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Strategic Interactions in Franchise Relationships

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Document Version

Publisher's PDF, also known as Version of record

Publication date:

2006

[Link to publication in University of Groningen/UMCG research database](#)

Citation for published version (APA):

Croonen, E. P. M. (2006). *Strategic Interactions in Franchise Relationships*. [Thesis fully internal (DIV), University of Groningen]. s.n.

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3 The Research Model

3.1 Introduction

As pointed out in Chapter 2, each theoretical perspective has its own contributions and limitations as regards gaining insight into how alliance partners in general and franchise partners in specific interact given the exploration-exploitation paradox. Therefore, this study's research model is based on different theoretical perspectives.

This chapter will first describe a model developed for analyzing responses of partners in strategic alliances in general ('the general model'). Since franchise relationships are considered a specific form of alliance, this general model was further specified to a research model for understanding responses in franchise relationships. Both the general model and the research model have been developed on the basis of the preliminary study (see section 4.3 for details of the preliminary study). Subsection 3.1.1 first discusses the general model and subsection 3.1.2 introduces the research model that was actually used in this study. The sections 3.2 up to and including 3.6 specify the variables of the research model and discuss the indicators used for the measurement of these variables. Finally, section 3.7 graphically presents the research model developed in this chapter.

3.1.1 The general model

Nooteboom's model (1999) has served as an initial starting point for developing the general model (see Appendix 1 for a graphical presentation of Nooteboom's model). Nooteboom's model is a model for diagnosing, (re)designing and managing different types of alliances. There are two reasons why this model has provided a good starting point for this study:

- First, it synthesizes a resource-based perspective, a transaction cost perspective, a game perspective, a social exchange perspective and a perspective of learning and knowledge. Therefore, the model offers an integrated perspective on alliances and takes into account the growing importance of trust and exploration in a rapidly changing business environment. From a resource-based perspective, the model assumes that both partners cooperate because they offer value to each other in the form of complementary resources. Often the partners have alternative ways of obtaining these resources, for example in the form of another partner. However, if they want to switch to an alternative they need to take into account the costs of switching. This is where the 'paradox of governance' arises; both partners have to deal with a certain degree of 'relational risk' in the relationship. This relational risk has two dimensions. The first is the size of loss when the relationship ends or when the partner acts opportunistically. This size of loss depends on the *value* offered by the partner in terms of resources compared with alternatives and the costs of switching to these alternatives (*switching costs*). Nooteboom refers to this issue by using the terms 'dependence' or 'captiveness'. The second dimension is the probability that the loss will occur. The probability of loss is caused by the partner's opportunity for abandoning the relationship or 'cheating' in it (*room for opportunism*), and the partner's intent to do so (*intent toward opportunism*).
- Second, Nooteboom's model views both partners in the alliance as 'intelligent' partners who are able to influence the development of the alliance by means of

adopting different types of ‘strategies’⁶ for managing the relationship. Both partners can either bind or loosen the relationship in an adversarial as well as a cooperative way. In contrast with the largest part of the franchising literature, this study acknowledges that franchisees are also intelligent partners who may adopt their own responses toward the franchisor and are therefore capable of influencing the development of the relationship and the franchise system.

Next to Nooteboom’s model, other sources were used during the preliminary study to develop the general model and the research model, such as exploratory interviews among franchise partners and consulting alliance and franchising literature. In the alliance literature, various researchers distinguish two variables that determine the ‘value’ that alliance partners ascribe to each other: ‘strategic compatibility’ and ‘operational compatibility’ (cf. Niederkofler 1991, Medcof 1997).

Strategic compatibility deals with the question: ‘Should we cooperate?’ (Niederkofler, 1991). Strategic compatibility is achieved when the partners’ interests in a specific area overlap and when each controls part of the resources required to pursue the shared goals. In other words, the partners ascribe a certain strategic value to their relationship. According to Koza & Lewin (1998 and 2000) alliance partners can have several strategic objectives in mind for the alliance, such as gaining access to a restricted market or overcoming entry barriers, gaining market power, acquiring new skills, pooling resources, reducing uncertainty, or sharing risky research. This demonstrates that alliance objectives can differ a great deal among alliances and even among alliance partners. As indicated in Chapter 1, with respect to entering alliances Koza & Lewin reduce all these different objectives to two basic logics (or ‘strategic intents’): an ‘exploitation’ intent and an ‘exploration intent’. In their view, the exploitation intent refers to the elaboration and deepening of existing capabilities and to incremental improvements in efficiencies. The exploration intent concerns experimenting with or establishing new assets and new capabilities. Koza & Lewin (1998) argue that regarding most types of alliances an asymmetry or incompatibility of the strategic intents of the partners could lead to alliance instabilities.

In short, partners have a certain ‘strategic intent’, consciously or unconsciously, with respect to the alliance. Both partners will evaluate each other in terms of the compatibility of their strategic intents, which can be either exploitative or explorative. Ideally, strategic compatibility is established at the outset of the relationship: both partners’ intents are assumed to be clear at the start. However, researchers increasingly acknowledge that alliances are dynamic and that alliance intents can change, resulting in changes in their strategic compatibility (Koza & Lewin, 1998 and 2000). Since strategic alliances are embedded in a firm’s strategic portfolio and co-evolve with the firm’s strategy and the environment (institutional, organizational and competitive), it can be expected that changes in these factors will result in changes in the alliance. In that case, the partners’ perceptions of strategic compatibility may also change (either decrease or increase), and they will re-evaluate their positions. The question then arises what responses the partners will adopt and why they adopt these responses. The research model distinguishes five types of strategic compatibility that franchise partners will take into account in evaluating their relationship (see section 3.2).

Osborn & Hagedoorn (1997) argue that the notion of ‘strategic compatibility’, which was generally accepted, seems to be fading in popularity. They find that the measurement

⁶ In this thesis I use the term ‘responses’ rather than ‘strategies’ (see section 3.6).

of strategic compatibility is unclear and it is the question whether strategic compatibility should be determined on the basis of organization characteristics that can be measured objectively or on the basis of the perceptions of the people involved. In this study's model, the *perceptions* of the alliance partners influence their responses which, in turn, results in interactions between them. In sum, strategic compatibility is not measured in terms of organization characteristics, but on the basis of the partners' *perceptions* regarding the compatibility of these characteristics.

