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The fee structure in franchising: a property rights view

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Abstract

The paper offers a property rights explanation for the structure of royalties and initial fees in franchise relationships. We argue that the structure of royalties and fees depends on the distribution of intangible assets between the franchisor and franchisee. Contrary to the agency theory our property rights approach predicts a positive relationship between royalties and fees. This hypothesis was tested by using data from the Austrian franchise sector.

Keywords: Franchising; Initial fees and royalties; Ownership rights; Intangible assets; Residual income

JEL classification: M30; L20

1. Problem

The present article focuses on a property rights explanation of the fee structure in franchise relationships by emphasizing the role of intangible assets as determinant of the residual income rights. By applying the property rights theory of the firm (Hart and Moore, 1990; Hart, 1995; Brynjolfsson, 1994) we argue that the allocation of residual income rights depends on the distribution of intangible assets between the franchisor and the franchisee, i.e., the importance of the franchisor's system-specific assets relative the the franchisee's local market know-how to generate the residual surplus. Based on the property rights approach we derive the following hypothesis: The higher the franchisor's (franchisee's) intangible assets relative to the franchisee's (franchisor's), the more residual income rights should be transferred to him, and the higher (lower) are the royalties and fees. Contrary to the agency theory the property rights approach predicts a positive relationship between royalties and fees. This hypothesis was tested by using data from the Austrian franchise sector. The empirical results are supportive of the hypothesis.

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The paper is organized as follows: in Section 2 we review the different approaches to explain the fee structure in franchising and argue why they cannot explain the fee structure in franchise relationships. Section 3 develops the property rights hypothesis. Finally we test the hypothesis that the fee structure depends on the distribution of intangible assets between the franchisor and franchisee.

2. Literature review

According to the agency theory of franchising (Rubin, 1978; Mathewson and Winter, 1985; Lal, 1990) royalties are chosen as a function of risk and incentives and the initial fee extracts rents left downstream by the royalty rate. Therefore the principal/agent models imply that the franchise fee as present value of all future profits left downstream should be inversely related to the royalty rate. Although this approach offers an explanation of the fee structure in franchise agreements empirical results do not support the negative relationship between royalties and initial fees. No significant correlation was found by Lafontaine (1992, 1993), Lafontaine and Shane (1998) and Dnes (1992a,b). On the other hand, Baucus et al. (1993), Wimmer and Garen (1997) and Rao and Srinivasan (1995) show that a significant and positive relationship exists between initial fees and royalties.

A further explanation of the franchise fee is offered by the screening theory (Dnes, 1992a,b). According to this theory fixed fees and specific investments have a screening function by attracting competent franchisees. The higher the initial fees and specific investments, the more likely franchisees with high entrepreneurial capabilities are selected. In addition an alternative explanation of the initial fees is given by the transaction cost model of Klein (1980) and Williamson (1985). They show that the initial fee serves as a hostage in the franchise relationship. The payment of the initial fee prevents the franchisee from expost opportunistic behavior, i.e., from expropriating quasi rents generated by the franchisor's system-specific assets (brand name capital). Empirical results support the positive relationship between initial fees and system-specific assets (Bercovitz, 1999). In addition to these approaches Galini and Lutz (1992) developed a signalling theory of franchising. In this model the franchisors have private information about the brand name value of their franchise system that they intend to communicate to potential franchisees. High (low) variable fees and/or a high (low) number of franchisor-owned outlets serve as a device to signal high (low) quality investments of the franchisor in his brand name. Empirical results do not support this theory (Lafontaine, 1993).

In sum, these approaches offer partial explanations of the fee structure in franchising. On the other hand, the empirical results contradict one of the main propositions of the agency theory, namely that initial fees and royalties should be inversely related. To explain a positive relationship between fees and royalties the property rights approach may offer a theoretical foundation. By applying the property rights theory of the firm we argue that the structure of royalties and initial fees depends on the distribution of intangible assets between the franchisor and franchisee.

