International Journal of Disaster Recovery and Business Continuity
Vol.11, No. 1, (2020), pp. 2849–2856

The Franchising Contract And Franchise Profitability: A Literature Review

Dr. Leopoldo Francisco T. Bragas, Cresilda M. Bragas

College of Business Administration, Polytechnic University of the Philippines
lftbragas20@gmail.com, cmbragas@yahoo.com

Abstract

Franchising is one of the most preferred businesses nowadays due to some reasons. Foremost of these is the issue of profitability and low level of risk on the part of the franchisee. Although some may have gained some level of satisfaction there are few whose profitability has been compromised due to some issues like choice of location, franchising fees, royalties, lack of control over franchisees' staff. These factors may have contributed a lot to low profitability on the use of the franchisees. Thus, imperative to understand that franchisee's financial success or failure can have implications not only on the former business interest but equally to franchisors. It is then for this reason that as much as possible the two parties must find a common ground by which both may be financially benefited. The franchisor has a lot to contribute in this aspect because both technically and practically he runs indirectly the whole of franchising as they say; he runs the show, the franchisee is just an expectator. He decides everything; the location, the facilities, the staff, production process and inventories, and even for such matter as pricing and quality, and of course franchise fees and royalties. It is at this juncture to safely conclude that the outcome of the business in financial terms primarily rests in the hands of the franchisor. If this is the case so, therefore, the financial outcome of the business is totally in his hand. It can all affect the financial interest of the franchisors but research made on franchising failed to take a closer look at this aspect that the franchisor's financial goals are not as well properly served if some of its franchisees do not realize the appropriate level of returns.

INTRODUCTION

Franchising is one of the most promising forms of business ventures today garnering huge proportion of the total business intake for processing and registration with government entities and widely preferred by entrepreneurs with limited capital who want to engage in a much bigger type of business with corporate-like status and more importantly can provide them with stable market and income. Franchising is noticeable everywhere especially in services particularly food; it sprouts a lot not only locally but also internationally. The massive growth of franchising worldwide has caught the attention of a lot of people especially those intending to engage in business. We ask basic questions like what is needed to be able to engage in that business; capital legal requirements, possible earnings, managerial competence, etc.? and some secondary questions like what is in this business such so that a lot are enticed to go into it? Primarily, we can enumerate factors like high market acceptance, readily-devised management system, good operation, and production management system, and market stability, and very low marketing and advertising costs and its economic implications. When we decide whether to franchise or not to franchise, we can look at the studies conducted to prove that in franchising there are more chances to earn bigger and create value for the (Moon and Sharma, 2014). However, as the franchise business is getting bigger together with profit margin there is always the temptation by the franchisor to redirect franchise outlets into company-owned outlets (Kaufmann and Dant, 1996). In franchising developing a presence in the emerging market is supposedly a good proposition to pursue however because this entails a lot of problems, thus entry into this market must

ISSN: 2005-4289 IJDRBC

be determined by the following factors; geographical distance, cultural orientation, uncertainty avoidance, individualism, political stability, and corruption (Baena, 2012; Buena and Cervino, 2014).

Franchising from international franchisors, it helps a lot f the home country of the franchisor economically through the preservation of jobs domestically and bring in a sizable amount of foreign exchange (Bracker, and Pearson, 1986; Fenwick and Stromborn, 1998) and quite, enormous in regards to its growth in the developed world with most acceptable brands in its products Z as state by Jumadildayeva and Uspanova (2015). However, not all areas profitable as some people think; it is still contingent on a host of factors. The franchise agreement takes a very dominant role in this regard (Blair and Kaserman, 1982; Mathewson, and Winter, 1994; Tikoo, 1996; Goaled, 2016). A highly profitable franchise brand is not exactly profitable this is still dependent on the agreement on franchise fees, and some other terms and conditions of the franchise contract, KL, Ailawadi, BA Harlam, and J. Cesar (2006), N Wreden (2007)M. Yeung, and B. Ramasamy (2008), Nirmalya Kumar (2003) LC Winters (1991) KL Ailawadi (2004). The success of a franchisee financially is all affected by the way the franchisor will satisfy his financial objectives which may have bearing on profitability because in a more traditional approach of the franchisor to achieve this is by way of collecting more franchise fees and royalties which consequently affect in a negative sense franchisees' level of investment return.