With respect to *operational compatibility*, different authors use different definitions. According to Niederkofler, operational compatibility deals with the question 'Can we make it work?' Operational compatibility addresses the ways in which and means by which the relationship can be implemented in a mutually beneficial way. He argues that operational incompatibility of the partners will cause frustrations in the relationship, and that the resulting responses are a reflection of these frustrations. Medcof (1997, p. 719) distinguishes four criteria ('the four C's') for measuring the 'operational workability' of an alliance:

- 1) The capability of the partner.
- 2) The operational compatibility of the partner.
- 3) The commitment of the partner.
- 4) The appropriateness of control mechanisms.

The capability criterion deals with the question whether partners have the capability to perform their tasks in the alliance. Medcof's second criterion, operational compatibility, refers to the compatibility of people and operating procedures. In this study, these two criteria have been put together because they both influence the partners' capabilities of performing their tasks in the alliance (this is referred to as 'operational compatibility regarding capabilities', section 3.3.1).

Medcof's third criterion refers to the partners' commitment to the alliance. Partners need to commit resources to and put effort into the alliance. They need to be sure that the other partner is committed to the alliance and will not behave opportunistically, for example by putting minimum effort in the alliance, while reaping its full benefits. In this study, this form of operational compatibility is referred to as 'operational compatibility regarding trust/fair dealing' (see section 3.3.3).

With respect to Medcof's fourth criterion, the question is whether control mechanisms will contribute to the alliance's effectiveness. The partners have to agree upon what is the most appropriate control structure. Medcof argues that in some cases strong leadership by one of the partners is required and that dominance by one firm may be desirable. In a franchising context, this is a very fundamental issue and therefore it was put under 'strategic compatibility' rather than under 'operational compatibility' ('degree of hardness', see section 3.2.2).

Based on the preliminary study, one additional factor has been added to the model, namely the profitability of the alliance. Irrespective of the degree of strategic compatibility, in the end the alliance has to result in a certain level of profitability on the part of the alliance partners. Since profitability is not a strategic characteristic of an alliance, but an outcome of how the individual relationship is implemented, this is considered as a factor of operational compatibility. In the model, this referred to as 'operational compatibility regarding profitability' (see section 3.3.2).

Fig. 3.1 presents this study's general model for gaining insight into the response of a strategic alliance partner toward the other partner at a certain point in time. It is assumed

that partners interact because they adopt certain responses toward each other. The model distinguishes a partner X and a partner Y. It includes the following independent variables from the perspective of X: strategic compatibility with Y as perceived by X, operational compatibility with Y as perceived by X, the attractiveness of alternatives to Y as perceived by X, X's perception of the costs resulting from switching to these alternatives (switching costs). The response of partner X toward partner Y is the dependent variable in this model. By means of adopting a response, partner X might in turn influence strategic and/or operational compatibility and/or switching costs, which is indicated by the broken line in Fig. 3.1. The model can be reversed in the sense that Y evaluates the strategic and operational compatibility with X, the attractiveness of alternatives to X, and the switching costs, which in return all influence the responses toward partner X.

The model in itself is not dynamic; it represents a 'snapshot' of one alliance partner's perception of the independent variables at a certain point in time and this partner's response toward the other partner at this point in time. In the case studies, several of such 'snapshots' were made on the basis of this model in order to create a more dynamic 'movie' of relationships over time. The model was used to analyze how and why franchisees respond to the introduction of a strategic change trajectory (SCT) initiated by the franchisor, and to analyze the responses that the franchisor adopts in return. The details of this approach are discussed in Chapter 4.

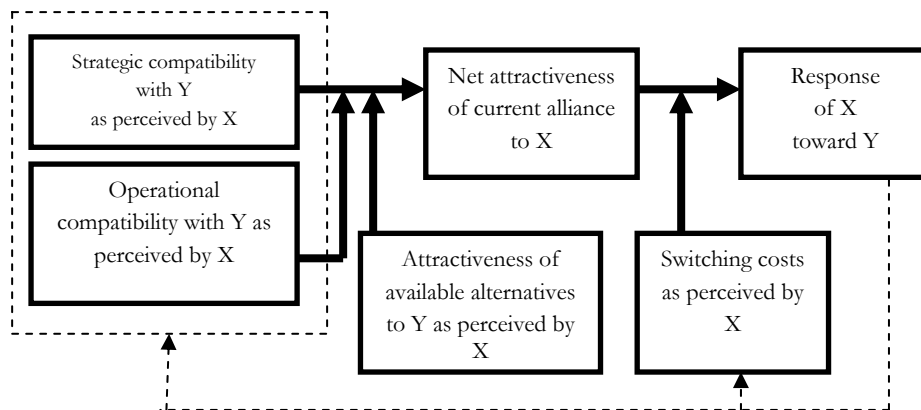


Fig. 3.1: Understanding the response of alliance partner X toward Y at a certain point in time

3.1.2 Introduction to the research model

The remainder of this chapter discusses the research model that was used in this study. Since franchise relationships are a specific form of alliance, the general research model of Fig. 3.1 has been specified to franchise relationships: the variables of strategic and operational compatibility are specified for franchise relationships and indicators have been developed for measuring these variables in the case studies. These indicators are presented in Appendix 2. I discuss them in this chapter (not in the methodology chapter) because it provides a better picture of the contents of the variables. The sections 3.2 up to and including 3.6 discuss the variables of the research model and their indicators. Finally, section 3.7 depicts the graphical presentations of the model from both the franchisee's and the franchisor's perspective.

3.2 Strategic compatibility

With respect to strategic alliances in general Koza and Lewin (1998 and 2000) distinguish between an exploration intent and an exploitation intent. However, only few researchers have studied the exploration-exploitation paradox with respect to franchise relationships as a specific alliance form. Exceptions are Winter and Szulanski (2001, see Chapter 1) and Sorenson and Sørensen (2001). Sorenson and Sørensen have directly referred to this paradox by acknowledging that franchise systems, like any other organization, have to try to balance exploration and exploitation. Sorenson & Sørensen (2001) argue that regarding exploitation and exploration both franchised units and company-owned units have different benefits to offer their chains. To a large extent, these authors base their arguments on Bradach (1998) who has studied the benefits of the 'plural form' applied by franchisors. This plural form refers to a system in which both company-owned and franchised units are present. In his view the plural form provides a context for franchisors in which both control (exploitation) and innovation (exploration) are supported. Bradach as well as Sorenson and Sørensen argue that company-owned units enhance exploitation, while franchised units enhance exploration. According to them, company managers are monitored more extensively, and their evaluations are often based on observable outcomes, for example unit turnover. This encourages 'exploitative' behavior, such as the improvement of existing routines of company managers. On the other hand, franchisee behavior is often monitored in a way that encourages 'explorative' behavior, such as experimentation with new routines or local adaptations to the business format.

