The Development of International Franchise Network

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ABSTRACT

International franchising is deemed as relatively low risk and commitment entry mode compared with high risk and commitment entry modes such as wholly foreign-owned subsidiaries for many services-based sectors. However, there exist the issues of support and control within the franchise network to maintain the franchise relationship. The monitoring cost will be higher and monitoring ability becomes more complex in the international market than in the domestic market that results in the choice of appropriate control mechanisms which will be imperative issues for international businesses operating in the Taiwanese marketplace. The empirical investigation of the research, indentified that control mechanisms consist of two dimensions: an economic mechanism in the form of a franchise contract and social mechanisms in the form of the degree of interaction and the quality of support. The two mechanisms are a complement. In addition, the selection in the area development franchising emerges from the qualitative findings as further control mechanisms become available to international franchisors.

Keywords: control mechanisms, franchise relationship, economic mechanism, social mechanisms

INTRODUCTION

International franchising is regarded as a unique entry mode unlike the exporting, licensing because it incorporates two (or three) independent legal entities working closely together in the arm's length transaction with separate ownership and engages in the on-going relationship to establish a mutual benefit within a franchised network (Rubin, 1978; Mendelsohn, 1992; Shane, 1996). Based on the definition, the relationship between franchisor and franchisee consists of three components (1) a contract-based agreement; (2) independent parties but interdependent and (3) an ongoing relationship.

Firstly, a franchising agreement regulates responsibilities, the decision rights and the resources of the franchisor and the franchisee (Rubin, 1978; Pizanti & Lerner, 2003) that is a major source of control, power and conflict (Stern & El-Ansary, 1992; Fulop & Forward, 1997). There are many unfair clauses for the franchisee which may include territory clauses (Kaufman & Rangan, 1987; Hoy, 1994), reward systems (Stern & El-Ansary, 1992), termination clauses and restrictions on post-termination activities within the agreement (Fulop & Forward, 1997). It suggests that the contract has a coercive power to manage the franchisor and franchisee relationship (Quinn, 1998; Doherty & Alexander, 2006). However; individuals may choose franchising as a preferred method because they regard themselves as an independent business entity and have considerable access to many resources and support from franchisors (Fulop & Forward, 1997). Secondly, the franchisor and the franchisee are independent legal entities with separate ownership but are two parties working closely together (Rubin, 1978; Mendelsohn, 1992; Shane, 1996) to achieve the mutual benefits. The whole revenue of a franchise system is based on the profits of small localised outlets associated with economies of scale of the entire system (Kaufmanns & Eroglu, 1998). Franchisees are dependent on the know-how, trademark, experience and support of the franchisors (Dant & Gundlach, 1998; Nathan, 2004). If the franchisees attempt to reduce costs through lowering the
quality of service this may deteriorate the image and reputation of the whole franchise system (Combs & Castrogiovanni, 1994). Thus, the two parties engage in a long-term mutual benefit under the relationship. This relationship generally leads to the creation of a successful business format where quality is enhanced and maintained to the benefit of both parties.

The franchisor and franchisee also engage in an ongoing, long-term relationship (Fulop & Forward, 1997) for ten years or more. The relationship begins with the franchisor who is highly dependent on the local human, consumer information and financial capital of franchisees to access local markets. In the meantime, the franchisee is motivated by the franchisor’s knowledge and well-proven reputation to establish their business (Kaufmann & Stanworth, 1995; Nathan, 2004). In the long term, the relationship between the two parties becomes more interdependent (Nathan, 2004) as franchisees gain more experience and knowledge of the franchise system (Bradach, 1998; Nathan, 2004), and may develop new products and discover new solutions to system-wide problems through local adaptation methods (Dant & Gundlach, 1998; Nathan, 2004). Although the franchisor is familiar with the local environment, he/she has to encounter the problems of consistent support for and maintaining the franchise and the degree of satisfaction of the quality relationship.

The purpose of the paper is to provide the explanation of the methods which are used by international franchisors to control and co-ordinate the dynamics and complexities of the franchise network in the Taiwanese marketplace. How to balance the control and autonomy of the franchisee within the bounds of the relationship is imperative for franchisors as supporting and maintaining franchisees is considered particularly difficult and the cost of providing franchise support is higher in overseas markets than in domestic ones. The research question of the paper is to examine: How do the international franchisors maintain the franchise network relationship in the Taiwanese marketplaces?