METHODOLOGY

A review of literature on firms' profitability in a franchise contract arrangement is conducted emphasizing subjects in the contract that would significantly impact profitability; we classify these areas as location, franchise fees, firm's size, brand name, types of products, and competition. These are considered elements of profitability framework with significant bearing on the profitability of franchised firms. To gather the needed literature, every journal both university published and that by renowned publishers are scooped for literature on profitability impacted by such factors as firm size, brand name, franchise fees, the product sold, and competition. This study aims to determine how various studies in those areas create an impact on the firm's profitability. The information generated may be used to build a theoretical foundation that may help explain profitability subject to conditions precipitated by the various variables enumerated above. Each variable is analyzed based on sub-variables as each of them contributes to a certain degree to the profitability of the franchised firm. It is equally important that the method used in analyzing the relationship between the dependent variable which in this case profitability and the dependent variables: size, location, ownership whether local or foreign, level of competition (the type of market), and costs (franchising costs and royalties). We take a view about the contribution of the various studies in the development of theory which may extensively explain the various factors both the major's ones and the underlying which may help greatly in fully understanding profitability. How the studies have been conducted are evaluated and undertake a critique on it whether the authors have reasonable arguments in his methodology for his research paper.

RESULTS AND DISCUSSION

In business, bigness is a critical factor of financial success (Hall and Weiss, 1967; Tepuric, 2002; Akinyome, et. al, 2013; Isik, et.al, 2017;) however, firm size may not be at all a passport to higher profitability (Abeyrathna and Priyadarshana, 2019)and this does not preclude franchising as both are into a similar endeavor. The franchisor's enormous assets enable them to influence franchisees' financial success because they are more able financially to spend for good technology, hire competent managers and staff, purchase good business location and brand development. However, franchisees business management acumen, experience, and characteristics still play a critical role but limited to just supervision because the business final decision is still a franchisors' domain such that a low performing manager may not be fired

ISSN: 2005-4289 IJDRBC

easily even though you pay their salaries and wages because the franchise contract says so. However for franchisees with great experience and a good attitude, a sort of autonomy may be provided but still, the franchisor ensures that compliance is regarded as the most essential in their business relationship (Gomes, 2019). All business operations issue which the franchisees is not authorized to decide is always referred to the franchisor for final disposition. This is the difficult part of it because being an owner of a franchised store your ability to influence business decisions are strictly limited so that financial success of a franchised business is entirely a (built-in) phenomenon hence a franchise brand which has a good name and commands popularity in the market can be more successful financially. Thus franchisees' chance of achieving business success is entirely contingent on the size of the business which commands greater popularity and market share.

The perception of a strong relationship between franchisors" level of assets and franchisees' financial success is signified in the study however when these variables are interlocked with franchise fees especially royalties franchisees' financial viability diminishes especially when they are into a contract with foreign-based franchising because of the impact of fluctuating exchange rates and their strict adherence to labor standards. Foreign-based franchising strictly observed the labor laws of the country particularly wages, benefits, and security of tenure. These conditions have made them pay a greater amount for labor costs. This is the predicament of the franchising contract with foreign-based franchising; the franchise cost may fluctuate because of the irregularity in the exchange rate of the local currency. The choice between a local-based and foreign-based franchising is enormously hindered by this factor. Although foreign-based franchising is preferred over a local one but the impact of Peso volatility restrains franchisee to choose in favor of foreign a franchise. Except for some consumers, the general attitude for buyers is predicated on price mostly, and secondarily quality, buyers adhering to foreign brands are mostly influenced by advertising and promotion.