On the basis of the preliminary study I have translated the exploration-exploitation paradox to franchise relationships by relating it to the central element of franchise relationships: the system's business format that represents a certain identity toward customers. I distinguish different types of exploration and exploitation within the franchise system, which is partly based on Bradach's (1998) paradox of control and innovation in franchise systems. He argues that in the management of their franchise systems franchisors face four primary challenges⁷. These challenges are the following:

- Maintaining uniformity in the shared identity across all units of the system.
- Allowing local responsiveness by units of the system.
- Making adaptations to the identity at the level of the system as a whole ('system wide adaptation').
- Adding units to the system.

These challenges are strategic choices the franchisor has to make concerning the franchise system, which largely affect the franchisees. Bradach's challenges have served as a starting point for developing five so-called 'franchise system characteristics' that influence the degree of strategic compatibility between the franchise partners. Next to Bradach's challenges, two other franchise system characteristics have been added: the positioning of the system and the organization of the franchisees' strategic participation. Moreover, I have made some small adaptations to the abovementioned challenges, which has resulted in a total of five franchise system characteristics. These franchise system characteristics reflect the challenges franchisors have to deal with in managing the exploration-exploitation paradox in their franchise systems.

⁷ Bradach (1998) developed his theory by studying management practices in fast-food chains.

The remainder of this section will discuss the meaning of each of the franchise system characteristics:

- The positioning of the system.
- The degree of hardness.
- The rate of innovation.
- The organization of the franchisees' strategic participation.
- The type of growth objectives.

Note that these characteristics refer to the level of the franchise system (broken lines in Fig. 1.2). One franchisor may administrate different systems, which differ with respect to these characteristics. In the empirical part of this study (Chapters 5 up to and including 8), for each of the four franchise systems studied timelines were drawn representing the development of these franchise system characteristics, so that the reader can understand the context of the individual franchise relationships within these systems.

On the relationship level, the five system characteristics influence both franchise partners' perceptions of their mutual strategic compatibility. Strategic compatibility regarding a specific franchise system characteristic as perceived by one franchise partner has been measured as the difference between this partner's desired score on this franchise system characteristic and his perception of the actual score on this characteristic.

In the remainder of this section, the franchise system characteristics as well as their indicators will be discussed (see Appendix 2, Part A). These indicators were used to develop the time lines of the franchise system characteristics (see section 4.3.5, step 1) and to determine the degree of strategic compatibility on the relationship level.

3.2.1 Strategic compatibility regarding positioning

The positioning of a system refers to the 'contents' of the business format; it concerns the identity of the system in the market. With respect to retail chains, Sullivan and Adcock (2002) distinguish two forms of positioning of single retail stores or a group of stores, such as franchise systems. An important strategic decision for retail organizations to make is whether to choose for an 'added-value' positioning ('high in the market') or a 'pile it high, sell it cheap' positioning with relatively lower added value and lower prices ('low in the market').

The issue of the retail system's positioning relates to Porter's generic competitive strategies: overall cost leadership, differentiation and focus (Porter, 1980). A cost leadership strategy means that the firm competes at low costs. This requires tight cost and overhead control and economies of scale. Although the profit margins are relatively small, it is possible to obtain profits as a result of lower costs and relatively high sales volumes.

Porter's differentiation strategy refers to differentiating a firm's products and/or services in order to create something that is considered as unique in the industry. It could be compared to the added-value strategy in retailing. By adding extra value to their products or services, retailers can attract customers who are willing to pay higher prices. The sales volumes are lower, but the margins are higher, which makes it possible to obtain profits. The term 'differentiation' or added value encompasses various dimensions in which firms can compete. Firms have to try to find out what dimensions are important to their customers, and compete accordingly. Usually, customers do not buy products based on only one dimension, and firms have to combine several dimensions in order to attract

them. The business format reflects those dimensions, and in turn the units of the franchise system reflect these dimensions in their shared identity.

The focus strategy of Porter concerns a firm's focus on a particular buyer group, customer segment or geographic market. The aim of firms competing in this way is to serve their narrow target more effectively or efficiently than their competitors who have broader targets. Within this narrow target, the 'focuser' can adopt either a cost leadership strategy or a differentiation strategy, or he can adopt both strategies.

Measurement

In this study, positioning is depicted by a five-point scale ranging from 'very low in the market' to 'very high in the market'. In the retailing literature (cf. Sullivan & Adcock, 2002), these two strategies each have their own characteristics depending on the different aspects of the business format (see Appendix 2, Part A1): the composition of the assortment, the degree of service, price level, store appearance (interior as well as exterior) and promotion activities.

With respect to the composition of the assortment, I have made a distinction between the sub-indicators 'width' and 'depth'. This is the most common distinction in the retailing literature. However, different authors give different definitions of these two terms, and some even add other variables, such as length and consistency (cf. Leeftang, 1994). I have defined width as the number of product groups in the assortment. In my definition, a product group refers to a group of products satisfying similar needs. In the Dutch drugstore industry the assortment consists of four parts: health, beauty, care and miscellaneous (see section 4.3.2). These parts all contain different product groups; for example health consists of product groups such as non-prescription medicines, wound-dressing, diet food and food supplements. One important element of the width of the assortment is the presence of drugstore-related and non-drugstore-related products. The drugstore-related products refer to products that are somewhat related to general drugstore products, such as beauty-cases, or towels. The non-drugstore-related products refer to products completely unrelated to the regular drugstore assortment; these include for example vases, video tapes or quilt covers. The depth of the assortment concerns the number of different products and product varieties within a product group. A deep assortment often includes the more specialized products with higher margins.

In a retail chain that positions itself low in the market, the assortment is broad and not deep, while in a higher positioned chain the assortment is narrower but deeper. As regards the other indicators, in a chain with a low positioning the degree of service is low, price levels are low, store appearance is sober and promotion activities are mainly focused on prices ('action brochures') rather than the on provision of information about products ('theme brochures'). The chains that position themselves higher in the market provide a higher degree of service, they apply a higher price level (within certain boundaries), their stores look less sober, and their promotion activities focus more on theme brochures rather than on action brochures.

3.2.2 Strategic compatibility regarding degree of hardness

The second franchise system characteristic that influences the degree of strategic compatibility between the franchise partners is the system's degree of hardness.