LITERATURE REVIEW

The Explanation of Control in International Franchising

Franchising proved an increasingly popular method of expansion for international services-based business (Quinn, 1998; Doherty & Quinn, 1999) and appears an important long-term strategic choice for two independent entities (Fladmoe-Lindquist & Jacque, 1995). The issues of control mechanism used by the international franchisors to control and co-ordinate the international franchise network is receiving much attention in international franchise research recently (Quinn & Doherty, 2000; Pizanti& Lerner, 2003; Doherty & Alexander, 2006).

Control mechanism is defined as the methods used to monitor and coordinate the behaviors of franchisees to ensure the consistency of the franchise system. Previous studies provided valuable insights into the control facet of the franchisor and franchisee relationship (Quinn & Doherty, 2000; Pizanti& Lerner, 2003) and identified that international franchisors exercise control over the franchise network through formal and informal control mechanisms (Quinn & Doherty, 2000; Pizanti& Lerner, 2003; Doherty & Alexander, 2006). The formal control mechanism is characterized by codified rules and regulations, that is primarily through the franchise contract. The informal control mechanism depends on the development of common beliefs and shared values between franchisors and franchisees (Koza&Dant, 2007). Studies suggest that a franchise relationship performs better when its values and norms relating to the desired attitudes and behavior of both the two parties are shared (Doherty& Alexander, 2006; Moore, Birtwistle & Hurt, 2004). The study conducted by Liu, Lou and Liu,(2009), based on the assumption of the economic and social exchange insight, surveyed 225 pairs of
manufacturer-distributors in China, and suggested that transactional mechanisms are more effective in restraining opportunism while relational mechanisms are more powerful in improving relationship performance. This performance is improved more significantly when both contracts and relational norms are used jointly than when used separately. Likewise, franchisee opportunism is curbed more effectively when both contracts and trust are used jointly than when used individually. The explanations of control mechanism will be theoretically examined in the context of the relational exchange theory and agency theory.

Agency Theory vs Control Mechanism

The premise of the agency theory contends that the franchise network is the principal-agent relationship (Eisenhardt, 1989). Franchisees were expected to maintain the high reputation of the company, the high standard of shop fitting, to sell only approved products and to comply with franchisor’s advice under the guidelines of the contract. Franchisors exercise other common control devices including financial documentary, the use of expatriates and hiring a third party to audit the behaviour of franchisees (Dant & Nasr, 1998). However, their use is limited to the outcomes rather than the behaviours that can be problematic if the intent is to control quality, especially in services where the intangible aspect of the work is more important to monitor (Fladmoe-Lindquist & Jacque, 1995). The agency theory focuses on formal control that is emphasized when the requirement to control the franchisee behavior is tight (Fama & Jensen, 1983; Stanworth et al., 1996; Choo, 2005).

A franchise contract serves as the formal and legal relationship between the franchisors and franchisees and sets out comprehensively and specifically the obligations and rights of the two parties (Sibley & Michie, 1982; Pizanti & Lerner, 2003; Doherty & Alexander, 2006). In effect, the contract typically serves as the main source of power and control of the franchisees because it allows the franchisor to severe the relationship as a punishment for the misconduct behaviors (Felstead, 1991; Hall & Dixon, 1988). Control is relatively tight in the early stages of international development; therefore, this contract is likely to be the most efficient means by which to execute the tight control (Quinn, 1999). The established franchisees in the system would have a longer and more accumulated experience and thus, a decrease of dependence on master franchisors, unless the franchisors can afford the adequate support (Quinn, 1999). A study conducted by Pizanti and Lerner (2003) support that the length of the contract, the size of the franchise system and the degree of complexities as being the determinants of the degree of franchisees autonomy. Thus, the contract is considered as a static, legal document and clan of control mechanism for the short term.

The control through the strict enforcement of contract is unilateral mechanism. In addition, the cost of monitoring and supporting are higher in international marketing than in domestic marketing because of the cultural and geographical distance. Moreover franchisees that consider themselves to be independent entrepreneurs might not willingly accept such tight control over time (Stanworth, 1996). Thus, many debates claim that agency theory focuses on an economics viewpoint through a formal control mechanism which leads to an ignorance of relational complexity within the franchise system and fails to reflect the dynamics of the franchisor-franchisee relationship. Thus, the social aspect viewpoint is examined through control mechanisms within the context of the relational exchange theory.

Relational Exchange Theory vs Control Mechanism

The social aspect viewpoint is examined through control mechanisms within the context of exchange theory. Many debates claim that agency theory focuses on the economic viewpoint through
formal control mechanisms which ignore relational complexities within the franchise and fail to reflect the dynamics of the franchisor-franchisee relationship (Macneil, 1980; Cocbet, Dormann & Ebrmann, 2008). The exchange theory focuses on informal control mechanisms in which control is utilised when the requirement is for a low level of franchisor control (Choo; 2005). This, contrary to agency theory, occurs most readily when franchisors have developed effective relationships with franchisees, with an established set of common beliefs and shared values (Ouchi, 1980; Choo; 2005).