The issue about the location is a factor of success in franchising. The franchisor has all the power to assign a location for the franchisee; it is an arrangement of "take it or leave it" principle. The franchisor comes up with this arrangement because of competition. The clustered firm normally has less profit than when the firm is spatially located Nguyen Diem (McCraken, et al, 2019) However, the presence of corporate power should rationalize the position taken by the firm based on this argument that if you are a dominant firm in the industry the negative impact of your location on profitability is neutralized by the level of corporate power you have in the industry which means that no matter how bad is your location is or how saturated is it? These don't matter if the brand is enormously competitive, thus location doesn't' matter much to your profitability (Tavakolnia and Makrani, 2016). The firm can control its rivals foray into its market. Thus, what we see instead are outlets of the strong firm competing against its other. The issue of location decision is also a factor of demand variability in the local market thus would make the franchisor resort to have its business franchised to earn more rather than unilaterally owned it (Mishra, 2016). The rationality behind this is competition; competition vis-à-vis location of the business can have bearing on profitability however the degree of the firm's corporate power neutralizes this condition. The problem of supervision is another factor worthy to look at more consistently and aggressively because it affects not only the profitability of the franchised firm but also its reputation and eventually its market value. To maintain the firm's market position and profitability, there must be consistency in the systems or processes it adopts for all its operations. As stated by Hornsby (2011) to maintain trust because the quality of all its products no matter where it is sold is standardized and is carried in the mind of buyers.

In franchising as in another type of business, brand name command a significant pull on customers' adherence to a product. Although the brand name is more of a product-specific for some companies, the brand name carries a bundle-like recognition such that a company may be known only in a particular product but customers attitude towards such brand may engulf all other products of the firm, however, such loyalty may continue for as long as the company is consistent with all its product and pricing policies. In some instances, customer loyalty towards a brand is all a factor of quality as defined by its buyers, and to

ISSN: 2005-4289 IJDRBC

the most extent, it is more of a culture thing that the company able to maintain over a wide length of time. In some markets, branding is carried out through the following medium namely: brand packaging, brand personality, and word of mouth. Among the three, the word of mouth is more powerful when it comes to the medium used in promoting the brand of the product significantly influenced profitability (Akhtar, et.al, 2017). Branding extension is a good strategy to introduce a new product using the company's existing product to create a new product that is related to it. It is also important to be mindful of the contribution of each group of consumers to the financial health and growth of a brand. All consumers of a brand are important to a firm but focusing on the most profitable buyers is a wrong strategy for growth because other groups are neglected especially average buyers. It is most essential that added buyers must be considered valuable and the firm must initiate a recipe of consumer satisfaction which is appealing to everybody; both new and existing consumers (Anschuetz, 2002). It is equally important that the branding should be coordinated with consumers' mindset on price and the societal contribution of such brand. These three elements hold the key to financial success however branding along these lines must be consistent with consumers' mindset which of course is changing. Entrepreneurs must always be aware of these changes and initiate the appropriate redirection of their policies towards that new mindset (Rappaport, et.al, 2013). Brand awareness may be important but to some people, the brand name may not be that essential which therefore quite easy to say that brand loyalty is not a factor to significantly impact profitability. However, when we combined the two with quality perception about a product there are more chances for profitability to increase (Yassen, et. al, 2011).

Product Market Competition is a state of rivalry among firms in an industry. The standing theory suggests that as competition rages in a market manager will have to improve their performance and achieve a greater impact on the firm's value otherwise they will be removed. Thus it is eloquent to state that competition will put pressure on managers to improve performance and achieve greater value for the firm. However, when this theory is tested among firms in the European Union, corporate governance has a positive relationship with the firms' value but limited only to non-competitive industries. Managers make decisions on enlarging capital expenditures, fewer acquisitions, and less exposure in diversifications (Ammann, et al, 2013). Price competition among franchisees in a certain location is tighter than those of ordinary businesses. When franchisors attempt to reduce price competition among his franchises, the franchise's subsequent action on price reduction does not result to achieve joint benefits for the two sides (Conlin, 2004).

In franchising as in any form of business, it is well understood that the longer the franchise relationship is the more the franchise becomes financially stable, and the more it should charge for franchise fees to survive much longer. It is also a recipe of success for franchisees that they have to open more outlets at a sustainable pace, increase franchise fees as the brand name of the franchise increased in value and must be coordinated and managed the franchise more efficiently and increase profitability (Monge, et. al, 2017). It is also a piece of common knowledge in franchising about the existence of franchise costs which other kinds of businesses do not have. In a franchised firm the net margin is computed as the difference between revenues received and expenses incurred while in franchising there is a need to deduct the franchise royalties which makes the net margin much lower (Benjamin, et. al, 2006).

