

**What do Potential Franchisees look for in a Franchise? An exploratory investigation using signalling theory**

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**Abstract**

This paper presents exploratory research which investigates and identifies attributes of franchised businesses and how those attributes are perceived by potential franchisees in the early stages of the business sale process. This research adopts a view of the nature and effectiveness of the franchise disclosure document and its usefulness in the franchise sales process to prospective franchisees? We apply a signalling-theoretic perspective of the value proposition of franchise opportunities with the goal of assisting key franchising stakeholders to design effective (generic) disclosure documents, within the context of mandatory provisions, so as to minimise franchisor and franchisee goal divergence, conflict and (ultimately) franchise unit and system failure. We find that much of the required material has little value to prospecting franchisee.

Keywords: conflict, channel, dissonance, franchising, relationships

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### **Introduction**

The Australian Franchising sector has been coined 'the franchise capital of the world' (Walker, 2004, p. 36) with 71,400 franchise system units contributing \$131 billion in sales to Australia's Gross Domestic Product each year (Frazer, Weaven, & Wright, 2008). Although franchising has grown rapidly in the past three decades in Australia, the sector continues to experience problems. In the period 2006 to 2008, an average of 26 percent of franchisors reported being involved in substantial disputes with franchisees (Frazer, Weaven, & Wright, 2006; Frazer et al., 2008). While research is being conducted into the nature and potential prevention of conflict in franchising, questions still remain regarding franchising relationships and the suitability of current sector regulation (Frazer, Giddings, Weaven, & Wright, 2007). The Australian Franchising Code of Conduct (1998) (the 'Code') was introduced to address a perceived imbalance of power between franchisors and franchisees. Administered by the Australian Competition and Consumer Commission (ACCC) under the Trade Practices Act (1974), one of the Code's main thrusts is to ensure that franchisors disclose pertinent information to prospective franchisees within disclosure documents. However, concerns remain as to the effectiveness of the Code in ensuring that franchisors comply with this stipulation (Frazer et al., 2007; Ritchie, 2001).

### **Franchise Disclosure Documents**

A central tenet of the Code is the full disclosure by system owners (franchisors) regarding their business and financial operations (which is broadly consistent with a prospectus for an initial public offering), which should encourage mutually beneficial outcomes for both franchisors and franchisees. However, the current high levels of conflict within the franchising sector suggest that a significant number of franchise relationships suffer from goal divergence between principals and their agents (Dant, 1995; Frazer et al., 2006, 2008). This goal divergent conflict may be symptomatic of perceptual incongruity, domain dissensus, communication failure or personal ideological differences between channel members (including values, beliefs and ambitions) (Bowersox & Cooper, 1992; Lusch & Ross, 1985). All of these symptoms can be traced back to insufficient formation of the relationship ex-ante. Hence, the only recourse for potential franchisees to be fully informed in the purchase of a franchise is the disclosure document. The disclosure document represents a significant step in the purchase of a franchise and one that has not been previously investigated. How the disclosure document is formed under the mandatory code of conduct is, therefore, a significant contribution to the franchising sector and academic research in this area. A number of these factors contributing to franchising channel conflict and discontinuance have been highlighted within the marketing and management literature including information asymmetry between channel members, misinformation resulting from inadequately conducted due diligence, with goal divergence resulting from changing expectations and comparison levels between channel members (Dant, 1995). However, most of this research focuses upon existing franchising relationships, providing (at best) limited insight into issues surrounding the formation of channel member relationships. In recognition of the importance of this area of research, there has been a renewed focus on investigating proactive recruitment and selection processes in manufacturer and reseller dyadic exchange relationships (Berman, 1996; Stern, El-Ansary, & Coughlan, 2006).

However, recruitment and selection approaches have only received cursory attention within the franchising domain. Thus, the aims of this research are to determine the attributes of the franchise relationship as perceived by potential franchisees and examine how these attributes are defined within the disclosure document and franchise agreement.

