Determinants for Franchise Success

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Abstract

At a time when the rest of the economy has been gloomy, franchising in New Zealand has seen annual growth rates of between 8 to 30% over the last five years. The first of the annual surveys in 1997 recorded a turnover of $3.5B. This year's estimates exceed $10B with 14,000 units and employment figures of around 70,000. Yet the success and growth has not been uniform across all of the 300 systems involved in this business format. The failure rate of the individual units over a three-year period is around 7%, ranging from 0 to 50%. It is hard to pin down accurate figures for non-franchised businesses but they are commonly reported to be much higher. The franchisor's initial investment is typically in the order of $100,000 and the median start-up costs of franchised units is $125,000. It is therefore in the best interests of both parties to ensure that the franchisees receive the correct types of support and training in return for the investment and on-going royalties, to maximise their survival and the overall health of the system. This paper examines some of the factors that contribute to the success of franchise systems. In particular the return on investment (ROI), failure rates and overall satisfaction levels are analysed against the training and support services offered by the systems using a variant of the Mahalanobis Taguchi System (MTS).

1 Introduction

Since the 1980's franchising has undergone unprecedented growth in New Zealand. The essence of a franchise is that the founder sees an opportunity to expand the existing business by taking on 'partners' who will own their own business, thus accessing their financial and human capital as well as local market knowledge. A trend that is emerging is the selling of 'company-owned' businesses in favour of franchisee-owned units. However, a system is only as strong as the individual units that earn the system its revenue. These in turn depend upon the services provided by the franchisor. Since 1997, the annual franchising survey of franchising in New Zealand has measured the factors critical to the individual franchise systems [17]. As part of this, the surveys have examined the franchisees, but from the franchise owner's (the franchisor) perspective.

The franchisee satisfaction survey was an opportunity to examine the franchisees, and based on this examination, to further explore the relationships between franchisees and franchisors. The survey was set up as an international study with twelve participating nations. Each nation was responsible for running its survey, but using a common instrument (albeit with minor changes to take into account regional differences [16]). To obtain a realistic sample size in each country, the fast food industry was targeted – one of the few industries present in each of the 12 countries.

The essential core and uniqueness of business format franchising is the relationship between the franchisee and franchisor [13]. Spinelli and Birley [20] discuss the potential

for conflict between franchisees and franchisors. They state that franchisor-provided services are the principal method of franchisor contract fulfilment. In return for fees, royalties and some controls on their independence, the franchisees receive initial and on-going support services and other benefits such as cheaper supplies or a certain level of profitability. Yet little empirical research is available on franchisee satisfaction in relationship to these services.

Hing [8] invited 27 Australian restaurant franchise systems to participate in a mail survey. The effective response rate was 40.9 percent (9 firms). Questionnaires were mailed to the 229 franchisees of these 9 franchisors, with a 58 percent response rate. The characteristics found to contribute to post-purchase franchisee satisfaction were the level of need for achievement and the use of advisors prior to purchase by franchisees, and the amount of disclosure documentation, the number of types of franchisee assessment methods, and initial and ongoing franchisee support services provided by franchisors.

2 Survey Methods

The franchisee satisfaction survey forms measured 12 factors (using 91 questions, some of them of more than one part). The factors were: overall assessment (1), financial (13), relational (7), support services (5), brand image (5), entrepreneurial control (5), encroachment (5), communication (6), contract fairness (8), training (5), general (17) and demographics (14). The survey responses were coded using SPSS and further analysed using Excel.

An initial difficulty of the study was in determining which systems to include, and then in finding the contact information for the individual units. The franchise systems were selected from the same list used to prepare the 2000 franchisor survey. Most of the systems, deemed to be fast food (others sold packaged food as well and a further two had no franchisee-owned outlets), were part of hamburger or pizza chains. Michael [14] explains why the numbers of outlets that are franchised can affect the service quality in restaurants.

