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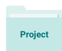
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Searching for a Dynamic View of Franchising

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Abstract

This paper suggests a new perspective of franchising networks. We start from the limitations of what we have called the traditional management literature about franchising and look at the current research about franchising and the recent advances in the Economics of the Organisation, in order to propose a Capabilities View of Franchising Networks.

From this perspective, we suggest that the emergence of franchising networks may be seen as a kind of dynamic arrangements, which seek to combine the franchisor's and franchisee's partly idiosyncratic capabilities. Franchisees are seen as heterogeneous as they can and often hold different knowledge and experiences. Hence, they may be an important source of dynamic capabilities for the franchising network. Thus, in contrast to traditional approaches, a Capabilities Approach emphasises the processes of creating, transmitting and coordinating productive knowledge. Analysing franchising from this perspective may also help us to understand the plural form by linking their existence and dynamics to previous experiences and commitments with a particular system, including the investments made in inter-firm relationships and the need to preserve a degree of variety within the franchise network.

Keywords

Franchising, business networks, firm capabilities.

Introduction

Franchise arrangements and contracts are a very broad research field. Elango and Fried (1997) identified three main streams of research. In the first stream, these authors included the work published in the *Economic and Law literature*. These studies concern the analysis of cost-benefit of franchising contracts for society, and they discuss whether these should be legally allowed. Typically, in a franchise contract, the franchisee is bounded to buy its inputs from suppliers chosen by the franchisor. And, most often, the 'chosen supplier' is the franchisor himself. This constrain is justified by the need to maintain the uniformity of the quality and image of the brand or concept being franchised. Moreover, it allows both franchisor and franchisees to benefit from scale economies that, otherwise, might not exist. A second stream purposed by Elango and Fried (*op. cit.*) concerns the *Management literature* about these contracts, which tries to justify the emergence of franchise contracts, both at business and unit level, as well as to explain the contract terms, namely the franchise fee and the royalty rate. Two different perspectives propose an answer to these questions (Lafontaine and Kaufmann, 1994). On the one hand, the Resource-Based View emphasises the importance of franchise contracts as a mean to overcome resource constrains to growth. On the other hand, the Agency Perspective argues that these contracts are a result of moral hazard and incentive issues. Finally, the third stream relates to the *Marketing literature* that sees franchising as another distribution channel, and seeks to determine that best way to operate that system. The focus is often on identifying the best ways to control the franchisee, since this will allow the franchisor to reach its objectives.

This paper follows the Management stream of literature. It also establishes some connections to another flourishing branch on the literature which tries to break grounds from what we might call the traditional theories about franchising. However, in spite of the growing emphasis on the learning processes within franchising networks, this new literature

has not devoted the deserved attention to the emergence of franchising and the existence of the plural form. In the first part of this paper, we present a critical revision of the traditional literature about franchising. In the second part, we shortly review the new work that is presently being done. Finally, we propose a new perspective based on the Capabilities View of the Firm which may be useful to broaden our knowledge about franchising networks.

A Critical Overview of Traditional Franchising Theories

Three main questions have been debated in the traditional literature about franchising. First, the grounds for its emergence. Second, the reasons underlying the choice between keeping company-owned units and franchising them. And, finally, the determinants of the terms of the franchise contract. We will focus on the first two. Although there seems to be some consensus around the explanation advanced by the Agency Theory, there seem to remain some open issues. According to Norton (2003, p.1), "scholars of franchising have made remarkable progress in the past few decades in understanding franchising", namely the existence of franchising and its grounds, the decision between company-owned and franchised units, the contract terms (*e.g.* franchise fees and royalty rates), the nature of termination procedures and the role of capital structure. However, Norton (2003) agrees that, in spite of these advances, there still remain a number of important unexplained issues. In fact, several limitations of these theories can be identified.

