VALUE INNOVATION IN THE FRANCHISOR AND MULTI-UNIT FRANCHISEE RELATIONSHIP: IMPLEMENTING NETWORKING MECHANISMS FOR ENTREPRENEURIAL MANAGEMENT

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ABSTRACT

This paper examines the franchisor and multi-unit franchisee relationship through a value innovation lens. That literature, combined with principles from resource-based theory suggests several ways of working including internal governance mechanisms that may facilitate entrepreneurial behaviour among franchisors and franchisees. The case study research method in a single franchisor organization along with thirty of its largest multi-unit franchisees presents a unique opportunity to study the critical shared services and the governance mechanisms implemented to achieve and sustain competitive advantage. Hypotheses are presented concerning these work and governance mechanisms, and practical suggestions are made to motivate research regarding the implementation of entrepreneurial management in franchising.

1. INTRODUCTION

Resources or capabilities can be a driving force in the creation of competitive advantage in companies (Penrose 1959, Barney 1991, Wernerfelt 1984). The available complement of resources enables action, performance and growth (Combs and Ketchen 1999). In franchising, a franchisor and its franchisees manage these cooperatively to achieve sustainable benefits.

Franchisors and franchisees are uniquely qualified to leverage resources for competitive advantage. Franchising continues to be a significant force in the economy, accounting for 37% of retail sales in the United States and a growing amount internationally. Domestically, franchising generates nearly $1.53 trillion dollars in goods and services and includes businesses such as restaurants, hotels and banks (Davis 2007). Franchising growth stems, in part, from the customer value that the franchisor-franchisee relationship generates (Shane 1996).

Another important contributor to the growth in franchising is the tendency of franchisors to allow franchisees to own multiple units (Elango and Fried 1997). Kauffman and Dant (1996), who studied the relationship between multi-unit franchising and chain growth, found that 88% of the franchisors of fast-food-chains they surveyed included multi-unit franchisees. Unfortunately, theory has not kept pace with the development of this "modal form of franchising" (p.355) as the prevailing theories of agency and transaction cost do not fully capture multi-unit franchising (Grünhagen and Mittelstaedt 2005). Relational exchange theory provides additional insight but more work is needed. This study draws on value innovation (Kim and Mauborgne 1997) for additional insight.

Using the case study research method we study a large, international fast food franchisor and 30 of its largest multi-unit franchisees. Data include in-person interviews with senior executives and value curves constructed from these interviews. Focusing on the core services which are jointly provided by the franchise system (Achrol and Etzel 1993, Spinelli and Birley 1998), we asked both parties to assess their own competency as well as that of their partner's on groups of services which we labelled, key relationship variables due to their criticality in the exchange relationship (see Table 2). The resulting value curves, which show competency from low to high on the vertical axis and the key relationship variables across the horizontal, are constructed and discussed. Then, analysis suggests work and internal governance mechanisms for improving entrepreneurial management of the franchising system. Our goal in this paper is to explore for the first time how a franchisor and its multi-unit franchisees perceive each other's competency. Further, given this set of competencies we offer suggestions for franchise system improvements which include entrepreneurial management (Sleier, Chrisman and Chua 2004).

The paper is organized as follows. In Section 2 we provide a brief overview of resource-based theory in relation to the franchisor and multi-unit franchisee relationship. Section 3 discusses the applicability of value innovation to this relationship. The method, sample, and results are given in Section 4. In Section 5 a discussion of the findings and their implications are provided. Finally, Section 6 offers the study's limitations and recommendations for future research.

2. RESOURCE-BASED THEORY AND FRANCHISING

The resource-based theory of the firm purports that sustained competitive advantage can be achieved through the bundling of resources or capabilities (Penrose 1991, Barney 1991, Wernerfelt 1984). Resources or capabilities which are controlled by the organization have value, are difficult to imitate and are not easily substituted (Barney and Ketchen 2001). The unique way that an organization bundles these tangible and intangible assets, including management expertise and skills, knowledge and information, processes and routines, and brand name and image can produce a distinct competitive advantage (Porter 1985).