The exchange theory emphasizes the process of interpersonal interaction that is based on the interests of participants and the transfer of compensations between them. Exchange relations are easily created and maintained when each party views transactions as beneficial. Pizanti and Lerner (2003) examined autonomous relationships within franchise systems using the exchange theory and found that franchisor-franchisee relationships deriving from exchange transactions are flexible and dynamic. The capacity of each party to arrange deals to his/her own benefit is influenced by the balance of resources between the parties. Due to the diverse background, franchisees possess different resources that may lead to differing perspectives on benefit exchange and potential conflict between the two parties so that control mechanisms may be applied when there is a need to re-establish relevant incentives for each party. Based on the exchange theory, relational norms are an important informal mechanism for independent parties.

The empirical study conducted by Cocbet, Dormann and Ebrmann, 2008 suggested that franchisors can utilize relational governance as a control mode to lessen the agency problem which results from the desire of a franchisee’s autonomy. It indicated that the relational governance can resolve the difficulties because of the inconsistency in objectives/interests between the franchisor and the franchisee.

Therefore, the paper aims to address the research question by presenting findings from an in-depth interview and case study analysis of the international franchisors operating in the Taiwanese marketplace and exploring the methods these franchisors employ to control their master franchisees and maintain their franchise relationship.

**METHODOLOGY**

**The Relational for Methodology**

It is considered that there are two major research orientations in social sciences: one is qualitative research which is generally directed towards the case -oriented method; the other is quantitative research which is considered to be a variable-oriented method in the social sciences (Sauders, Lewis & Thornhill, 2000). The qualitative method tends to adopt an inductive approach that leads to the creations and integrations of new concepts or theories through the data collection process and its examination (Neuman, 2003). Within international franchising research, previous studies have been conducted by the quantitative method through the mail survey (Hackett, 1976; Aydin & Kacker, 1990; Preble, 1992). Further, Doherty and Quinn (1999), Frazer (2003) advocate that the adoption of the qualitative study of international franchising is required in order to obtain rich and relevant data of the company operations. In addition, the adoption of interactive methods of data collection and the acquisition of qualitative data can complement and redress some of the weaknesses of the large scale statistical survey (Fulop & Forward,1997). Thus, the qualitative study is used to gain close proximity with those involved in the process of managing international relationships.
Case Study

Case study is considered to be an elastic, empirical inquiry that investigates a contemporary phenomenon within its real-life context (Yin, 2003). It is useful when the boundaries between phenomenon and context are unclear and where there has been limited prior research undertaken (Yin, 2003). Case studies also provide an in-depth explanation of the particular context and situation that may lead to further exploratory research (Yin, 2003). The case study method also offers a flexible and innovative method to collect and examine data and allows an intensive description and analysis of single respondents, an individual, group or organization (Eisenhardt, 1989). The data may not be limited to the interview process but can be gathered from different sources including naturalistic observation, interviews, personal documents, archival records and secondary data. Based on the comprehensive data, theoretical propositions can be developed. However the data can be used to not only develop theory but additionally test theory (Yin, 2003; Eisenhardt, 1989).

For the study on the control mechanisms used by international franchisors in the Taiwanese marketplace, the multi-case approach would be suitable, as it allows both theoretical and literal replication approaches to be used. According to Eisenhardt (1989) and Yin (2003), replication logic enables a research to identify the subtle similarities and differences. Replication logic also encourages the researcher to go beyond initial impressions. These forced comparisons allow new categories and concepts to be identified. By using the multiple-case approach, a better understanding of an international franchisor’s control mechanism can be attained.

Case Selection

The analyses of the franchise systems were chosen according to the following criteria:

- Firms originated from America or Japan.
- Taiwanese master franchisee directly communicated with the headquarters of the organization.
- Firms that have settled in Taiwan for at least 15 years.
- Firms that have, so far, expanded over 3 countries.
- Firms that have made great marketing mixes and adapted internal managements.

Two franchised systems of American and Japanese food-retail companies were used in this study: America A, America B, Japanese A and Japanese B. America A represents one of most successful and the highest market share fast-food franchised system in Taiwan through many efforts and a few adaptations. America A has also achieved great success and has had a strong impact on the franchising industry in the country by setting an example of excellence.