CONCLUSION

This study aims to establish the relationship between some elements of the franchising contract and some other market variables with enormous implications on the profitability of franchising. This is a literature review- based study wherein studies conducted covering a wide array of topics with an enormous bearing on the profitability of franchising are analyzed. The topics include branding, product market competition, business locations, franchising costs, and governance systems.

ISSN: 2005-4289 IJDRBC

A royalty fee extracted from sales will cause dis-incentives to the franchisees and thus would not make him able to attain his financial objectives (Tikoo and Nair, 1999; Benjamin, et.al, 2006). The profit-based royalty fees can have bigger incentives for the franchisees to pursue higher sales goals that would be beneficial as well to franchisors. However, franchise fees are also means by which the franchising may lengthen its life provide financial stability not only on the part of the franchisors but as well the franchisees which may enable the latter to create more outlets as the brand name increases its value and the efficient and highly coordinated management system which may be put in place (Monge, et. al, 2006).

This study concluded that the profitability of the franchisees primarily hinges on the brand of the product. Those franchisees whose franchisors are selling branded products tended to generate more sales and profit than those under contract with a less popular brand. The brand image can have an enormous consequence on the product's profitability through word of mouth thus enabling the product to be advertised in a non-formal manner but effective in enhancing its marketability (Akhtar, et.al, 2017). Although, foreign franchising is good branding and may provide a good name in the local market however the issue of foreign exchange fluctuation is a critical factor to affect the franchisee's rate of return. It would also be profitable to consider the so-called bundle branding, customers' attitude towards a brand normally is a sweep for all other products of the business. To maintain the customer's loyalty towards your products, a company must be consistent with the quality of its product. It is equally important to note that the brand is not an ultimate tool to exact customers' loyalty; the firm from time to time must introduce innovation according to customers' state of mind.

The franchise contract renewal is a financial burden to franchisees that would generate a negative impact on the profitability of the franchisee. It is a high capital cost that will take time for the franchisee to recover and perhaps can have enormous repercussions on the profitability of their investment. The franchise contract stipulates that the operational aspect of the franchisees is subject to franchisors' control. This includes human resources a very important element in business profitability. The performance of people in the organization is subject to how these people can be productively and efficiently manage. The lack of direct disciplinary measures by the franchisees disables the franchisee to effectively manage its human resource. The problem of motivation and skill development and franchisees' lack of autonomy and their being risk-averse undermines their psychological and financial objectives (Zolfagharian and Naderi, 2019). Because a huge amount of money is invested in them, having them less productive can have an enormous implication on the profitability of the franchisees. In franchising, the franchisees pay the operational cost for manpower and other inputs but they cannot manage them more efficiently and productively because the decision on this matter is a sole prerogative of the franchisor. The franchisor's unwillingness to provide greater autonomy to franchisees vis-à-vis HR decisions may be gleaned from the fact about brand damage and liability risks, the cost of providing HR support, and franchisees' needs and expectations of support. Kellner, et. al, (2011) state that these areas will determine the extent of HR support in the franchise contract.

Business location is one of the highly contentious issues in franchising. The franchisors alone decide on where the business location of the franchisee is to be established. The franchisor has his trajectory about the location of branches and considers the viability of all branches when deciding for the location. The franchisor normally would want to avoid clustering and would rather endorse a spatial positioning of outlets (Nguyen Diem, et.al, 2011). However, this can be disregarded depending upon the corporate power which the franchise exact on its market. Whether your outlets are located close to one another or sparsely distributed but you are highly competitive still your franchise is highly profitable (Tavakolnia, and Makravi, 2016). Mishra (2016) suggests that if there is demand variability in the franchise products, it would be more appropriate to put up outlets in various locations to maintain profitability and the franchisors must approve more franchise applications, to be set up in various areas regardless of demand conditions. Another consideration is supervision that franchisors having franchised outlets in many far locations can be problematic to maintain its production and operations standards due to distances (Hornsby, 2011).