In franchising, franchisors and franchisees work together to produce competitive advantage. Franchising is a unique and important organizational form (Rubin, 1978). Franchising has been defined as a strategic alliance (Porter 1980), a partnership (Brickley and Dark 1987), an offspring relationship with a "parent" company (Mendelsohn, 1985), an inter-organizational form (Michael, 2001) and a hybrid organization (Williamson, 1991). While there is some disagreement about the exact characterization of franchising, most researchers agree that a key aspect of franchising is inducing scale through a share contract between the franchisor (brand owner) and the franchisees (local market license holder).

Franchising continues to be a significant force in the economy, accounting for 37% of retail sales in the United States and a growing amount internationally. Domestically, franchising generates nearly $1.53 trillion dollars in goods and services and includes businesses such as restaurants, hotels and banks (Davis 2007). Franchising's unique competitive advantage stems, in part, from the customer value that the franchisor and franchisee relationship generates (Shane 1996).

Increasingly, franchisors are serving customers more effectively by allowing franchisees to own multiple units. Multi-unit franchisees have different needs from single unit operators as, in a sense, they manage mini chains. Also, this difference is uniquely challenging for sustaining competitive advantage as multi-unit franchisees can own from two units to hundreds of units. The large number of units owned can result in a plethora of differential communication, training, and operational requirements (Kalanis and LaFontaine 2004).

Through the entrepreneurial process and work with channel partners these resource inputs can be implemented to understand, discover and serve market opportunities. A unique mechanism for viewing these opportunities is value innovation (Kim and Mauborgne 1997). The next section describes value innovation and its application to franchising.

3. VALUE INNOVATION

Value innovation (Bartlett and Ghosal 2000, Kim and Mauborgne 2002, Kim and Mauborgne 1999a, Kim and Mauborgne 1999b, Kim and Mauborgne 1997) provides a unique and insightful perspective from which to view the franchisor and multi-unit franchisee relationship. By pictorially displaying the factors of competition along the horizontal axis and the competency of both the franchisor and franchisees on each factor along the vertical, the value curve enables the parties to plan and implement their strategy. Furthermore, together, they may progress to a more profitable position in the industry.

Examining the value curve for the franchisor and multi-unit franchisee relationship may suggest new opportunities to achieve growth. For example, the curve may highlight which processes or services to adopt, change, or eliminate as well as the implementation of more sophisticated capabilities (Bartlett and Ghoshal, 2001). These underlying factors guide how the franchisor and its multi-unit franchisees market themselves and understand each other.

To begin, Kim and Mauborgne (2002) suggest that key organizational members map their organization's competency on a number of critical processes (or factors). These processes are then graphed on the value curve. The critical processes are listed on the horizontal axis while the organization's competency, ranging from low to high, on each is mapped on the vertical axis. Hence, the value curve describes the organization's distinctive capabilities in the marketplace, showing its unique ability to compete.

The next section describes the study's method, sample and results.

4. METHOD, SAMPLE AND RESULTS

4.1 Method

Given the limited understanding of the governance processes of the franchisor and multi-unit franchisee relationship as well as the infancy of the theoretical development, the exploratory case study research method was employed. This research method is particularly appropriate under these circumstances as it enables the researcher to simultaneously investigate the experiences of the individuals and the context in which the actions occur (Mohr 1985, Yin 1984). A deep understanding of the environment in which the franchisor and multi-unit franchisees operate is needed to fully understand each party's role in providing sustained competitive advantage.

Case study research methodology is distinguished from teaching cases, ethnographies and participant observation (Yin 1984). It is a qualitative methodology in which the researcher goes into the field to observe, study, and collect data about a phenomenon in its real-life context. Data are usually collected through multiple means such as interviews, surveys, and documentation including reports and memos. Case studies are rich due to the contextual and circumstantial nature of the observation and the in-depth knowledge obtained by the researcher (Eisenhardt 1989).