It was already argued in Chapter 1 that the business format is considered as the central element in chain organizations. This business format reflects a certain shared identity in the market. Bradach's challenge of maintaining uniformity means preserving the shared identity

of the units belonging to a certain chain (Bradach, 1998)⁸. However, Bradach's other challenge of local adaptation is in fact the other side of the same coin. The units of a franchise system operate in diverse local markets subject to different local circumstances. For example, different units may face slightly different customer tastes or competitive circumstances. Finding a balance between maintaining uniformity and adapting to local circumstances is an important and complicated management challenge for chain operators to deal with.

To franchisors, as chain operators belonging to a specific category, this challenge is even more complicated because they have to deal with franchisees who are independent business owners, and in that capacity franchisors have to negotiate with them as partners. This might raise the question why chain operators would want to work with franchised units. The franchising literature (cf. Carney & Gedajlovic, 1991) points at two motivations of chain operators to apply franchising: from the 'resource scarcity point of view' it is to realize quick and relatively cheap growth and from the 'agency point of view' it is because franchisees are assumed to be more motivated than managers, since they retain the rights to the establishment's earnings. Carney & Gedajlovic (1991) refer to these as the 'resource scarcity' and the 'agency explanation'.

In general, the paradox of maintaining uniformity versus local adaptation is a well-known paradox in the franchising literature (cf. Kaufmann & Eroglu, 1998, Dant & Gundlach, 1998, Stanworth et al., 1996). However, it seems that the term 'degree of hardness' of a franchise system is a typically Dutch term that captures this paradox (cf. Kneppers-Heijnert, 1988, Vrolijk, 2002).

In this study, the degree of hardness is about the tension between maintaining a system's uniformity (exploitation) versus allowing local adaptation by franchised units (exploration). According to Kneppers-Heijnert (1988), uniformity has to be considered both in a broad and in a narrow sense. In a broad sense, uniformity means that the business format itself should be uniform; for example in terms of assortment, shop interior, shop exterior etc. In a narrow sense, it means that all the products or services provided by the franchise system should be uniform. In order to maintain uniformity in business format franchising, in general, virtually every aspect of a unit's operations is formulated in operating manuals and procedures that the franchisee is obliged to follow.

Measurement

In this study, the degree of hardness varies on a five-point scale from 'very soft' to 'very hard'. The degree of hardness has been measured by the following three indicators, and is partly based on Vrolijk (2002) and Kneppers-Heijnert (1988) (see Appendix 2, Part A2).

First, there is the degree of requirements regarding the system's shared identity toward customers ('Degree of compulsory business format elements'). These requirements concern all elements that are visible to the customer: the use of the system's brand name, the degree of requirements with respect to the assortment, the degree of requirements concerning the unit's interior and exterior, and requirements relating to promotion activities. In some softer franchise systems the franchisee is permitted to use its private name next to the brand name written on the store. However, in harder systems the use of the private name is not allowed. That is why in the measurement of the degree of hardness this issue has also been included.

⁸ Chain organizations consisting of company-owned units only (in Dutch the so-called 'filiaalbedrijven') also face this challenge.

The second indicator of measuring the degree of hardness concerns 'back office requirements' in the franchise relationship. These do not directly refer to requirements regarding elements directly visible to the customer. These requirements indirectly influence the system's uniformity as presented toward customers. In this study, they are the following: requirements with respect to purchasing activities by the franchisor or by suppliers selected by the franchisor, requirements with respect to automation, requirements concerning training, requirements relating to selling the unit, and the presence of a competition clause. The preliminary study showed that these latter two aspects are important in relation to the perception of the franchisees regarding the degree of hardness.

The third indicator of the degree of hardness is the enforcement of the two types of requirements. The degree of enforcement has been measured by two elements: the importance and frequency of visits to the franchisee by people from the franchisor's organization, and the severity of the penalty clause in the contract: the height of the penalty combined with the type of infringement.

3.2.3 Strategic compatibility regarding rate of innovation

The third franchise system characteristic is related to Bradach's challenge of system wide adaptation (Bradach, 1998). As pointed out in Chapter 1, in recent years, strategic management of innovation has increasingly become important due to the current rapid technological and market changes, shortening product and concept life cycles, and changing customer tastes. These changes result in threats and opportunities, which, from the perspective of the franchisor, may require a system wide adaptation. As indicated in Chapter 2, this is a tension on the part of the franchisor: the franchisor has to decide whether to keep the business format 'stable' over time (exploitation) or to (try to) replicate certain innovations through the whole franchise system (exploration) and achieve a new level of uniformity. From the perspective of the franchisees, the same applies: at the local level sometimes opportunities or threats arise to which the franchisee may want to adapt its business. In this study, 'the rate of innovation' refers to if and how quickly both partners are willing to adopt innovations; from the franchisor's point of view this applies to the system as a whole, while as far as the franchisee is concerned it applies to the franchisee's own unit(s).

Measurement

In this study, the rate of innovation varies on a five-point scale from 'very low' to 'very high'. Bradach mainly concentrates on the adaptation of the business format by means of product innovations, such as the Filet-O-Fish and the Big Mac of McDonald's. This study focuses on three indicators concerning the rate of innovation, which reflect three different levels of innovation (see Appendix 2, Part A3):

- 1) Innovation on the level of products that are new to the business format. These are additions to existing product groups in the assortment. These entail, for example, new brands of certain products, or new varieties of products of existing brands. For example, as regards the cosmetics product group in the drugstore industry, this could be the introduction of a new perfume of a new brand, or the introduction of a new type of L'Oreal mascara.
- 2) Innovation on the level of new product groups and other adaptations (such as services) to the business format. Examples in the fast-food industry are the introduction of a salad bar at Pizza Hut, or the introduction of the health product groups at McDonalds. In the drugstore industry an example is the introduction of

the product group of 'home tests' at ETOS. Through these tests, people can check whether their cholesterol levels are too high or whether they have certain diseases.

- 3) Innovation on the level of the business format as a whole. This is the most 'radical' adaptation⁹, which refers to the introduction of an entirely new business format. One example is the DA-2005 format which is currently introduced in the DA-system (see Chapter 5) and the 'Four Worlds format' of the ETOS-system (see Chapter 7). Changes in the business format basically refer to changes in the unit's presentation, which is often combined with a new assortment and/or new services.

