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## FRANCHISE BUSINESS DEVELOPMENT MODEL: THEORETICAL CONSIDERATIONS

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**Abstract.** Franchising is not a popular business development form in Lithuania. Only 0.02% of all Lithuanian companies use franchising for business development, while in most of the developed countries franchise is recognized as a convenient business expansion form. So, what factors determine such differences in the use of franchising? Analysis of related literature showed, that mainly researchers analyse some aspects of franchising, however there is no systematized analysis which covers all the main franchise development elements. Therefore, the aim of this article is to systematize franchise business development phases, main elements and factors, influencing this process and to propose a theoretical franchise system development model. Thus, theoretical considerations about the main phases and elements of franchise system development as well as advantages and disadvantages of the system are analysed in the article. These theoretical considerations are generalized in theoretical franchise system development model, which shows, that development of franchise business consists of particular steps, starting from favourable conditions for the system to emerge; intention and ability of franchisor to form franchise based on his business; the establishment and initial development of franchise system; and its further functioning. The article does not test the model and even does not discuss the operationalization of it. Operationalization of the model as well as empirical evidence is presented by the authors in the forthcoming articles.

**Keywords:** franchise, franchise business development model, franchising system, business development, franchisor, franchisee, franchise elements.

**JEL Classification:** F23, L22, L24, L26.

## FRANŠIZĖS VERSLO VYSTYMO MODELIS: TEORINIAI SAMPROTAVIMAI

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**Santrauka.** Franšizė nėra populiarus verslo plėtros forma Lietuvoje. Tik 0,02 % Lietuvos įmonių naudoja šią formą, o kitose išsivysčiusiose šalyse ši verslo plėtros forma pripažįstama kaip viena iš patogiausių formų. Taigi kokie veiksniai daro įtaką tokiems skirtumams naudojant franšizę? Literatūros analizė parodė, kad mokslininkai gan dažnai analizuoja tam tikrus franšizės verslo aspektus, tačiau labai trūksta sisteminio požiūrio, kuris apimtų visus franšizės sistemos vystymosi elementus. Todėl šio straipsnio

tikslas – susisteminti franšizės verslo plėtros stadijas, pagrindinius elementus ir veiksnius, pateikti juos teoriniame franšizės sistemos plėtros modelyje. Šiame straipsnyje pateikiami teoriniai samprotavimai apie pagrindines franšizės verslo plėtros stadijas ir elementus, trūkumus ir privalumus. Teoriniai samprotavimai apibendrinami franšizės sistemos plėtros teoriniame modelyje, kuris rodo, kad franšizės verslo plėtrą sudaro tokios stadijos, kaip palankių sąlygų egzistavimas, franšizės pardavėjo ketinimai ir gebėjimai suformuoti franšizės paketą, paremtą jo verslo pagrindu, sukūrimas ir pradinis franšizės sistemos vystymas bei galiausiai nenutrūkstamas tos sistemos veikimas. Šiame straipsnyje minėtas modelis nėra testuojamas ir netgi neatliekama jo operacionalizacija. Modelio operacionalizaciją ir empirinį pagrindimą autorės pateikia kituose straipsniuose.

**Reikšminiai žodžiai:** franšizė, franšizės verslo vystymo modelis, franšizės sistema, verslo vystymas, franšizės davėjas, franšizės gavėjas, franšizės elementai.

## 1. Introduction

Franchise is one of the company's (business) development forms, which is based on contractual relations between companies, especially proliferated in services sector (Blair, Lafontaine 2005). This business development form became used more than a hundred years ago (Mendelsohn 2004a). Popularity of franchising has extremely increased over the past few decades due to the intensive globalization processes. Due to the intensive globalization processes the cultures are mixing, consumption habits change, people tend to travel more and they seek for the same well-known brands of the same goods, services and quality (Alon 2006; Blair, Lafontaine 2005).