The first one is related with the emergence of franchising itself. According to the Resource-Based View, in order to protect a newly developed concept or brand name, a company must grow fast. But it may face some sort of resource constraint that prevents its fast growth. This problem is especially prevalent in immature companies, which end up adhering to franchising as a way to overcome those restrictions (Caves and Murphy, 1976).

On the other hand, the Agency Perspective assumes that the franchisor-company possesses a well known, recognised brand name. In many cases, these companies have serious problems controlling the agents' actions that might damage their brand names. In short, the franchise contracts reduce agency costs by solving some incentive issues (Rubin, 1978, Brinkley and Dark, 1987). However, anecdotal evidence supports neither of these explanations. The franchise contracts are not exclusively used by small, resource-limited companies (Brickley *et al*., 1991; Lafontaine, 1992). Some mature, even public companies, like for instance McDonald's, intensively use franchising (Love, 1986). On the other hand, franchising is also adopted by star-up/ entrepreneurial firms which do not yet have a strong brand (Carney and Gedajlovic, 1991; Marnoto, 2000). More recently, some authors have tried to reconcile both theories. In the beginning of their life cycles, firms tend to use franchising as a mean to overcome some sort of resource constraint, and, later in their lives, they adopt franchising due to agency concerns (Martin and Justis, 1993). However, by neglecting the production costs, both these theories and the conciliated perpective implicitly assume that what a company may manufacture, another one can produce just as well (Demsetz, 1988). But the costs of production are not the only ones to be overlooked. Also the costs of generating, diffusing and coordinating productive knowledge have all been neglected by the franchising traditional literature.

The question of the franchising life cycle is not at all new. Indeed, one of the basic assumptions of the Resource-Based View of franchising is the existence of a tendency towards the vertical integration of the former franchised units. As the company matures, it becomes easier to acquire the resources it needs to expand and, therefore, the franchisors buy back the previously franchised units (Oxenfeldt and Kelly, 1969). Underlying this assumption is also the idea that franchisors prefer the company-owned units and, if it was possible, they would have wholly-integrated chains (Lafontaine and Kaufmann, 1994). Most empirical

works have found this conversion tendency[1] (Hunt, 1973; Caves and Murphy, 1976). Further, some criticisms to the Agency Perspective of franchising have also been based on this evidence. If a company chooses to franchise in order to reduce agency costs, it will be expected that, as the company matures, it will use franchising more intensely, since the strengthening of the concept or brand name will increase the cost of the agent's shirking (Carney and Gedajlovic, 1991). Brickley *et al.* (1991), however, have tried to explain the buy-back phenomenon from the Agency Perspective. With time, in certain geographical areas, it is expected an increased concentration of franchised units, which reduces the *in loco* monitoring costs and decreases the advantages of the franchise format. According to Lafontaine (1992), the tendency towards the vertical integration is a result of an increase on franchisor moral hazard which leads to an increase in the preference for company-owned units. Lafontaine's (1992) study, however, has not supported this hypothesis.

In what concerns the emergence of franchising and the evolution in time of the chains, it is worth noting that although most empirical works support the buy back prediction (Hunt, 1973; Caves and Murphy, 1976; Minkler; 1990; Carney and Gedajlovic, 1991; Lafontaine and Kaufmann, 1994; Thompson, 1994), some other studies find a tendency in the opposite direction (Martin, 1988, Lafontaine, 1992, Scott, 1995), which questions those theoretical proposals. Thus, there does not seem to be a clear tendency in either direction. Actually, there may not be one at all, when we recognize that each chain is unique in what concerns the involved capabilities. In this context, history may matter and, in fact, empirical studies on franchising are usually of a cross-sectional type, since there is not enough available data to perform time-series analysis (Lafontaine and Kaufmann, 1994). Hence, not only a possible tendency of conversion into either direction, but also the reasons to explain it, might vary between industries, and also between companies in the same industry. Therefore, this

[1] Several authors supportive of the Resource-Constraints View have found on those studies the evidence to

suggests the interest in studying how and why specific chains evolved over time, *i. e.*, how its mix of company-owned and franchised units changed and the underlying reasons for those changes.

