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Strategic Interactions in Franchise Relationships

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1 Strategic Interactions in Franchise Relationships: Introduction

1.1 Introduction and research objective

In recent years, firms have increasingly entered into alliances with other firms that possess complementary resources. Besides the amount of alliances, the variety in forms and functions of alliances has also increased (Osborn and Hagedoorn, 1997). The term 'alliance' refers to many different forms of inter-firm cooperation: *'from incidental cooperation between independent firms, through licensing, more systematic and lasting forms of cooperation, equity swaps and equity joint ventures all the way to mergers and acquisitions'* (Nooteboom, 1999, p.1). These terms all refer to forms of cooperation that go beyond market transactions. They have at least one characteristic in common: in each form the paradox of governance is present to some extent. This is due to the fact that alliance partners aim at creating mutual advantage through cooperation, but at the same time they have to deal with the risk of dependence in the relationship (Nooteboom, 1999). In other words, firms in an alliance are legally separate and autonomous, but in actual fact they are interrelated and to a certain degree dependent on each other. Although this dependence is a common characteristic, there is a wide range of alliances. Therefore, researchers need to take into account the different forms and functions of alliances and their unique capabilities and limitations (Osborn and Hagedoorn, 1997).

In the last few years, researchers have started to recognize the fact that there are different alliance forms. According to Osborn and Hagedoorn (1997), this differentiation among forms is accompanied by a broader view on alliance functions and motivations. Koza and Lewin (1998) divide the different motivations that alliance partners may have into two categories: a motivation to exploit existing resources ('exploitation alliance') and a motivation to explore new opportunities ('exploration alliance'). This distinction of exploration and exploitation is based on March (1991). *Exploration* includes issues such as search, variation, risk taking, experimentation, play, flexibility, discovery, and innovation. *Exploitation* involves aspects such as refinement, choice, production, efficiency, selection, implementation, and execution. March argues that firms should try to find a proper balance between exploration and exploitation in order to survive and prosper in their environments both in the short and the long run. Exploration and exploitation vary with respect to expected returns. Returns from exploration are less certain and more remote in time, while returns from exploitation are more certain and can be appropriated quicker. Organizations that engage in exploration with the exclusion of exploitation may find that they suffer the costs of experimenting without gaining a great deal of its benefits. On the other hand, organizations that engage in too much exploitation might become inert and unable to adapt to their environments in the long run.

This thesis focuses on how franchisors and franchisees as alliance partners deal with this exploration/exploitation paradox in their franchise relationships. A franchise relationship is a specific form of strategic alliance that has become more important both in a practical and an academic sense. In the practical sense, over the past decades, the number of franchise relationships has increased in various parts of the world (Fulop and Forward, 1997). For more and more firms franchising has become an important strategy for wealth creation in dynamic and uncertain environments (Sorenson and Sørensen, 2001). According to Jacobs

(1999), an important reason for small business owners to enter into a franchise relationship is that it allows them to adapt more easily to the new requirements of trading in a knowledge-based economy.

In academic research, franchise relationships have also gained importance. In the past decades, a significant amount of research has been conducted in the field of franchising in various disciplines, such as law, economics, marketing and management science (Elango and Fried, 1997). However, this literature mainly views franchise relationships from narrowly defined perspectives that merely consider the 'exploitative' aspects of franchising. Moreover, this literature mostly considers franchise relationships as static relationships with franchisees as passive partners, which is too simplistic.

The *main objective* of this thesis is to grasp the complexity of how franchise partners as strategic alliance partners respond to each other given the exploration/exploitation paradox, and why they adopt these responses. The basic research questions are:

- 1) How does the exploration/exploitation paradox manifest itself in franchise relationships?
- 2) How do franchise partners respond to each other in dealing with this paradox, and why do they adopt these responses?