In this study exploratory case research methodology is used to develop a more complete understanding of inter-organizational responsibilities that are implemented by the franchisor and the multi-unit franchisees. A large franchise company is studied using interviews and observations of the franchisor senior management, the franchisor's 30 largest multi-unit franchisees, a group of franchisee leaders, and a series of interactive meetings between franchisor senior management and the franchisee leaders. Questionnaires responses and field notes of three researchers were used to construct the data set.

4.2 Sample

The data for the study were collected from a large, international fast food franchisor based in southern New England, USA. The franchisor has approximately 5,000 franchise outlets in the United States and more than 12,000 outlets worldwide in 45 countries. Their premier quick service restaurants have a leading position in the coffee, bakery, and ice cream segment of the food and beverage industry selling brands that are widely recognized by customers.

Executives from the franchisor and 30 of its largest franchisees participated in the study. Data collection was conducted by three Babson researchers through a series of interviews, group discussions, and interactive meetings with franchisor senior management and franchisee owners. Specifically, the following individuals from the franchisor were interviewed:

- President
- Executive Vice President
- Marketing Vice President
- Director of Operations
- Chief Information Officer
- Chief Financial Officer
- Franchising Vice President

The franchisees interviewed were the franchise owners. These individuals were personally responsible for the franchise and its relationship with the franchisor, had signed the franchise license agreement, and were active in the business. Table 1 provides additional information on the franchisees.

Table 1, Summary statistics of participating franchisees

Total operating units represented	1,157
Units represented as a percent of system	19%
Mean units owned per franchisee	38
Median units owned per franchisee	33
Modal units owned per franchisee	30

Interviews and group discussions were focused on the unique characteristics of the franchisor and multi-unit franchisee relationship which made them particularly effective in the marketplace, in essence those variables which contributed to sustained competitive advantage. To direct discussions, researchers used a list of eighteen core franchisor services developed by Achrol and Etzel (1993). These were defined as the contractually mandated services which each party is obligated to perform as part of the franchisor-franchisee license agreement. Spinelli and Birley (1996) reasoned that the perception of contract fulfilment is contingent not only on the importance of the service but also the adequacy with which it is performed and delivered to customers. Together, importance and adequacy defined the transaction points and sights of interaction between the franchisee and the franchisor. To the extent that these are optimized, the relationship becomes more successful and effective.

During initial discussions, from this larger list of services, study participants reduced the list to six core factors - supply, marketing, operations, real estate, management information systems, and product innovation. These were then termed *key relationship variables* as they defined the critical services or processes that must be cooperatively managed and successfully executed by the multi-unit franchisees and the franchisor to ensure ongoing effectiveness and efficiency in the relationship as well as continued customer satisfaction.

Working backwards the other services were grouped under these key relationship variables and one service, access to franchisor management, was thought to be endemic to each variable. Table 2, services grouped by key relationship variable, provides the results of this process. Together, these variables define how the franchisee and franchisor work and, in combination, these variables govern the strategic orientation of the organization.

Questionnaire responses and field notes from the researchers were used to construct the data set. As mentioned above, three researchers participated in the study. This helped to ensure data quality and data integrity as well as the ability to triangulate results.

Data collection was conducted in four phases. The first phase of the study investigated the unique relationship between the franchisor and the multi-unit franchisees. Researchers paid particular attention to the role each party played in providing a distinct competitive advantage. Each party completed a brief questionnaire including perspectives on their role in the relationship. The second phase of the research involved assimilating what was learned in the first phase and constructing value curves. In the third phase researchers presented the value curves to study participants and discussed examples of and discrepancies with current practice. Finally, researchers amended the curves based on the feedback from participants and prepared the final results.