A very close and puzzling question is the existence of the plural form. A company that adopts franchising may still keep some company-owned units. According to the Resource-Based Perspective, the dual form can be seen as a transitory phase in the company's life cycle: as the firm matures, it overcomes its growth constraints and converts into a wholly-integrated chain. The Agency-Perspective, on the other hand, has focused on the decision between to franchise and to integrate a particular unit. According to this theory, there is a trade-off of agency costs to be considered in this decision (see, for instance, Brickley and Dark, 1987). However, neither of these theories seems to have adequate empirical support. On the Resource-Based Perspective, we have already discussed the limitations of the life-cycle justification. On the Agency Theory, although its trade-off proposal is somewhat empirically supported, the reason why company-owned and franchised units coexist in the same locations still remains unexplained (Minkler, 1990).

There are some other issues that we think can be useful to improve our knowledge on franchising systems. We already discussed how the omission of the production side of the firm may have narrowed our understanding of franchising. However, other factors have also been missed by traditional theories, namely heterogeneity within and among chains, the role played by the franchisee in the franchising relationship and the dynamics of a system of connected relationships.

Regarding the issue of heterogeneity, although franchising is used in very different companies, industries and economies, it can be said that the traditional theories are built on a homogeneity assumption: franchisors, franchisees and franchising relationships are supposed

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sustain their predictions.

to be homogeneous, as they are seen as aggregate entities. Yet, we might wonder whether so diverse franchisors like the American McDonald's and the Portuguese Cenoura should in fact be seen as homogenous. Further, are Mc Donald's and Cenoura's franchisees really alike? Further still, is it reasonable to assume that all McDonald's franchisees, spread around the globe, share the same exact characteristics? As shown, this question stands at two levels. First, heterogeneity among chains, there is to say, between different franchisors and their businesses, activities and franchisees. Second, the heterogeneity inside each chain, *i.e.*, among the chain's franchisees and among the relationships between themselves and between them and the franchisor.

Somewhat related to the neglect of the heterogeneity issue is the question of the disregard of the role played by the franchisee in the franchising relationship. Indeed, the traditional literature has essentially focused either on the assumed franchisee's free-rider nature (Mathewson and Winter, 1985; Brickley and Dark, 1987) or on its ability to supply capital or another scarce resource (Caves and Murphy, 1976). According to Elango and Fried (1997, pp. 76), traditionally, the franchisor and the franchisee have a top-down relationship where the "franchisee is perceived to be a good franchisee if it does as the franchisor wishes. The franchisee is viewed as a user of franchisor expertise and knowledge, not able to contribute to the system". Croonen (2003, pp. 8) also considers the traditional perspective over the franchisee as "the antithesis of entrepreneurship and strategic thinking".

Indeed, in the literature, the franchisee is typically seen a relatively passive part of the relationship. In fact, although the franchisee's firm is an independent company, it is very dependent on the franchisor's decisions. The franchisor may determine (or approve) matters such as the location of the unit, the design and layout of the outlet (including building materials), the average level of stocks, the suppliers of inputs, the exposition and decoration on the shop windows (Cherto, 1989; Leite, 1990). Yet, some authors reported on important,

active roles played by the franchisee. According to Love (1986), the McDonald's franchisees have an important part in the development process of new products which latter spread through the chain. Minkler (1990, 1992) also pointed out the franchisee to hold superior information about its local markets. As Dnes (1996, pp. 305-306) has put it, in Minkler's work, "franchising allows the use of the trade mark to be exchanged for the franchisee's local entrepreneurship, which is defined as noticing and acting upon opportunities". Thus, in such circumstances, both the exchange and combination of experiences and knowledge may be critical to the dynamics and performance of the franchising network. More recently, as we shall see, several studies have tried to shed some light over this issue.