USA is still the biggest market of companies pursuing franchise business system. According to the data of 2009, 7.88 million employees have been working in franchising sector in USA, generating 1280 billion Euros per year. The other large markets of franchising are: China with 3.5 million employees, Japan with 2.4 million employees and 243 billion Euros turnover, Australia with 0.7 million employees and sales of 130 billion Euros, as well as South Korea with 1.2 million employees and sales of 95 billion Euros in 2009. The other rapidly developing markets of franchising business are Brazil and South Africa with 0.72 and 0.46 million employees respectively and approximately 35 billion Euros sales (PriceWaterhouseCoopers 2009).

USA is considered as a pioneer of franchise business system. Nevertheless, due to development of global market, USA market tendencies have a great influence on businesses in Europe. Therefore, franchise business system was transferred to the European market and now it is successfully expanding. The countries with largest franchising business markets are France, Germany and UK with 0.69, 0.45 and 0.45 million of employees respectively, whereas the highest sales are generated in Germany, which in 2009 were 48 billion Euros. Also franchising is rapidly developing in Turkey and Poland, which already employed 0.25 and 0.35 million of employees respectively in franchising business in 2009 (PriceWaterhouseCoopers 2009).

It total approximately 28 thousands of franchising brands exist all over the world, where Europe counts for 35%, Asia for 45% and North America (USA and Canada)

for 12%. However, it should be pointed out that major part of the franchising brands all around the world are of USA origin, and only in recent years the local Asian and European brands are also emerging rapidly.

Rosenberg International Center of Franchising carried out a research in 2006 with the aim of determining the situation of franchise business system prevalence in EU among international companies of USA origin. One hundred and nine companies of USA origin participated in the research, all of them were members of International Franchising Federation with 115 thousand business units worldwide. The research demonstrated that 18% of the respondents were from the fast food sector, 14% were from retail and services sector and 12% were from household and commercial services sector. However, only 8.4% of all the respondents had their business units in Europe, although even 52% of them had business units outside the USA (Rosenberg International Center of Franchising 2006). This study has shown that franchise business system is not very widespread in Europe. Nevertheless, these results might be influenced by plethora of reasons, which are not adequately analyzed in the scientific literature.

In Lithuania franchising is not a popular business development form as only 0.02% of all companies in Lithuania operate in franchising mode (according to the data of Lithuanian statistics department in 2009). Therefore, it can be stated that franchising is very poorly extended in Lithuania. Also, very few scientific researches have recently been carried out in Lithuania in the field of franchising. Some theoretical insights about franchising promotion in Lithuania were presented by Šmitas and Jucevičius (Šmitas, Jucevičius 1999). Most recently, Levickaitė and Reimeris analyzed the situation of franchising in Lithuania (Levickaitė, Reimeris 2010) and the perceived franchise value (Levickaitė, Reimeris 2011). These researches cover some aspects of franchise system development, however the reasons of franchise undevelopment in Lithuania require more systematized analysis which covers all the main franchise system development elements.

Thus, the aim of this article is to systematize franchise business development phases and main elements into a unified theoretical model, which could be used for identificati-

on of impediments to franchise business development in the market. The article discusses main theoretical preconditions and phases of franchise business development, as well as advantages and disadvantages of franchise business. Finally, the theoretical franchise business development model is presented.

## 2. Preconditions for franchising

Franchise is one of the development forms of the company (business), which is based on contractual relations between companies and especially proliferated in services sector (Blair, Lafontaine 2005). In case of franchising, franchisor sells the “know-how” of his business to franchisee (Falbe, Dandridge 1992). Supporters of this type of development, Windsperger, Clinquet (2007), state that franchising is attractive alternative business systems in foreign markets, when business founders are not sure about the purchasing power potential of the target market, adaptation of products requires great expenses, political situation is unstable, or international experience of the company is poor. Nevertheless, some particular conditions are necessary for development of franchise business system:

- Registered, protected and well-known brand (Mendelsohn 2004a);
- Business system which is clearly formed and protected from competitors business system (Sherman 2004; Mendelsohn 2004a), which ensures business effectiveness and attraction to customers (Blair, Lafontaine 2005);
- High interaction level between franchisor and franchisee, which provides long-term economically and legally effective relations between separate business units (Majocchi, Pavione 2003; Gehrke 2008);
- Legal system and legislation of a particular country, which ensures protection of a brand, intellectual property, trade secrets and other key elements of franchise business system (Mendelsohn 2004b; Sherman 2004).