ISSN: 2005-4289 IJDRBC

RECOMMENDATIONS

The franchising contract as much as possible must incorporate both the interest of the franchisors and the franchisees. It is a means by which the relationship between the two should be clearly defined and such should be a product of negotiation and bargaining. Although hard positions are taken by the franchisors and that is highly understandable because of their desire to protect the market value of their brand. However, clinging unto this philosophy does not make the franchisee a productive partner.

The brand development must also be a matter of big concern for franchisors and franchisees alike. The development of a strong brand does not necessitate the total development improvement in all the company's products. A single but highly developed product would be enough to entice more buyers and develop the brand of the firm to include all of its other products. Although the quality of all its other products is not consistent with its main products, the customer's psyche on the brand is of good quality. This, however, must be complemented by the company's continued innovation based on its customers' state of mind and must not revise prices oftentimes and must maintain quality standards.

The location is a factor that must be considered based on the firm's level of competitiveness. There is no problem with outlets in a non-dispersed positioning provided the brand has the corporate power and has a certain degree of market competitiveness. It would also be beneficial if several outlets must be limited to a certain degree with which the franchisors can effectively and efficiently supervise to avoid the quality of its products and services compromised. In franchising, the rate of return for franchisees is normally lower than any other business because of franchise cost which in most instances reaches 20% of the gross sales. Although this can make prospective franchisees to be less interested, this should not be the reason for the franchisor to reduce franchise fees. The franchise fees are needed to develop further the franchise and its brand to increase its market value and enable the company to initiate further improvement in quality and efficiency so that the brand name may be more popularize and widen its market share which can be beneficial to both the franchisors and the franchisees and this must be explained well to incoming franchisees that structurally as both are aiming for higher investment return. The franchising contract must not only for restrictions but means to develop a sort of giving and take relationship wherein the feeling of the partnership should be strong (Monroy and Sanchez, 2018). The franchise system must be capable of serving the goals of the franchisee through provisions of franchisor services (Achrol and Etzel, 1992). The franchisors must think that helping the franchisees gained profit is also providing an opportunity for its business to be profitable and both are mutually benefited. Thus reasonable to conclude that the relationship which existed in franchising is one that engages both the franchisor and the franchisee in an entrepreneurial relationship and not one that promotes dependency (Stanworth, 1993).

Therefore, one way a good way to promote this is for the franchisor to take the initiative to extend help to the franchisee attain a good take-off for his business to enable him to attain financial stability. But in what manner the franchisees should be aided? The franchise level of competitiveness is one of the factors that may create bearing on promoting franchisee's financial objectives and the relationship may well be served and promoted if there is a good communication system between the franchisor and the franchisee (Chiou, et. al, 2003; Kang, et. al, 2018) and fairness in their relationship (Shaikh et. al, 2018).

References

ISSN: 2005-4289 IJDRBC

1. Achrol, R. S., &Etzel, M. J. (1992).Enhancing the effectiveness of the franchise systems: franchisee goals and franchisor services. In *Babson Research Conference*.

2. Ailawadi, K. L., & Keller, K. L. (2004).Understanding retail branding: conceptual insights and research priorities. *Journal of retailing*, *80*(4), 331-342.

3. Ailawadi, K. L., Harlam, B. A., Cesar, J., & Trounce, D. (2006). Promotion profitability for a retailer: the role of promotion, brand, category, and store characteristics. *Journal of Marketing Research*, *43*(4), 518-535.

4. Aissa, S. B., &Goaied, M. (2016). Determinants of Tunisian hotel profitability: The role of managerial efficiency. *Tourism management*, *52*, 478-487.

5. Akhtar, S., Xicang, Z., & Iqbal, S. (2017). Impact of Brand Image on the Profitability of Firm, Analysis of Nestle Company Pakistan. *Review Pub Administration Manag*, *5*(230), 2.

6. Akinyomi, O. J., &Olagunju, A. (2013). Determinants of capital structure in Nigeria. *International Journal of Innovation and Applied Studies*, *3*(4), 999-1005.

7. Hall, M., & Weiss, L. (1967).Firm size and profitability. *The Review of Economics and Statistics*, 319-331.

8. Blair, R. D., &Kaserman, D. L. (1982).Optimal franchising. *Southern Economic Journal*, 494-505.

9. Bracker, J. S., & Pearson, J. N. (1986).The impact of franchising on the financial performance of small firms. *Journal of the Academy of Marketing Science*, *14*(4), 10-17.