2.1 Franchisee Survey (Zee)

Many franchise systems have not historically participated in the annual survey and would be unlikely to supply a list of their franchise units. Therefore, these were taken from the electronic white and yellow pages. In some instances the franchiser cooperated in specifying which were company-owned and which owned by franchisees. It soon became evident, than unlike the rest of the franchise sectors, in the fast food sector many of the systems retained ownership or all or a large proportion of the outlets. One large chain, Pizza Haven, had recently been bought by Restaurant Brands and converted to company-owned units to complement its Pizza Hut operations. 228 survey forms were sent out in September-October 2000 to the individual units (Table 1), knowing that some of these were company-owned and therefore ineligible to participate in the survey. From these a response of 54 completed forms was received. This gives a response rate of 24% of the forms sent. In addition there is a trend towards multi-unit franchising. This is especially prevalent in the fast-food industry. This tendency does not seem so pronounced in New Zealand (perhaps because of the younger age of the systems and the smaller size of the market). 84% of those franchisees responding owned only one unit,

10% owned two, 4% owned three and 2% owned five. Correcting for these two factors gives a response rate of 43% of the estimated systems based on the estimated numbers of franchisees.

Basis	Count	Response Rate
Franchisee Forms returned	54	
Letters sent to all units not known to be company-owned	226	24%
Estimated number of units franchising	138	39%
Estimated number of in multiple ownership (2nd or subsequent units)	13	
Number of distinct franchisees	125	43%
Franchisor Forms returned	114	
Letters sent to all organisations possibly franchising	410	28%
Estimated number of organisations franchising	300	38%

Table 1: Estimated response rates for the two surveys

2.2 Franchisor Survey (Zor)

As the annual survey is typically quite large (200 or more questions), and is principally designed to measure industry statistics, not all the items from the franchisee satisfaction survey could be used. One or two questions from each section of the franchisee survey were selected to represent the 12 factors. In all there were 23 questions in section A, "Our View of the Business", representing the equivalent view to that of the franchisees. Where necessary the question was changed from the franchisee to franchisor perspective. The remaining sections in the survey were B: domestic operations, C: international operations, D: regulation and service providers, E: franchise profile and F: franchise support. These sections are not discussed here, except in the context of the questions in section A. For example "A6: A wide variety of support services meet the needs of the franchisees" can be discussed in the context of section F: franchise support.

A mailing list of all the systems, known or thought to be franchised, was compiled after updating that used in the previous year. Pre-notification letters were sent out before the survey asking the addressee to pass the survey form when it arrived (one week later) to the appropriate person in the system (if it was not themselves) or to faxback, on the form provided, the reason why they were not completing the survey (no longer franchising, not interested, too confidential etc…). As an incentive to complete the survey or faxback, respondents would be eligible for a prize draw. In all 410 survey forms were sent out (the 2000 and 2001 surveys estimated that there were 300 operational franchise systems in the country). This gives a response rate of 28% of the forms sent, or 38% of the estimated systems based on the returns and phone calls made following up the survey (Table 1). None of the franchise systems that responded were in the quick response (fast) food sector, so comparison is made across all systems.

3 Survey Results

3.1 Franchisees (Zee) Survey Results

Overall, 25% rated the system as excellent, and another 27% as above average, 23% rated it average, 13.5% below average and 11.5% poor. It became evident from entering the surveys that the responses from franchisees belonging to different systems varied

greatly. In particular, although most franchisees clearly indicated that the operation of their franchise system was a success, two in particular (one pizza, the other fast service meals) had many dissatisfied franchisees.

The background of the respondents differed greatly. 27% were female; their ages ranged from 28-60 (median 44), and business experience before entering their first franchise system from 0-15 years (median 5, 32% had none), and in the amount of capital required to invest in the franchise varied from less than $50k to more than $2M, (median $100-200K). These demographics were consistent with the annual franchisor surveys. The annual return ranged from a loss to over $200,000 (median over $50 000) and 60% had broken even (and of these, over 50% within the first year). The longest a franchisee had been with the franchise system was 18 years with the median being 3-4.