Table 2, Franchisor services grouped by key relationship variable

Supply	Real Estate
Financial assistance and credit	Support in new store development
Provision of standardized equipment	
Advice on inventory control	Management Information Systems (MIS)
Acting as a supplier of products	Training in accounting
	Advice on financial management
Marketing	Advice on management problems
Promoting new products and services	
Market information and research	Product Innovation
Effective national advertising	Developing new products and services
Organizing local cooperatives for advertising and promotion	
Operations	
Clearly defined operating procedures	
Resolving disagreements quickly and fairly	
Programs for training employees	
Training in management skills	

The resulting data set contains each participant's assessment of its own competency for each of the six key relationship variables as well as the assessment it gave to the other party. For example, each multi-unit franchisee provided a measure of its own competency on the supply variable; at the same time the franchisee also provided its assessment of the franchisor's competency on the same variable. Thus, the data set contains both parties' perspective on their own adequacy on each variable as well as that of their partner's.

4.3 Results

This section presents the study's findings which are displayed on value curves. First, the findings from the franchisees' perspective are shown and described. Next, the franchisor's viewpoint is given. Finally, the results of both perspectives are mapped onto one graph and the findings presented.

Figure 1 shows the franchisees' perspective on the perceived competency of both the franchisee and franchisor. Competencies from low to high on the six key relationship variables (i.e., supply, marketing, operations, real estate, MIS, and product innovation) are shown across the horizontal axis; competency from low to high is given on the vertical axis. The line with the boxes portrays the franchisees' perspective on their own competency while the line with the circles shows the franchisees' perspective on the franchisor's competency.

Evident from this value curve are the following observations. One: Franchisees have low competency for supply, MIS and product innovation whereas the franchisor has high competency for each of these key relationship variables. Two: For operations, the reverse is true. That is, the franchisees perceive their own competency as high and that of the franchisor as low. Three: For both marketing and real estate the competencies are very close and in the middle of the competency range.

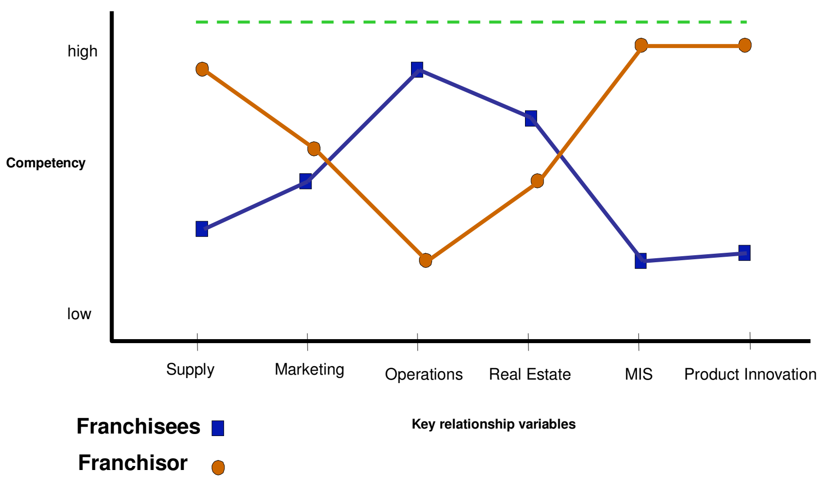

Figure 1, Value Curve: Multi-unit franchisees' perspective

Figure 2 also illustrates the perceived competency from low to high for the six key relationship variables. However, this figure shows the perceived competency from the franchisor's perspective. Supply, real estate, MIS, and product innovation show a clear differentiation of perceived competency with the franchisor having high competency and the franchisee having relatively low competency. Marketing and operations lie in the middle of the competency range. However, while both competencies are in the middle to high range, for marketing the franchisor believes its competency is slightly higher. The reverse is true for operations.