Franchise is a popular business development system due to the key elements separating it from other business development systems. Therefore, five essential elements of franchise business are distinguished (Mendelsohn 2004a):

- Brand;
- License to use the brand;
- Business system;
- Taxes;
- Business development investments of franchisee in local country or defined territory.

Analysis of franchise business development shows that it goes through few development phases. Each phase has its own prerequisites, which affect the success of franchise

business during following phases. We distinguish the following franchise development phases:

- Specific business environment conditions, which are important for emergence of the franchise business system;
- Franchisor’s wishes and possibilities to form the franchise which is based on his business.
- Establishment and initial development of the franchise.
- Further operation of the franchise.

This part of an article reviewed the main phases and elements of franchise system development, however a deeper analysis of each of the elements is needed for the development of theoretical franchise system development model.

## 3. Stages of franchise system development

***For the first stage specific business environment conditions are needed for the emergence of franchise business system.***

Various researches have shown that the brand is one of the most important elements of franchise business, because in most cases it is an essential reason for the franchise agreement, and therefore is inseparable from the whole company’s image and design of business units (Sherman 2004; Mendelsohn 2004a).

Franchisee buys not only the brand but also a clearly formed business system. Therefore, franchisor has to ensure the protection of the business “know-how” from the competitors and continual assistance in its implementation and application to business (Mendelsohn 2004a).

For the franchise business system to be attractive to potential franchisees, it has to have exclusive practice and management methods, which must be easily understandable and could be written in the business management instructions, but cannot be easily copied by the competitors (Sherman 2004).

Thus, risk management and fair legal system are important factors for franchise based business relations establishment. Mendelsohn (2004b) distinguishes the following most important factors for the franchise development: legal system of the host country, laws related to franchising and contractual business relations.

***Next step – the second stage – Initiative of franchisor.***

In case of franchising, human factors are essential as business partners relations are the essential part of franchise. Franchisor and franchisee are involved in a voluntary long-term business relationship which will determine business success in the future (Sherman 2004). Majocchi and Pavione (2003) stated that voluntary involvement in franchise business system is a strategic decision for developing long-term relations between separate business units, which are economically and legally effective, and could be developed

into a successfully operating organizational model based on continual communication and cooperation. Thus, long-term relations and continual effective communication are emphasized in franchise system as the key elements for its success.

Human factors become very important at the very first stage of franchise expansion to a particular country or market, when franchisor selects franchisee. Thus, not only rational factors, but also trust and personality of prospective business partner are important for this type of business. In this stage the biggest role and responsibility is assigned to franchisor, because it is his/her advantage and responsibility to select the franchisee and decide whether he/she is suitable for the development of the particular franchise business (Mendelsohn 2004a). Sherman (2004) emphasizes that difficulties in attracting qualified franchisees and inappropriate selection system can prevent the successful establishment and development of franchise system. Therefore, initial, further activities and effectiveness of franchise system mostly depend on the franchisor. Franchisor firstly has to be a leader, able to gather experienced and professional team for franchise management as well as other specialists responsible for consultation and continual communication with franchisees (Sherman 2004).

Alon (2006), Azevedo, Silva (2007), and Sherman (2004) have determined that the contents of franchise contract depend on the relations between franchisor and franchisees, franchisor's relations with clients and suppliers, quality control and competition. Therefore, franchisor must maintain good relations not only with franchisees and suppliers, but also with governmental institutions and their employees, control and regulation institutions, etc. Thus, franchise system is characterized by a very high interaction level between its participants, firstly determined by franchisor as the main initiator and ideological leader for franchise business development and his/her qualified team. Secondly, franchise system is characterized by the selection process of interested franchisees who determine the development of the franchise in a particular company.

***The stage of establishment of franchise and development elements for its initial stage.*** When potential franchisor decides to expand his business using franchise business system, he has to prepare properly for the establishment and the initial development stage of franchise system because mistakes during this stage and inappropriately prepared procedures and other key elements can lead to further failure of franchise system.