### **Signalling Theory**

Gallini and Lutz (1992) developed a signalling theory model where franchisors constructed confidential information about the brand value of their franchise system from which they communicate that value to potential franchisees. This initial development of signalling theory focussed on franchise fees (at a high or low level) and/or the number of franchisor-owned outlets which served as a device to signal high or low quality of investment in the respective franchise system brand. However, subsequent application of this research found franchise contracts (royalties and franchise fees) were inefficient in signalling value to prospective franchisees. Alternatively, membership to industry associations was seen as positive reinforcement of the franchise brand. Ultimately the long-term relationship sought by franchisors and potential franchisees could be derived from the franchise agreement (Lafontaine, 1993). Thus, signalling theory focuses on the externalities of market imperfections and knowledge asymmetries to explain organisational choice. Entrepreneurs desirous of attaining the incentive advantages of franchising are depicted as facing an asymmetric information problem: How do good franchisors signal the quality of their concept to prospective franchisees when bad franchisors have the incentive to misrepresent their quality in an attempt to sell franchises? While application of signalling theory explains some actions by franchisors in the investment market place there is a paucity of research on the links between information asymmetry and ex-ante conflict. Therefore, this research extends the current conceptualisations of signalling theory within asymmetric exchange relationships.

### **Research Question**

At this early stage of the research project, we want to learn from potential franchisees what they looked for when they were considering a franchise opportunity. We wanted to learn of their personal experiences that drove their evaluative criteria and how they judged the material that was required to be given to them. Specifically, which features of the disclosure document were of value and ultimately is the disclosure document useful in the franchise sales process to prospective franchisees? The generic disclosure document required by the ACCC (2008) is composed of four areas consisting of the following. The franchise territory being sold; franchisor experience and history; system information (details of existing and terminated franchises in the last three years, trade mark, patent, design/copy right, marketing and co-operative funds, establishment costs and other payments/financing arrangements; and finally legal requirements including money required prior to signing the franchise agreement, summary of conditions of the agreement that deal with all obligations, summary of the conditions of the agreement, details of the goods and services the franchisee may acquire or provide, and any obligations to sign related agreements including leases, hire purchase, security, confidentiality, restrictions to business, provision for acknowledging receipt of the disclosure document.

### **Method**

Each year franchise sales expositions are held capital cities throughout Australia. Interviews were conducted at the Sydney exposition in March 2009. Criteria for selection in the interview process were the type of franchise, cost of franchise, time-frame for potential purchase of franchise, a potential mix of age and gender, and exposure to the disclosure document. This ensured a cross-section of typical insights for evaluating and assessing franchise attributes as displayed in the disclosure document. In the interview process participants were asked to specify attributes they saw as important in the franchises they were investigating. Further, they were asked to rank order each attribute in importance. Data were obtained through semi-structured interviews. Extensive notes were taken as digital recording was not possible in the open environment (Douglas, 2003). Thematic development involved the analysis of data while interviews were being conducted (Eisenhardt, 1989; Yin, 2003). Coding then involved close scrutiny of the data. The aim of open coding was to begin the unrestricted labelling of all data and to assign representational and conceptual codes highlighted within the data. As the process moved forward, iterative reflection was considered for subsequent data collection and categorisation (Parry, 1997; Goulding, 2002; Locke, 2001; Strauss & Corbin, 1998). Five interviews were attained from a total of twenty one prospects. Potential respondents were approached and screened for experience in the franchise sales process and exposure to a franchise disclosure document. The final five participants were recruited when the screening process revealed that they had extensive experience in the franchise business sale process and been exposed to at least one disclosure document. Most respondents were couples, either married or business partners. They were interviewed immediately upon successful screening. In these types of interviews participants expressed their true feelings and/or deep convictions regarding the topic being discussed (Malhotra, Hall, Shaw, & Oppenheim, 2002; Zikmund, Ward, Lowe, & Winzar, 2007).

### Summary of Findings

Table 1 summarises the background of each respondent, and how each ranked franchisor attributes contained in the generic disclosure document.

