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Non-contractibility and Market Uncertainty in Franchise Systems

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Abstract

Franchisors face a tradeoff between centralization of decision rights and decentralization of decision rights. Regarding the problem, we developed a causal model considering that the relationship between non-contractibility of assets and the allocation of decision rights is not constant, but is contingent on market uncertainty. The results of the analysis showed that a franchise system would be centralized when (1) the franchisor’s assets are intangible and are impossible to be transferred by contract, (2) the franchisees’ assets are less intangible and are possible to be transferred by contract, and/or (3) the market is uncertain.

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1. INTRODUCTION

Allocating decision rights between franchisors and franchisees in franchise systems has been an important question in marketing literature. Allocating decision rights to a franchisee would induce the franchisee to invest its own assets and would lead to an increased total profit of the franchise system. According to Windsperger (2004), the non-contractibility of assets, which refers to the degree of difficulty in transferring assets by contract, is the most important factor in determining the allocation of decision rights. However, he ignored another important factor, market uncertainty.

The franchise system is a type of vertical marketing system, which is coordinated by contract between a franchisor and franchisees (McCammon, 1970). In a franchise system, a franchisor provides franchisees with rights for doing business and receives royalty fees in return. Generally, decision rights tend to remain in franchisors (Blair and Lafontaine, 2005). In this regard, the franchisees' activities (e.g., developments of new products and services, assortments, branding,

and advertising) are limited and the franchise systems are controlled by the franchisors. However, some franchisors adopt decentralization and delegate some decision rights to their franchisees in order to adapt their market offerings to local markets (Minkler, 1992).

Franchisors and franchisees have their own assets. In order to increase total profits of the franchise system, not only the franchisees, but also the franchisor should make relation-specific investments in their assets, for example, in information systems, logistics systems, branding, and store operating systems. Regarding the issue, property rights theory implies that firms would allocate decision rights to the owners of the valuable assets for the inter-firm relationship (Grossman and Hart, 1986; Hart and Moore, 1990). According to the theory, the contractibility of assets is the most important factor in allocating decision rights (Windsperger, 2004). It was suggested that firms with non-contractible assets have decision rights. However, previous studies have regarded relationship between the contractibility of assets and centralization as constant: They have ignored the fact that the relationship is affected by external factors—especially environmental uncertainty. Thus, in this paper, we consider not only the contractibility of assets, but also environmental uncertainty to propose a new causal model regarding how franchisors allocate their decision rights between their franchisees and themselves.

2. LITERATURE REVIEW

Franchise systems have attracted considerable attention in various fields of research, e.g., marketing, economics, management, law, and finance (Dant and Kaufmann, 2003). Previous studies have addressed various topics such as why firms choose the franchise system to manage chain stores (Oxenfeldt and Kelly, 1968–69), what determines the ratio of company-owned stores to franchise stores in a franchise system (Oxenfeldt and Kelly, 1968–69; Lafontaine, 1992; Lafontaine and Kaufmann, 1994; Dant and Kaufmann, 2003; Windsperger and Dant, 2006; Maruyama and Yamashita, 2010), and how franchisers decide royalty rates and franchise fees (Caves and Murphy, 1976; Rubin, 1978; Brickley and Dark, 1987; Lal, 1990; Lafontaine, 1992; Sen, 1993; Bhattacharyya and Lafontaine, 1995; Várquez, 2005).

Nevertheless, the choice problem between centralization and decentralization has received little attention. As a rare exception, Windsperger (2004) addressed the problem with property rights theory as a theoretical background. Originally, property rights theory explains how asset ownership determines the boundaries of the firms (Grossman and Hart, 1986; Hart and Moore, 1990). According to the theory, a firm with valuable assets needs to have property rights over the other firm's assets if the firm's relation-specific investments in its assets increase the value created in the inter-firm relationships, and vice versa (Hart, 1995; Besanko, Dranove, Shanley, and

Schaefer, 2009).

