

# **Do Disclosure Documents Signal Value to Prospective Franchisees? A Conjoint Analytic Approach**

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## **Do Disclosure Documents Signal Value to Prospective Franchisees? A Conjoint Analytic Approach**

### ***Abstract***

This paper presents research that 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 regulatory framework, 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 prospective franchisees.

Keywords: conflict, channel, dissonance, relationships

## **Do Disclosure Documents signal value to prospective franchisees? – A conjoint analytic approach.**

### ***Introduction***

The Australian Franchising sector has been coined ‘the franchise capital of the world’ (Walker, 2004, p. 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 substantial disputes with franchisees (Frazer, Weaven, & Wright, 2006; Frazer et al., 2008). While research has been conducted into the nature and prevention of conflict in franchising, questions still remain regarding the franchise relationship 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 (Frazer et al., 2007, Spencer, 2008) One of the Code’s main aims is to ensure that franchisors disclose pertinent information to prospective franchisees via the disclosure document. However, concerns remain as to the effectiveness of the Code (with the Disclosure Document as central to the Code’s application) (Frazer et al., 2007; Ritchie, 2001). Hence, do prospective franchisees value or even consider the disclosure document in their search for a franchised business? A conjoint analysis is utilised to ascertain if prospective franchisees value part or all, of the disclosure document.

## ***Franchise Disclosure Documents***

A central tenet of the Code is the full disclosure by system owners (franchisors) of their business and financial operations (which is broadly consistent with a prospectus for an initial public offering), to encourage mutually beneficial outcomes for both themselves 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, one possible recourse for potential franchisees to be fully informed in the purchase of a franchise is through 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 the 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.

### ***Signalling Theory***

Gallini and Lutz (1992) developed a signalling theory model by which franchisors constructed confidential information about the brand value of their system and from which they communicated that value to potential franchisees. The 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 viewed as positive reinforcement of the franchise brand.

Ultimately the long-term relationship sought by franchisors and potential franchisees' can 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. Franchisors desirous of attaining the incentive advantages of

franchising are depicted in previous studies 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 (Lafontaine, 1993)? 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 and specifically focuses on whether the disclosure document overcomes operationalisation of the asymmetric information axiom at the incubation stage of the franchise relationship.

### ***Research Question***

In this research, we wanted to learn from potential franchisees what they looked for when considering a franchise opportunity. The framework of signalling theory focuses on the critical mass of company owned units to confidently signal profit potential in their own system. In close alignment with signalling theory, does the enforcement of the disclosure document add to prospective franchisees positive decision making process and potentially overcome goal divergence post-purchase? Hence, we wanted to learn of potential franchisees personal experiences that drove their evaluative criteria and, how they judged the material given to them. Specifically, which features of the disclosure document were of value and ultimately is the disclosure document (all or part) useful in the franchise sales process to prospective franchisees? The generic disclosure document required by the Australian Competition and Consumer Commission (ACCC) (2008) is composed of four areas. They are, (i) the specifics of the franchise territory being sold; (ii) detailed franchisor

experience and history; (iii) 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 (iv) 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. We further develop this signalling theoretic argument in a two stage exploratory process described in the next section.

## ***Method***

This research was conducted in two stages. Firstly, an exploratory stage to crystallise specific issues regarding the disclosure document, and subsequently a survey to collect data for analysis.

### ***Stage 1 - Interviews***

Each year franchise sales expositions are held capital cities throughout Australia. In stage 1, 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 recent 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. 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 occurred of data while interviews were 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 (Goulding, 2002; Locke, 2001; Parry, 1997; Strauss & Corbin, 1998). Five interviews were completed from 21 intercepts. These 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 Interview 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
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<b>Franchisee background and motivations</b>	<b>Attributes by importance</b>
<p>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.</p>	<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>
<p>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 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>	<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 important. “But doesn’t the success of the overall business represent experience?”</li> <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>

Franchisee background and motivations	Attributes by importance
<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>

<b>Franchisee background and motivations</b>	<b>Attributes by importance</b>
<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 led 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.