**Table 1 – Summary of background and attribute rankings**

Franchisee background and motivations	Attributes by importance
Respondent #1 - The first respondents had owned a commercial painting business and were looking for a working environment that was a change of lifestyle. They could afford virtually any type of franchise. They had been looking for a franchise for approximately 12-18 months (this represented the time taken from initial perusal to significant investigation – which included discussions with franchisors). They had read one disclosure document.	<ol style="list-style-type: none"> <li>1. Profit was highly important. Respondent was clear that they were not 'buying a job' but wanted a business to provide an acceptable return (although they could not articulate what an acceptable return was).</li> <li>2. Territory details were vital. This was critically related to the history of the site (an on-going franchise unit, not green-field). This was to determine if the site had been successful or not.</li> <li>3. Personal experience with franchisor was necessary for a successful relationship.</li> <li>4. Experience of franchisor and the senior executives were important.</li> <li>5. Details of ex-franchisees were important but not critical to the process.</li> <li>6. Previous litigation, minimal records were important.</li> <li>7. Broker commission not important at all.</li> </ol>
Respondent #2 - These potential franchisees were looking for a working environment that produced flexible working hours and were very focused on the \$50K franchises or less. This clearly focused on lifestyle but also they quoted the 'be your own boss' phrase. They wanted to purchase an established brand such as VIP or Jim's. When asked if they had considered James Home Services they did not recognize	<ol style="list-style-type: none"> <li>1. Profit was highly important.</li> <li>2. Territory details were only important to the extent that this related to travelling.</li> <li>3. Personal experience with franchisor was necessary for a successful relationship. They felt that they would be guided in their business by the franchisor.</li> <li>4. Experience of franchisor and the senior executives were</li> </ol>

<p>the brand. They only wanted to consider purchasing a franchise close to their current home (or a reasonable distance) thereby keeping travelling to a minimum.</p>	<p>important. "But doesn't the success of the overall business represent experience?"</p> <ol style="list-style-type: none"> <li>5. Broker commission not important</li> <li>6. Previous litigation not important</li> <li>7. Details of ex-franchisees were not important.</li> </ol> <p>They did not think that the rest of the disclosure document was important. They were focused on what they had learnt about the franchise systems (brands) and the relationship with the franchisor. This affected how they perceived the brand.</p>
<p>Respondent #3 - This pair had been looking for a franchise for approximately 5 years. They had considered a couple of different types of franchises (fast food, restaurant) and were focused on the higher end of the franchise price systems. They have nearly closed on three different franchises. They felt that disclosure documents could be misleading and felt it unimportant for purchasing a franchise. They stated that actual observation of the franchise was critical to indicate customer traffic sales value. Therefore, other criteria were important. They had not proceeded with other franchises as the 'business model' that was disclosed was not viable. Subsequently the retail outlet and the franchisor had gone out of business. They had already established views on what was a successful/unsuccessful strategy in business (although there was no clear articulation of this). Both men were still searching for 'what' business to buy. They were very focused on how the business model produced 'profit'.</p>	<ol style="list-style-type: none"> <li>1. Sales and profit was highly important.</li> <li>2. Locations and territory selection details were critically important. This was relative to sales and profitability and specifically how these were calculated by the franchisor. They could not articulate a generic method that would suit.</li> <li>3. Rent was important and how this fit into the 'business model'.</li> <li>4. Broker commission not important</li> <li>5. Previous litigation not important</li> <li>6. Details of ex-franchisees were not important.</li> <li>7. Personal experience with franchisor was necessary for a successful relationship. They felt that this would be important as to how they would be guided in their business by the franchisor.</li> <li>8. Experience of franchisor and the senior executives were not very important.</li> </ol>
<p>Respondent #4 - This potential franchisee was looking for a franchise for approximately 1 year. He had considered a couple of different types of franchises but was focused on a system that required no manual labour. He had considered a franchise called 'Red DVD' and thought that this system provided the flexibility and return that he was looking for. He was focused on the location model that the franchisor had created and felt that this would provide the 'make or break' for the store. Had received significant information from a number of systems but disclosure documents from two systems.</p>	<ol style="list-style-type: none"> <li>1. Sales and profit was highly important and linked to the location and territory selection. This was relative to sales and profitability and specifically how these were calculated by the franchisor. He could not articulate a generic method of calculating this.</li> <li>2. Personal experience with franchisor was necessary for a successful relationship. This was important because the franchisor would guide them in the business.</li> <li>3. Previous litigation/criminal history was important as this reflected on previous relationships with franchisees.</li> <li>4. Considered that the skills/experience of the franchisor was more important than the success of the system. Felt that the skills and experience of the franchisor would assist with his personal success.</li> <li>5. Broker commission not important</li> <li>6. Details of ex-franchisees were not important.</li> </ol>
<p>Respondent #5. These potential franchisees were looking for a franchise for approximately 1 year. They had considered a number of systems but their primary focus was on a system that created 'wealth'. They wanted flexibility in entering and exiting the business on daily business activities. This meant that they wanted a business that could be run by management. They wanted to set up a new franchise locally to where they lived. They thought that the location/site selection model was more important than the overall success of the system. They had received significant information from a number of systems and a disclosure document from one system. They had looked/observed a franchise system locally and had decided not to proceed with this system because of the information they had gathered themselves. The location model was not successful. Both had extensive previous business history in the construction/building industry.</p>	<ol style="list-style-type: none"> <li>1. Profit was highly important and linked to the location and territory selection. This was relative to sales and profitability and specifically how these were calculated by the franchisor. They could not articulate a generic method of calculating this.</li> <li>2. Previous litigation/criminal history was important as this reflected how previous relationships with franchisees could be interpreted.</li> <li>3. Broker commission not important</li> <li>4. Details of ex-franchisees were not important.</li> <li>5. Personal experience with franchisor was not necessary for a successful relationship.</li> <li>6. Considered that the skills/experience of the franchisor was not important</li> <li>7. The success of the system was not important.</li> </ol>