A preliminary study was conducted to establish how the exploration/exploitation paradox manifests itself in franchise relationships and to develop a research model for gaining insight into the reason why franchise partners adopt certain responses toward each other in dealing with this paradox. The preliminary study consisted of a review of alliance and franchising literature, a review of specialist magazines, and exploratory interviews among franchisors and franchisees in various industries (see section 4.3 for details). This resulted in the definition of five 'franchise system characteristics' on which franchisors have to make strategic decisions when managing the exploration/exploitation paradox in their franchise systems and relationships. In the research model, these franchise system characteristics have been supposed to influence the franchise partners' perceptions of their strategic compatibility, which, in turn, could affect the partners' responses toward each other. Next to strategic compatibility, the partners' perceptions of operational compatibility, the attractiveness of alternatives and switching costs were expected to influence the franchise partners' responses. These responses vary on two dimensions: active versus passive and constructive versus destructive. Fig. 1.1 depicts the research model from the franchisee's perspective, but it can be reversed to the franchisor's perspective. The model is discussed in detail in Chapter 3.

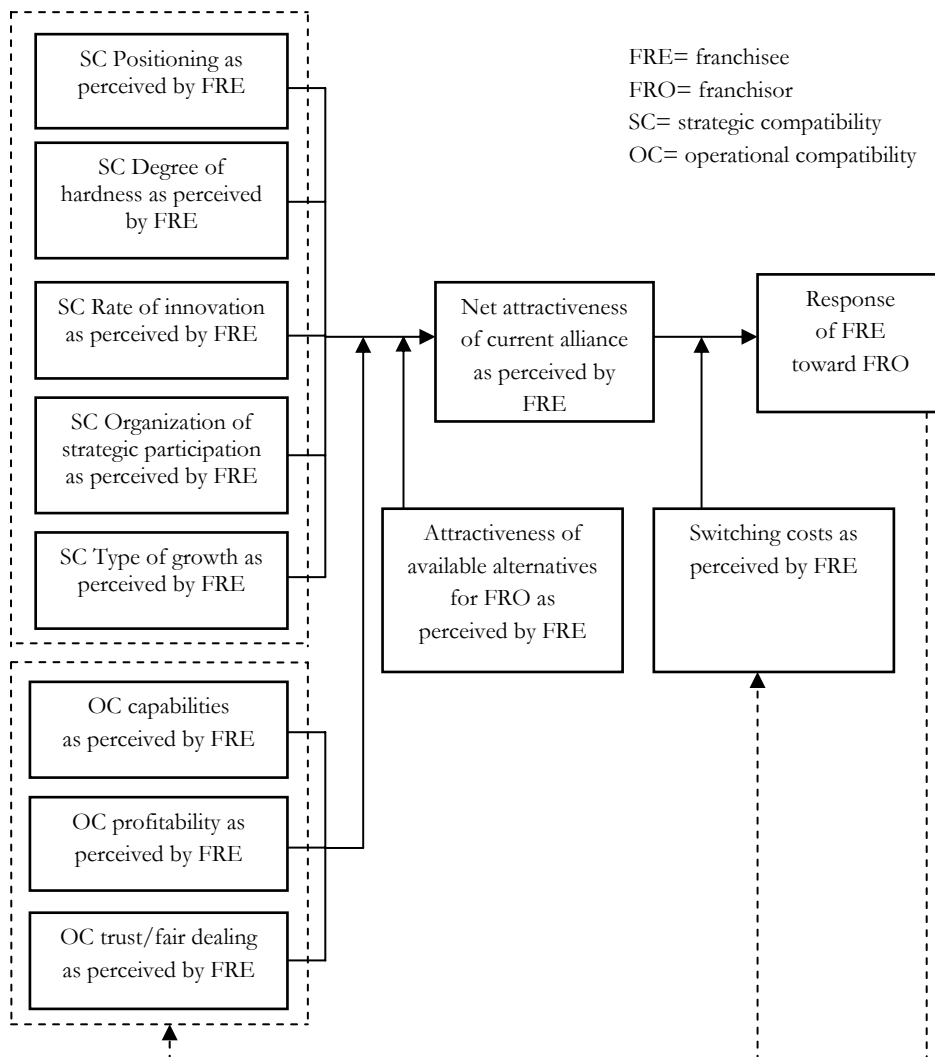


Fig. 1.1: Understanding the response of FRE toward FRO at a certain point in time