With respect to 'newness', the innovation literature often distinguishes between three levels (Bodewes and De Jong, 2003): new to the organization, new to the industry and new to the world. According to Bodewes and De Jong, most economists only consider the level of new to the world as really innovative, while studies of management and organization define innovation as something new on the level of the organization. This study applies the level of 'new to the organization'. Translated into a franchise context, this means that adaptations that are new to the franchisor and the franchisees are considered as innovations.

3.2.4 Strategic compatibility regarding the organization of the franchisees' strategic participation

The fourth system characteristic is based on Weima (1974) who argues that franchisees can be involved in strategic decisions about the franchise system by means of a Franchise Board. The preliminary study also showed that as far as the franchisees are concerned this is an important variable.

In a hard system, franchisees have little room for local exploration, but they can be involved in the franchisor's decision-making policies concerning the franchise system by means of a Franchise Board. According to Weima (1974) in the United States franchisees used to put pressure on their franchisors by means of individual or collective actions; for example by undertaking a lawsuit against the franchisor. Additionally, Weima points out that franchisees who felt uncomfortable with the influence of the franchisor united in associations of franchisees joined in the same system or in general franchisee associations, which were often operating on a national level. At the time of Weima's book, franchisees were not very well organized on the system level, but more so on the national level. Nowadays, these system-level associations are more common, and have been taken into account in this study because they have more effect on the franchise relationships within a system than the national franchisee associations have. In general, all franchisees of a system are members of the system's Franchisee Association. The Franchise Board also consists of members of this Franchisee Association. This Board is supposed to represent the interests of all the franchisees within the system.

⁹ Because these adaptations require relatively more investments they are considered as more 'radical' than the other levels of adaptations.

Bradach (1998) does not explicitly take into account the degree to which franchisees are involved in the decisions made concerning the system. He briefly mentions it, but does not refer to it as a specific management challenge for franchisors. Actually, this could be considered as a more general research gap: as far as I know there have been no empirical studies on Franchise Boards and their influence on the interactions between the franchise partners, while in franchise-oriented specialist magazines the existence of Franchise Boards on the level of the franchise system is fully acknowledged.

Measurement

In this study, the organization of the franchisees' strategic participation varies on a five-point scale from 'very low' to 'very high'. On the basis of the preliminary study, I have focused on the following indicators concerning the organization of the franchisees' strategic participation (see Appendix 2, Part A4): the presence of a Franchise Board, the presence of approval rights on the part of the Franchise Board, the degree to which the subjects of approval rights are laid down, and the degree of detail of other procedures, such as the election of Franchise Board members, or the time period that franchisees are allowed to be involved in the Franchise Board.

3.2.5 Strategic compatibility regarding type of growth objectives

The fifth franchise system characteristic focuses on different types of growth objectives, and has been added on the basis of the preliminary study. This study distinguishes two types of growth: 'quantitative' versus 'qualitative growth'.

Through quantitative growth, the franchisor aims at growing by means of adding more units to the franchise system, showing relatively less concern for the performance of the individual units. According to Bradach (1998) it is very difficult to boost the sales of existing units beyond a certain threshold. He argues that franchisors in the fast-food industry therefore heavily rely on growth by means of adding new units- either company-owned or franchised units- to the system¹⁰.

Through qualitative growth, the franchisor mainly aims at growing by means of improving the performance of the existing units or by attracting units that fit certain criteria. In contrast with quantitative growth, here the franchisor sticks more to certain selection criteria, for example in terms of floor area and/or sales level. With respect to already existing units, both company-owned and franchised, the franchisor might aim to meet the criteria by means of renovating the store or by moving to another store location (called 'relocation').

This franchise system characteristic is slightly different from the other franchise system characteristics. On a local level, the franchisee will not care about the type of growth of the franchisor. A low degree of strategic compatibility in type of growth objectives will only

¹⁰ The fast-food systems Bradach (1998) studied often used existing franchisees to add a large number of units to the system. This is called 'multi-unit franchising'. With respect to the 'economics', as far as the franchisor is concerned there is no difference with adding new franchisees: for each new unit the franchisor receives franchise fees and royalties. One important advantage of multi-unit franchising is the fact that the franchisor already knows the franchisee, which reduces the franchisor's concern of unexpected behavior on the latter's part.

arise if it poses specific problems in the relationship. In case of quantitative growth of the franchisor, the franchisee might be confronted with the ‘entry’ of another franchisee or company-owned unit in its local market. The degree to which this might happen depends on the size of the exclusive territory of the franchisee.

In case of qualitative growth, the franchisor mainly aims at improving the performance of the existing units by means of renovation or relocation. This could be problematic in case the franchisee does not agree with this.

Measurement

In this study, the types of growth objectives vary on a five-point scale from ‘mostly quantitative’ to ‘mostly qualitative’. They were determined by asking the franchisor about the importance he attached to growth both in terms of number of units and in terms of ‘quality’ of units (see Appendix 2, Part A5). The franchisee was only asked whether he experienced problems due to the franchisor’s type of growth objectives.

3.3 Operational compatibility

On the basis of the preliminary study, the general model distinguishes three general factors that influence the operational compatibility with partner Y as perceived by X: capability of Y as perceived by X, the profitability of the relationship with Y as perceived by X, and the degree of trust and fair dealing with Y as perceived by X. These variables have already been introduced in the discussion of the general model, but they are specified to franchise relationships. These specifications will be discussed in the next sub-section.

3.3.1 Operational compatibility regarding capabilities

Variable and measurement

The first factor is partner Y’s capability to carry out its role in the alliance as perceived by X. This factor is relevant to both franchise partners’ perspectives. From the *franchisee’s perspective*, these capabilities refer to the franchisor’s capabilities regarding managing the franchise system. From the franchisee’s perspective, important franchisor capabilities are: automation, purchasing prices, logistics, communication, information provision, and the degree and quality of supporting its franchisees. The franchisee’s perception of the operational compatibility regarding franchisor capabilities was determined by asking franchisees to grade these aspects (see Appendix 2, Part B, 4.8-4.13). From the *franchisor’s perspective*, the most important capability of the franchisee is to fulfill his financial requirements, such as the payment of royalties or payments for other franchisor’s services.

3.3.2 Operational compatibility regarding profitability

Variable and measurement

The second factor of operational compatibility concerns the net returns of both franchise partners in the relationship, referred to as operational compatibility regarding profitability. From the *franchisee’s perspective*, the profitability of the relationship is the result of the franchisee’s turnover of his units achieved by applying the business format minus the costs of operating on behalf of this business format. These costs consist of the fees and royalties that have to be paid to the franchisor. The franchisee’s perception of operational compatibility regarding profitability was determined by asking the franchisees to grade the

profitability of the relationship (see Appendix 2, Part B, 4.6). From the *franchisor's perspective*, the profitability of a specific franchise relationship depends on the fees/royalties the franchisor obtains from the franchisee¹¹.

