

## **The Relationship Quality in Franchise Networks: Is it important to performance?**

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### **Abstract**

The concept of relationship quality evolved from relational marketing theory, and provided the impetus for a paradigm shift from transactional relationships to more cooperative and service-centred relationships in business-to-business processes. In the marketing literature, relationship quality has been considered a key component in relationship marketing and business-to-business relationship exchange such as buyer-seller, exporter-importer and franchisor-franchisee. In franchising, the key to a successful franchise system is dependent on the effectiveness of franchise relationship management where both parties are characterized by mutual interdependence and cooperation. Despite the importance of this topic in franchising, very little is known about how to develop effective franchisor-franchisee RQ and how it impact performance/loyalty. Therefore, this paper investigates relationship quality in franchise networks towards the firms' performance and loyalty from a franchisee's perspective. It also discusses three elements of the franchisor-franchisee relationship quality namely: trust, commitment and satisfaction. The paper examines the interactions of relationship quality towards a firm's performance and loyalty in the franchise network.

**Keywords:** Relationship quality, franchising, franchisee, franchisor, firm performance and loyalty.

### **1. Introduction**

Franchising has become an extremely popular trend in most countries in the world when a company wishes to expand their business operations in either domestic or international markets (Sydow, 1998). Franchising has been the leading edge of business since 1950, shown by the impressive growth rate in sales and market share. In the global economic down turn, franchising can still survive by decreasing operations costs and being able to increase of unit sales and take a leading position in the economy recovery (Justis & Judd, 2003). Franchising can be explained as a contractual agreement between two parties (franchisor and franchisee) in which the franchisee pays the franchisor for the right to sell products or services and/or the right to use trademarks and business formats in a given location for a specified period of time (Blair & Lafontaine, 2005).

Franchising has become the dominant force in the distribution of goods and services in the United States and in many other parts of the world (Khan, 1999). In the USA, there are approximately 700,000 franchised businesses producing approximately one US\$1 trillion in annual sales and approximately 17 percent of the country's Gross Domestic Product (Justis & Judd, 2003). According to *The Economic Impact of Franchised Business Report* conducted by PricewaterhouseCoopers (PWC), franchising industries contributed US\$2.3 trillion towards the US economy which provided approximately 11 million direct employments and over 11 percent of the nation's private sector economy (IFA, 2005). This study also highlighted that franchising industries in the US expanded by 18 percent from 2001 to 2005, adding more than 140,000 newly established franchise businesses and creating more than 1.2 million new jobs. In the UK, the franchise business system increased from 170 in 1984 to 677 in 2002, accounting for US\$1.4 billion to US\$15.2 billion (NatWest, 2000). In Malaysia, the franchise industry contributed RM 21.48 billion or 2.5 percent to the Malaysian Gross Domestic Product (GDP) in 2012 and is expected to continue to contribute RM23.6 billion in 2013 (Times, 2013). The franchise industry is expected to contribute 4.3 percent in 2016 and 9.4 percent in 2020 as aligned with the Malaysian vision of becoming a high income country by 2020 (Raja Adam, 2012). Therefore, franchising businesses have contributed greatly in the creation of employment and continue to be a significant force in a country's economy.

The contributions of franchising in countries' economy have raised the issue of the effectiveness of franchise systems in cultivating entrepreneurship compared with traditional methods. Initially, most studies in franchising tended to focus more on motivations for franchising as an organizational form (Watson & Johnson, 2009; Watson, Stanworth, Healeas, Purdy, & Stanworth, 2005). In addition, the

issue of performance in franchising was not a main agenda item and remained under-explored (Barros & Perrigot, 2007; Watson et al., 2005). In addition, Verbieren, Cools & Van den Abbeele, (2008) argue there is a lack of franchising studies focusing on the franchisee as compared to the franchisor view. Furthermore, little research has investigated the success factor for franchise relationships (McDonnell, Beatson, & Chih-Hsuan, 2011; Watson & Johnson, 2009). For that reason, understanding franchising relationship management from the franchisee perspective is considered an important gap in franchise research and is the research agenda for this paper.