The empirical part of this study consists of four in-depth case studies of different franchise systems in a retailing industry, namely the Dutch drugstore industry. The case studies focus on important strategic change trajectories (SCTs) in which the exploration-exploitation paradox manifested itself. During these SCTs the franchisor aimed at changing one or more of the franchise system characteristics, which was expected to result in changes in the franchisees' perceptions of their strategic compatibility with the franchisor, and therefore in certain responses toward the franchisor. In the case studies the franchisor started by introducing the SCT to the franchisees. The case studies discuss what responses franchisees adopted in a reaction to the introduction of the SCT, the response the franchisor adopted in turn, and why both partners adopted these responses.

This introductory chapter starts with presenting various definitions and levels of analysis in franchising (section 1.2). Next, in section 1.3 the contributions of this thesis will be discussed. Finally, section 1.4 presents the structure of the thesis.

1.2 Franchising: definitions and levels of analysis

The term 'franchising' has different meanings to different people. Price (1997, p.3) has listed several business relationships that have been labelled as 'franchising' by various authors. Some examples he refers to are the following: the broadcasting of television programs within certain territories, the operation of airline and railway routes and the use of cartoon characters on products. Price argues that in actual fact franchising does not exist in so many forms, but that the term 'franchising' is often applied incorrectly to express what is mostly described as a licensing agreement. The various applications of the term 'franchising' require a clear categorization of franchising forms.

Kneppers-Heijnert (1988) distinguishes three forms of franchising:

1) 'Product-distribution franchising'

In this form, the 'franchisor' grants the 'franchisee' the right to sell specific goods by using the name of the franchisor. In the Netherlands this is not called 'franchising' because it is actually a form of licensing. In the U.S. it is often referred to as 'first generation franchising'. According to Kneppers-Heijnert, the most important characteristics of this form are:

- The products are licensed or 'franchised'.
- The 'franchisees' operate by using their own names and do not really form part of a chain with a uniform identity.
- The 'franchisees' do not follow certain standardized methods and ways of presentation toward customers. The cooperation only entails the distribution of goods for which sometimes an exclusive territory is established.
- The 'franchisees' are often existing retailers who adapt or renew their assortments by means of these products.
- The franchisees do not pay royalties or fees.

An example of product-distribution franchising is referred to by Price (1997): in the brewing industry brewers lease real estate to tenants on the condition that they only sell beer supplied by these brewers.

2) 'Trade mark franchising'

Through trade mark franchising the 'franchisor' grants the 'franchisee' the right to use a certain production system to produce certain goods. The franchisor arranges the presentation and promotion of the goods. Also to this type applies that in the Netherlands it is not termed 'franchising', while in the U.S. it forms part of 'first generation franchising'. This type of franchising is mostly used in the soft-drinks industry, for example Coca-Cola.

3) 'Business format franchising'

In business format franchising, the franchisor offers a complete 'business format' to the franchisees. This format reflects a certain identity toward customers. In the Netherlands, the use of the term 'franchising' is restricted to this type of cooperation. In the U.S. it is called 'second generation franchising'. Some of the earliest business format franchise systems in the U.S. are Holiday Inn, Mc Donald's and Kentucky Fried Chicken, which started franchising in the early and mid-fifties. In the Netherlands, franchising actually

started in the mid-sixties, with, for example, Wimpy (fast-food), Hubo (retail in building materials) and Prenatal (retail in baby products).

According to Kaufmann and Eroglu (1998) a 'business format' consists of four elements:

- *Product/service deliverables*: the unique differentiating features of the format that define a competitive niche in the market. These are, for example, a unique menu or the quick preparation of food.
- *Benefit communicators*: elements of the business format that make intangible benefits more tangible. For example, a mint on the pillow in a hotel could stand for elegance or prestige.
- *System identifiers*: the visual and auditory elements that link a specific retail outlet to a system or chain. For example, the trade name or brand name, color schemes, architectural features, characters and uniforms etc.
- *Format facilitators*: the policies and procedures that form the foundation of both the format's efficient functioning within the individual franchised outlets and the franchise system as a whole. At store level examples are specification of equipment, layout and design, and at system level matters such as financial reporting requirements, royalty payment procedures, and data collection.