The asset is divided into tangible assets and intangible assets (Hall, 1989, 1993). Tangible assets have a physical substance while intangible assets lack of physical substance. Therefore, the value of tangible assets is relatively easy to measure than the one of intangible assets. Intangible assets are far more than essential than tangible assets in determining inter-firm relationships because tangible assets are relatively easy to transfer between firms than intangible assets. Hall classified intangible assets into intellectual property rights and knowledge assets. The former refers to contractible intangible assets, such as patents, brands, copyrights, registered designs, and databases. In contrast, the latter refers to non-contractible intangible assets, such as capabilities (skill and know-how), reputation, and goodwill, which are more difficult to be transferred among firms by contract than intellectual property rights. Previous literatures of allocating decision rights have focused on non-contractible intangible assets (Windsperger, 2004). In order to examine the effects of non-contractible intangible assets on the allocation of decision rights, Windsperger proposed the concept of contractibility. This concept refers to the degree to which assets are easily transferred by contract. For example, contractibility of capabilities is relatively low because the documentation of capabilities is almost impossible (Nelson and Winter, 1982).

Windsperger suggested that firms with non-contractible intangible assets have decision rights in franchise systems. His findings are as follows: First, it is desirable for franchisors to

centralize decision rights when franchisors' assets are non-contractible and franchisees' assets are contractible. Second, it is desirable for franchisors to decentralize decision rights when franchisors' assets are contractible and franchisees' assets are non-contractible. Third, both centralization and decentralization are desirable for franchisors when both franchisors' and franchisees' assets are either contractible or non-contractible.

Despite of these interesting findings, Windsperger (2004) had two problems. First, he ignored environmental factors. Previous studies have suggested that firms change their organizational structures depending on the level of environmental uncertainty (Achrol, 1991; Daft, 2001). Thus, not only the non-contractibility of the assets, but also market uncertainty should be considered. Second, Windsperger regarded franchisees' intangible assets as being uni-dimensional, while it could be multidimensional in the real world. Thus, it should be measured multidimensionally.

3. HYPOTHESES

Both franchisors and franchisees should make relation-specific investments mutually if they want to maximize their profits (Grossman and Hart, 1986; Windsperger, 2004). When a franchisor's intangible assets are essential to the franchise system and cannot be transferred to the fran-

chisees by contract, it is reasonable that the franchisor centralizes decision rights over the assets so that it has incentives to invest in the assets. If the franchisor adopts decentralization, it will be less willing to invest in the assets. Thus,

H₁ The non-contractibility of a franchisor's franchise system-specific know-how has a positive effect on centralization in the franchise systems.

When franchisees' intangible assets are essential to the franchise system and cannot readily be transferred to the franchisor by contract, it is reasonable that decision rights are delegated to the franchisees. As a result, the decision rights in the franchise system would be decentralized.

Franchisees have two kinds of intangible assets, exploration and exploitation assets (March, 1991; Windsperger and Dant, 2006). Exploration refers to the development of new routines and exploration assets denote those that allow franchisees to explore local market information and adaptive capabilities (March, 1991). Exploitation refers to improvements of existing routines (March, 1991) and exploitation assets denote those that allow franchisees to exploit administrative capabilities over quality and human capital (Windsperger and Dant, 2006). While exploration assets allow outlets to adapt themselves to various markets using new routines, exploitation assets allow outlets to increase efficiency by implementing standardized operations (Sorenson

and Sørensen, 2001). Thus,

H₂ The non-contractibility of a franchisee's exploration assets has a negative effect on centralization in the franchise system.

H₃ The non-contractibility of a franchisee's exploitation assets has a negative effect on centralization in the franchise system.

