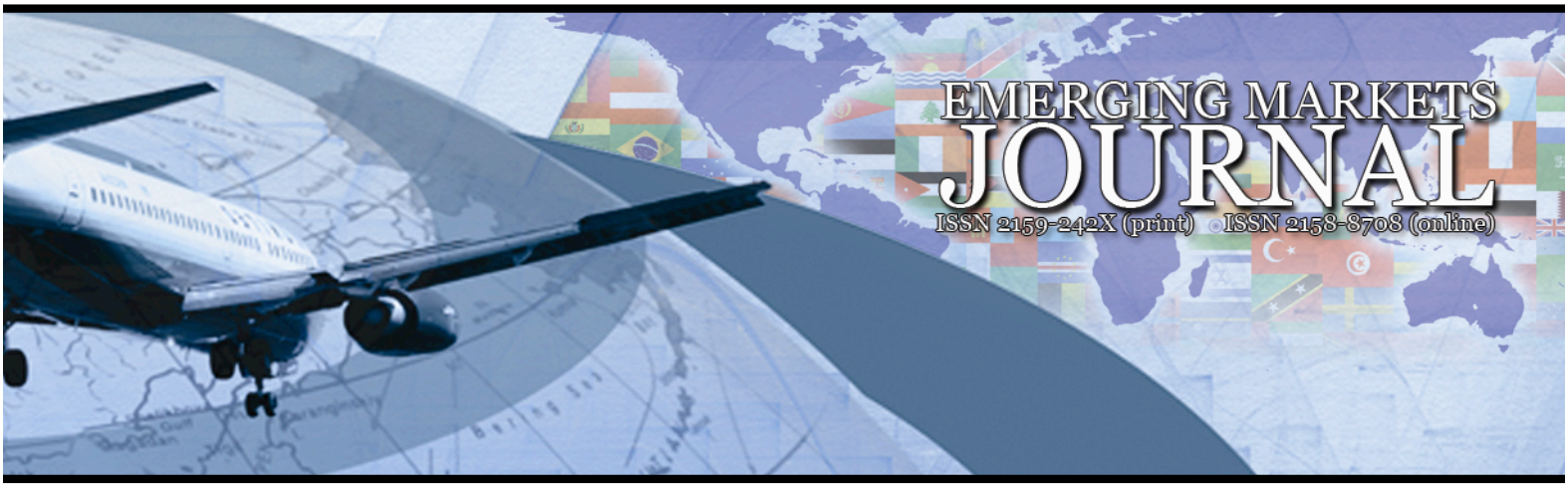

DETERMINANTS OF GROWTH IN FRANCHISING CONTRACTS IN EMERGING MARKETS; EVIDENCES FROM TURKEY

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Abstract

This study aims to examine the franchise sector and determine the significant factors that contribute to an increase in the number of franchiser's contracts in Turkey. Secondary data is used from the Turkish Franchise Association and multivariate regression models are run for each sector. Our models explain the change in the number of franchise contracts with R^{2}'s varying between .6577 and .7549. We provide evidence that success factors in increasing the number of contracts change depending on the sector firms operating in and contracts may be designed thusly to pursue success.

Keywords: human capital, organizational performance, hotel chain

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Determinants Of Growth In Franchising Contracts In Emerging Markets; Evidences From Turkey

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I. Introduction

Emerging markets are developing rapidly in the last decade and firms that aim to be ubiquitous in these markets are utilizing mostly franchise contracts in order to exploit these markets. Contracts may also be a useful tool to look at firms and their inter-organisational relations (Williamson 2003). There are various types of contracts including joint ventures, venture capital, consortiums and franchising contracts. However, in this study, franchise contracts are only examined and the rest of the contracts are out of the scope of this study.

Among the various definitions of a franchise, Stanworth et al (1995), define a franchise as a contractual relationship between a franchisee and a franchisor in which the former agrees to produce or market a product or service in accordance with an overall blueprint devised by a franchisor. Franchising can also be defined as a network of interdependent business relationships that allows a number of people to share a brand, a successful method of doing business and a proven marketing and distribution system. Franchisees are the ones that invest their assets in a system and get a licence in return to utilize the brand name, operating system and on-going support. La Fontaine (1992) states that in a franchisee agreement," the franchisee pays the franchiser for the right to sell the franchiser product and/or the right to use his trademark at a given place for a certain period of time." However, plain descriptions of a franchise contracts doesn't provide information about the details. Some contracts provide wider flexibility to franchisees some don't depending on the situation. Our concern is to investigate the determinants of growth in the number of the franchise contracts of franchise chains in Turkey.

Franchises can be broken down into two categories as traditional franchises and business franchises. Traditional franchises give the right to the franchisee to sell a product or service in a certain location where as, the business format, a high level of monitoring and regulating of the activities of the franchisee exists in return for providing advertising, service methods and delivery models to the franchisee.