In a franchising business, the franchisor-franchisee relationship quality (RQ) is considered an important indicator in successful cooperation over the long term between both parties (Monroy & Alzola, 2005). This franchisor-franchisee RQ is very complex and requires complex delineation and integration of individual roles on both sides. This complexity can potentially lead to hazards and conflicts between both parties. Without proper control and monitoring, conflicts between them are unavoidable. Studies on franchisee-franchisor relationships from the franchise contract is very important (Rodríguez, Pere, & Gutierrez, 2005). Peterson and Dant (1990) claim a lack of research on franchisee motivations for entering into the relationship. Monroy and Alzola (2005) stress that it is important to develop a scale for measuring the quality of the franchisor-franchisee relationship in order to assess the strength of those dyadic relationships and to explain not only the behavior of the network partners but also the franchise performance.

This paper is structured as follows. It addresses the RQ constructs and the performance dimensions in franchising relationships. This then entails the issues of “what are the dimensions used in operationalizing the concept and main outcomes in franchising perceptives?” Secondly, we will discuss “What are the effects of RQ towards performance?” Thus, we will explore the dimension representing RQ and its outcomes. Lastly, our paper will highlight the most important dimension of RQ in influencing franchise performance in franchise networks “How do RQ dimensions in franchising differ from other business models?” Therefore, this paper will address the factors contributing to a successful long-term franchising relationship.

## **2. Research model and hypotheses**

Relationship quality (RQ) has become an important issue in maintaining continuity of any partnership business, especially in franchising. In franchising businesses the relationship quality between franchisor-franchisee is important and crucial for long term business success (Evanschitzky, Backhaus, Woisetschläger, & Hartleb, 2009). Research in relationship quality has shown that companies are putting more effort into developing long-term relationships with their stakeholders such as customers, suppliers, strategic partnerships, employees and competitors. This indicates the importance of quality relationships in business-to-business relationship contexts, especially for franchising businesses.

The RQ concept is embedded in the field of relational marketing (RM) (Dwyer and Oh 1987; Crosby, Evans et al. 1990). RM is often referred to as a new paradigm in the marketing discipline, which had previously focused on marketing mix variables such as product, price, promotion and distribution (Brodie, Coviello et al. 1997). The key aspects of RM are important not only in gaining customers and creating transactions but also in maintaining and ensuring continual relationships (Grönroos 1996). Most papers related to RQ found in the marketing channels (e.g. Dorsh et al., 1998; Kumar et al., 1995) and sales literature (Crosby et al., 1990, Bejou et al., 1996) have measured the RQ between manufacturers-sellers and salespersons-customers. Nevertheless, the lack of focus regarding RQ in franchising literature has motivated us to better understand RQ in franchisor-franchisee relationships in determining positive outcomes for the companies.

Many studies related to RQ (e.g. Crosby et al., 1990; Morgan et al., 1994; Ganesan, 1994; Kumar et al., 1995; Doney & Cannon, 1997; Bordonaba-Juste & Polo-Redondo, 2008; Fynes et al., 2008; Wong et al., 2008; Liu et al., 2009) employ different dimensions in various research contexts and business

settings. Nevertheless, researchers agree that the concept of RQ is a higher order construct that consists of several distinct but related dimensions (Rauyruen and Miller 2007; Skarmeas and Robson 2008). Previous research of RQ has used different dimensions, the variables of trust, commitment and satisfaction are the most frequently studied (Dwyer and Oh 1987; Moorman, Zaltman et al. 1992; Rauyruen and Miller 2007). Furthermore, Ishak & Jantan (2010) also found, in their meta-analysis, that the most cited studies in RQ are identified as trust, commitment and satisfaction. Based on the above justification, we are adopting trust, commitment and satisfaction as key dimensions of relationship quality within the franchising dyadic relationship.