Environmental uncertainty refers to the degree to which markets that the franchisees face are volatile and customer needs change frequently (Klein, Frazier, and Roth, 1990). When markets are uncertain, exploration and exploitation assets become increasingly important as a means of profit maximization of the franchise system. It is because market uncertainty increases the necessity of creating new routines and improving efficiency of existing routines. Therefore, the negative effects of both exploration and exploitation assets on centralization in franchise systems would be reinforced by market uncertainty. Thus,

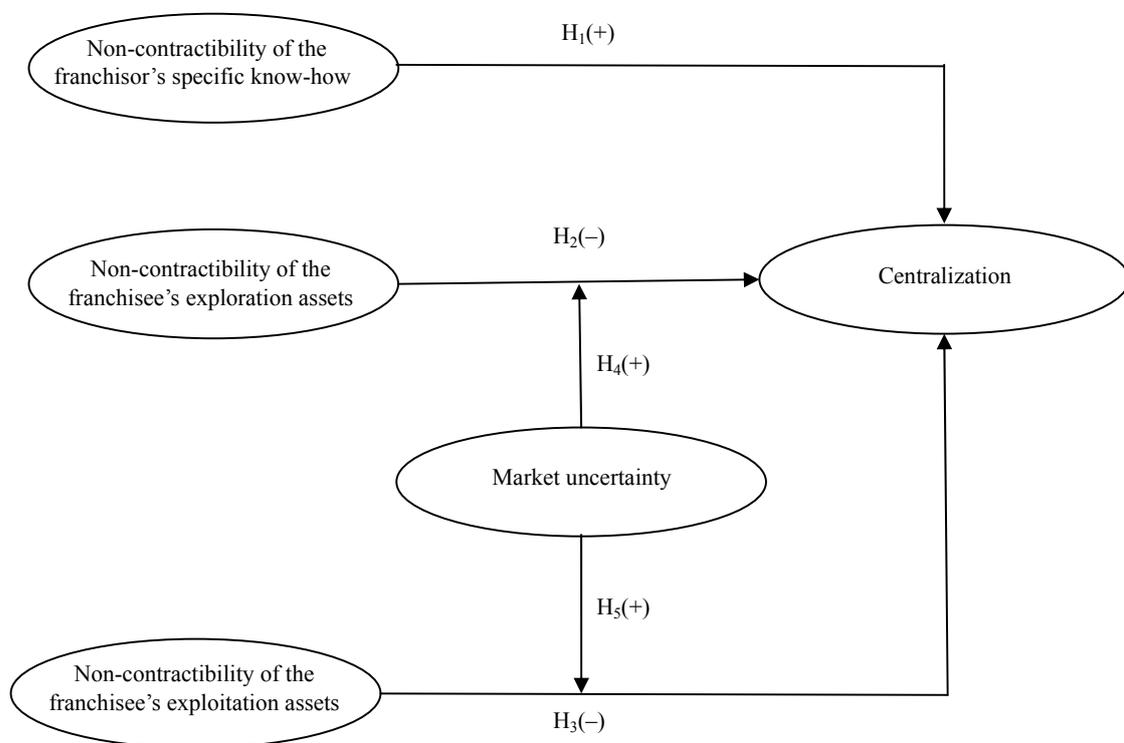
H₄ The negative effect of non-contractibility of a franchisee's exploration assets on centralization in franchise systems is stronger when market uncertainty is higher.

H₅ The negative effect of non-contractibility of a franchisee's exploitation assets on centraliza-

tion in franchise systems is stronger when market uncertainty is higher.

The set of hypotheses can be summarized as shown in Figure 1.

Figure 1: Conceptual Framework



4. EMPIRICAL ANALYSIS

In order to test the proposed hypotheses, we collected primary data from managers of fran-

chisors by a questionnaire survey. Correspondents were key persons who worked in managing relationship with franchisees and committed to contracting with them. In 2011, we mailed all franchisors which appeared in *Franchise Chain in Japan 2006 (Shogyokai)*, including fast food, restaurants, cleaning services, and other sectors. We received 88 questionnaires (11.9% response rate). Of these, 14 were dropped due to incomplete responses. Thus, 74 were usable for the analysis (10.0% usable response rate).