These results gave us insight into the value placed on those features of the Disclosure Document that are required of franchisors. Very rarely do we see a franchise that is ideal – a

low-priced, high profit, established business model, managed by experienced franchise principals, with high levels of integrity, and many very happy existing franchisees. While certainly there are such business opportunities on offer, the question for this study is how do potential franchisees decide when confronted with opportunities that are less than ideal? That is, what tradeoffs are they willing to make when facing a franchise purchase decision?

### ***Stage 2 – Conjoint Analysis***

In this stage of the research, a survey was structured via a conjoint analytic technique. Conjoint analysis was chosen as the analytic tool as it allows a subset of possible combinations of a product (or system) features to be used to determine the relative importance of each feature in the purchasing process. This method is based on the premise that the relative values of attributes considered jointly can be better measured than when considered in isolation.

When asked to perform choice decisions many consumers are unable to accurately determine the relative importance that they place on product attributes. For example, when asked which attributes are the more important ones, the response may be that they all are important. Furthermore, individual attributes in isolation are perceived differently than in the combinations found in a product. (Louviere, 1988) It is difficult for a survey respondent to take a list of attributes and mentally construct the preferred combinations of them. A low price is important, for example, but quality is also very important, so how do people make the tradeoff? The task is easier if the respondent is presented with combinations of attributes that can be visualized as different offerings.

## ***Instrumentation***

In the exploratory stage respondents were asked to identify attributes of franchise systems they considered important in the purchasing decision process. These attributes were then condensed into a list of choices via the survey. Respondents were then asked to choose from a list of combinations of system attributes in a best-worst scenario. This method is efficient in the sense that the survey does not need to be conducted using every possible combination of attributes. The pattern of stimuli are mapped against the pattern of responses so that the responses are decomposed to extract estimates of the relative value of each to the attributes and attribute levels. The technique is explained in detail in Zikmund *et.al.* (2007). From these results we can derive parameter estimates for a formula for each respondent which enables prediction of the desirability of the combinations can be made from those that were not tested.

Suggested attributes and levels used in this study are presented in Table 2.

*Table 2: Testable attributes and Attribute levels*

<b><i>Testable Attributes</i></b>	<b><i>Levels</i></b>
Territory	Exclusive or non-exclusive
Site selection	Policy or no policy
Franchisor (and team) experience (including current litigation)	High level of experience - Low level of experience
Current franchise status (including liquidity and size)	Mature - Infant
Franchise outlet price	\$80, \$120, \$180, \$210

Four variables at two levels, plus one variable at four levels, would require 64 different profiles for evaluation, but these can be reduced to just eight profiles in a Fractional Factorial

design (FFD) like the following. The given FFD experimental design permits each attribute level to be traded off against each other level, providing sufficient information to calculate main-effects-only attractiveness measures for each attribute.

The FFD translates into the following product descriptions.

- 1: *non-Exclusive territory, No site-selection policy, <5 yrs average team experience, Franchise operating 10+ years, \$320K*
- 2: *Exclusive territory, No site-selection policy, <5 yrs average team experience, Franchise operating <5 years, \$80K*
- 3: *non-Exclusive territory, Well-defined site-selection policy, <5 yrs average team experience, Franchise operating <5 years, \$160K*
- 4: *Exclusive territory, Well-defined site-selection policy, <5 yrs average team experience, Franchise operating 10+ years, \$40K*
- 5: *non-Exclusive territory, No site-selection policy, 10+ yrs average team experience, Franchise operating 10+ years, \$40K*
- 6: *Exclusive territory, No site-selection policy, 10+ yrs average team experience, Franchise operating <5 years, \$160K*
- 7: *non-Exclusive territory, Well-defined site-selection policy, 10+ yrs average team experience, Franchise operating <5 years, \$80K*
- 8: *Exclusive territory, Well-defined site-selection policy, 10+ yrs average team experience, Franchise operating 10+ years, \$320K*