3.3.3 Operational compatibility regarding trust and fair dealing

Variable and measurement

Third, the research model focuses on the perception of the degree of trust and 'fair dealing' between the partners¹². These factors are also relevant with respect to both franchise partners' perspectives. First, there is the degree of 'trust' of one partner in the other. There is a relationship between trust and opportunism. According to Nooteboom (1999, p.30): *'To have trust in the narrow sense, or "real" intentional trust is to accept or neglect the subjective probability that a partner will not utilize opportunities for opportunism even if it is in its interest to do so'*. Opportunism entails actions against the interest of a partner and against the letter or intent of an agreement, if necessary by cheating or concealment of the truth. For example, partners can give a wrongful representation of costs and revenues. In sum, this study assumes that when one franchise partner trusts the other, it means that he believes that the other is likely to cooperate, even if he is not coerced to do so and has no direct material interest (Nooteboom 1999). From the franchisee's perspective, operational compatibility regarding trust was determined by asking the franchisee to what extent he trusted that the franchisor would not utilize opportunities to act opportunistically, that the franchisor would take into account the franchisee's interests, that the franchisor was committed to the relationship and that he was willing to continue the relationship (see Appendix 2, Part B, 4.1-4.4)

Ring and Van de Ven's (1994) 'fair dealing' is very close to this concept of trust. It is not required that inputs or outcomes are equally divided between the partners, but a partner should at least have the impression that in the relationship with the other partner his benefits are proportional to his investments. In other words, in the perceptions of both partners the costs and benefits should be fairly divided. This concept is related to trust because it requires the partners to represent the costs and revenues of the alliance truthfully. From the franchisee's perspective, his perception of fair dealing was determined by asking to which degree he had the impression that costs and benefits were divided fairly between him and the franchisor (Appendix 2, Part B, 4.5).

3.4 Attractiveness of available alternatives

Partners in an alliance perceive a partner's attractiveness in comparison with available alternatives. In the research model this is called the 'net attractiveness'.

The availability of alternatives is part of a regularly-used construct in the literature, namely 'dependence'. As pointed out in Chapter 2, Emerson (1962) defines dependence as

¹¹ These royalties can be calculated in several ways, for example as a percentage of turnover or as a percentage of profits. The franchisor can make various considerations in deciding how to calculate royalties (cf. Caves and Murphy, 1976).

¹² Here the term 'fair dealing' is used differently than lawyers generally do. In certain countries, the term 'fair dealing' (cf. Canada or Australia) or 'fair use' (U.S.) is used for certain provisions that permit people to use copyright materials without the copyright owner's permission. In this study, Ring and van de Ven's interpretation is used, which starts from the more sociological connotation of 'fairness' or 'indebtedness'.

a function of 1) the attractiveness of the present relationship and 2) the availability of alternatives. In the research model, the attractiveness of the present relationship results from strategic and operational compatibility. It was expected that the higher the strategic and operational compatibility as perceived by the partners, the higher their inclination to continue the relationship. However, the attractiveness of available alternatives is also important in understanding the responses of alliance and franchise partners toward each other. A partner in an unattractive relationship will probably be more apt to switch to an alternative if there is an attractive one available. This is relevant with respect to both franchise partners' perspectives.

Measurement

From the franchisee's perspective, possible alternatives are: leaving the system for another system (in the same or a different industry sector), starting a new business without being part of a system, or becoming an employee (Appendix 2, Part B, 5.1-5.5). From the franchisor's perspective, alternatives to collaborating with a specific franchisee are either approaching another franchisee or a operating with a company-owned unit.

3.5 Switching costs

Even though there might be an attractive alternative available, according to Emerson (1962) partners will also evaluate the costs generated by such an alternative. These are called 'switching costs'. According to Nooteboom (1999), switching costs are determined by the following factors: the occurrence of specific investments and their ownership, the occurrence of hostages and other guarantees and the percentage of the partner's total production that the partnership covers. In this study's research model, these factors have been categorized according to three indicators: investments and ownership of specific investments, guarantees and hostages, and the income from the relationship as percentage of the total income.

First, the switching costs of the franchise partners will increase through their investments in specific assets. From the franchisees' perspective, franchisees have to deal with a greater asset specificity than completely independent business owners (Dnes, 1992). At the start of the relationship franchisees often pay a lump sum and invest in equipping their businesses. The business format entails certain distinguishable (and therefore specific) assets in which the franchisee is obliged to invest by virtue of the franchise contract. These assets are specific to the business format and likely to be useless in other situations (Dnes, 1992). Therefore, investments of this kind contribute to the franchisee's switching costs, unless the franchisee can sell them back to the franchisor or to a new franchisee.

Second, the switching costs as perceived by the franchise partners increase through guarantees and 'hostages' provided in the relationship. According to Nooteboom (1999, p.121), *'a true hostage satisfies the condition that it has value to the giver but not for the keeper, to ensure that when the time has come that the giver has honoured his commitments, the keeper will not be tempted to retain the hostage and will not hesitate to return it'*. In other words, by posting a hostage, a partner shows the other that it intends to honor the agreement and that it will not act opportunistically. Dnes (2003) points out that the definition of hostages has varied across authors. In his view, the hostage is an alternative enforcement mechanism, which works by ensuring that *'...the promisor has more to lose by cheating than sticking with the original terms...'* (p.319). According to Dnes (1992), franchisees post hostages by making specific

investments, by building goodwill in a certain area¹³ and by paying an initial lump sum. If the franchisee does not honor the agreement, the franchisor may terminate the contract and the franchisee loses the investments and future returns on these investments. According to Dnes, in actual fact the franchisor never posts hostages of this kind. However, the franchisees are protected from opportunistic behavior by the franchisor because it runs the risk of damaging his reputation. Additionally, guarantees can take several forms, for example, by means of a minimum duration of the relationship or a minimal number of transactions stipulated in the contract. These guarantees make sure that franchisees can recoup their specific investments. Another example of a guarantee is the exclusive territory in which the franchisee is allowed to operate without the interference of franchisees from the same system or the franchisor himself.