Montagu (2002) differentiates stand-alone franchises and fractional franchises as well. Stand-alone franchises are the norm in the West: they exclusively promote the goods and services of the franchisor, for example, in a Pizza Hut restaurant; it is not allowed to sell the products of a competing restaurant. However In a fractional franchise, which is more likely the norm for micro franchises in developing countries, adds a franchised product or service to an existing business, creating additional income for the franchisee and using existing business assets such as shop space (Sireau, 2011).

II. Contractual Completeness

When a franchiser makes a contract with a franchisee; specific and residual rights have to be assigned among the contract partners. Specific rights refer to the decision actions in the ex-ante period where as residual rights refer to the planning of decision procedures to decide on specific actions in the ex post period (Hendrikse and Windsperger 2011). In a complete contract every possible situation is covered comprehensively and all actions are specified. Therefore there is no residual right in that contract. All rights are specific and clearly defined in the contract. The ratio of specific right to residual rights in a contract determines the degree of

contractual completeness. In other words, the higher the ratio, the higher the contractual completeness. Contractual completeness may be a significant factor in franchising contracts and may be investigated in a further study.

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IV. Literature Review

Despite numerous studies regarding with franchise contracts, we fail to find a study that provides evidence for the factors that are effective in increasing the number of franchise contracts of a firm within a sector of a particular market. From this perspective our contribution may be unique and shed light for further researches. Past researches are grouped into three parts:

Franchising

From many different perspectives, researchers have studied franchising contracts; management, law, economy, marketing and finance (Dant and Kaufmann, 2003). Investment capital and the majority of management decisions belong to the franchisees which lead to new store expansions and this is one of the factors that have made franchising a successful business model. Secondly, fixed costs are distributed across the franchisees and economies of scale are reached and finally franchisees have to work hard with a lower level of supervision as they bear their own risks (Montagu, 2002). Corts and Singh (2002) have investigated turnkey and day rate price solutions seen in contracts of 1874 oil drilling projects and found that when the frequency of interactions increases between the parties involved, the likelihood that turnkey solution is been chosen decreases.

Furlotti (2007) have asserted that the contracting problem can be solved via an arrangement of proper set of incentives in franchise contracts. Arrunada, Garicano and Vazquez (2005) have examined 23 franchising contracts in automobile distribution; they asserted that allocation of authority to the car manufacture is positively related with the possibility for dealers to damage brand reputation throw improper behaviour.

Even though numerous studies exist regarding with franchising, we couldn't find any country and/or sector specific study examining the success of franchising chains and its determinants that may affect the demand of the potential franchisees. This study is unique from this aspect and may shed light to further studies.

Completeness of Contracts

Regarding with complete contracts, two explanations exists for the presence of incomplete contracts; one is to reduce transaction cost, even circumstances can be verified, it may be too costly to describe it in a contract (Williamson 1975).

Second explanation claims that the contract may fail to distinguish contingencies or specify some dimension of contractual performance (Bernheim and Whinston 1998). These arguments are for any contract but when the franchising is the case, the second argument is expected to be more relevant. An incomplete contract may be perceived as something negative. However, this may be an outcome of the desires of the parties involved as they want to reduce their transaction costs (Saussier 2000). Earlier Crocker and Reynolds (1993) have have analyzed 45 airplane engine purchasing contracts to prove that degree of contract completeness is endogenous to the relationship and also asserted that the degree of contractual completeness is a reflection of the will to minimize economic costs regarding with contractual exchange which makes it clearer that there is a trade-off between completeness and cost. Moreover, more simple contracts maybe more smart and less costly when there is less danger in the nature of the contract (Joskow, 1987). Hansen and Higgins, 2007, have asserted a direct relationship between contractual complexity and the allocation of the control rates in technology sourcing agreements by using the data of pharmaceutical and biotechnology firms. Luo (2002) asserts that completeness of contracts is cure for motivation and incomplete commitment problems.

Determinants of Complete Contracts

Hendrikse and Windsperger(2002) have examined a database which has 52 franchise systems in Austria. They have used training days, trust, behavioral uncertainty, initial investments, contract design capabilities, environmental uncertainty and intangible system assets to explain completeness and found that behavioral uncertainty, trust and intangible system assets are significantly affecting completeness. Reuer, Arino and Mellewigt (2004) have examined the factors that affect the contractual complexity via sending 257 questionnaires (response rate of 32%), in line with transaction cost theory in the German telecommunication industry. They provide evidence that entrepreneurial firms design more complex contracts the higher the cost of searching for a partner and the higher the strategic importance they assign to the alliance. They have used assets specificity, relational capital, search costs, strategic importance, alliance scope, multiple partners, and the firm being foreign and firm size as independent variables to explain contractual complexity. They show evidence that contractual complexity is driven by the cost of searching for a new partner and the strategic importance of the alliance. For environmental uncertainty which is represented by contract duration, is taken as a fundamental variable in the study of Klein, Crawford and Alchian (1978). Poppo and Zenger (2002) had response from 152 computer executives for their main surveys and they have used 7- point scale, to measure performance, relational governance, contractual complexity, asset specificity, technological change, measurement difficulty, duration of relationship and other control variables to prove that they are the significant determinants of contractual complexity. Their results confirmed that assets specificity, tenure of the directors and magnitude of budget increase the level of contractual complexity