10. Brent, A. (2009). Franchisee satisfaction among food franchisees: an exploratory study. *Southern African Business Review*, *13*(1), 1-20.

11. Chiou, J. S., Hsieh, C. H., & Yang, C. H. (2004).The effect of franchisors' communication, service assistance, and competitive advantage on franchisees' intentions to remain in the franchise system. *Journal of Small Business Management*, *42*(1), 19-36.

12. Fenwick, G. D., &Strombom, M. (1998). The determinants of franchisee performance: an empirical investigation. *International Small Business Journal*, *16*(4), 28-45.

13. Hua, N., O'Neill, J. W., Nusair, K., Singh, D., &DeFranco, A. (2017). Does paying higher franchise fees command higher RevPAR?. *International Journal of Contemporary Hospitality Management*, *29*(11), 2941-2961.

14. Isik, O., Unal, E. A., &Unal, Y. (2017). The effect of firm size on profitability: evidence from Turkish manufacturing sector. *Journal of Business Economics and Finance*, *6*(4), 301-308.

15. Jumadildayeva, Z., &Uspanova, M. (2015). Franchising as a Tool for Small and Medium Business Development. *Mediterranean Journal of Social Sciences*, *6*(5), 429.
16. Kang, B., & Jindal, R. P. (2018). The Dual Role of Communication in Franchise Relationships: A Franchisee Perspective. *Journal of Small Business Management*, *56*, 197-214.

ISSN: 2005-4289 IJDRBC

17. Kang, J., Asare, A. K., Brashear-Alejandro, T., & Li, P. (2018). Drivers of franchisor growth: a meta-analysis. *Journal of Business & Industrial Marketing*.

18. Kaufmann, P. J., &Dant, R. P. (1996). Multi-unit franchising: Growth and management issues. *Journal of Business Venturing*, *11*(5), 343-358.

19. Kumar, N. (2003). Kill a brand, keep a customer. *Harvard business review*, *81*(12), 86.

20. Mathewson, F., &Winter, R. (1994). Territorial restrictions in franchise contracts. *Economic Inquiry*, *32*(2), 181-192.

21. Moon, J., & Sharma, A. (2014). Franchising effects on the lodging industry: optimal franchising proportion in terms of profitability and intangible value. *Tourism Economics*, *20*(5), 1027-1045.

22. Monroy, M. F., & Sánchez, I. G. (2008).Desarrollo de relacionessatisfactoriasen la franquicia: unanálisis de losantecedentesdesde el enfoque de redes/The development of satisfactory relationships in the franchise system: an analysis of the antecedents from the network perspective. *Cuadernos de EstudiosEmpresariales*, *18*, 151.

23. Pizanti, I., & Lerner, M. (2003).Examining control and autonomy in the franchisor-franchisee relationship. *International Small Business Journal*, *21*(2), 131-159.

24. Shaikh, A., Sharma, D., Vijayalakshmi, A., & Yadav, R. S. (2018). Fairness in franchisor–franchisee relationship: an integrative perspective. *Journal of Business & Industrial Marketing*.

25. Stanworth, J., Purdy, D., Zafiris, N., Wilson, P., Woods, A., & Kirby, D. (1993).Small firms in recession. *Small firms: recession and recovery, London: Paul Chapman*.

26. Tikoo, S. (1996).Assessing the franchise option. *Business Horizons*, *39*(3), 78-83.

27. Tikoo, S., & Nair, S. K. (1999). Variable royalty rates for improving franchise channel coordination. *Decision Sciences*, *30*(2), 469-479.

28. Winters, L. C. (1991). Brand equity measures: some recent advances. *Marketing Research*, *3*(4), 70.

29. Wreden, N. (2007). *Profit Brand: How to increase the profitability, accountability & sustainability of brands*.Kogan Page Publishers.

30. Yeung, M., &Ramasamy, B. (2008). Brand value and firm performance nexus: Further empirical evidence. *Journal of Brand Management*, *15*(5), 322-335.

ISSN: 2005-4289 IJDRBC