Several were disappointed with their return on investment. Indeed, some had closed and departed from the system. The maximum estimated failure rate was 40% over a three-year period, with a median failure rate 2%. Royalty payments and advertising fees in particular were a source of contention. In some instances the relationship with the franchisor was very poor and the support services provided non-existent. Many felt frustrated with their being unable to exercise entrepreneurial control, and felt consequently that the brand image suffered. Interestingly, there were few complaints about encroachment by the franchisor. As could be expected, the responses differed greatly in the measures of communication with the franchisor. Most considered the contracts to be fair, but some felt that there was inadequate disclosure (members of the franchise association are obliged to adhere to a code of practice that includes a disclosure agreement).

50% considered the support services received in exchange for the fees to be clearly identified in the agreement (27% disagreed) and 62% felt that the franchisor provided adequate support services (31% disagreed). Whereas most (54%) systems provided excellent training, for others the franchisees felt that it was poor or non-existent (38%). Few considered it unfairly priced (17%) or poor value (25%), against 57% thinking it represented good value. Most considered the training created a learning environment where franchisees were encouraged to participate (57% agreed, 25% disagreed) and to learn from each other (52% agreed, 29%).

The findings indicate that prospective franchisees need to research carefully the systems that they intend to join, and that franchisors need to pay attention to the services provided and the communication and support systems that they put in place to deal with their 'customers', the franchisees.

3.2 Franchisor (Zor) Survey Results

114 survey forms were returned [17], although one did not answer section A so cannot be used in this analysis. Some did not answer all of the questions in this section. Unlike the franchise units where few survey forms would be filled in by managers (rather than owners), many of the respondents were not necessarily creators or owners of the system. Some are subfranchisors of overseas-owned systems (23%), whereas others are managers within larger organisations where the franchise operation might play a small part in the overall operation. Some non-owners could express dissatisfaction levels unlikely to be recorded by the owners (especially where they also are the creators). In all 19 matched questions, the satisfaction recorded by franchisors is higher than that of franchisees (Table 2). For example, the franchisors' estimation of the ability of their

franchisees to run the business was higher than that of the franchisees' assessment of the franchisor.

The only mid-point (agree, rather than strongly or very strongly agree) scores recorded for the franchisors were on the freedom of the franchisee to determine the selling prices, or how to run the business and whether they could exploit their entrepreneurial abilities. These mid-point scores were caused by the franchisors having franchisees at either end of the extreme, or that different systems allowed different degrees of autonomy.

4 Empirical Findings

The differences between the two surveys was analysed using SPSS and Excel (Table 2). In the case of the comparison of the ROI, for the franchisor and the franchisee in the franchisor survey, a paired *T*-test was used assuming unequal variances.

Question	Z'ee	Z'or	Diff.	Sig.
Overall, how would you rate your franchise system	2.64	1.97	0.67	.001
The franchise does not provide a good ROI to the Z'or.		5.00	*0.37*	*.002*
The franchise does not provide a good ROI to the Z'ee.	4.17	5.37	1.20	.000
Our relationships with my franchisees/or are very good	3.23	2.36	0.87	.001
Our franchisees/or are competent to run this franchise	2.11	1.80	0.31	.281
A wide variety of support services meets the needs	2.70	1.57	1.13	.001
The franchise system has a recognisable company name or trade mark	2.47	1.84	0.63	.005
The franchise uses innovative ways to market the brand	3.58	2.74	0.84	.002
The franchise has an excellent brand image compared to our closest competitor.	3.13	2.29	0.84	.003
Our/My franchise system is not flexible enough to allow innovation of new ideas or products	4.36	5.26	0.90	.001
The franchise gives the amount of freedom and independence that Z'ees ideally want from owning a business	3.85	2.40	1.45	.000
The franchisees can exploit their entrepreneurial abilities	4.00	2.45	1.55	.000
Franchisees have the freedom to determine how they manage the business.	3.70	3.47	0.23	.356
Selling prices are imposed (on me) by the franchisor	3.36	3.24	0.12	.700
Do the franchisees have a territory?		86.5%		
Franchisees have a guaranteed and protected territory.	3.62	1.99	1.63	.000
The franchisor maintains frequent communications with franchisees.	3.55	1.89	1.66	.000
The franchise agreement does not offer adequate conflict resolution methods.	3.81	5.44	1.63	.000
The franchise has a excellent training program	3.74	2.74	1.00	.001
The training creates a learning environment where franchisees are encouraged to participate	3.74	2.33	1.41	.000
My choice to buy(/create) this franchise was a wise one	3.36	2.03	1.33	.000
Average difference			**0.99**	
Failure rate for franchisees in your system over a three year period	7.46	6.37	1.09	.738