Reuer and Arino (2007) received 91 responses (48 % response rate) to their mail surveys to firms that made alliances according to F&S Countries Index-Europe. In order to explain contractual complexity, they have used assets specificity, prior ties, time bound, strategic importance, firm size, foreign ownership, horizontal alliance and equity as independent variables. They measure contractual complexity as:

$$\text{Contractual Complexity (weighted)} = 1/36 \sum_{i=1.}^{8} Di$$

Where Di equals i if the it provision2 was employed and zero otherwise Parkhe (1993).

Their finding shows that contractual complexity differs from one alliance to another; assets specificity is a significant influencing factor for the complexity of the contract.

1The relationship between complexity and completeness has been discussed briefly in the study of Hendrikse and Windsperger (2002). They claimed that a more complex contract can be bought more or less complete; they are negatively related when the use of assets is costly and hard to specify in a contract, positively related when the use of assets can be specified.

Parkhe developed a series of indicators of contractual provisions that are namely; Periodic written reports of all relevant transactions; Prompt written notice of any departures from the agreement; The right to examine and audit all relevant records; designation of certain information as proprietary and subject to the confidentiality provisions of the contract; non-use of priority information; arbitration clauses and law suit provisions (Reuer and Arino 2007).

V. Data and Methodology

This study has used secondary data from the dataset of Turkish Franchise Association (UFRAD) as it is less time consuming and easier to obtain. There are 126 firms that are members of UFRAD as of 17 January 2012. However, we have eliminated the brand new chains that have just started operating and the ones with inadequate information and have reduced our sample to 106 which is categorized into three groups; namely, food with 53 firms, service with 33 firms and store with 18 firms. Quantitative data such as the initial fees, average working capital, contribution for advertising, continuous franchising fee, number of employees within parent company, number of employees within franchise system, age of franchising and age of the parent company have been obtained from the databases of Turkish Franchise Association.

Multi regression analyses are run for the clusters generated from the database. Three main firm sets are formed depending on their type of businesses they are running; these business types are namely; food, service and store. Three regressions are as follows:

(1) $NOF_{FOOD} = ß_0 + ß_1IF + ß_2SC + ß_3AC + ß_4ORF + ß_5AF + ß_6AP + ß_7EF + ß_8COS + ß_9EC + e$

(2) $NOF_{SERVICE} = ß_0 + ß_1IF + ß_2SC + ß_3AC + ß_4ORF + ß_5AF + ß_6AP + ß_7EF + ß_8COS + ß_9EC + e$

(3) $NOF_{STORE} = ß_0 + ß_1IF + ß_2SC + ß_3AC + ß_4ORF + ß_5AF + ß_6AP + ß_7EF + ß_8COS + ß_9EC + e$

Number of franchise contracts (NOF) is our dependent variable. Initial fee (IF), required start up capital (SC), advertising contribution (AC), on-going royalty fee (ORF), age of franchising (AF), age of parent company (AP), number of employees in franchises (EF), company owned stores (COS) and number of employees in the centre (EC) are the independent variables that are examined to be effective in explaining the change in the number of franchising contracts in each sector. By intuition, the last two independent factors are expected not to be highly significant but still worth to examine as trust may be embedded in these two factors.

VI. Findings

Multivariate regression for equation 1 is run (appendix 2) and after controlling for multicollinearity, an R^2 of 0.6577 is attained. Significant factors affecting the number of franchise contracts are as follows: company owned stores with a -2.99 t-statistics, 99 % significant; age of franchising with a 1.92 t-statistics, 95 % significant;

initial start-up cost with a -1.79 t-statistics, 95 % significant; advertising contribution with a 2.57 t-statistics, 95 % significant; number of employees in the center with a 1.81 t-statistics, 95 % significant; most significant factor, number of employees in franchises with a 4.67 t-statistics, 99 % significant. Turkey is an emerging market where labor costs are relatively low and in food sector, profit per employee may be higher than developed countries whereas, initial fee is interestingly, an insignificant factor in food business. Age of franchising is also valued and this may be related to the trust attributed to the franchiser. Investors value franchisers that invest in advertising but refrain from the ones that heavily invest on their own.