Finally, the traditional literature also neglected a dynamic perspective over franchising, meaning that the analysis mostly refers to a particular moment in time. In Croonen's (2003) opinion, these theories do not analyse the dynamics of the relationship between franchisor and franchisee. The way the two parties interact, the way the relationship evolves over time and the effect of path dependence are neither studied nor even considered. Further, the importance of the development of the system itself, *i.e.* the development of the concept or brand name through an innovation process such as the development of new products, is also not considered. Thus, by introducing the time dimension, learning processes and relationships may matter to improve our knowledge on franchising system dynamics, including the persistence of the plural forms.

New Perspectives on the Franchisee's Role

There is an increasing interest on organizational learning in networks (Easterby - Smith *et al.*, 2000). Within the franchising literature, some authors have been approaching issues related with the creation, maintenance and diffusion of knowledge in franchise chains.

It can be said that these studies have in common a new perspective over the franchise contracts. This perspective overcomes some of the previously mentioned traditional limitations by assuming heterogeneity, recognising the franchisees' (potential) active role in the franchise relationship and taking a more dynamic view of franchising.

According to Gorovaia (2003), the chain's success depends both on the transmission of "system knowledge about the business and the brand" from franchisor to franchisee and of "local market conditions and country specific knowledge" from franchisee to franchisor. Langenhan (2003, pp.2) defines the franchise package as the franchisor's organizational knowledge about the "successful management" of the business. To this author, in a franchising network, there are two sorts of knowledge. The core knowledge that is contained in the franchise package and is transferred from the franchisor to the franchisee, and the decentralised knowledge that each franchisee possesses and that is not included in the franchise package. Since the franchisee is closer to the customers, this decentralised knowledge may take an important nature. However, Langenhan (2003) also noted that this knowledge it is not necessarily shared with either the franchisor or the other franchisees, since its importance may not be recognised by either of them.

Further, this literature also recognises the franchisee's (potential) contribution to the development of the franchised concept or brand. According to Sorenson and Sørensen (2001) franchisees may play an important part in this process for two reasons. Firstly, because they are less risk averse than company managers, otherwise they would not have become entrepreneurs. Secondly, because they have larger time horizons which induce them not to be short-sighted and to be willing to invest in innovative projects that may only produce returns in the long run. Also Cliquet and Ngoc (2003, pp.10-11) consider that the franchisees are especially important in the phase of generating ideas, the first of the innovation process. They are "a good source of local ideas" because they are closer to the customer and know the local

market, they have “good intuition based on their experience”, they have a higher incentive to improve the unit’s performance and finally they push “forward company managers and the chain operator to be more dynamic and to generate more ideas”. Argote and Darr (2000) have actually found several innovations added by the franchisees to the production process of the fast-food chain they have studied in an empirical study.

In contrast with the traditional literature, and the Agency Perspective in particular, which focused on understanding what determines the franchisor’s choice between integrating and franchising a particular unit, the emerging literature however is concerned with assessing the advantages of the plural form. Several authors agree that combining franchised and integrated units might be fruitful in managing March’s (1991) Exploitation and Exploration Paradox (Sorenson e Sørensen, 2001; Croonen, 2003; Bradach, 1998). According to March (1991), a balance must be found between the exploitation of old certainties (production, selection, implementation, refinement of present elements) and the exploration of new possibilities (research, experimentation, innovation of future elements). Franchisees might be, for several reasons, more prone to ‘Exploration’ than company managers. In turn, these would have a higher incentive to ‘Exploitation’, essentially due to both the franchisor’s incentives and monitoring type (Sorenson e Sørensen, 2001). In Cliquet e Ngoc’s (2003) opinion, the plural form is preferred, in what concerns the innovation process. If the franchised units are seen as especially relevant in generating ideas, the company-owned units may have an important role in testing and implementing the innovations.