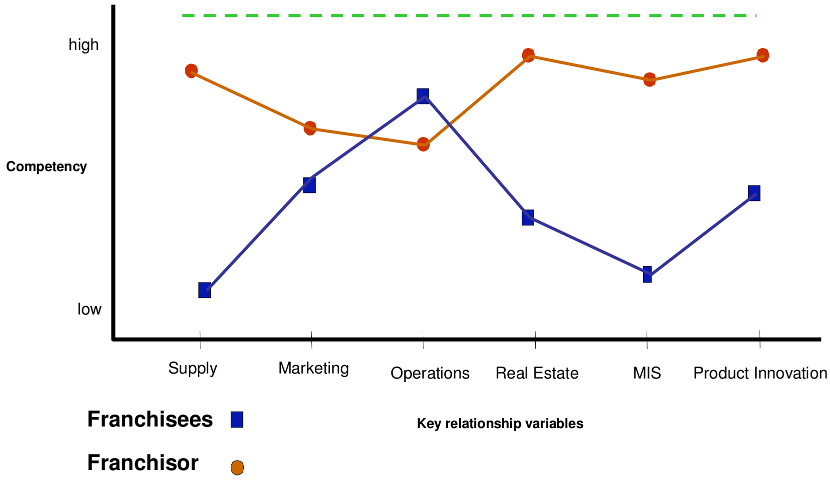

Figure 2, Value Curve: franchisor perspective

Figure 3 combines the data from Figures 1 and 2 onto one value curve. Here, it is apparent that supply, MIS, and product innovation are perceived similarly by both franchisees and the franchisor; franchisees' competency is low and the franchisor's competency is high. Also, these competencies are clearly differentiated from each other as there is a large distance between low and high.

Marketing, shown in the left most oval, is perceived by both parties as having mid range competency with the franchisor having a slightly higher competency than the franchisees. However, any differentiation in competency is difficult to discern and may be spurious given the tightness of the observations. Operations show a different profile. Here, both the franchisees and the franchisor agree that the franchisees had high competency for this key relationship variable. However, the franchisor perceives its own competency as lying in the middle whereas the franchisees perceive it as low. Finally for the real estate variable, competency for each party is dispersed throughout the competency range, indicating no agreement on this key relationship variable.

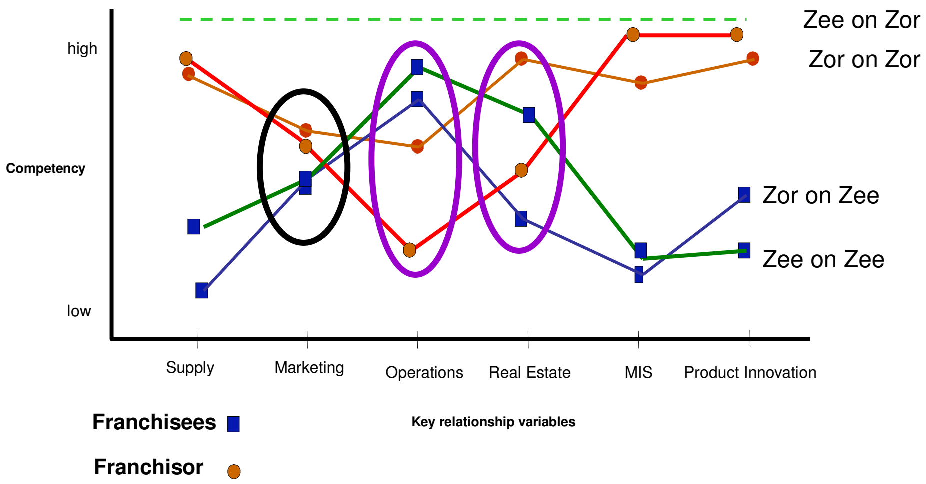

Figure 3, Value curve: differing perspectives

The next section presents a discussion of the findings and the implications thereof.

5. DISCUSSION AND IMPLICATIONS OF FINDINGS

The basic hypothesis of this research was that sustained competitive advantage of an existing franchisor and its multi-unit franchisees could be improved if the parties understood each other's position on a set of key relationship variables and were willing to work to implement change based on this knowledge. The unit of analysis in this study is the relationship between a franchisor and its multi-unit franchisees. We highlight the phenomenon of multi-unit franchisees as an important and unique occurrence in franchising. We measure both parties' perceptions of competency on a set of key relationship variables. Propositions arising from this study were given in Spinelli and Lentz (2007). This section, informed by resource-based theory of the firm, results from the case study, and additional multi-unit franchising examples provides discussion and implications of the findings.