3. A property rights view of the fee structure

3.1. Intangibility of assets as determinant of the property rights structure

The asset characteristics relevant for the determination of the residual income in franchising is the degree of intangibility (Hart and Moore, 1990; Brynjolfsson, 1994). Intangible assets refer to knowledge and skills (know-how) largely stored in the minds of men (Nelson and Winter, 1982, pp. 75–76) that cannot be codified and easily transferred to other agents since they have an important tacit component (Polanyi, 1962; Itami and Roehl, 1987; Lazaric and Marengo, 2000). For instance, if the local market know-how of the franchisee cannot be made fungible, it is critical to the success of the network to give him residual income rights to improve his incentive to undertake intangible investments.

What are the intangible assets in franchising? The franchisee's intangible assets refer to the local know-how, i.e., the franchisee possesses "knowledge of the particular circumstances of time and place" (Hayek, 1945, p. 524) that result in efficient marketing strategies in combination with the franchisor's system-specific know-how. The franchisor's intangible assets refer to the system-specific know-how as brand name assets (Klein and Leffler, 1981; Norton, 1988). If the franchisor's brand name investments (e.g., national advertising) are very important to the market success of the product or service, he has to be given an important ownership stake to provide the necessary investment incentives.

3.2. The property rights hypothesis

According to the property rights approach the allocation of residual rights should encourage investments in intangible assets that create a large fraction of residual income. This means relatively high initial fees and royalties when the system-specific assets of the franchisor are very important for the creation of residual surplus, and relatively low initial fees and royalties when the local market know-how of the franchisee is very critical for the success of the network.

3.2.1. Initial fees

Initial fees are the remuneration for the system-specific know-how transferred to the franchisee at the beginning of the contract period. The higher the franchisor's intangible assets as brand name capital at the beginning of the contract period, the higher are the rents generated by his know-how and the higher are the initial fees. These results are consistent with the view that the franchisor may recover his sunk investments through the initial fee because high sunk investments may arise when the system-specific know-how is very important for the success of the franchise (see Rubin, 1978; Dnes, 1992a, 1993; Frazer and McCosker, 1996; Bercovitz, 1999).

3.2.2. Royalties

By linking the franchisor's residual income to his investments in system-specific assets, he has an incentive to undertake the requisite investments during the contract period. Therefore, the more important the franchisor's intangible investments are relative to the franchisees's intangible investments, the higher is the fraction of residual income created by him, and the higher should be the royalties (Rubin, 1978; Rao and Srinivasan, 1995; Brickley and Dark, 1987). Conversely, the more important the franchisee's intangible investments are relative to the franchisor's intangible investments, the higher should be his fraction of the residual income and the lower should be the royalties to provide the necessary incentive for the franchisees. In addition, a further proposition about the relationship between fees and royalties can be derived: The franchisor's specific investments depend on the initial stock of assets because a franchise with a high brand name capital requires more system-specific investments to assure a certain franchise value compared to a franchise with a low brand name capital. For instance, as argued by Klein and Leffler (1981, p. 630), advertising expenditures are brand name investments that signal the presence of firm-specific assets. Hence a high brand name capital requires high advertising expenditures. Consequently, the higher the franchisor's system-specific assets, the higher are his intangible investments during the contract period, and the higher are the fees and royalties as residual income rights.

As a result, the property rights view of the fee structure can be summarized by the following proposition: the higher the franchisor's (franchisee's) intangible assets (know-how) are relative to the franchisee's to generate the residual surplus, the more residual income rights should be transferred to the franchisor (franchisee), and the higher (lower) should be the fees (initial fees and royalties). The following testable hypothesis can be derived from this approach:

H1: The fees are positively related to the franchisor's fraction of intangible assets and negatively to the franchisee's fraction of intangible assets.