Table 2: Comparison of survey responses

It is clear that the franchisors rate their individual systems higher than do the franchisees. The biggest differences (greater than one-and-a-half on the Likert scale) were in the conflict resolution methods, protection of the territories (although not all systems have territories, so to some extent this can be discounted), communications, entrepreneurial freedom and ROI for the franchisee. It is noteworthy also that franchisors rated the ROI to franchisees higher than they did for the ROI to themselves (P=0.002, paired-T test). The franchisees cannot determine the ROI for the franchisors, so this question was not asked of them.

Those questions where the difference was greater than one point were: the choice of buying/creating the system was a wise one, a participative training environment, the variety of support services available and the excellence of the training programme.

The only questions on which the franchisors (as a body) did not significantly rate their systems higher than the franchisees were in the freedom afforded franchisees, the respective competencies of their counterparts and the imposition of selling prices.

Surprisingly, there was no difference between the estimated survival rates of the franchise units. As some of the franchise systems had been in operation for less than three years, these observations were removed and a new mean of 7.08 was observed. This was closer to that estimated by the franchisees. Fast food franchise systems are mostly older, as this sector is generally regarded as the first to have franchised (e.g. McDonalds have been in New Zealand for 25 years) but the age of the systems corresponding to the franchisees that responded was not known. However the average age of these systems in New Zealand was 15 years. Conversely, such is the growth, 32% of the respondents had been in the franchise system for 2 years of less.

The only area where the franchisors and franchisees were on opposite sides of the Likert scale involved conflict resolution. This is surprising in the light of the fact that there is a low level of disputes, despite the prominence recorded to them at times [7]. The (franchisor) surveys revealed a figure of around 1% of units being involved in disputes from 1997-2000 [21,22,23,15]. The 2000 survey also revealed that more disputes were being resolved by mediation than previously. This was confirmed in conversation with franchise legal advisors. Gassinheimer et al [6] found that participative communication improves relations and performance of the franchise system while enhancing franchisees' freedom to act on entrepreneurial tendencies and advance their own business ventures. It is of some concern then that communication (followed by conflict resolution) was the factor with the greatest disparity in the scores between the franchisees and franchisors. This is likely to cause problems in other areas such as entrepreneurial freedom.

Two factors are particularly worthy of further investigation – entrepreneurship and support systems. Literature suggests the possibility of conflict in the first of these. The potential for conflict within franchise organisations, where owners can be said to be "bulls" and employees "bears", with franchisees representing an intermediate position is dealt with separately [18]. The fact that 32% of the franchisees had no prior business experience implies that the support provided by the franchisor is of high importance to at least these franchisees.

4.1 Support systems and training

When the franchisees sign the franchise agreement they are exchanging money (in terms of an initial payment and on-going royalties) for the knowledge (intellectual

capital) of the franchise system. This knowledge is embodied in the franchise support systems. These in turn can be broken down into the initial support structures and the on-going support systems, as well as 'group-office' support. Training is generally an essential element of each. Most systems provide a wide variety of support systems (Tables 3-4). The franchisors rate the support structures and training higher than do the franchisees: "*A wide variety of support services meets the needs.*", "*The franchise has a excellent training programme.*" Franchisees need to think about the quality of services that they should receive when they purchase a franchise [1].