One of the main differences between franchise and separate business unit is the form of ownership. Franchise business system involves both: business units owned by the franchisor and business units owned by franchisees. However, when franchising system is broadly expanded and rather big income is generated from the taxes paid by

the franchisees, franchisor can decide to give up his own business units. Williamson (1988) points out that the main advantage of the dual system in franchise business to the franchisor is the ability to test the new products, marketing ideas, management methods and to divide financial flows. However, Hendrikse, Jiang (2007) see some threats in the dual franchise system, since the dual management system has two decision making modes, that is, local business units' managers, who act as hired workers and franchise business, where the managers act as business owners. Dual business form is more often used in retail sector rather than services due to the required intensive involvement of the franchisee in business and closer proximity to the client in services sector (Perrigot, Clinquet 2007). Therefore, the ability to integrate business units managed by the franchisor and franchisee creates a great advantage of franchise business over other business systems.

Franchising also provides financial flexibility, because business can be expanded in respect of the current financial resources. The establishment of a new business unit is usually financed by the franchisee, thus it is financed from "outside", since the new business unit is fully managed by the franchisee. However, when the franchisor establishes a new business unit, it is financed from the "inside" (Ehrmann, Spranger 2007a).

Foremost important element in this stage of franchise development is a correctly prepared franchise agreement. The relationship between franchise business participants is based on the agreement, therefore all franchise business questions or problems are solved according to it (Mendelsohn 2004a). Economides (1993) indicates that agreed profit rate is one of the main franchise development advantages for the franchisor, which is closely related to the franchise agreement. Nevertheless, the content of franchise agreement depends not only on the relations between franchisor and franchisee, but also on the relations between franchisor and his clients, suppliers, the quality control and competition (Alon 2006; Azevedo, Silva 2007; Sherman 2004).

The particular franchise system usually has one agreement for all franchisees with the same license tax rate and tax from turnover or profit. This unification is used to provide all franchisees with the same operating conditions, this also decreases operational and administrative costs (Blair, Lafontaine 2005). However, franchisor can seek to control franchisee as much as possible in order to lessen his business risk. Franchisor does not invest in the new business unit, but on the basis of the franchise agreement, he receives initial franchise purchase fee and afterwards continual income in the form of taxes depending on the sales of the franchisee (Justis, Feltes 1986). All these conditions related to taxation must be well defined by the franchisor in the first franchise agreement, because these conditions have to be similar or identical for all franchisees. Generally, franchise agreement

must encompass very explicit business aspects, since it is a key to business success and effectiveness.

Effective management system of the company operating in franchise mode depends on the distribution of intangible assets between franchisor and franchisee, the degree of property rights' transfer, which in turn depends on the distribution of remaining decision-making rights (Windsperger, Yurdakul 2007). The status of franchisee in franchise system is related to organizational structure, communication system and rights assigned to him. The more franchisor lessens the opportunism of franchisee in franchise system, the bigger the growth in a particular business unit. In other words, the more franchisee is able to feel like an owner of his franchise, the more effort he will render to operate successfully and generate profit (Ehrmann, Spranger 2007b).

All participants of franchise system have to follow homogenous strategies, procedures and specifications. They are in detail described in quality specifications, operating procedures and standards therefore they combine elements and allow franchising system to operate (Sherman 2004).

Distribution of business risk among business partners makes franchise business more attractive. Usually the risks of entering new market are cared by franchisee, due to his initial investment in franchise agreement. Nevertheless, risks of brand failure and unpopularity are cared by the franchisor, while allowing franchisee to use it in particular market or country (Martin 1988). Despite these risks, the costs of operating supervision are also distributed among franchise business partners: the costs related to materials, selection of products and marketing are taken by the franchisor, whereas the costs related to everyday operations and employees are taken by the franchisee (Chaudhuri 2001). Therefore, the possibility to share the operating risks without profit losses is an attractive factor for both, franchisor and franchisee. Consequently, the synergy of business advantages and transfer of business experience determine the attractiveness of the franchise as business development system.