The literature identified trust, commitment and satisfaction as relevant dimension of RQ. Moorman et al. (1992) define trust as “a willingness to rely on an exchange partner in whom one has confidence”, while Anderson and Narus (1990) define trust as “the firm’s belief that another company will perform actions that will result in positive outcomes for the firm, as well as not to take unexpected actions that would result in negative outcomes for the firm.” Commitment refers to the franchisee complying with the terms and conditions that legalize the franchise contract and other agreements (Williamson, 1993). Geyskens, Steenkamp and Kumar (1999) define relationship satisfaction as “a positive affective state resulting from the appraisal of all aspects of firm’s working relationship with another firm”. Satisfaction plays an important role in the relationship, leading to fewer terminations of relationships (Ganesan, 1994). Moreover, Dwyer and Oh (1987) suggest that satisfaction is a significant criterion for evaluating channel relationships.

In this study, the main outcomes for RQ are identified as business performance and franchisee loyalty. These outcomes are aligned with Ishak & Jantan's (2010) study who found relationship performance and relational benefits (loyalty) are most important outcomes for RQ in business-to-business. Furthermore, Athanassopoulou (2009) reports that the main consequences for RQ in business-to-business are efficiency and performance variables. Business performance is considered to be a main objective of any organizational establishment. Furthermore, business performance is a major issue in marketing research (Ambler & Kokkinaki, 1997; Toole & Donaldson, 2000). As recommended by O’Toole and Donaldson (2002), this study will use relationship performance consisting of the financial and non-financial dimension. Moreover, many studies now focus on mixed financial and non-financial performance measurements (Fynes, et al., 2004; Henri, 2006; Perera, Harrison, & Poole, 1997).

The empirical research related to RQ and performance is found in most studies in the business-to-business perspective. Fynes et al. (2008) find that RQ has a positive effect towards firm performance in electronics companies’ supply chain systems. Nyaga and Whipple (2011) also find RQ positively affects supply chain operational performance and satisfaction with strategic performance for both supplier and buyers. They conclude that higher levels of RQ (buyers and suppliers) lead to greater levels of operational and strategic performance. In export markets, Ural, (2009) examines RQ with financial export performance and strategic export performance and finds that long term orientation and relationship satisfaction (constructs of RQ) are positively associated with financial and strategic export performance. Dickey, McKnight and George (2007) suggest that satisfaction with franchisors will positively affect franchise performance; and empirical findings by Morrison (1997) notes that satisfied franchisees are likely to be more profitable than dissatisfied franchisees. This leads to the following hypotheses:

H1: RQ is positively related to financial performance.

H2: RQ is positively related to relational financial performance.

The concept of customer loyalty is frequently seen as an expected outcome of relationship marketing activities (Palmatier, Dant, Grewal, & Evans, 2006). Moreover, loyalty marketing is used interchangeably with relationship marketing (Egan, 2008). The loyalty concept has become an important factor in sustaining a firm’s competitive advantage (Dick & Basu, 1994). The importance of

loyalty in business-to-business is supported by researchers who use several constructs that reflect the key aspect of retention (loyalty) in long-term relationships such as relationship continuity, long-term orientation, repurchase intention, intention to continue, commitment, attitudinal loyalty and loyalty intention (Bordonaba-Juste & Polo-Redondo, 2008; Crosby, Evans, & Cowles, 1990; Dwyer, Schurr, & Oh, 1987; Ganesan, 1994; Palmatier, Dant, Grewal, & Evans, 2006; Selnes, 1998). In franchising, Chiou, Hsieh, & Yang (2004) found that the high level trust of franchisees will increase their intention to stay in the franchise system. Furthermore, the recent study by McDonnell et al., (2011) found that RQ has a direct and positive effect on franchisee loyalty to stay in the franchise system. This leads to the following hypotheses:

H3: RQ is positively related to loyalty.