5.1 Discussion

To begin, this study found that the dimensions of the relationship, that is, the key relationship variables, are not surprising. Supply, marketing, operations, real estate, MIS, and product innovation are not only intuitively critical for franchisors and franchisees but these are validated by the study data. That is, participants chose these six as the key components of the relationship. Second, the study found that it is important that each party understand the perception of competencies of the other party. A thorough understanding of competency is particularly important in the case of multi-unit franchisees where sales are concentrated in a small group of people. Third, map the competencies of both the franchisor and the franchisees. Building value curves enabled both parties to pictorially view the relationship. Participants found this process very enlightening. Fourth, manage those variables where there are divergent opinions among the parties. Minimizing organizational conflict was achieved through this process. Fifth, and finally, build a set of formal communications mechanisms that allow a level of understanding that enables construction of tolerance zones. A tolerance zone is the boundary of acceptable behaviour which surrounds each relationship variable (Spinelli and Birley 1998). These five processes are summarized in Table 3.

Table 3, Five step process model for achieving competitive advantage

Step 1.	Focus on key dimensions.
Step 2.	Understand competency perspectives of each party.
Step 3.	Map franchisor and franchisee perspectives.
Step 4.	Manage divergent opinions.
Step 5.	Build a set of formal communications mechanisms.

5.2 Implications of Findings

In franchising it is desirable that both parties in the relationship do not possess the same competencies rather that the franchisor and franchisees complement each other (Elango and Fried 1997). That is, a wide divergence between each party's perceptions of the others' competencies was found to be an important element in making the relationship work well (Spinelli and Lentz 2007). These distinctive competencies are an important contributor to the establishment of competitive advantage (Barney et al. 2001). In one franchising example, an online ordering system for customers enabled each to enter customized orders through a toll free number for pick up today or next week at a local franchise outlet. The detailed and robust system also depleted inventory while utilizing input from both the staffing and buying patterns of each store. The MIS expertise of the franchisor combined with the detailed knowledge of the franchisees enabled the cost effective implementation of the system. Furthermore, the knowledge generated from the system in terms of the performance of profitable and not so profitable franchisees enabled franchisor management to drive individual improvements and raise the performance and profit levels in the franchise system overall. Such a system would have been nearly impossible for a single franchisee or small group of franchisees to develop. Yet working together with the franchisor that had deep MIS expertise and systems' capabilities and the franchisees that had detailed operational knowledge, the delivery system is being implemented nationwide among all franchisees. Executives project that this specialized delivery system will provide a competitive advantage in their market.

Cooperative arrangements such as those in franchising require shared goals so partners can fully discuss issues, accurately communicate information and exchange resources and assistance (Baucus et al. 1996). This was clearly the case with the establishment of this service product delivery system. These data lead to the generation of Hypothesis One.

> ***H1*:** Perceived consensus on the parties' competency on a key relationship variable relates positively to the establishment of a sustained competitive advantage in franchise systems.

A critical component of ensuring the competitive advantage attributed to franchisor and multi-unit franchisee relationships is the means by which they compete (Alvarez and Busenitz 2001). Assessing competitive advantage in businesses can be challenging, particularly measuring its impact (Pilling 1991). Compounding this fact is the acknowledgement of the network of relations in which the franchisees operate (Baucus et al 1996). For example, franchisors offer a standard business format tested over time and with hundreds of franchisees. Nonetheless, franchisees operate in a dynamic, unique, and highly textured environment where real estate and operational nuances greatly impact profitability and competitive position. Location vís a vís the "going to work" or "coming home" side of the street, proximity of competitive or complementary businesses, particular site peculiarities (such as turning radius or site lines), available labour pool, operating hours, and customer preferences are all important factors arising from discussion with franchisees. These must be fed back to the franchisor so that the business format is modified and new franchisees can learn from the recent experiences of others'. As one franchisee suggested "it is necessary to find the feedback loops in the interactive relationship and the reciprocity of understanding in the relationship that makes the model more dynamic based on the experiences that the franchisees are experiencing."