This Exploitation/ Exploration Paradox is somewhat related with another one, the Standardization / Innovation Paradox. Standardization is important because it is ultimately through it that the chain’s unified identity is guaranteed. It is one of he specific features of franchising, as it permits that in a distant market when a customer sees one of chain’s units he/she immediately knows what to expect from the product or service on sale. Further,

without a high degree of standardization, it would not be possible to split the costs of generating or acquiring new knowledge among the chain's units (Sorenson e Sørensen, 2001). But, simultaneously, it may be necessary to develop the franchised concept or brand and the diffusion of innovations in a franchise chain may not be easy. It is suggested that the franchisees may lack the incentive to adopt the franchisor's innovations, either because they do not want to take the risk or because they do not want to make the required investments. Further, typically, the franchisor cannot make them accept those innovations since this is not included in the contract (Cliquet e Ngoc, 2003). Second, when a franchisee produces a local innovation, which is adequate to its specific context, it may not interest other franchisees. And even if it actually does, it will not easily spread through the chain because the innovative franchisee may not want to support the spreading costs (Sorenson e Sørensen, 2001). Also he/she may be more interested in meeting the franchisor's performance indicators (Argote e Darr, 2000) and may perceive the other franchisees as rivals, especially if there is significant cannibalisation between units when the market is saturated.

Following the research above, it is possible to identify some advantages of franchised over company-owned units and *vice-versa*. According to Sorenson and Sørensen (2001), the company owned units are preferred when the market is homogeneous and the exploitation is more important, while the franchised units have an advantage when the market is heterogeneous and exploration is essential. In Yin and Zavac's (2004) opinion, being more flexible and decentralised, the franchised units are preferred when the chosen strategy requires flexibility and local adaptation. The company-owned units are best suited for strategies that emphasise prevision and control.

These latter studies have introduced new elements to the comprehension of franchise systems. They are particularly interesting for understanding the role of the franchisees, as they are seen as having its own idiosyncrasies and being an active part of the franchise

relationship. They also suggest a link between the presence of the plural form and a degree of variety on the characteristics of local markets.

Firm Boundaries, Capabilities and Networks

The issue of Firm Boundaries and its evolution in time have been studied by several authors (*e. g*. Langlois and Robertson, 1993, 1995; Araújo *et al*. 2003; Mota and Castro, 2004) focusing on the processes of creating, diffusing and coordinating capabilities, unlike previous work that emphasised the minimisation of transaction costs associated with opportunism (Williamson, 1975). Those perspectives are essentially founded on the seminal contribution of Richardson (1972). In a sense, it can be said that the traditional 'make or buy' decision has been turned into an option between 'making, buying or having it done by a partner'.

According to Richardson (1972), an industry entails a countless number of activities which must be performed by organisations that have the adequate capabilities. Some of these activities are similar because they are based in the same capabilities. Other activities are complementary because they are linked by the production chain. Firms tend to specialise in activities that use similar capabilities while complementary, yet dissimilar, activities are supplied by other organisations. Inter-firm cooperation is a result of the necessity to coordinate closely complementary but dissimilar activities. Since these are not similar, they should not be coordinated through the firm. But they should not be coordinated through the market either, because there is a need to meet qualitative and quantitative requirements and not only to match aggregate demand and supply.

Following Richardson's (1972) work, Langlois and Robertson (1993) assume firm heterogeneity and consider that this is due to the idiosyncratic, tacit knowledge each firm

holds. In their opinion, the firm's capabilities might be of two different kinds: the core capabilities which are tacit and idiosyncratic and the ancillary capabilities that are easily transferable and imitated and, therefore, are common to several firms. To these authors, the choice between 'making' and 'buying', between 'hierarchy' and 'market' is influenced by the cost of using other firms' capabilities, when these are needed. However, at that moment, the market might not offer that particular capability and, since tacit knowledge can only be attained through a long, time-consuming learning process, firms may face dynamic transaction costs (Langlois and Robertson, 1993). Unlike Williamson's, these costs are not related to incentive issues but to problems of coordinating productive knowledge and can be defined as the costs of negotiating, coordinating and teaching external suppliers. The authors suggest that in the long run, with the codification of knowledge and the generalisation of capabilities, these dynamic transaction costs tend to reduce and, consequently, the "make or buy" decision might change. The firm boundaries are, therefore, dependent on the market availability of capabilities[2]. Thus the "make or buy" decision is a function of the dynamic transaction costs which, in turn, are a function of the market distribution of capabilities.