4. Empirical analysis

The empirical setting for testing this hypothesis is the franchise sector in Austria. The data set was collected in 1997. After several preliminary steps in questionnaire development and refinement, including in-depth interviews with franchisors and representatives of the Austrian franchise association, the final version of the questionnaire was pretested with 10 franchisors. The revised questionnaire, which incorporated the alterations suggested by the pretest, was mailed to 216 franchisors in Austria. We received 83 completed responses with a response rate of 38.4%.

4.1. Measures

To test our hypothesis two groups of variables are important: Intangible assets and fees as residual income rights.

4.1.1. Intangible assets

They refer to the non-contractible system-specific assets of the franchisor and the outlet-specific assets of the franchisee. As argued in organization theory, knowledge transfer methods vary with the degree of ambiguity (equivocality) of the decision situation (Daft and Lengel, 1986). As shown by Simonin (1999), greater ambiguity is associated with assets that are more tacit. The higher the degree of tacity, the lower is the degree of codification of knowledge, and the more personal (face-to-face) knowledge transfer methods are used, such as telephone, meetings, visits and personal training. By applying this approach the intangibility of franchisor's assets are operationalized by the number of franchisees' training days per year representing the use of face-to-face knowledge transfer methods. A similar measurement concept was used by Darr et al. (1995), Argote (2000) and Dyer (1996). The assumption behind this measure is that as intangibility of assets increases, so does the number of days of face-to-face interaction. Intangible assets of the franchisee refer to the franchisee's local market know-how. The higher the degree of intangibility of franchisees' know-how, the larger is the local market knowledge advantage of the franchisee compared to the manager of a franchisor-owned outlet. Therefore, we use the local market knowledge advantage of the franchisee as indicator of the degree of intangibility of franchisee's outlet-specific assets. In the questionnaire the franchisors were asked to rate on a seven-point scale to evaluate franchisee's local market knowledge advantage.

Table 1
Descriptive statistics

	n	Minimum	Maximum	Mean	S.D.
Royalties (as percentage of sales)	73	0.00	20.00	4.2305	4.2682
Initial fees (as percentage of sales)	62	0.00	28.00	3.3216	4.6573
Local market knowledge advantage	71	1.00	5.00	3.8732	1.2754
Franchisees' training days (per year)	76	0	70	8.63	9.68

4.1.2. Fees

Fees refer to the initial fees (as percentage of sales) and the royalty rate (as percentage of sales). Table 1 presents descriptive data for the sample.

4.2. Test of hypothesis

To test the hypothesis first we carried out a OLS regression analysis with royalties as independent variable and annual training days and local market knowledge advantage as explanatory variables. Based on the hypothesis royalty rates are higher, the higher the number of annual training days and the lower the local market knowledge indicator. Therefore the coefficient of annual training days (as franchisor's know-how indicator) has a positive sign and of local market knowledge advantage (as franchsiee's know-how indicator) has a negative sign. Second, if the result of this regression analysis is significant, the question to ask is which relationship exists between royalties and initial fees. Our property rights hypothesis suggests a positive correlation between fees and royalties because higher system-specific know-how as brand name capital requires more intangible investments of the franchisor during the contract period to maintain a certain brand name value (Klein and Leffler, 1981). The relationship between fees and royalties were tested by carrying out a correlation analysis and a OLS regression analysis with royalties as independent variable and franchisees' training days, local market knowledge advantage and initial fees as explanatory variable.

In order to show the effect of initial fees on the dependent variable, we tested two models. In Model 1 franchisee's local market know-how advantage and franchisee's training days are included as explanatory variables and in Model 2 additionally the initial fees are included as independent variable. The data provide support for the hypothesis (see Table 2). First, consistent with the hypothesis, the coefficient of local market knowledge advantage is negative and significant in both models ($P < 0.05$) indicating that franchisee's local market knowledge advantages result in a lower royalty rate and therefore in a higher portion of residual income for the franchisee. Furthermore, the coefficient of annual training days is positive and highly significant ($P < 0.01$) indicating that more training days due to system-specific know-how results in a higher fraction of residual income of the franchisor. In addition, the coefficient of annual training days is much higher than the coefficient of local market knowledge advantage suggesting that the franchisor's system-specific investments have a larger impact on the royalty rate than the franchisee's local market investments.