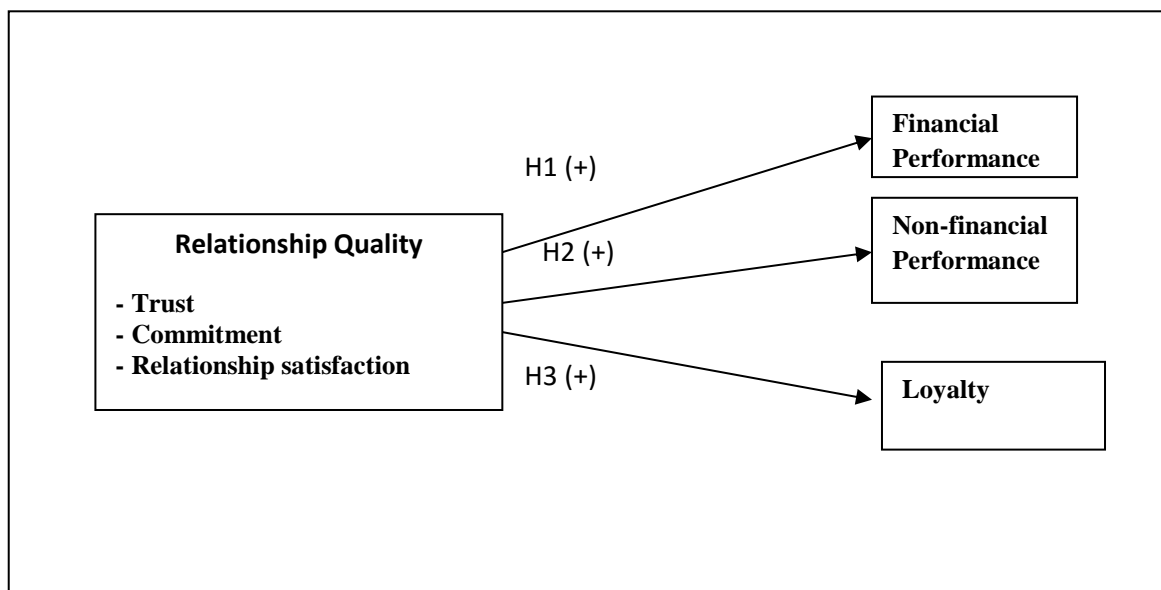


Figure 1: Research Model

### 3. Methodology

This study focuses on the Malaysian franchise system and will exclude foreign franchise businesses from the research sampling. The rationale for excluding foreign franchise businesses is because of the bureaucratic procedures to be accomplished where the authorization of information must be made and agreed upon by overseas headquarters offices. The approval process for this procedure is time consuming and can delay the data collection process. In the Malaysian franchise system, the franchisee is obligated under Section 26 (Confidential Information) not to disclose any information related to operations procedures during the franchise term. Thus, permission shall be granted by the franchisor before the franchisee can participate in this survey.

This study is based on a quantitative approach, applying a cross-sectional study. Thirteen franchisors were willing to participate in a survey. Based on the 13 franchisors, a sampling frame was developed which identified only 484 franchisees are actively operating in the franchise system. A total of 400 questionnaires were distributed and 133 questionnaires were successfully returned. Of the 133, five sets of questionnaires were identified as unusable resulting in 128 usable questionnaires for data analysis. Five questionnaires were categorized as unusable where the respondents had not completely answered the questionnaire. The usable response rate was 32 percent comprising 128 usable responses from a total of 400 questionnaires sent to franchisees.