However, Langlois e Robertson's perspective is essentially based in the market *vs.* firm dichotomy. Some authors have recently suggested that firms may substantially differ in their capabilities concerning their access not to an anonymous market but to a set of particular suppliers (Araújo *et al*. 2003; Mota and Castro, 2004). Consequently, the dynamic transaction costs may be, to a great extent, firm specific. A central notion to support this conclusion is Loasby's distinction between direct and indirect capabilities. Loasby (1998) sees the firm as a set of direct capabilities which are related with its knowledge about 'how to do something', and indirect capabilities that are associated with its knowledge about 'how to get something done'. These indirect capabilities are the means for accessing other firms'

[2] And they also depend on the nature of the economic change. When the development of a new capability

capabilities. According to Loasby (1998), each firm tries to build an external organization[3] of indirect capabilities that complements its set of direct capabilities. Since each firm specialises, there is a "consequent need to know how to get things done by other people, then we might recognise the possibility of building relationships to manage closely complementary capabilities (…). [The advantages of these relationships are not those] … of reducing transaction costs, but of increasing net benefits, and specially of increasing net benefits through the development of new skills, new methods, and new products (…). [These] advantages may justify increased costs of governance, and even new forms of organisation (…)" (Loasby, 1998, pp.156-157). According to Loasby, the firm's indirect capabilities might be tacit, idiosyncratic and result from its investment in its external organisation. Thus the boundaries of the firm, *i.e.*, the decision related to performing the economic activity through the firm, the market or cooperation, depends also on the firm's indirect capabilities.

This literature supports the notion that the development of firm capabilities does not take place in an isolated manner but in a context of relationships and, therefore, it is influenced by other firms' capabilities. As such, the distribution of capabilities in the industry influences the definition of firm boundaries but, at the same time, it is also influenced by the set of direct and indirect capabilities developed and held by the firms in the industry and also by the boundaries they set. The decision concerning firm-boundaries definition is therefore one of establishing, developing or terminating links between capabilities (Araújo *et al.*, 2003). According to Mota and Castro (2004), the evolution of firm boundaries is not so much shaped by the market distribution of capabilities, as in Langlois and Robertson (1993), but much more by its set of direct and indirect capabilities, as in Loasby (1998), that results from its investments and practice within the context of inter-firm relationships. This perspective is

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implies changes in several phases of the production cycle, the vertical integration alternative will be preferred (Langlois e Robertson, 1993).

[3] Loasby (1998) recovers the notion, introduced by Marshall (1920), of 'external organization'.

consistent with the Industrial Networks Approach which emphasises interdependent business relationships as a central mechanism to understand industrial dynamics (Axelsson and Easton, 1992; Hakansson and Snehota, 1995). Having this perspective in mind, it is possible to approach franchising arrangements and dynamics as systems of connected relationships involving several actors, holding partly idiosyncratic capabilities, within and outside the focal franchise network. In this context, the efforts to combine standardization with innovation, exploitation with exploration, are seen as involving different types of relationships, even if the replication of practices is a critical issue on sustaining franchising concepts. Exploration, in this context, may, for example, also include early experiments to test if the conjectures of the potential franchisor are correct regarding its capabilities to replicate a package through franchising relationships. In this sense, direct and indirect capabilities co-evolve as actors learn in a context which, we argue, is partly specific.