**Final stage – functioning of franchise system.** Strength of franchise system lies not in the absolute quality, but rather in the ability to retain homogeneous products or services throughout the system. For example, if the client is unsatisfied with the quality provided in one business unit, he might assume the same quality in others, despite the fact that quality there could meet the desirable standards. Although a single franchisee can increase his profit by lowering the quality, franchise system as a whole will immediately feel its negative effects. Thus franchisees are interested in controlling each other to retain the same quality and products (Blair, Lafontaine 2005). This control is necessary in order to achieve homogeneity of business units externally and in internal business processes and procedures. Without homogeneity, franchise as company development system cannot exist, as it loses one of its main features.

Since franchise system has to remain homogeneous, franchisees cannot take responsibility of developing new products. Therefore, franchisor has to search for possibilities to introduce new products and/or services for his clients or to improve the existing ones. Based on the perception of franchise as a network, we see that despite their status, members of franchise system are very dependent on each other (European Franchising Federation, *What is meant by franchising*), because client loss in one business unit of the franchise system implies his loss in all units (Mendelsohn 2004a). Nevertheless, a satisfied and loyal client benefits the whole group of business units, since depending on the situation client is able to use all business units and recommend them to other potential clients of that particular region. Therefore, franchisor can be successful only if the entire franchise system is successful, and franchisor can profit if his franchisees have profit.

Franchisor can increase autonomy of franchisees and give them more freedom to make decisions, however for that effective communication system and trust have to be developed with his business partners. Autonomy given to franchisee increases his/her motivation together with the costs for ensuring actions and processes, which are determined in franchisor and franchisee relations (Cochet *et al.* 2007). Considering the fact, that organizations usually seek to decrease their organizational costs thus when franchisor acts as a principal and franchisee acts as a representative, less supervision is needed (Norton 1988). Furthermore, training for the franchisees and transfer of experience from the side of franchisor gives more entrepreneurship and dynamics for the separate franchise business units and positive effect on the franchisees as small business owners (Tuunanen 2007).

Advertising is also an important aspect of the franchise system, it is perceived to be a public good for all business units. Therefore, franchisees pay a certain tax for advertising, which is later used by franchisor for a common advertising campaign (Blair, Lafontaine 2005).

Theories based on lack of resources state that franchising is used when entrepreneur financial resources are too limited to expand an individual business. Therefore, the more resources company acquires, the less likely it will use franchising. However, franchising is used for cost saving, when business units are widely spread geographically. The more popular the brand is, the more valuable is its “know-how”, the larger investments and taxes can be required from the franchisee by franchisor to maximize the profit (Combs, Castrogiovanni 1994). Taxes for franchising are one of the main management factors, which determine the appeal of this business development to franchisor and franchisees.

#### 4. Advantages and disadvantages of franchising

For any franchise system to emerge firstly the initiative of the franchisor is needed, therefore advantages and disa-

advantages of franchising were generalized considering the perspective of franchisor.

The main advantages of franchising (Sherman 2004; Economides 1993):

- Achieved business efficiency and economy of scale;
- Increased market share and brand value;
- More loyal clients;
- Faster market penetration with lower costs;
- Target customer is easier reached through the common advertising and promotion for the whole franchise system;
- Internal personnel is changed to motivated business owners;
- Initial responsibility of location and personnel selection, management and other administrative issues is transferred to franchisee;
- Franchisor ensures at least minimal requirements for quality and size of the assortment;
- Franchisee has a better understanding of local market. Therefore, he can adapt prices or products/services to the local purchasing power or cultural differences.

Therefore, it can be stated that the main advantages of franchising are better business efficiency, bigger market share due to lower costs and more clients that are loyal. Thereby, better understanding of a particular local market and greater profits due to the local businessperson – franchisee.

However, not every expansion via franchising system is successful. The main reasons of franchising system failure are directly related to the conditions necessary for successful franchise business (Sherman 2004):

- Lack of franchisor's leadership;
- Lack of assistance and control for franchisees;
- Lack of communication with franchisees;
- Complicated or irrelevant business standards;
- Late or unpaid taxes from the franchisees;
- Lack of financial control;
- Unprotected brands;
- Unsuitable training programs;
- Difficulties in attracting qualified franchisees;
- Inappropriate and unprofitable business unit as prototype;
- Inappropriate franchisees' selection system;
- Ineffective business and strategic planning;
- Easily copied business model;
- Lack of new products or their development;
- Etc.