This thesis focuses on business format franchising because it entails relatively closer relationships than product-distribution franchising and trade mark franchising do. These closer relationships are more interesting from a strategic point of view. A business format franchise relationship (in the remainder: 'franchise relationship') has the following characteristics:

- 1) One firm, the franchisor, owns a business format -including a trademark or trade name- as well as know-how, and allows another firm, the franchisee, to use these. The franchisee, who often is a small business owner, is granted the exclusive right to use the business format and know-how of the franchisor.
- 2) Both firms in the relationship are legally-independent firms. The franchisee retains the rights to the establishment's earnings (Rubin, 1978).
- 3) The relationship is of a contractual nature.
- 4) The franchisee pays a fee and/or royalties for the right to use the franchisor's business format and know-how.
- 5) The franchisor supervises to a certain degree the use of the business format by the franchisee to preserve the uniformity in both the presentation toward the customers and the quality of the provided goods and/or services (Kneppers-Heijnert, 1988).
- 6) The relationship is embedded in a 'franchise system' that consists of the franchisor and its franchised and possible company-owned outlets (Elango and Fried, 1997).

The intensity of the cooperation between franchise partners can vary from hard and/or full to soft and/or free (Kneppers-Heijnert, 1988). In the first form, cooperation is established by a large number of rules (hard) and entails almost all fields of business (full). In the second form, the cooperation is subjected to less rules (soft) and the franchisees have more freedom in running their businesses. This is in line with Leunissen's discussion of the different forms of interfirm collaboration in the Dutch retailing industry (Leunissen, 1998). The forms he describes vary from relatively loose to tighter relationships. The looser forms

merely focus on joint purchasing. In tighter forms, partners also share systems of administration or marketing. In the tightest forms, the partners cooperate in various fields, such as assortment, promotion activities, store presentation, purchasing, automation and training.

In recent years, the distinction between different forms of collaboration in the Dutch retailing industry has become more ambiguous. Many relationships have shifted from joint purchasing relationships toward so-called 'full-service organizations' operating according to a certain business format and offering continuing support to their participants. As regards the relationship with the participants, sometimes the central organization does not use the term 'franchising', because to some participants this has a negative connotation. They tend to associate franchising with no longer being an independent small business owner. However, this is an issue of definition. In this thesis the term 'franchisor' is used to indicate any organization that administers a certain business format while working with independent business owners. In addition, the term 'franchisee' refers to the business owners operating according to a particular business format.

Levels of analysis in franchising

As regards business format franchising I distinguish three levels of analysis (see Fig. 1.2):

1. The level of the *corporation*. This level is relevant when a franchisor is in itself part of a larger corporation. In this thesis, level 1 is not explicitly taken into account, however, it does form part of the context of franchise relationships and can therefore influence strategic interactions between the franchisor and its franchisees in the franchise system. One example of such a corporation is the Dutch AHOLD, which has several franchisors as subsidiaries, such as Albert Heijn BV, ETOS BV, and Gall and Gall BV.
2. The level of the *franchisor* (e.g. Albert Heijn BV, ETOS BV). A franchisor can simultaneously administer one or more different franchise systems with different business formats. These are the BFs in Fig.1.2. As argued earlier, to each business format a 'franchise system' is linked (indicated by the broken lines in Fig. 1.2), which consists of the franchisor, its franchised units, and sometimes also the franchisor's company-owned units. In Fig. 1.2 the franchised units are indicated as FR, and the COs indicate the possible company-owned units in the system. Fig. 1.2 shows an example of a franchisor that administers two franchise systems. Each franchise system has its own characteristics. These are discussed in Chapter 3.
3. The level of the *franchisees* who are part of the franchise system. This study focuses on the relationship between the franchisor (level 2) and the franchisees (level 3) within a specific franchise system. At this relational level, the research model proposes that the responses of the franchisor and franchisees toward each other are influenced by their perceptions of several variables. Chapter 3 discusses these variables in detail.