The research instrument questionnaire was developed specifically for the purpose of the study. The questionnaire consists of three main sections, namely: Section 1 detailing the franchisee's background data; Section 2 to measure the franchisee's relationship quality; and Section 3 to measure franchisees' financial, non-financial performance and loyalty. The dimensions of trust consist of credibility and benevolence. Trust was operationalized through six items adapted from Ganesan (1994), Kumar, Scheer, & Steenkamp (1995), Morgan & Hunt (1994) and Ruiz-Molina, Gil-Saura, & Moliner-Velázquez (2010) which describe the franchisees' beliefs towards their franchisor's credibility and benevolence in the franchise relationship. The commitment was measured by seven items adapted from Cater & Cater (2010), Gounaris (2005) and Sharma, Young and Wilkinson (2006) to measure the franchisor's affective and calculative commitment from the franchisee's view. Finally, relationship satisfaction was measured with three items adapted from Sanzo et al., (2003), Geysken and Steenkamp (2000) and Rajaobelina and Bergeron (2009). The non-financial performance measure comprises of 10 items which incorporate Kaplan and Norton's (1992) dimension of the balanced scorecard such as customer perspective, an internal business processes perspective and learning and growth perspectives. The financial performance dimensions were conceptualized by using four items: net margin, sales growth rate, returns on investment (ROI) and return on assets (ROA). The use of ROA, ROI and sales growth show an important aspect in performance measurement (K. Kumar, Subramanian, & Yauger, 1998). Franchisee loyalty was measured by two items each for behavioral and attitudinal loyalty. Four items of franchisee loyalty were adapted from Gilliland and Bello (2002). Most questions in Section 2 and 3 are mainly in a 5-point Likert Scale, while category and dichotomous scale was used widely in Section 1. All studied items were identified as reflective measurements.

#### **4. Results and Findings**

The measurement and structural model were tested by using structural equation modelling. The study uses SmartPLS software version 2.0 M3 in order to evaluate the validation of measurement scales and to test all hypotheses proposed. PLS is used when ordinary assumptions such as multivariate normality and large sample size are not met. PLS is a statistical tool specifically designed to cope with small datasets, missing values and the presence of multi-collinearity often exists in samples used in marketing research (Graber, Czellar, & Denis, 2002)..

In order to proceed with SEM-PLS, there are two stages for performing SEM which consist of a measurement model and structural model (Anderson & Gerbing, 1988; Hair, Ringle, & Sarstedt, 2011). Firstly, the measurement model is evaluated by checking the reliability and validity of each measure used in the framework model. The composite reliability and internal consistency reliability (Cronbach's alpha) are evaluated to ensure each value follows the recommended evaluations. The cut-off value for composite reliability and internal consistency reliability (Cronbach's alpha) is 0.7 (Bagozzi & Yi, 1988; Gefen, Straub, & Boudreau, 2000; Nunnally & Berstein, 1994). After all measurement of all constructs have adequate reliability and validity assessment, all the measurement items are kept for testing the structure model.

Table 1: Results of measurement model

Constructs	Items	Loading	Cronbach's Alpha	CR <sup>a</sup>	AVE <sup>b</sup>
RQ	TT01	0.802	0.957	0.962	0.662
	TT02	0.840			
	TT03	0.806			
	TT04	0.742			
	TT05	0.764			
	CMT1	0.795			
	CMT2	0.802			
	CMT3	0.861			
	CMT4	0.852			
	CMT7	0.748			
	SS01	0.880			
	SS02	0.799			
	SS03	0.873			
Financial Performance	FP1	0.880	0.913	0.939	0.793
	FP2	0.849			
	FP3	0.931			
	FP4	0.901			
Non-financial Performance	RP13	0.713	0.905	0.924	0.602
	RP14	0.719			
	RP15	0.800			
	RP16	0.773			
	RP17	0.743			
	RP18	0.807			
	RP19	0.802			
	RP20	0.842			
Loyalty	LY1	0.832	0.908	0.936	0.784
	LY2	0.916			
	LY3	0.883			
	LY4	0.909			

<sup>a</sup> Composite reliability (CR) = (square of the summation of the factor loadings)/{(square of the summation of the factor loadings) + (square of the summation of the error variances)}

<sup>b</sup> Average variance extracted (AVE) = (summation of the square of the factor loadings)/{(summation of the square of the factor loadings) + (summation of the error variances)}

The result of measurement structure is presented in Table 1. The composite reliability values for all the constructs as tabulated in Table 1 are greater than 0.70 and Cronbach's alpha is greater than 0.90. The results of Cronbach's alpha and composite reliability demonstrate that all constructs have adequate reliability assessment scores. In addition, the result for all measurement items loading are above the recommended value of 0.70, indicating that at least 50 percent of the variance in the observed variable is explained by the constructs. The AVE of all latent constructs ranges from 0.602 to 0.784, which exceeds the recommended level of 0.50 (Hair, Black, Babin, Anderson, & Tatham, 2006). For discriminant validity, the square roots of AVE for each construct as presented in Table 2 are less than the AVE latent variables. In conclusion, the measurement model demonstrates adequate convergent validity and discriminant validity.