Second, the data show a positive and slightly significant correlation between royalties and initial fees ($r = 0.233$ and $P = 0.087$). In addition, by including initial fees as additional explanatory variable

Table 2
OLS regression results

Dependent variable: royalties		
Independent variable	Coefficients	
	Model 1	Model 2
Intercept	7.088**	6.763**
	(1.841)	(2.111)
Annual training days of Franchisees	0.382**	0.389**
	(0.030)	(0.031)
Local market knowledge advantage	− 0.259*	− 0.287*
	(0.431)	(0.48)
Initial fees		0.251†
		(0.124)
F	8.505	6.964
Significance	0.001	0.001
R^2	0.240	0.332

**$P < 0.01$; *$P < 0.05$, †$P < 0.1$; values in parentheses are standard errors.

in Model 2 the results show that the coefficient is positive (0.251) and slightly significant ($P = 0.054$). Model 2 better fits the data because the explained sum of squares and R^2 increased compared to Model 1 (see Tables 2 and 3). This result is consistent with the property rights view where initial fees are the remuneration for the transfer of the system-specific assets and royalties are the incentives to undertake intangible investments to maintain a certain brand name value during the contract period. The higher the system-specific know-how, the more system-specific investments are necessary during the contract period and, consequently, the higher are initial fees and royalties as the franchisor's residual income. In addition, tests for heteroskedasticity and multicollinearity were performed. Multicollinearity and heteroskedasticity could not be corroborated.

4.3. Discussion and implications

The data suggest that the structure of royalties and initial fees in franchise contracts results from the different distribution of intangible assets between the franchisor and the franchisee. This study

Table 3
ANOVA (Models 1 and 2)

Model		Sum of squares	df	Mean square	F	P
1	Regression	275.101	2	137.550	8.505	0.001[a,b]
	Residual	873.322	54	16.173		
		1148.423	56			
2	Regression	354.725	3	118.242	6.964	0.001[b,c]
	Residual	713.152	53	16.980		
		1067.877	56			

[a] Predictors: (constant), local market knowledge, training days.
[b] Dependent variable: royalties.
[c] Predictors: (constant), local market knowledge, training days, initial fees.

presents the first empirical evidence that the structure of residual income rights in franchising may be explained by the distribution of intangible assets as firm-specific resources and capabilities. As suggested by our data, the franchisor's system-specific assets and the franchisee's local market know-how have a strong influence on the fee structure in franchise relationships. The higher the franchisor's intangible assets relative to the franchisee's, the higher is its portion of residual income rights and hence the higher are the fees. In addition, the property rights approach presents new insights about the relationship between initial fees and royalties. Contrary to the principal/agent theory a positive relationship between royalties and initial fees exists. Therefore, this approach may offer a theoretical foundation of empirical results that cannot be reconciled with existing explanations (see Baucus et al., 1993; Wimmer and Garen, 1997; Rao and Srinivasan, 1995; Lafontaine and Shane, 1998). The next step in our research will be to include additional explanatory variables from other approaches, such as agency theory, transaction cost theory, signalling theory and screening theory, to examine whether our results are generally valid.

5. Conclusions

The paper offers a property rights explanation for the fee structure in franchise relationships. I argued that the structure of initial fees and royalties depends on the distribution of intangible assets between the franchisor and the franchisee. The higher the franchisor's (franchisee's) intangible assets relative to the franchisee's (franchisor's), the more residual income rights should be transferred to him and the higher (lower) are the royalties and fees. This hypothesis was tested by using data from the Austrian franchise sector that support the hypothesis. In addition, to offering a solution to an anomaly in the literature, the property rights view suggests a positive relationship between royalties and initial fees. Consequently, this approach may give a theoretical foundation of empirical results that cannot be reconciled with the principal/agent explanations.

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