

**EXPLORING THE REASONS WHY FRANCHISORS DISCONTINUE  
FRANCHISING IN FAVOUR OF ALTERNATIVE METHODS OF  
OPERATION**

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# EXPLORING THE REASONS WHY FRANCHISORS DISCONTINUE FRANCHISING IN FAVOUR OF ALTERNATIVE METHODS OF OPERATION

## ABSTRACT

This paper provides a preliminary analysis of the strategic management decision of franchisors to discontinue franchising arrangements in favour of an alternative method of ownership. A sample of 14 ex-franchisors and 7 of their ex-franchisees was interviewed to gather data on reasons and outcomes of the decision to cease franchising arrangements.

The data analysis indicates that in general the firms were attracted to franchising because of resource constraints. However, the decision to adopt an alternative ownership strategy appears to be based on problems associated with human capital such as difficulties monitoring and motivating franchisees, and economic factors such as the downturn in the economy during the 1990s.

## INTRODUCTION

A common theme in the franchising literature has been why firms choose franchising as a means of expansion. Three main motivations for franchising have been proposed relating to resource constraints, efficiency, and agency related arguments (Dant, 1995). The first motivation, the *resource constraints* argument, assumes that firms use franchising as a means of accessing financial capital, human capital and local market knowledge through franchisees in order to expand (Oxenfeldt and Kelly, 1968-1969; Caves and Murphy, 1976; Ozanne and Hunt, 1971). An alternative proposition is that firms franchise for *efficiency* reasons to achieve economies of scale related to operational activities (Mathewson and Winter, 1985; Martin, 1988). A final perspective is provided by *agency theory* which attempts to explain franchising in terms of the alignment of goals of franchisors and franchisees. The agency relationship is used to develop the most efficient contract to govern the two parties given the conflicts of self-interest that may arise (Rubin, 1978; Kreuger, 1991).

Whilst the above debate about why firms franchise has persisted, scant attention has been paid to the issue of why franchisors discontinue franchising and adopt alternative strategies for expansion. An exception has been research by Kirby and Watson (1999) which investigated incentives for franchising in the construction industry. Dant (1995: 11) calls for further research on franchising choice by recommending that firms that have stopped franchising in favour of other modes of growth be examined: '... businesses that opted *against* franchising may hold a perspective to franchising we know little about'. The aim of this paper is to explore reasons why franchisors discontinue franchising but continue operating under an alternative structure. The methodology applied in this research is discussed next.

## RESEARCH METHODOLOGY

A qualitative research approach was adopted in this study because the topic has not been thoroughly explored in the literature (Adams and Schranefeldt, 1991). Hence, a combination of personal and telephone interviews was used to obtain data.

The impetus for this research came about when the author noticed that a large number of franchisors appeared to be discontinuing their franchised operations but were nevertheless still operating. During two mail surveys of the Australian franchising sector in 1996 and 1998 a total of 60 firms out of some 700 franchisors indicated that they were no longer franchising (Frazer and Perry, 1998; McCosker and Frazer, 1998). Considering that the decision of these franchisors was made before the introduction of franchising legislation in Australia, it seemed that quite a large number of firms were changing their ownership strategy. It was decided that these firms should be investigated to attempt to determine why their strategies had changed, given that franchising remains a popular form of doing business with a 16 percent per annum compounded growth rate reported from 1994 to 1998 (McCosker and Frazer, 1998).

No comprehensive list of franchisors in Australia is centrally held, but the surveys in 1996 and 1998 used a database maintained by McCosker and Frazer (1998). Although some less visible franchises may have been omitted, the database appears to include most franchisors operating in Australia. A total of 693 franchisors was confirmed to be operating in 1998. Of the 60 firms indicating they had ceased franchising, 41 were located in Brisbane, the Gold Coast, Sydney and Melbourne, which are the main centres where franchisor headquarters are held. These were also accessible locations for conducting personal interviews. In 1999 the 41 firms were contacted by telephone to confirm their status. It was determined that 7 had never started franchising (they had considered it but had not continued), 5 were apparently no longer operating (they were not listed in the Telstra White Pages), 3 were unable to be contacted and their status is unknown, and 9 said they were in fact still franchising (presumably they were unwilling to participate in the earlier surveys). The remaining 17 firms confirmed that they had previously franchised but had discontinued. Of this sample of 17 ex-franchisors, 14 agreed to participate in the study representing a response rate of 88 percent.

Interviews were conducted personally by the researcher for approximately 45 minutes and these were taped with the interviewee's permission and later transcribed. In most cases the interviewee was the founder of the firm and was responsible for the decision to discontinue franchising, but in five cases the interviewee was a new owner or a person involved in senior management of the firm and was privy to this information.

In addition, telephone interviews of approximately 20 minutes were conducted with seven ex-franchisees from six of these firms to gain a different perspective of the decision. It was hoped to interview at least one person from each firm if permission was granted, but in several cases the researcher was discouraged from contacting ex-franchisees and the interview was not pursued. In some instances, legal action was pending or under way making such contact inadvisable.