However, this does not mean that franchise system would be unsuccessful due to one of the above mentioned

reasons. Usually several of the mentioned challenges disrupt the development of the franchise system.

## 5. Theoretical franchise system development model

Above analysis of theoretical considerations about franchise system development leads to the generalization of the factors that influence franchise system development can be divided into four particular business function categories:

- 1) Management factors;
- 2) Marketing factors;
- 3) Legislative factors;
- 4) Human factors.

In different stages of franchise system development, different factors are acting or their level of influence differs. All those factors are systematized in theoretical franchise system development model (see Fig. 1). The model covers six main areas that influence franchising as business development form: elements of franchising, process of franchise development and functioning, management, marketing, legislative and human factors. Main franchising elements are the most important factors influencing franchise system, whereas management, marketing, legislative and human factors act as their supplements. All these factors in one or another stage of franchise establishment and/or further development influence franchise system and determine its success and effective growth. Franchising cannot exist without its main elements, whereas all other factors only need to be developed to a certain level in order to reach efficient operation of the system.

Establishment process of franchise system is very similar to development of other business forms, however it is influenced by different factors. Firstly, suitable business environment has to exist for franchise system to emerge. It has to be followed by the wish of the potential franchisor to expand his business using franchise business system. Later, the creation of the franchise system itself, then its initial development and finally fully functional franchise system must follow.

Elements of franchising imply its attractiveness as a business development form to the franchisee. Therefore, without suitable franchisors, suitable franchisees cannot appear. Brand, license and established business system compose the business package that is offered by franchisor to franchisee. Both parties have to offer particular amount of investments and franchisee has to commit to pay agreed taxes.

Management factors influence both parties of franchise system. Managerial factors influence franchisor's assessment of the market and the decision to expand his business using franchising. This is also influenced by the market specifics. Existing business units show if business is successful and if there is any sense to expand it using franchising. The establishment and further development of particular new franchise business unit require the assessment of financial

capacities of both parties. Distribution of risk and costs are very attractive and important factors for both parties of franchise business system. In addition, franchisor has to evaluate his financial and quality control systems.

The most important marketing factors are business idea, brand, and its image, because they determine the business attractiveness for franchisees. Franchisor cannot develop franchise system without business and marketing plan, or without demand for goods and services, because all these factors determine business attractiveness and potential success. The same design of business units and advertising allows the franchisor to develop the entire franchise system using the same principal.

Laws and legislative situation related to protection of brands are highly important to franchisor in order to secure legal and safe operation of his business. Whereas legislative aspects are significant for both business partners, as they

determine the cooperation conditions and ensure smooth functioning of franchise system. Business standards and procedures are very important for development of homogeneous franchise business system.

Franchise business partners are similarly influenced by human factors. Continual communications, level of control and coinciding interests are important for franchisor and franchisee. Nevertheless, franchisee's selection standards, his competences, personality and motivation are the most important to franchisor, since these factors determine the success of relations between business partners. However, without leadership, good team management and strong training programs franchisee would not be prepared to manage a particular business. External relations (with suppliers, governmental and financial institutions, etc.) are also necessary to ensure the effective operation of franchise network.