Table 2 : Discriminant validity of constructs

Constructs	1	2	3	4
1. FP	<b>0.891</b>			
2. Loyalty	0.345	<b>0.886</b>		
3. NFP	0.200	0.569	<b>0.776</b>	
4. RQ	0.406	0.756	0.611	<b>0.814</b>

Diagonals (in bold) represent the average variance extracted while the other entries represent the squared correlations

Next, the SmartPLS was used to run the hypotheses testing. For hypothesis testing, the path analysis was used to verify all hypotheses generated in this study., the PLS software generates estimates of standardized regression coefficients which refer to beta values for model path (Hammedi, Riel, & Sasovova, 2011). PLS uses re-sampling procedures known as nonparametric bootstrapping to evaluate the significance of the parameter estimates (Henseler, Ringle, & Sinkovics, 2009). In this study, the researcher uses 500 resampling procedures for bootstrapping as aligned with previous studies in the business-to-business context (Bin, 2009; Goo & Na, 2007; Völckner, Sattler, Hennig-Thurau, & Ringle, 2010).

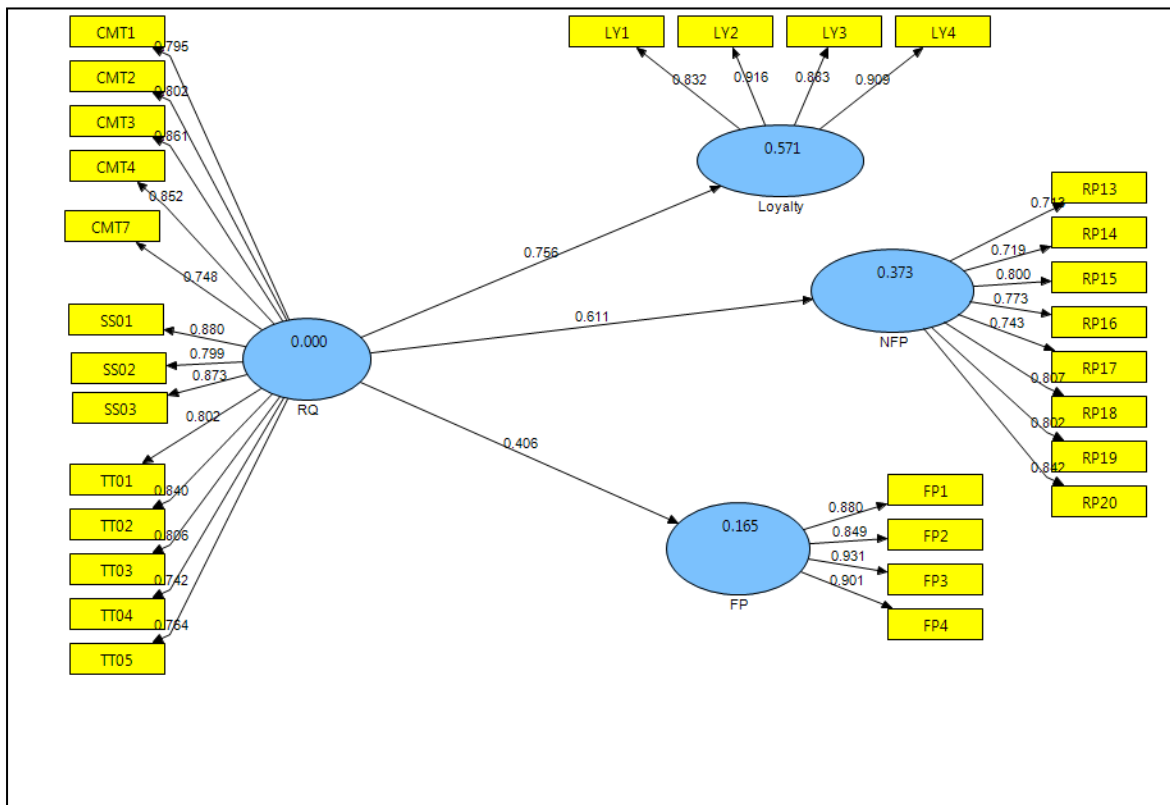


Figure 2 : Results of the path analysis.

Table 3 : Path Coefficient and hypotheses testing

Hypotheses	Relationship	Path Coefficient	T value	p -value	Result
H1	RQ -> FP	0.406	5.711	0.000	Supported
H2	RQ -> NFP	0.611	13.503	0.000	Supported
H3	RQ -> Loyalty	0.756	19.016	0.000	Supported

The results of the model estimation including standardized path coefficient, one-tailed significance of the paths and the amount of variance captured are presented in Figure 2. Based on Table 3, the results of hypothesis testing show that all hypotheses are supported at a minimum of  $p < .001$ . RQ is positively related to financial performance, non-financial performance and loyalty. Therefore, all hypotheses in this study - H1, H2 and H3 - are accepted. The results show RQ predicting approximately 57 percent of the variance for franchisee loyalty, 37 percent of the non-financial performance variance and 17 percent of variance of the financial performance variance.

## **5. Discussion and Conclusion**

Our study highlights the importance of RQ in influencing franchisee performance and loyalty in franchise systems from a Malaysian perspective. The results show RQ has a significantly positive effect towards financial performance, non-financial performance and loyalty in this study. Furthermore, three dimensions of RQ namely: trust, commitment and satisfaction, used in this study, have become important indicators in franchise relationships similar to numerous studies in a business-to-business context (Caceres & Paparoidamis, 2007; Palmatier, Scheer, Houston, Evans, & Gopalakrishna, 2007; Simpson & Mayo, 1997; Skarmeas & Robson, 2008; Smith, 1998a, 1998b; Walter, Muller, Helfert, & Ritter, 2003).