America B is chosen as an example because it is third in the market share of convenience stores in the Taiwanese marketplace but it has completely withdrawn from the market in 2007 because the home country cannot afford sufficient supporting resources anymore and raises the problem of brand hijack between master franchisor and franchisee.

Japanese A represents the typical Japanese fast-food franchised system and owns the second market share of fast-food franchised system in terms of the number of outlets in the Taiwanese marketplace. Japanese A is especially interesting because it is successful in spite of the challenge of unfamiliar service delivery and product concept and the brand name being totally unknown in Taiwan before it entered the country.

Japanese B is chosen as an example of an effort that originally failed in the Taiwanese marketplace. It serves as a model of how and what a company needs to do in order to turn around its operations, product and image in order to win back a lost market. The analysis of all the cases aims to examine how international franchisors exercise their control mechanisms over the Taiwanese franchisees.
Data Collection

In this study, in depth interviewing and document research will be the primary sources of data. Semi-structured interviews will be conducted which involve a series of open-ended questions in which the interviewer will have the freedom to probe the interviewee to elaborate on the original response or to follow a line of inquiry introduced by the interviewee (McMurray et al, 2004).

The interviews are conducted with the franchisee key decision makers, senior franchisee managers, and international franchise managers. All participants are informed by telephone, and have looked at the interview protocol beforehand. Participants agreed to conduct the face- to- face interview and tape-recorded interview without divulging the important secrets of the company. The researcher transcribed the manuscripts word by word according to the tape-recordings and these transcripts are regarded as the foundation of the research analysis.

The interviews will be conducted in Mandarin and be tape recorded and textually transcribed. The typical interview will take up to one hour to complete. To meet ethical requirements the transcripts they will not contain any individual’s names and the companies’ names will not be recorded. The typed material will be destroyed following the transcriptions. Document research will be used in this study to provide triangulation. Documents are good sources of evidence as many documents are often accessible free and contain information that otherwise will take the researcher some considerable time and resources to collect (Dexter, 1970). The data may be collected from documents such as the company websites, journals, annual reports, magazine articles, dissertations and other publications found in America and Taiwan such as The Journal of Business Venturing, International Marketing Review and The Journal of Global Marketing; the latest census on franchising in Taiwan conducted by the Taiwan Franchising Association and the Association of Chain and Franchise Promotion.

RESEARCH FINDINGS

The franchise relationship is very difficult to manage because of the divergent goals between franchisors and franchisees, particularly, the cultural and geographical distance which makes it more difficult in international franchising. Based on the qualitative data which emerge from the case studies and in-depth interviews, the paper proposes that control mechanisms in an international franchising relationship can be classified into two dimensions: economic mechanism in the form of franchise contract and social mechanisms in the form of the degree of interaction, normative expectation and the quality of support. The two mechanisms are complement. In addition, the use of the area development franchising emerges from the qualitative finding as the further strategic control mechanism available to international franchisors.

Economic Mechanism – Control Through Franchise Contract

From an agency theory perspective, the franchise contract is the legal binding basis for international franchise business. It is deemed as the formal control mechanism and includes the length of the contract, the renewal process and the terms of termination and finances as well as sales projections and the number of stores to be opened over a specified period.

Theoretically, the contract can be employed when the franchisee does not comply with the regulation of contract. However, research indicated that franchisors do not use the contract to place a control over their Taiwanese franchisee on the daily operation unless he/she revokes the legal issues. The Taiwanese codes of relationship invoke harmony as a higher priority than legal requirements.
Therefore, within the context of Taiwanese culture, contracts are an ineffective means for managing conflict between franchise parties. A franchise relationship is culturally understood to be long-term and on-going, where communication and trust are central to success. Thus, if franchisors hope to maintain a degree of control over business processes, brand/service quality and uniformity they must be willing to invest time and energy in building trust-based relationships with their franchisees. A contract is simply a legal agreement that outlines the terms and conditions of the franchise relationship. It is the last way to deal with disagreement and is the ineffective means by which to control the behavior of the franchisee.

SOCIAL MECHANISMS- THE INTERACTION AND THE QUALITY OF SUPPORTING

Control Through the Interaction

From the relational exchange perspective, the franchise relationship is established on these potential resources of transfer between the two parties. The interactions address the flow of the activities, resources and information from the franchisors to the franchisee and the contacts that occur between the two parties in the franchise relationship. The provision of information is regarded as a significant dimension of a franchise relationship whereas the tight control is not accepted by franchisees who has the desire of independence and autonomy. The provision of the helpful and authentic information to their partners is a key safeguard for the relationship continuance and social form of control (Dant & Nasr, 1998) Interaction between the franchise relationship is a critical activity as it can strengthen development of complementary goals, share values and a greater understanding of each party’s perspective. It can also facilitate information sharing, coordination, cooperation, trust and mutual commitment among the participants. Research indicated that interaction was offered by the two parties that will not only affect the motivation of sharing local information to franchisors, the joint development of marketing plan, the attitude of cooperation but also foster system-wide adaptability.