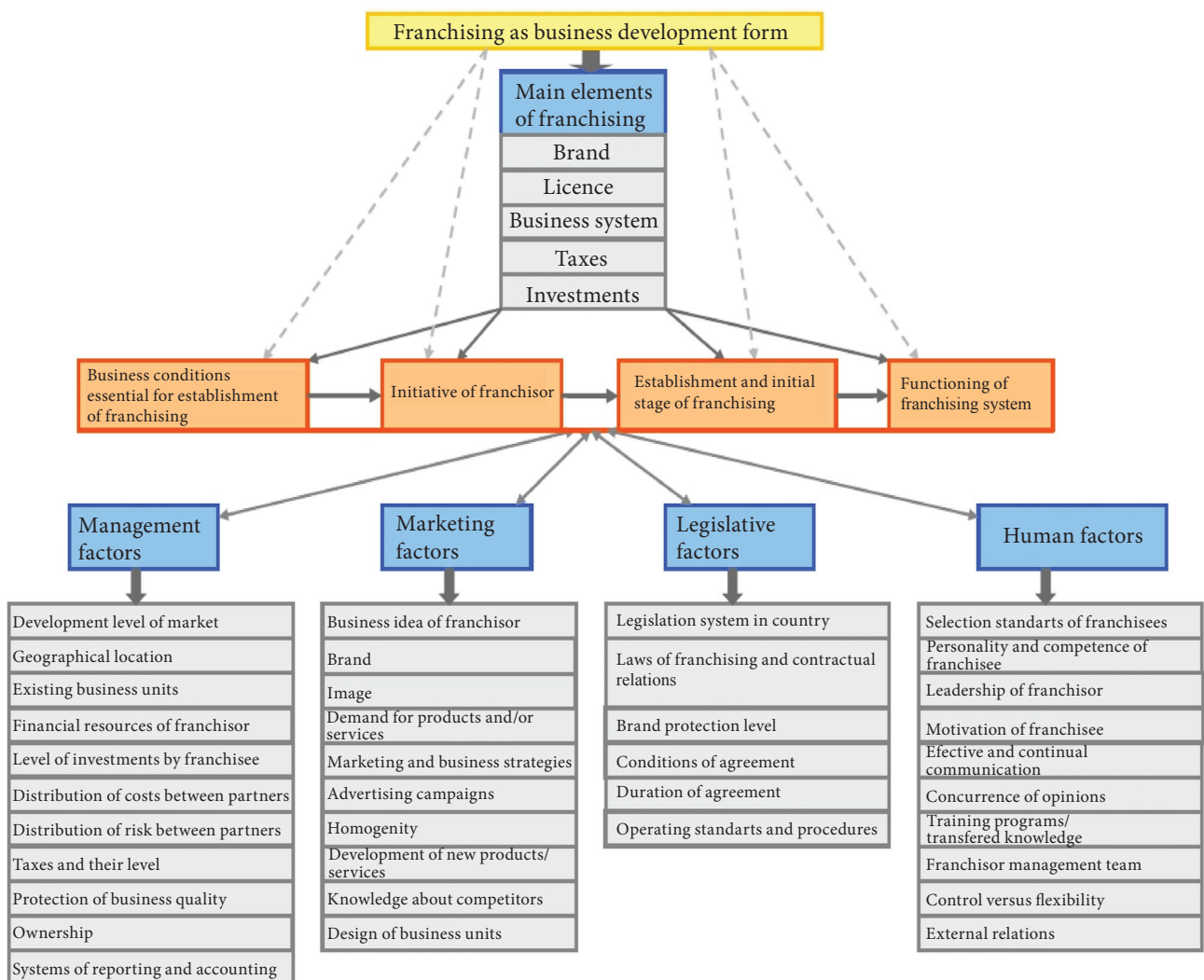


Fig. 1. Franchise system development model

## 6. Conclusions

The theoretical considerations about the main phases and elements of franchise system development as well as advantages and disadvantages of the system were analysed in the article. These theoretical considerations were generalized in theoretical franchise system development model, which shows, that development of franchise business consists of particular steps, starting from favorable conditions for the system to emerge, intention and ability of franchisor to form franchise based on his business, then the establishment and initial development of franchise system and its further functioning. All stages of franchise development are influenced by particular business factors and required elements that determine advantages of franchising and separate it from other business forms. Therefore, business can be expanded using franchise system if it has a well-known brand, successful business performance and clear system can be formed. Also, when brand and other intellectual property of the company are secured by legal system and laws, business owner does not have sufficient financial resources for independent business development and/or rather big differences exist for development of the potential market. Finally, potential franchisees exist that are interested in particular franchise. The potential franchisor might decide to expand his business using franchise business system if the above mentioned conditions are present. The model was formed including five main franchising elements, development stages of franchise system and business factors affecting this process.

This article does not test the model and even does not discuss the operationalization of it. However operationalization of the model as well as empirical evidence will be presented by the authors during the 4th annual EuroMed conference "Business Research Challenges in a Turbulent Era" in 2011.

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