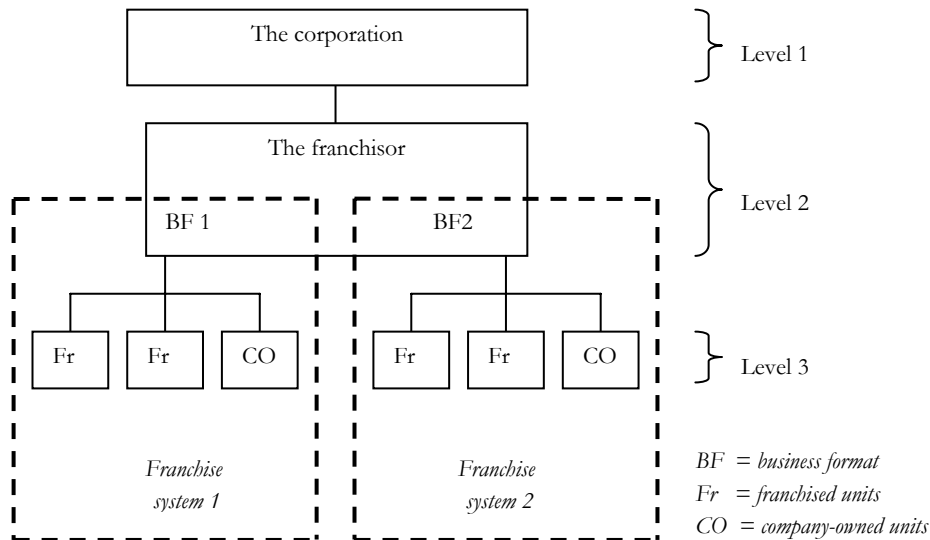


Fig. 1.2 Levels of analysis in franchising

1.3 Contributions of this study

The contributions of this study are the following:

- 1) It examines exploitation *as well as* exploration within franchise relationships rather than merely exploitative aspects.
- 2) It examines dynamic processes and interactions between franchisors and franchisees rather than static characteristics of franchise relationships.
- 3) It considers franchisees as intelligent and strategic partners in the relationship rather than relatively passive members.
- 4) It considers franchisees within a franchise system as a heterogeneous group rather than a homogeneous group.

These contributions are discussed in more detail below.

1) *Exploitation as well as exploration rather than only exploitation*

The exploration/exploitation paradox is a fundamental issue for every organizational form, including business format franchise systems. In today's environment of rapid technological and market changes, shortening product life cycles and changing consumer tastes, strategic management of innovation has gained considerable momentum (Stanworth, et al. 1996). In such dynamic environments March's exploration/exploitation paradox might be even more apparent. Also, according to Stanworth et al. (1996), strategic management of innovation has received increasing attention among researchers. Moreover, Jacobs (1999) points out that the traditional forms of innovation, product innovation and process innovation, have become more and more intertwined and have gained new meaning. Product innovation not only refers to new products, it also concerns, for example, new service concepts (such as McDonald's, or Benetton). Jacobs argues that with these concepts those organizations have been successful in relatively mature markets. Even though innovation (exploration) has become increasingly important over time, franchising researchers have mainly focused on

‘exploitative’ aspects of franchising. This thesis contributes to the literature by incorporating both ‘exploitative’ and ‘explorative’ aspects.

Winter and Szulanski (2001) discuss the exploration/exploitation paradox in connection with situations in which a large number of similar units deliver a product or perform a service. In this context, they refer to operating a large number of similar units as a ‘replication strategy’, of which franchising is an example. In franchising, the franchisor is the replicator who replicates a business format through franchisees and sometimes also through company-owned units. Franchising is not the only way to replicate: there are also replicators who only use company-owned units.