A third variable that influences the switching costs of a franchise partner is his income resulting from the relationship as a percentage of his total income. In most cases, the franchisee owns one or more units of one system and has a relationship with only one franchisor; in that case the franchisee's income resulting from the relationship equals his total income. However, in some cases franchisees have relationships with different franchisors, which means that their total income is spread across different areas. From the franchisor's perspective, if franchisees have multiple units within the same franchise system, the switching costs to be paid by the franchisor will be higher.

Measurement

In sum, from the *franchisee's perspective*, switching costs have been measured by asking franchisees about the degree of specific investments they made, the guarantees provided by the franchisor and their income resulting from the relationship as percentage of their total income (Appendix 2, Part B, 6.1-6.4). From the *franchisor's perspective*, the degree of specific investments, the guarantees provided by franchisees, and the franchisor's income from the relationship as percentage of its total income were assumed to contribute to the franchisor's switching costs.

3.6 Responses

As Koza & Lewin (1998) state, alliances co-evolve with a firm's strategy and its institutional, organizational and competitive environment. In other words, changes in strategic objectives or environmental circumstances may lead to changes in the alliance. According to the research model, when such changes occur, alliance partners will (re)evaluate their strategic and operational compatibility by comparing them with alternatives and they will take into account the costs involved in switching to these alternatives. On the basis of this evaluation, the partners may adopt several responses toward each other.

In the literature these responses are often classified by means of Hirschman's terminology (Hirschman, 1970). He has made a distinction between two general options for dealing with problematic relations: 'exit' or 'voice'. Exit refers to ending the relationship, while voice refers to actively expressing and discussing one's problems with

¹³ During the franchise relationship the franchisee puts effort in building goodwill in his franchise area. In several contracts a 'restrictive covenant' is present, which means that the franchisee can not continue in the same line of business within his previous franchise area. 'Lease control' by the franchisor has the same effect; in case the franchisor owns the building, the franchisee can no longer use this asset when the relationship is ended.

the intent to try to improve conditions in the relationship. Hirschman argues that the occurrence of 'loyalty' makes exit less likely. Loyalty refers to remaining 'silent' and confident that the problematic conditions will improve by 'giving things some time'. Based on research on customer relationships, Ping (1993) adds a fourth option for dealing with relationship problems: neglect, which means passively allowing the relationship to deteriorate by 'letting things fall apart'. Based on a research study on employer-employee relationships, Hagedoorn et al. (1999) argue that the category of voice responses is considered too homogeneous and that it needs to be differentiated further. Therefore, they distinguish between 'aggressive voice' and 'considerate voice'. The considerate voice response consists of attempts to solve the problem in the light of one's own concerns as well as those of the other partner. The aggressive voice response is more destructive than the considerate one, but less destructive than the exit option¹⁴. A partner that adopts this response wants to win, and has no considerations for the concerns of the other partner. This response can be seen as a 'cry for attention', between a destructive and a constructive response. In sum, this development has resulted in five possible responses that (franchise) partners can adopt in their relationship: considerate voice, loyalty, neglect, aggressive voice and exit. These are presented in Fig. 3.2. Here I emphasize that partners in a relationship may perceive responses differently from the way in which the other partner intended them. For example, one partner may try to construct the relationship actively, while the other partner perceives his response as an aggressive one and reacts accordingly. Moreover, responses may change over time. For example, a partner may start off with a constructive response, but he may find out that this does not work and turn to a more destructive one.

Both franchise partners can adopt these responses in their individual relationships ('relationship level'). However, the franchisor can also respond on a more general level ('system level'). On this latter level, the franchisor may respond by adapting one or more of the five franchise system characteristics, by starting a new system containing other characteristics or by dissolving the franchise system. Moreover, some decisions can be made on the level of the corporation (level 1 in Fig. 1.2), and the franchisor himself may then have little influence on these decisions.

¹⁴ With respect to the relationship aggressive voice is less destructive than exit. However, aggressive voice can be highly destructive to both the system and its uniformity.

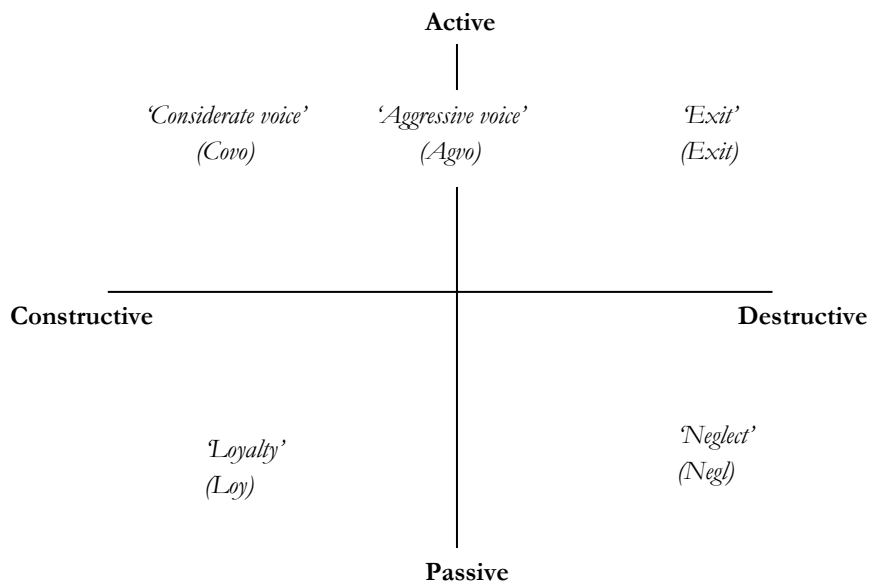


Fig. 3.2: Typology of responses of partners in relationships (based on Hagedoorn et al., 1999, p.312)

Appendix 2 (Part B, questions 3.1 to 3.6) depicts the questions that were used to determine the franchise partners' responses.

3.7 The research model for understanding strategic interactions in franchise relationships

In this chapter, the general model for studying strategic alliances (Fig. 3.1) has been adapted to a franchise situation. It is argued that franchise partners evaluate their *strategic compatibility* on the basis of positioning, degree of hardness, rate of innovation, the organization of the franchisees' strategic participation and type of growth objectives. Further, they evaluate their *operational compatibility* on the basis of capabilities, profitability and trust/fair dealing. Both franchise partners are proposed to evaluate their *alternatives* and *switching costs* before adopting a response toward one another.

Figs. 3.3 and 3.4 depict the research model from both partners' perspective. Fig. 3.3 presents the model from the franchisee's perspective as related to the franchisor; Fig. 3.4 presents the model from the franchisor's perspective as related to the individual franchisees.