All constructs for the proposed model were based on previous franchise and marketing channel studies (Dewer, Whetten, and Boje, 1980; Lafontaine, 1992; Kubo, 2006; Windsperger and Dant, 2006). “Centralization in franchise systems” refers to the degree to which the franchisor makes decisions and limits the franchisees’ decision-making (Dewer, Whetten, and Boje, 1980). “Non-contractibility of the franchisor’s franchise system-specific know-how” indicates the degree to which the franchisor’s knowledge that is specific to the franchise system is hard to transfer to the franchisees by contract (Windsperger and Dant, 2006). “Non-contractibility of the franchisee’s exploration assets” describes the degree to which the capability of developing new routines cannot be transferred by contract (Windsperger and Dant, 2006). “Non-contractibility of the franchisee’s exploitation assets” means the degree to which the capability for improving existing routines cannot be transferred by contract (Windsperger and Dant, 2006). “Market uncertainty” denotes the degree to which consumer needs are unstable and

change frequently (Kubo, 2006). Those constructs are based on previous research and scales developed in previous research were modified specifically for this paper. As control variables, we added the number of outlets and market uncertainty to our regression model, in order to control the effects of firm size and market uncertainty on the centralization.

Table 1: Results of regression analysis

Dependent variable: Centralization in franchise systems (Cronbach's $\alpha = .82$)				
Independent variables	α	Beta	t	Hypothesis
Non-contractibility of the franchisor's franchise system-specific know-how	.59	.377	4.219***	H ₁ (+)
Non-contractibility of the franchisee's exploration assets	.90	-.328	-2.906***	H ₂ (-)
Non-contractibility of the franchisee's exploitation assets	.83	-.374	-2.894***	H ₃ (-)
Non-contractibility of the franchisee's exploration assets * Market uncertainty	-	.204	1.852*	H ₄ (-)
Non-contractibility of the franchisee's exploitation assets * Market uncertainty	-	-.111	-.882	H ₅ (-)
Market uncertainty	.87	-.221	-2.549**	
Number of outlets	-	-.409	-2.239**	
F			12.480***	
\bar{R}^2			.485	
N			74	

Notes: *** Significant at 1% level, ** Significant at 5% level, and * Significant at 10% level.

Regression analysis was conducted using the principal component scores as the dependent and independent variables. Cronbach's α was calculated for each construct to analyze construct reliability. It suggested that the reliabilities of most constructs were acceptable except franchisor's franchise system-specific know-how (Table 1). Bagozzi and Yi (1988) showed that the α should be greater than 0.60 even in exploratory research. Thus, there may be a problem with the reliability of this construct.

The results of the regression analysis are shown in Table 1. Hypothesis 1 was supported ($\beta = .377$, $t = 4.219$, $p < .01$), as were hypotheses 2 and 3 ($\beta = -.328$, $t = -2.906$, $p < .01$; $\beta = -.374$, $t = -2.894$, $p < .01$). Hypothesis 4 was rejected but was statistically significant because the result had the opposite sign ($\beta = .204$, $t = 1.852$, $p < .10$). Hypothesis 5 was not statistically significant and, thus rejected ($\beta = -.111$, $t = -.882$, $p > .10$). It was found that decision rights in the franchise systems would be centralized when the markets are uncertain and the franchisees have local knowledge.

5. CONCLUSIONS

Understanding the mechanism of allocating decision rights between franchisors and franchisees in franchise systems is an important issue in marketing and distribution research. How-

ever, little consideration has been given to why decision rights are allocated in franchise systems.

Previous studies suggested that non-contractibility of the assets affect allocating decision rights. However, the effect is not constant, but is depending on market uncertainty. This study examines reasons why franchisors try to centralize decision rights , focusing on market uncertainty and finds that it becomes increasingly important for firms to invest to the non-contractible assets when market is uncertain.

We made three findings. First, franchise systems would be centralized when a franchisor's assets are intangible and are impossible to transfer by contract. Second, franchise systems would be decentralized when franchisees' assets are intangible and are impossible to transfer by contract. Third, the negative effects of non-contractibility of a franchisee's exploration assets on centralization in franchise systems are mitigated when market uncertainty is high.

This study has two limitations. First, royalty is not considered. Franchisors may set high royalty in order to give franchisees incentive to invest. Second, franchisors' intangible assets may be classified into several assets, e.g., brand name, operational system's know-how, and information system's know-how.

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