Multivariate regression for equation 3 is run (appendix 6) and after controlling for multicollinearity, an R^2 of 0.7549 is attained. Significant factors affecting the number of franchise contracts are as follows: initial fee with a -2,45 t-statistics, 95 % significant; initial start-up cost with a 2.19 t-statistics, 95 % significant; number of employees in the center with a 2.19 t-statistics, 95 % significant. Despite the lower number of observations, our findings indicate that franchise contracts of stores only give importance to initial fee as investors may value relatively higher initial fees as a waste of resources.

VII. Conclusion

Turkish Franchise Sector may well be a representative for emerging markets where labor is cheaper and population is higher and this study provides evidence for the factors affecting the growth in franchising. Investors of food sector, service sector and stores have differing demands from franchisers and our inference is that this is partly due to the cost structure and presence of available financing in Turkish market. Franchisers that wish to expand their businesses via franchise contracts may be advised to offer their franchisees differing contracts depending on the sector they are operating and to be successful, they may design their contracts by taking our significant factors into consideration.

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IX. APPENDIXES

Appendix: 1

Variable	Obs	Mean	Std. Dev.	Min	Max
AP	53	18.60377	21.43536	0	89
AF	53	5.169811	4.846632	0	22
COS	53	16.79245	46.39353	0	326
NOF	53	25.30189	35.65626	0	160
IF	53	52601.4	66506.14	0	467500
SC	53	220930.7	230218.1	0	1103300
AC	53	.0177358	.0175018	0	.06
ORF	53	.0349057	.0254666	0	.08
EC	53	50.77358	67.06617	0	300
EF	53	508.7547	1086.557	0	7358

Appendix: 2

Equation	Obs	Parms	RMSE	"R-sq"	F	P
NOF	53	10	22.93916	0.6577	9.181961	0.0000

	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
NOF						
COS	-.6428045	.2148167	-2.99	0.005	-1.076024	-.2095854
ORF	-143.0251	169.078	-0.85	0.402	-484.0034	197.9533
AP	-.2060216	.1809796	-1.14	0.261	-.5710017	.1589585
AF	1.454681	.7582385	1.92	0.062	-.0744529	2.983814
IF	-.0000483	.0000515	-0.94	0.353	-.0001521	.0000555
SC	-.0000426	.0000238	-1.79	0.081	-.0000906	5.49e-06
AC	587.0077	228.1713	2.57	0.014	126.8565	1047.159
EC	.1072043	.0593441	1.81	0.078	-.0124746	.2268831
EF	.0421998	.0090313	4.67	0.000	.0239865	.0604131
cons	12.01984	7.498242	1.60	0.116	-3.101803	27.14149

Appendix: 3

Variable	Obs	Mean	Std. Dev.	Min	Max
AP	33	14.54545	12.15291	2	53
AF	33	4.848485	3.914087	0	15
COS	33	6.727273	16.86207	0	95
NOF	33	47.63636	85.34189	0	343
IF	33	20375.39	20208.8	0	100000
SC	33	73682.58	116837	0	650000
AC	33	.0115152	.0182211	0	.06
ORF	33	.0293939	.0291483	0	.1
EC	33	19.42424	19.86365	0	80
EF	33	212.9394	356.8096	0	1700

Appendix: 4

Equation	Obs	Parms	RMSE	"R-sq"	F	P
NOF	33	10	56.04813	0.6900	5.687908	0.0004

	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
NOF						
AP	-.5655523	1.339718	-0.42	0.677	-3.33697	2.205865
AF	-3.350069	3.407774	-0.98	0.336	-10.39959	3.699448
COS	-.0370718	.6411137	-0.06	0.954	-1.363317	1.289173
IF	-.0006669	.0005751	-1.16	0.258	-.0018566	.0005228
SC	-.000042	.0001233	-0.34	0.736	-.000297	.000213
AC	-265.6371	581.0681	-0.46	0.652	-1467.668	936.3939
ORF	325.7342	446.916	0.73	0.473	-598.7819	1250.25
EC	.180422	.5491409	0.33	0.745	-.9555625	1.316407
EF	.2038621	.032219	6.33	0.000	.137212	.2705121
cons	35.60958	22.55452	1.58	0.128	-11.04799	82.26716

Appendix: 5

Variable	Obs	Mean	Std. Dev.	Min	Max
AP	18	19.77778	14.775	2	61
AF	18	7.722222	12.05285	1	50
COS	18	15.94444	19.80633	0	63
NOF	18	28.33333	65.98752	0	284
IF	18	32012.5	56572.17	0	187000
SC	18	205360.1	236373.9	20000	1066666
AC	18	.0088889	.0145072	0	.05
ORF	18	.0105556	.0248459	0	.08
EC	18	58.94444	77.09999	0	300
EF	18	423.8333	870.9067	1	3600