## **DATA ANALYSIS – FRANCHISOR INTERVIEWS**

In this section the demographic attributes of the sample of franchisors as well as factors relevant to the decision to discontinue franchising are examined.

### **Demographics**

The sample of 14 firms covered a range of industries, reflecting the diversity in the Australian franchising sector as a whole (McCosker and Frazer, 1998). Three firms were involved in retail trade (non-food), two each were involved in retail trade (food), accommodation/cafes/restaurants, and property/business services. One firm was involved in each of education, communication, manufacturing, cultural/recreation, and personal/other services. Although only a small sample it would appear that the decision to exit franchising may not be related to the type of industry. It has been suggested that the extent of business risk and the requirement for specific human capital may be factors associated with a lack of franchising in particular industries (Michael, 1996). However, in the present study the firms choosing not to franchise were from a wide range of industries suggesting that other reasons may be relevant.

The firms in the study were well established in their operations with 11 of them operating for more than 10 years. However, most had not been operating for very long before turning to franchising. Five firms began franchising either immediately or within the first year and another four did so within five years. Although this short period of experience may be regarded as undesirable, it is very similar to the practice of franchisors in Australia who establish their business format for a median of only three years before franchising (McCosker and Frazer, 1998). It is uniformly recommended that firms establish their operations for at least two years before attempting to franchise the concept (for example, Weinrauch, 1986; Morgen, 1999) and this may be something that intending franchisors should consider if they want to continue long term. The decision to discontinue franchising was also made early with half the sample ceasing to franchise within the first five years. Only one firm had been franchising for more than 20 years. In comparison, the median number of years that firms have been involved in franchising in Australia is 7 years (McCosker and Frazer, 1998).

Although it is routinely advised that franchisors maintain company operations both as a benchmark for their franchised operations and as a means of product development, the median number of company owned outlets in Australia is only one (McCosker and Frazer, 1998). All but two of the franchisors in the sample owned company outlets while they were franchising, although most held only one or two outlets which reflects the trend in the sector.

Most of the firms in the sample were small operations in terms of number of franchised outlets. Nine of the firms held up to 10 franchised outlets prior to the suspension of their franchising activities which is comparatively lower than the median of 17 franchised outlets held by active franchisors (McCosker and Frazer, 1998) and lower than most estimates of break-even (Frazer, McCosker and Paynter, 1999). Only one firm was large, holding more than 100 franchised outlets prior to ceasing franchising. It is important to note that the firms in the sample have remained small,

with all holding less than 20 company outlets today, indicating that their decision to adopt an alternative ownership structure did not enhance expansion.

### **Motivations for franchising**

The two most common reasons for starting franchising provided by the firms in the study were the use of franchisees as a source of capital and franchising as a means of rapid expansion. These motives are also reflected in the literature (for example, Caves and Murphy, 1976; Melon, 1988; Cavaliere and Swerdlow, 1988). When asked why they discontinued franchising the major factor cited was disappointment with franchisee performance and a secondary factor was a downturn in the retail sector which may have impacted on that particular industry. In a study of franchising in the construction industry in the United Kingdom it was found that firms abandoned franchising mainly because of difficulties with recruiting and monitoring franchisees (Kirby and Watson, 1999). In the present study, recruiting franchisees was not cited as a problem area but the issue of monitoring and motivating franchisees to perform was mentioned by most.

### **Contractual and operational arrangements**

Data on franchised outlet start-up costs and fees were collected but these are difficult to compare because of the different time periods involved. Most of the franchisees interviewed felt that the fees were too high and that a major disincentive to be involved in franchising was the necessity to pay fees. This negative reaction about fees is a common phase that many franchisees experience during the lifecycle of their businesses (Mendelsohn, 1992; Nathan, 1999). All but three of the firms charged percentage-based ongoing fees with these three firms supplying products at a mark-up to franchisees instead. Of interest is that five of the firms did not use any form of marketing or advertising levy although such a levy is commonly employed in franchises to promote both franchised and company owned operations (Sen, 1993). It is possible that the lack of marketing activity in these firms may have been related to the disappointing results obtained.

Around one-third of the firms used franchising consultants to set up the franchising structure or to recruit franchisees. Most franchisees were attracted via advertising in newspapers or franchising directories but in four of the firms franchisees actually approached the franchisor about franchising.

No set criteria were used to select franchisees from the pool of applicants in four of the firms, with these firms relying on 'gut feel'. A common mistake made by new franchisors is the acceptance of unsuitable applicants due to their inexperience in selecting franchisees or their haste to get started (Mendelsohn, 1992). Of the remainder who used specific criteria, the most common requirements were the necessary capital and industry experience. In general, only 10 percent of franchisors require their franchisees to have specific industry experience (McCosker and Frazer, 1998), possibly indicating that firms with this specific requirement may be less suited to franchising.