Thematic development of respondents' comments leads to the following attributes in order of importance. Where individual respondents differ in order of importance the most frequently stated are utilised. These are as follows. Profit was regarded as the most significant attribute by prospective franchisees. Territory and location modelling were intrinsically important to the generation of sales and profit. The business model; while respondents could not articulate specifically how the model should work, a focus on significant costs in the business were necessary (e.g., rent). Franchisor-franchisee relationship is important to the development of the business. Experience of the franchisor, and the executive staff, were not important to the overall progression of the business. Broker commission was unimportant. Details of ex-franchisees were not important. The two broader areas of system information and legal requirements as set out in table 1 were seen as necessary for the operations of the business but not important to the decision to enter the franchise.

### **Conclusion and Significance**

This initial research shows that potential franchisees use the disclosure document in a limited manner to formalise the relationship with franchise systems. Significant portions of the document were seen limited in use, of no use, or counter-productive to the formative stages of franchise system selection. Therefore, respondents felt that franchise system quality and any subsequent potential evaluative opportunities were not effectively signalled through the disclosure document. This potentially reinforces earlier research into signalling theory highlighting the limited value of mandated information such as previous franchise relationships, broker commissions and legal requirements.

This research is a first step in developing a greater understanding of how franchise systems can be more effectively signalled to potential investors and subsequently, more productive and positive franchise relationships should form. Further research in this area will assist in promoting goal alignment between external regulatory bodies (e.g. ACCC) and franchisors in relation to how they develop the disclosure document. Greater communicative collaboration between franchisors and regulators will improve the perception of equity in franchising exchange relationships. Extension of this research will identify the factors influencing relationship management in franchising networks and develop generic attributes for disclosure documents in an asymmetric information exchange. Therefore, this research is exploratory in nature and will be used to develop a model designed to inform key franchising stakeholder groups (franchisors, potential franchisees, franchisees, franchising professionals, regulatory authorities and government) on how to proactively inform the active investment community of their respective businesses so as to minimise costs associated with conflict management in their systems, post hoc. Further, more effectively forming franchisees' expectations at the initiation of the franchise relationship will have important implications for the evolution of the franchisor-franchisee dynamics.

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