Respondents applied a score to each profile. A number of different methods are available for extracting a score from respondents, from simple 1-10 rating scales, to complex choice-based methods. (Karniouchina, Moore, van der Rhee, & Verma, 2009).. We elected to use a new approach suggested by Louviere and colleagues known as Best-Worst scaling (Finn & Louviere, 1992; Auger, Devinney & Louviere, 2007; Flynn, Louviere, Peters, & Coast, 2007). Best-Worst scaling makes very few assumptions about the nature of human decision making, is consistent with current theory on information processing and evaluation,

overcomes many problems of idiosyncratic evaluation styles within each person or cultural group, and is a relatively natural and straightforward task for most respondents. Six such evaluation tasks were required of each respondent. From the evaluation stage, we had from each respondent an attractiveness score for each of the eight profiles ranging from -3 to +3. These were regressed against the pattern of stimuli (the fractional factorial design), using dummy-variable regression, to gain estimates of the relative value of each franchise profile attribute and attribute level. Such data were gathered for each person in our sample.

*Table 3 - Example Best-Worst evaluation used in this study*

Consider the four different franchise opportunities below. Please indicate which <b>one</b> is most attractive to you and which <b>one</b> is least attractive to you.		
<b>Except for the differences shown below the franchise opportunities are the same.</b>		
<b>Most attractive</b>		<b>Least attractive</b>
	non-Exclusive territory      No site-selection policy <5 yrs average team experience      Franchise operating 10+ years \$320K	
	non-Exclusive territory      No site-selection policy 10+ yrs average team experience      Franchise operating 10+ years \$40K	
	Exclusive territory      No site-selection policy <5 yrs average team experience      Franchise operating <5 years \$80K	
	Exclusive territory      No site-selection policy 10+ yrs average team experience      Franchise operating <5 years \$160K	

***Sample***

Stage two interviews were conducted at the Franchising Exposition in Brisbane, Australia, in June 2009. Respondents were recruited by a pair of trained research assistants, and vetted for their level of interest in buying into a franchise. Like those in the preliminary qualitative

interviews, most were married couples looking for a change of career, or to go into business for themselves. For our purposes, a married couple counted as a single respondent making a purchase decision. One hundred respondents qualified for the study and agreed to complete the questionnaire, yielding 83 useable questionnaires. The majority of those who did not complete the questionnaire abandoned it because it was too complicated.