In combination, agreement and a partnership style of relationship positively affects performance (Henderson 1990). Working cooperatively is the essence of franchising (Hunt 1977). In the words of one franchisee "the tension builds where in the larger view of the core asset and the focused view of the dynamic asset meet." These data lead to the generation of Hypothesis Two.

> ***H2*****:** Perceived consensus on the parties' competency on a key relationship variable relates positively to the performance of franchisees' retail operations.

In the franchising system, a franchisor works closely with its multi-unit franchisees to produce a sustained competitive advantage. As reported in Spinelli and Lentz (2007) three different theories, agency, transaction cost and relationship exchange, lead to this result. An overlap of responsibilities as well as divergent goals can cause confusion and the development of hard feelings, ill will and organizational stagnation (Spinelli and Birley 1994). In the case this was evident in one aspect of marketing. The franchisor believed that to continue to build the brand the coffee available in the franchisee stores also ought to be readily available in grocery stores. The franchisees believed that this strategy would cannibalize their sales while the franchisor took all the profits for itself. The stalemate "caused the franchise system to bog down" and was resolved eventually when the franchisor and the franchisees developed a mutually agreeable revenue sharing arrangement.

Learning from experiences and applying them to the working relationships of the parties not only contributes to innovation (Henderson and Lentz 1995, 1995/1996) but also results in more satisfying working relationships (Spinelli and Birley 1994). This was the case in this example and leads to Hypothesis Three.

***H3*: Perceived consensus on the parties' competency on a key relationship variable relates positively to the franchisees' satisfaction.

Limitations of this research study and recommendations for future research are provided in the final section.

6. LIMITATIONS AND RECOMMENDATIONS FOR FUTURE RESEARCH

The goal of this research was to develop an understanding of how a franchisor and its multi-unit franchisees can work together and establish internal governance mechanisms which may facilitate entrepreneurial management among franchisors and their multi unit franchisees. However, one study cannot completely exhaust all the questions researchers and executives generate on this topic. There are many ways to extend the current body of knowledge on franchising. Limitations of this study and recommendations for future work are given below.

The study has three main limitations. First, the retrospective nature of this study makes it difficult to guarantee that the incidents as indicated by the respondents are absolutely accurate due to problems of memory recall of past events. However, this retrospective approach to data collection is not expected to be a serious limitation because respondents are senior executives whose work typically involves assessments of past and present situations in order to plan for the future. Hence, they should not have great difficulty is responding to the retrospective nature of the interviews and discussions. Also, the events recalled during the interviews were in the most recent past, some only a few months or weeks before the interviews took place. A second limitation of this study was that it was conducted in a single industry. This methodological choice had the benefit of controlling for many extraneous variables (thus strengthening the validity of the results) but at the cost of generalizability. The third limitation is the exclusion of single unit franchisees. These represent a significant portion of the population of franchisees and their particular peculiarities in the implementation of key relationship variables warrant study and individual attention. For example, work on the granularity and specificity embodied in the key relationship variables could prove constructive. Variables such as marketing contain a diverse range of processes from promotion to research and their textured nature exists on many levels in the relationship (e.g., local, regional and national).

Recommendations for future research can be made in two areas: methods and practice. First in the area of methodology, the employment of a longitudinal design, inclusion of more respondents, and exploration of other industries may provide additional data on the independent and dependent variables. Such methodological extensions in design are likely to disclose hidden assumptions and interactions in the key relationship variables as well as their effect on franchisor and multi-unit franchisee performance. Additionally, as performance is a latent variable and its effect on the key relationship variables may not be evident for some time. A more substantial and varied sample may shed light these intricacies. In sum, these methodological extensions may contribute to additional insights into the operation and implementation of mechanisms for entrepreneurial management.

Finally, practice may be improved through future research. Creating franchising relationships in which the parties thrive, as partners, is desirable and the probability of sustaining the advantage may be enhanced using this program of research.

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