Research Agenda: A Capabilities Perspective in Networks

Departing from (1) the limitations of the traditional Management literature about franchising which, to our view, excludes some of the complexity of these arrangements, (2) the new work being done and that somehow partially overcomes those limitations and, (3) the recent advances in the capabilities and networks view of firms and industries, we propose a new perspective to look at franchising networks. Such a perspective assumes that actors and relationships are heterogeneous, *i.e.*, the franchisors, the franchisees and the relationships between them are heterogeneous, and path dependent processes may help to explain the development of franchising networks as systems of connected relationships and capabilities.

To adopt the proposed perspective, we must, first, identify the franchisor's and the franchisee's capabilities and how these were developed through time. Langlois and Foss

(1999, pp. 207-208) define capabilities as "team-embodied and partly tacit production and organizational knowledge that can be employed by team-members for a strategic purpose". Dosi *et al.* (2000, p.1) describe them as "the know-how that enables organisations to perform (…) [their] activities". On the franchisor's side we can apparently distinguish two sorts of capabilities. First, we can find the capabilities related with the management of the franchised brand or concept. There we can include the know-how about the productive process and technology, the definition of the product or concept positioning and image, the maintenance of the franchised concept through advertising and franchisee monitoring and, finally, its development through new products, services or markets. Second, we can find the capabilities required to attract new and good franchisees, to replicate routines and to create, codify and diffuse knowledge throughout the network. The franchisee's capabilities would include its know-how about the unit's management and the ability to combine these with knowledge held about local specific characteristics. These would amount to local perspective and idiosyncratic capabilities.

In the traditional literature, as we have seen, stands an open issue regarding the emergence of franchise contracts. We will try to approach this issue by considering whether the franchisor's and the franchisee's capabilities, including early experiences, may help explain the emergence of franchise contracts. At the business level, this question can be related with the definition of firm boundaries. Basically, it is a complex decision involving 'making', 'buying' or 'getting it through a franchisee'. At the unit level, this question concerns the decision between 'owing' and 'franchising' a particular unit and it is closely related with the issue of the plural form.

Following Richardson (1972), at the business level, franchise contracts might result from the need to coordinate closely complementary yet dissimilar activities. In a franchise relationship, the activities performed by the franchisor and the franchisee may be apparently

closely complementary but partly dissimilar. Typically, in a franchising relationship, the franchisor is responsible for the activities concerning the management of the brand or concept and the franchisee is responsible for the activities involving direct contact with the customers. Thus, the coordination of these activities certainly poses firms with the need to meet qualitative and quantitative requirements.

Moreover, franchise contracts can also be due to reduced dynamic transaction costs as a result of the perceived availability of capabilities deemed adequate to perform a set of activities. This may mean that the decision to franchise is due to the fact that the costs of negotiating, coordinating and teaching franchisees are inferior to the costs of internally developing the needed capabilities and the costs of getting them through other suppliers in the market and even through other alliances. We also suggest that this dynamic transaction costs can be said to be a function of the indirect capabilities of the franchisor. For example, at an early stage, we believe the franchisor's main indirect capabilities which allow it to access the franchisee's capabilities might refer to its ability to attract and motivate the new franchisees to adhere to a concept that might not yet be known. This ability might depend on the know-how about the creation of an attractive concept, the codification of knowledge in manuals, the diffusion of knowledge through the chain, the franchisee's formation, the replication of routines, etc. Latter, as the firm matures, the franchisor's capabilities related with the creation and maintenance of a reputation in the market might be extremely important for capturing new franchisees. Mathewson and Winter (1985) describe the existence of waiting lists of potential franchisees associated with the franchisor's reputation. This indirect capability may depend on the performance of the concept in the market and the investment made by the franchisor on the present and past relationships with its franchisees (as *in* Mota and Castro, 2004).