Winter and Szulanski (2001) argue that a replication strategy is often typically conceptualized as little more than the exploitation of a business format. Authors often assume that a business format is a clever implementation of a particular insight into consumer needs, which is easy to replicate. However, there are three complicating factors in replication strategies in general and franchising in specific:

- First, an important challenge for replicators is the question how to replicate the business format in different local circumstances. In franchising research this is often referred to as the tension between standardization of the business format across all units versus local adaptation (cf. Bradach, 1998, Kaufmann and Eroglu, 1998). By standardizing the business format, the franchisor maintains the shared identity of the franchise system, which makes it easily recognizable. On the other hand, individual units may face different competitive circumstances that necessitate the adaptation (exploration) of the business format. In other words, there is a paradox between the exploitation of the business format across all units of the system and their local exploration at a certain point in time. This is what Winter and Szulanski (2001) call a ‘steady-state perspective’ of exploitation and exploration.
- The second complicating factor in replication strategies is that a business format is not a timeless concept. According to Winter and Szulanski (2001) a replication strategy should be considered as a process that involves a phase of exploration in which a business format is developed and refined followed by a phase of exploitation in which the business format is stabilized and leveraged through large-scale replication. This phase is then followed by yet another phase of exploration and exploitation and so on. It is what Winter and Szulanski call a ‘life-cycle perspective’ of exploration and exploitation. Bradach (1998) also points at this tension: sometimes the business format needs to be adapted to the system as a whole in order to discern new threats and opportunities.
- The third complicating factor is not explicitly distinguished by Winter and Szulanski because it only applies to franchising as a specific kind of replication strategy. Franchising is a replication strategy involving independent business owners, which is completely different from replication by company-owned units. Bradach (1998, p.1) describes this difference as follows: *‘The company-franchise relationship (the franchise relationship, EC) is like a marriage. You agree to enter the relationship, there are some basic rules, but there are a whole lot of things you have to work out as you go. The company arrangement (the hierarchical relationship, EC) is as a military model. If there are eleven people in the room who think one way and I think the other, then we may still do it my way’.*

In sum, this study assumes that the exploration/exploitation paradox also manifests itself in franchise relationships. Ideally, franchise systems are based on a proven, more or less

standardized, business format, which reflects a uniform identity of its units, so that customers know what to expect when visiting a unit belonging to this franchise system (Kneppers-Heijnert, 1988). Such a standardized and uniform format may seem paradoxical in view of the current dynamic environment and the different local circumstances to which the business format might need to be adapted. Moreover, as pointed out, dealing with the exploration/exploitation paradox is even more complicated in a franchise system than it is in a hierarchical organization. It is therefore surprising that only few researchers have raised the question of how franchise partners deal with the exploration/exploitation paradox in the light of the business format.

2) Franchise relationships as dynamic relationships

As a second contribution, this thesis considers alliances and franchise relationships as dynamic rather than static relationships. In general, researchers have devoted relatively little attention to studying the developmental processes or 'dynamics' of alliances. Instead, they have focused on static issues, such as comparing governance structures. Ring and Van de Ven (1994) argue that processes in alliances have an important influence on the partners' perceptions of the relationship, their responses toward each other and the performance of the relationship.

The focus on static aspects is also present in the franchising literature: researchers generally view the franchise relationship as a fixed relationship in which no exploration takes place and that does not develop over time (Elango and Fried, 1997). However, through time this relationship may change, which will influence the partners' inclination to either continue it or not.

Additionally, authors often argue that alliances are instable and have high failure rates. For example, Das and Teng (2000) argue that alliances are instable and can easily be dissolved. They mention several reasons for this. However, these instability rates and reasons for dissolving can vary between different alliance forms. In other words, it is likely that one form of alliance has a higher failure or instability rate than others. Franchising researchers have generally viewed the franchise relationship between the franchisor and its franchisees as fixed and stable. Moreover, quantitative data on the (in)stability of franchise relationships are not (yet) available in the franchising literature, and neither are there any significant data regarding the Dutch situation. This study has actually found various examples of 'instable' franchise relationships.