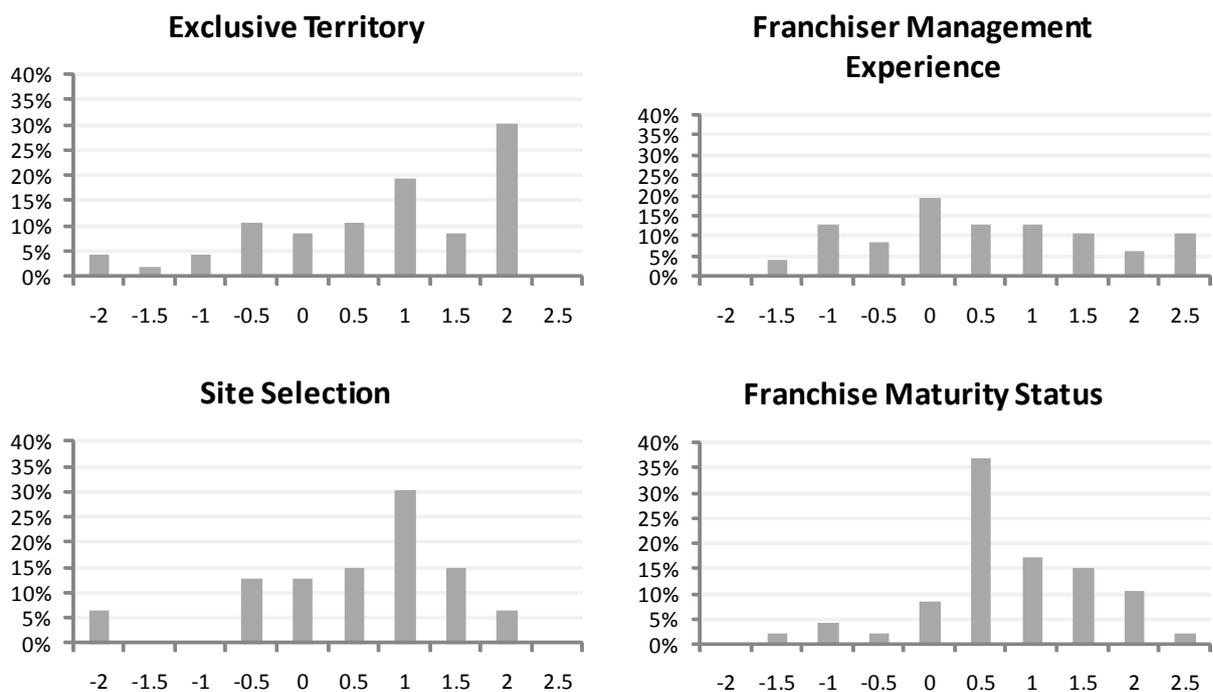
### ***Conjoint results***

The focus of this stage of the study was to find the relative importance of different components of the disclosure document amongst potential franchisees. Implicit in such a study is the ability of respondents to process such information and make sound assessments. One issue that was immediately apparent was that many respondents were unable to process the information independently of the salesmanship that, by its nature, must accompany a franchise agreement. Here we found that a significant number were unable to complete this task. Of the 100 people who were qualified and who agreed to participate, 17 failed to complete the questionnaire, most explaining to the research assistant that the questionnaire was too complicated, 18 made random (nonsense) evaluations, as evidenced by extremely low Adjusted-R-squared values in their regression output, and a further 19 were removed from analysis because their coefficients for price were estimated to be positive, implying that they preferred to pay a higher price for a franchise – clearly an irrational evaluation. This left 46 respondents for analysis.

Figure 1 summarises the distribution of coefficients for those remaining respondents. The X-axis is the coefficient for the regression equations for each respondent. They range from -2 to +2.5. A positive coefficient implies a preference for that franchise feature, and a negative

coefficient implies a preference for not having that feature – the larger the value the stronger the preference. We can see that about 22% of respondents seemed to prefer a franchise that did not offer exclusive territory, 20% preferred a franchise that did not offer help with site selection, and 26% preferred to work with franchise management with relatively less experience. These would seem to be not sensible evaluations. Arguments could be made for or against the value of a mature franchise, but a majority of respondents clearly preferred an

*Figure 1: Summary of Coefficients for Franchise Attributes*



established franchise.

Clearly, a small number of potential franchisees make rational evaluations when presented with clear choices, but there remain a large number who seem unable to make evaluations of opportunities that would be in their best interests. Of the 100 respondents we interviewed, just 24 made completely rational evaluations of the franchise opportunities presented to them.

## ***Conclusion***

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 as 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 necessarily 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 greater understanding of how franchise systems can effectively signal quality to potential investors and subsequently generate more productive and positive franchise relationships. Further research in this area should assist goal alignment between external regulatory bodies (e.g. ACCC) and franchisors in relation to how the disclosure document framework is developed. The factors influencing relationship management in franchising networks can be identified, through this research, and subsequently assist the development of useful generic attributes for disclosure documents. Therefore, the potential is to reduce asymmetric information exchange. Hence, this research is exploratory in nature and will be used to develop a model designed to inform these key franchising stakeholder groups (franchisors, potential franchisees, franchisees, franchising professionals, regulatory authorities and government) on how to proactively inform an active investment community of their respective businesses to minimise costs associated with conflict management in their systems, *post hoc*. Further, early franchisee

expectations can be potentially more positively affected at the initiation of the franchise relationship which will have important implications for the evolution of the franchisor-franchisee dynamics.

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