From a franchising context, the RQ elements such as trust and commitment are considered as complementary for franchise contracts to overcome the issues of non-compliance and opportunism behaviour raised in franchise relationships such as free riding and non-compliance with systems standards (Dickey, McKnight, & George, 2007). The existence of trust in franchise relationships will reduce transaction costs (monitoring costs) and lead to higher commitment in the franchise relationship. Trust is built in franchise relationships through the experiential interaction and communication between franchisor-franchisee (Dickey et al., 2007), whereas building and retaining trust is important to a successful franchise relationship (Modell, 2010). In addition, Ganesan (1994) argues that trust in retailer relationships is positively affected to the retailer's joint outcomes such as profits, sales growth and return on investment in the long term. Furthermore, a recent study by Liu, Luo, & Liu (2009) highlights that the relational mechanisms such as trust and norms are more effective in enhancing relationship performance compared with transactional mechanisms. In addition, our findings are also consistent with Skarmeas, Katsikeas & Schlegelmilch (2002) who found that commitment has a strong positive effect towards performance; and Morrison (1997) who identifies that franchisee satisfaction is positively affected towards franchisee performance and intention to remain in the franchise system. Therefore, high levels of RQ lead to trust, commitment and satisfaction, thereby influencing franchisee performance and loyalty.



In conclusion, RQ in the context of the franchisee perspective consists of trust, commitment and satisfaction as important contributors in determining the franchisee's performance and loyalty to stay in the franchise system. The development of RQ in a franchisor-franchisee relationship is critical in predicting important relational outcomes such as performance and loyalty. As it is inter-organizational dependency in the franchise system, one firm's success will depend on the other, achieving high RQ will result in the high performance of both parties for a long term business relationship.

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