If the franchisees considered support services to be inadequate they were asked why. It is clear that these are for the most part (9 of the 20 comments) communication issues. This was the area where the difference between the franchisor and franchisee ratings was the highest (Table 2).

The support systems and training were examined in detail in the 1997, 1998 and 2001 surveys (Table 3). The number (and % response) of forms sent of the respective surveys were: 119 from 323 (37%), 87 from 295 (29%) and 114 from 426 (27%), although not all respondents answered each question.

Average number/percentage of:	1997	1998	2001
Support methods	3	4	3.5
Group office support	N/a	5-6	6
Pre-opening training (days)	28	18	10
Start-up training (days)		14	8.5
On-going training (days)	10	8	4
Manuals	3	3	3
Pages	422	425	400
Turnkey operation	57%	45%	41%
Internet support	17%	39%	62%

Table 3: Support Methods

The main change noted was the number of systems that offered Internet support in 2001 and/or had a web site to support and promote the franchise operations. This was subsequently examined in the 2001 survey. Conversely, the training offered and the amount of documentation and percentage of turnkey systems was dropping over time. McCosker et al [11] allude to the lack of agreement between franchisees and franchisors in regard to the franchisees power to make changes to the franchise system. Franchisees have the power to recommend only. Franchise Advisory Councils (FACs) in this sense are a way of extracting surplus from the entrepreneurial input of franchisees; any input from the franchisees remains the property of the franchisor. It is therefore surprising that such a low percentage (30%) of systems make use of this means of communication, although tests showed no correlation between having a FAC and performance. Foulds [4] suggests that empowering tools could result in real gains if OR could provide workers the means to monitor, understand and continuously improve performance. By extension, these tools would be invaluable to franchisees.

Franchising is a knowledge transfer process and training plays an important role. However, training and range of support showed very low correlation, $\rho^2 = 0.25$. Including the independent variables, pre-opening, and start-up training in the regression above, only marginally improved the R square to 0.27. From the regression analysis done on the range of support given and training programmes, pre-opening training,

start-up training, manuals supplied, no of pages, etc., it is found that R square can be only a maximum of 0.54, when all the variables are included. However, the first fifteen independent variables give an R square of 0.516.

Support (percentage)	1997 (119)	1998 (87)	2001 (114)
Newsletter	78	79	84.2
Annual conference	70	65	77.2
Regional Conference	68	--	62.3
Master Franchisees	23	21	13.2
On-going training	80	72	78.1
Franchise Advisory Council	29	30	27.2
Other	39	42	19.3
Average	55.3	51.5	50.0
Group office Service			
Accounting services		39	36.8
Advertising/Promotion		83	85.1
Banking		20	18.4
Central Bookings Phone Number		14	31.6
Credit Control		32	15.8
Group Buying		71	74.6
Human Resources		33	23.7
Insurance	55	58	56.1
Internet	17[1]	39	62.3
National Advertising Fund	53	66	69.3
On-sale franchises (resales)		47	46.5
Point-Of-Sale		45	41.2
Telephone Hot Line Service	61	43	37.7
Other		13	10.5
Average	N/a	43.1	42.7

Table 4: Support Services and Group Office Support

Frazer [5] found that although the majority of franchisors that had discontinued franchising had initial support, only half of these franchisors offered systematic ongoing support, typically in the form of ongoing training and field visits by franchisor staff. Overall, it would appear that the firms in this study offered less initial and ongoing support than is standard in the sector, where the majority of franchisors offer a combination of several different types of support [12].

Castrogiovanni et al [2] found franchisee failure rates of 16% in comparison with the US department of statistics rate of 4% (the same order of magnitude as found in this study). They could not relate this to factors influencing the level of support services provided (age, size, business type and capital intensity). Falbe and Welsh [3] found that franchise executives rated system quality, brand (a factor that included the quality of the operating system), local environment, communication and the specific characteristics of a system as the important determinants of its success.

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[1] In the 1997 survey this was included in the general category of support systems. "Support services" was not included as a separate question although there were questions on Insurance and other services.