## **Management of systems**

The majority of franchisors in the sample provided some form of initial support to new franchisees. This was most likely to be in the form of pre-opening training and the provision of Operations Manuals. However, only half the franchisors offered systematic ongoing support, typically in the form of ongoing training and field visits by franchisor staff. Overall, it would appear that the firms in this study offered less initial and ongoing support than is standard in the sector where the majority of franchisors offer a combination of several different types of support (McCosker and Frazer, 1998).

The apparent lower levels of assistance by franchisors may be linked to the disappointing results reported in the operation of franchisees' businesses (Kreisman, 1986). The most common problem area portrayed by franchisors in the study related to franchisee effort, such as a breach of operational standards or an unwillingness to work hard in the business. Two franchisors also mentioned they discovered their franchisees were underreporting their income, a common problem where percentage based fees are used (Acheson, 1996) or where insufficient monitoring of franchisee activities is performed (Hesseling, 1997). A total of six franchisors (43 percent) had been or were currently involved in litigation with franchisees. This is a much higher proportion of franchisors in litigation than the 17 percent recorded in the franchising sector (McCosker and Frazer, 1998). As can probably be expected with franchise systems that ultimately chose to alter their ownership strategies, disputes with franchisees were relatively common.

When asked about their decision to discontinue franchising arrangements, most franchisors felt they had made the right decision but three regretted the result and were reconsidering franchising again in the future. However, only one of the three who were undecided was aware of the existence of the Franchising Code of Conduct that became effective in 1998 so their planning was not yet well advanced.

## **The Franchisees**

Of particular interest in this study is the fate of the franchisees who were attached to the firms. Most franchisors indicated they felt their franchisees had profitable operations and this was confirmed in the small sample of franchisees also interviewed. Five of the firms reported that franchisees were happy with the decision to discontinue franchising arrangements. Of the remainder, four firms indicated that their franchisees were unhappy with the decision and four reported mixed reactions from their franchisees. One executive referred to the predicament as 'a messy divorce'.

A summary of the fate of the franchisees immediately following the cessation of franchising appears in table 1. Very few of the outlets were actually repurchased by the franchisors which suggests that an ownership redirection strategy was not their goal (Caves and Murphy, 1976; Brickley and Dark, 1987). Two of the arrangements adopted involving operations under licensing and distribution arrangements may now be technically regarded as franchising since the introduction of franchising legislation in Australia in 1998 (Franchising Code of Conduct, 1998). However, this was not the case

prior to the introduction of the legislation and the two ex-franchisors involved may find themselves unwittingly involved in franchising again by default. A full 54 percent of franchisee outlets continued operating in some form indicating that at least half the outlets were not failures. Only 9 percent of outlets were closed, although one firm alone is responsible for the 37 percent of outlets that were converted to employment contracts and most of these have since been disbanded making the closure rate much higher.

Table 1 About Here

In summary, the main factors affecting the change of ownership strategy in this sample of franchisors appear to be related to *human capital factors* and *economic factors*. Human capital factors include problems with motivating and monitoring franchisee activity, difficulties associated with finding suitable operators, and disputes with franchisees. The main economic factors relevant to the decision to change ownership strategy were related to the downturn in trade experienced during the 1990s and the underpayment of franchise fees.

## CONCLUSION

Contrary to the franchising literature there was no evidence in this sample of firms that franchisors employ an ownership redirection strategy to buy back franchised units for company ownership. The motives for discontinuing franchising appear to be related to performance issues arising out of problems associated with agency issues of monitoring franchisee activities. A common theme was that franchisees were not expending enough effort running their businesses, indicating that more care was needed in the selection of franchisees and greater incentives were required for franchisees to perform at a desirable level.

This study revealed no apparent link between industry type and the discontinuance of franchising, although a specific requirement for industry experience by prospective franchisees may be a factor. The effect of regulation on the franchising sector is not regarded a factor in this study because the decision to discontinue was made well before franchising legislation was introduced, although a minority of franchisors did allude to their fear of possible litigation by franchisees which was perhaps based on their prior experiences.

This study provides some preliminary data only on the subject of franchising strategy. Future research should aim to collect a larger sample of firms that discontinue franchising so that the motives of franchisors can be further analysed. In particular, it is recommended that future research examines the effect of the recently introduced regulation of Australia's franchising sector.

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TABLE 1

**Fate of franchisees immediately following decision to discontinue franchising**

<b>Fate of franchisee outlet</b>	<b>Percentage of franchisee outlets</b>
Undecided at this stage	1
Closed	9
Converted to employment contract	37
Purchased by franchisor	3
Franchisee continued operating – independently under original name	5
Franchisee continued operating – independently under new name	19
Franchisee continued operating – under license from franchisor	4
Franchisee continued operating – under distribution agreement with franchisor	4
Sold to an external party	18
<b>Total</b>	<b>100%</b>