26, 36-53.

Yin, R., 2003. Case study research: Design and method. Applied Social Research Methods Series, 5, Sage, Newbury Park, CA.