4. 2 Mahalanobis Taguchi System

It would be interesting to identify factors that influence the franchisor (franchisee) to perform exceptionally well or exceptionally poor. With this, in view, if a multidimensional scale could be developed then using that scale one could look for the exceptions and explain the reasons.

Mahalanobis Taguchi System (MTS) is a recent development in multivariate measurement systems that is used as a diagnostic tool in medical and inspection environments. This approach requires a "healthy or normal" group of known n, individuals, on whom multidimensional data on k variables are collected. Based on these measurements, a metric called scaled Mahalanobis distance (MD) is defined. It can be shown that the average and variance of the MD's for the healthy group are one and 2/k respectively. Mahalanobis distance is known for a long time in multidimensional classification and clustering applications. Mahalanobis [10] defined a multi dimensional metric generalising the Euclidean distance by defining the squared distance for the jth observation in a sample of size n with k variables, from the sample means. The scaled Mahalanobis Distance (MD) is given by,

$$MD_j = (1/k)Z'_j C^{-1} Z_j$$

where Z_j is the standardised vector, that is obtained from the jth observation,

C^{-1} is the inverse of the correlation matrix.

Mahalanobis Taguchi System (MTS) has two phases. In the first phase, the MD's are computed based on the normal group, and the corresponding Mahalanobis space (an ellipsoid) is identified. In the second phase, a set of useful variables from among the k variables is determined for future classification purposes. The usefulness is determined by maximising the signal to noise ratio as done in Taguchi methods. In addition, use of orthogonal arrays (OA) is suggested to experiment for the selection of useful variables. A recent doctoral work explains MTS and its variants and their applications and compares the performances of known multivariate methods like principal component analysis, stepwise regression and discriminant analysis [9].

Returning to the problem of identifying exceptionally good or bad performers among the franchise systems, we notice that a major hurdle for using MTS is we do not know the *normal* group of franchisor/ee. However, in the literature on MTS, it is always assumed that the normal group is given, as in medical diagnosis; the specialist has the expertise to identify the healthy and abnormal cases. It was decided to develop a methodology to identify the normal group, when expert knowledge is not available, based on the multidimensional data and other auxiliary information available on the franchisors. Initially, all the data available on all the systems were used to find the Mahalanobis space. Then the MDs for the individuals are used to identify the *extreme* cases. If the axillary information available can explain the extreme cases well, either giving reasons for their abnormality in the positive direction or negative direction then we continue to identify further cases. Then we leave out these observations, treat the rest as the normal group, and find the corresponding Mahalanobis space. A bisection search-like approach with respect to MD can be done to arrive at the cut-off distance in defining the normal group.

Using this approach it was found that a distance of 1.5 identified 5 franchisees among the 53 to be considered abnormal. When we looked at these they were typically disaffected franchisees that considered that they had a low level of support,

felt that they did not receive value for the marketing levy and were struggling to break even. Others represented more established units that may have felt they knew better and want to break from the prescribed methods of the business format that is part and parcel of a franchise operation.

Similarly 18 franchisors identified among the 114 franchisors were considered to be abnormal either in the good (8) or bad sense (10). When we examined these outliers they tended to fall into two distinct categories: those that might be considered as poor performers – typically young start-up systems with 0-2 franchise units and little support – and good performers – typically well-established systems with multiple support methods.

5 Conclusion, Limitations and Future Research

There is a gap between how the franchisors see their systems and the satisfaction level felt by the franchisees. It will be interesting to see if for instance this communication gap is closed by the advent of such technologies as the Internet or in fact if they exacerbate it. Despite the considerable effort put into their systems by the franchisors, in both the initial set up and the on-going services, the franchisees still see a shortfall in this area. A problem with the MTS approach though is revealed with further analysis of the data. Some units, among the franchisees in particular, could also be considered as atypical when we look at their responses, yet they were not identified by this method. Future research will see more data collected in the 2002 survey and further analysis and experimentation applied using MTS.

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