3) Franchisees as intelligent and strategic partners

In most franchising literature, the franchisor is seen as the only intelligent actor in the franchise system. In this thesis, franchisees are considered as intelligent partners who may contribute to exploration, make their own strategic decisions and adopt certain responses toward the franchisor. For franchisors it is important to understand what factors franchisees take into account when evaluating their franchise relationships and why they adopt certain responses. Especially, destructive responses by franchisees should be properly interpreted and managed by the franchisor. If not managed properly, such responses can harm the franchise system and/or delay strategic change processes. Insight into these processes as well as the variables that influence franchisee responses will enable franchisors (and/or consultants) to properly analyze and manage their franchise relationships. From the franchisees' perspective, these insights can help them in analyzing their own position in the relationship and in deciding how to respond accordingly.

4) *A heterogeneous group of franchisees*

In most franchising literature, franchisees are viewed as a homogeneous group that can be managed by the franchisor in a standardized way. This thesis acknowledges that franchisees may not be that homogeneous. Instead, they may differ in their strategic objectives and situations as well as in their responses toward the franchisor. Therefore, different groups of franchisees may need to be managed differently by the franchisor when dealing with the exploration/exploitation paradox.

1.4 Structure of the thesis

Fig. 1.3 depicts the structure of this thesis. Chapter 2 reviews several relevant theoretical perspectives that have often been used in alliance research and specifically in franchising research.

Chapter 3 presents the research model to analyze what responses franchise partners adopt toward each other given the exploration/exploitation paradox and why they adopt these responses.

Chapter 4 discusses the methodological choices made in this study. It elaborates on the choices between quantitative and qualitative research approaches, the choice of case studies as research approach, and the specific case study design. The chapter also provides a description of the Dutch drugstore industry, since it forms the context of the case studies.

Chapters 5 up to and including 8 form the empirical part of this thesis. Each chapter focuses on a specific franchise system and ends with the conclusions based on this system.

Finally, Chapter 9 presents the ‘across-case conclusions’ and the final conclusions of the study. Furthermore, it discusses the practical implications for franchisors and franchisees and the way in which they can respond to each other in a better way, given the exploration/exploitation paradox. The chapter also offers suggestions for future research.

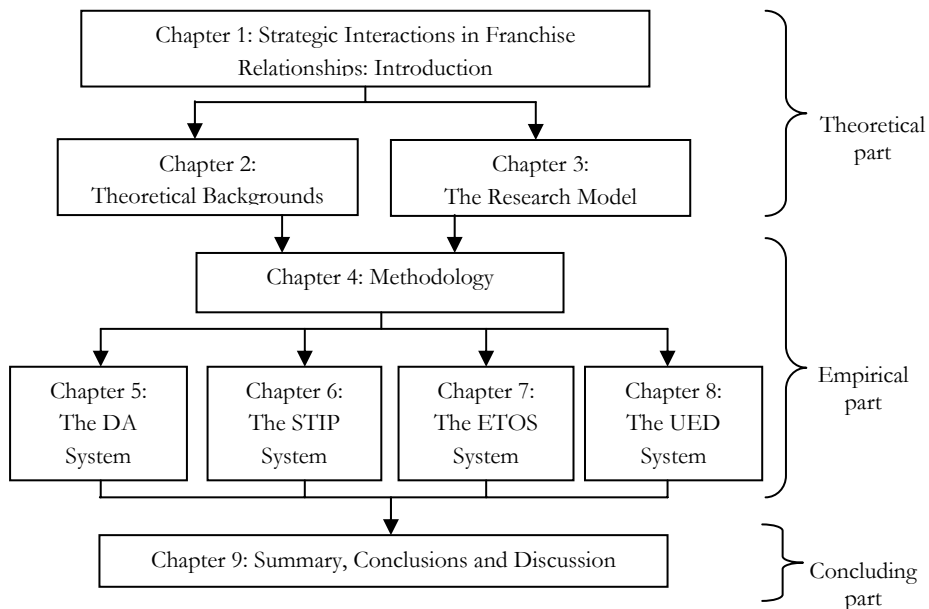


Fig. 1.3: The structure of this thesis