At the unit level, the decision between 'owing' and 'franchising' a particular unit might depend on the capabilities required to manage that unit and how those capabilities might be combined within the wider network. Thus, the plural form might as well be a result of the advantages of combining the franchisor's and the franchisee's capabilities in a wider context. This is someway in line with the work of Bradach (1998), Sorenson and Sørensen (2001), Cliquet and Ngoc (2003), Croonen (2003) among others who seek the advantages of the plural form. The evolution of this mix might be influenced by past investments on both direct capabilities and relationships as a manifestation of indirect capabilities (Mota and Castro, 2004).

We have already discussed how the traditional literature has overlooked the franchisee and has essentially focused on the franchisor. A new perspective based on the Capabilities of the Firm might bring the franchisee under the spotlight. Not only its capabilities may have a part in the explanation of the emergence of franchising and the existence and dynamics of the plural form, but also it might have a central role in the development of the chain. In fact, the diversity of franchisees might be an important issue, especially in what concerns knowledge creation and innovation. The different locations, experiences and path dependencies of the franchisees might turn them into an important source of dynamic capabilities for the chain. However, apparently most franchisors neglect this potential contribution. If we adopt an Industrial Network Approach we may be facing one of the network paradoxes of Ford *et al.* (2002, 2003). According to these authors, the actors in a network seek its control. However, the network control can be detrimental because it imposes a limit to heterogeneity and therefore to the creation of knowledge and innovation. The undervaluation of the franchisee's role and the franchisor's control of the chain might this way explain some failure stories.

Conclusion

In this paper, we departed from the limitations of what we have called the traditional management literature about franchising, from the current research about franchising networks, and from the recent advances in the Economics of the Organisation, to propose a new perspective over Franchising.

The emergence of these contracts is a central theme in the management literature about franchising. These might result either from resource limitations to growth or from agency costs concerning a well known brand name. Although most scholars agree with the Agency explanation, there still remain some open issues. First, anecdotal evidence shows some important contradictions. In particular, franchising is used by small immature firms which do not have yet a well known, strong valued brand. Second, the production costs as well as the costs of creating, transmitting and coordinating productive knowledge have been neglected. If, in accordance with the Capabilities Perspective of the Firm, we assume that the productive knowledge is heterogeneous, is not uniformly distributed in the industry and has to be coordinated, then the emergence of franchise contracts might be explained by the franchisor's and franchisee's idiosyncratic capabilities. Three possible reasons might concur to this explanation. First, since the franchisor's and the franchisee's activities might be closely complementary but partly dissimilar, there might be a need to coordinate them through inter-firm cooperation (Richardson, 1972). Second, the franchising alternative might have inferior dynamic transaction costs (Langlois and Robertson, 1993). Third, franchising contracts and related dynamic transaction costs might be a function of the indirect capabilities of the franchisor (Loasby, 1998).

Analysing franchising from this perspective might also help us understand the mix of franchised and company owned units, in what concerns the reasons for both its existence and its dynamics. In the traditional theories, the plural form is explained by being either a

transitory phase before the firm wholly integrates or the result of a trade-off between agency costs. However, the empirical literature does not completely support either of these explanations. We suggest that the plural form might be a result of perceived and partly specific advantages in the combination of franchisor's and franchisee's capabilities which is somehow in line with the new research being done (Bradach, 1998; Sorenson e Sørensen, 2001; Cliquet e Ngoc, 2003; Croonen, 2003). In fact, plural forms may reflect the need to preserve or manage a degree of variety within the franchise network.

In sum, the traditional theories have assumed a passive franchisee who is either a source of scarce resources or a shirking agent. From a Capabilities Perspective, the franchisees and their knowledge and experiences are seen as heterogeneous. Hence, they might be a source of important dynamic capabilities for the network. By taking a Capabilities Perspective to research franchising networks, we expect to improve our understanding on the emergence of these arrangements and the evolution of the mix of franchised and company-owned units, having in mind the role of the franchisee and the dynamics of the franchise relationship.

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