Thus, interaction can be regarded as a social way of control mechanism as the tension of franchise relationship such as strategy non-compliance, goal incompatibility can be mitigated through intensive communication, information exchange, the development and maintenance of communicative and trust franchise relationship.

Control Through the Quality of Supporting

International franchising is a contracted-based organizational structure for entering new markets. The franchisor has to offer a successful support system including the proven franchise business concept associated with operational guidelines to the franchisee. The provision of a successful support system is the key successful factor for the development of an international franchise network and a means to maintain the brand image and consistency quality.

Research indicated that the proven business concept is referred to in the franchise manual that can assist franchisees to develop the new business and establish the business image including marketing strategy, human resource strategy, the outlet of monitoring and management. In these case companies, the successful case is that the franchisor supports the franchisee through the joint development of a local marketing plan. In this way, the new product development, and marketing position are devised.

In addition to a proven business franchise concept, franchisors may provide operational support to franchisees in order to maintain the quality of services and avoid franchisee opportunism. The operational support contains the initial store opening from the site selection, the design of the outlets, to the merchandise allocation and assistance in helping to train the local workforce, the uniforms and the
field visit. The quality of the operational support to the franchisee influences the degree of the franchisee’s satisfaction and the intention of the cooperation. Research indicates that one of America’s franchise systems withdrew from the Taiwanese marketplace in 2007 because the master franchisee was dissatisfied with the quality and quantity of support received from their franchisor. The key factors influencing these negative perceptions of support were derived from the high degree of market competition in Taiwan and insufficient, late support from the home company. This finding is consistent with the study of Quinn and Doherty (2000) in that the franchise relationship would deteriorate through the quality of support if the resources were not available to provide the expanding network with the desired levels of the support.

Thus, the quality of support is one of social mechanisms required to maintain the franchise network that is based on the explanation of relational exchange.

Control Through the Use of Area Development Franchising

Area development agreements are a special type of master franchising which requires the master franchisee to open and operate multi-unit outlets within a geographical area according to a prespecified schedule. The research indicated that the use of area development franchising is regarded as the most popular organizational form for these case companies operating in the Taiwanese marketplace. The choice for area development franchising was strongly informed by motives inherent in Taiwanese culture. It is assisted by the master franchisor’s access to special assets, financial reserves and technological know-how to facilitate set-up. In the initial phase, balance between the limited potential of the Taiwanese market, the high costs of real estate and initial outlay, were hard to achieve. Often, first contracts are signed for a duration of 10 years. The franchisor and franchisee must consider how to break even, while maintaining high levels of cooperation.

In addition, the franchised business is regarded within Taiwanese culture as a family business with a minimal management structure, a low level of staff skill and dominantly cash-based. It most clearly resembles the 1990 Chinese Family Business (CFB) management style. The CFB management style has become the dominant form of the overseas Chinese business organization, and one of the major forms of Asian business within Asia itself. Under this management style, franchisees assume that the franchise outlet, its products and its profits are the sole domain of the core owning family. This can lead to endemic problems such as free-riding and brand hijacking. Furthermore, the legislative protection of intellectual property does not appear to be respected in most parts of Asia. These attitudes increase the probability of “brand hijacking” behaviors’ once franchisees have gained the operational know-how in running the business. Thus, the use of area development franchising is one of control mechanisms used by a franchisor because the role of a master franchisee is not only principal but also the agent on the master franchising agreement. The problem of free-riding and an undo-investment problem can be overcome through multi-unit outlets as the master franchisee has no reason to dilute the brand equity.

CONCLUSION

Based on the above discussions, the findings of the research revealed that the contract, the interaction and the quality of support and the selection of entry modes are operated to control the behavior of the franchisee over the franchise network. Bradach (1998) suggests that the contract measures the outcome—based on that fact it can not completely reflect the actual conduct of the franchisor and franchisee relationship. In fact, the franchise network mainly represented an interdependent, on-going
relationship. In that respect, formal contracts and social mechanisms are complements. Thus, well-specified contracts may actually promote more cooperative, long-term and trusting exchange relationships. At the same time the continuity and cooperation encouraged by social governance may generate contractual refinements that further support greater cooperation.

REFERENCES