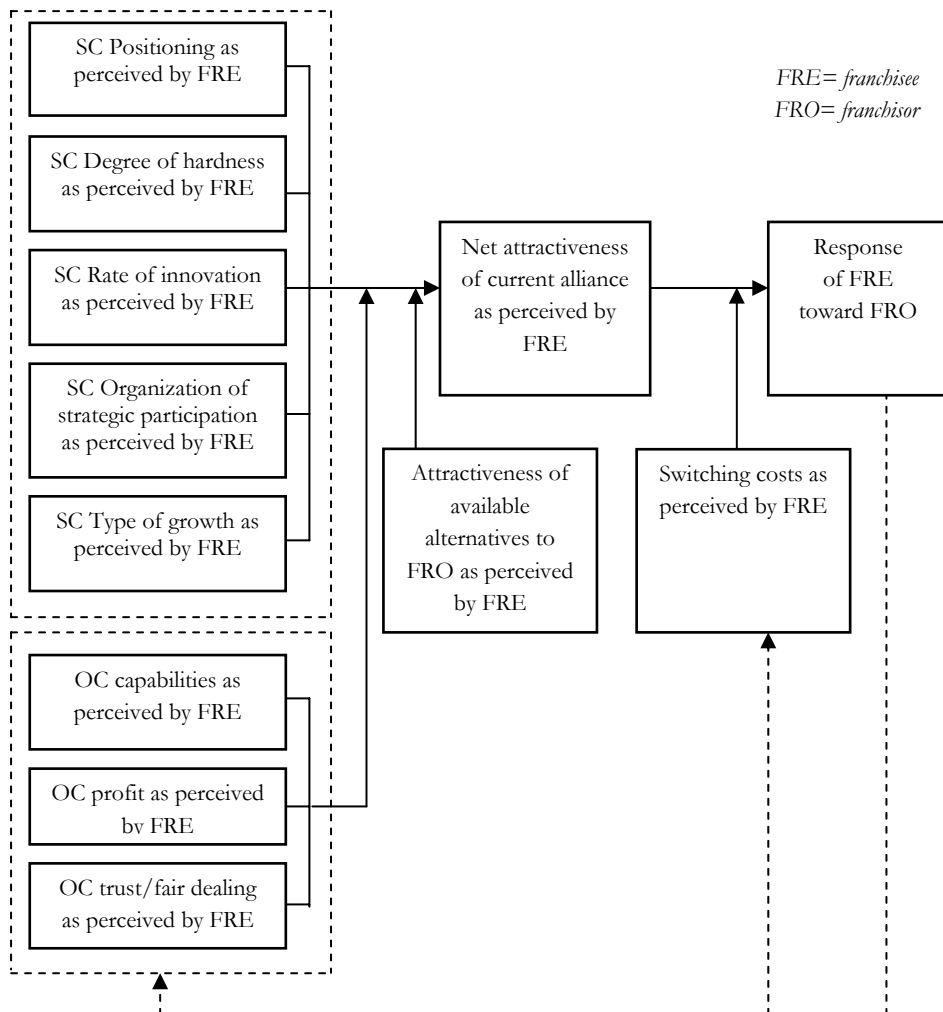


Fig. 3.3: The research model: understanding the response of FRE toward FRO at a certain point in time

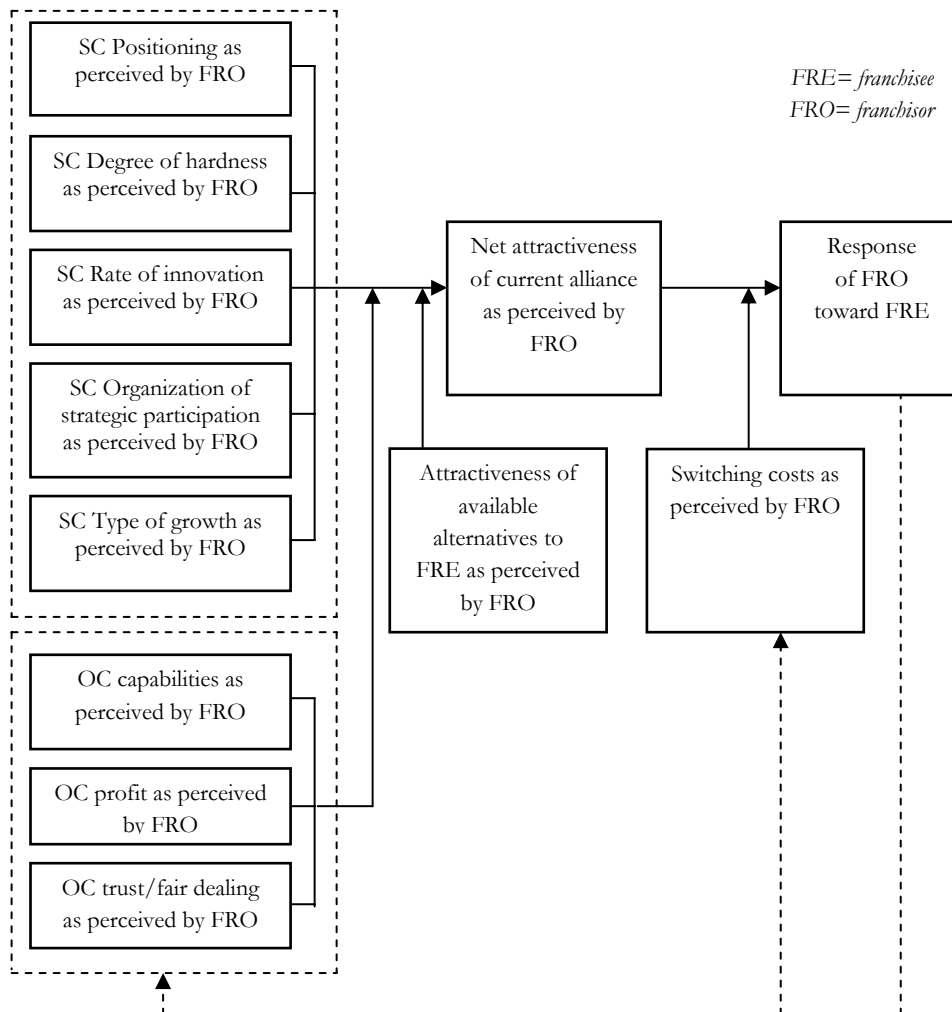


Fig. 3.4: The research model: understanding the response of FRO toward FRE at a certain point in time

