

# **The use of franchising in the hotel industry: A preliminary analysis of performance<sup>1</sup>**

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## **Abstract**

The objective of this paper is to discover if the use of franchising in Spanish hotel chains improves performance. For this purpose, we use relevant variables commonly used in the franchising literature to explain the difference between profitability of hotel chains that employ franchising as an organizational form and those that do not.

A survey is conducted to complete information obtained from Annual Guidebooks and hotel official webpages. Finally, the sample includes data for the most relevant Spanish hotel chains for the period 2009 – 2013. Information from public databases is also introduced.

With the information, first the sample is divided into two groups –chains that use franchising and those that do not- and a means difference test is performed to determine if economic profitability is statistically different for both groups. We expect to find that the use of franchising enhances performance.

Second, a regression analysis is performed to discover the independent variables that are statistically significant in order to explain economic profitability of franchising chains.

Franchising is a hybrid organizational form that delivers high or powerful incentives to franchisees and, therefore, results or profit generated in this type of outlets should be superior compared to outlets owned by the franchisor and where certain employees are hired to perform activities. Therefore, according to agency theory, franchised outlets should enhance performance and show higher rates of profitability

Most hotel chains typically employ franchising as a mode of growth, especially as geographical dispersion increases and accelerated expansion is necessary. The franchisor, in some instances, chooses to expand activities through franchised units.

Franchisees have incentives to be diligent because they put their work, and sometimes, most of their financial resources in the opening of their outlets. This should improve profitability of franchised outlets compared to franchisor-owned units where managers employed by the chain can have a percentage of variable pay but, mostly, receive a fixed salary in exchange for their work.

The paper is structured as follows. After the introduction, the variables used in the analysis are presented from a resource perspective. Then, the sample and methodology employed are described. Finally, results and the concluding remarks are displayed.

The objective is to analyse if results are statistically significant

## **Introduction**

At least two essential things make franchising chains different from other alternative organizational forms (Combs et. al., 2004). On one side, franchising activity itself is most common when a relevant portion of production or service must be made locally or near the consumer. This rises the problem for the central offices of the chain of controlling uniformity of many disperse outlets. And, on the other side, a contractual balance must be achieved between the need to centralize some decisions and leave others in the hands of franchisees. In this sense,

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the contract that regulates the relationship between the parties specifies the distribution of responsibilities, rights and generated economic rent between the franchisor and the franchisee. Franchising itself, is therefore, a hybrid organizational form because the system shares characteristics of both extreme solutions. Hierarchy represents the case of maximum centralized decision making while the market, in the opposite situation, entails decentralization allowing local and better informed agents to choose the best option.

In business-format franchising, it is common to observe that the franchisor is the owner of some units –usually the larger ones-, while other outlets belong to the franchisees. Far from establishing the superiority of one organizational form or another, many studies have highlighted that the presence of both types of outlets has relevant complementary and synergetic effects (Bradach and Eccles, 1989; Lewin, 1997, Bradach, 1997, Lafontaine y Kaufman, 1994; Pénard et al., 2003; Yin and Zajac, 2004; Windsperger, 2004; Acevedo and Silva, 2005; Dant et al., 2008). The so-called plural form is considered to be an efficient solution to reduce hazards caused by information asymmetries, bounded rationality and incomplete contracting

Related to this, the existence of franchising has been justified using different, sometimes theoretical perspectives. In this paper, we basically, employ the resource-based view. From this perspective, organizations base their competitive advantage on the existence of intangible assets and distinctive competitive skills (Wernerfelt, 1984; Barney, 1991; Dierickx & Cool, 1989; Peteraf, 1993). Each organization has a unique combination of tangible and intangible resources, capabilities, skills and know-how that cannot be transferred easily or without cost and that constitute its resources and capabilities (Teece et. al., 1994; Grant, 1991). The latter are a basic determinant of firm success and growth and, therefore, constitute the basis of organizational strategy and sustainable competitive advantage (Schoemaker, 1990). Nevertheless, only resources that are valuable, scarce, not subject to possible imitations and lack substitutes are potential sources of competitive advantages (Barney, 1991; Grant, 1991; Peteraf, 1993).

This is of special relevance for franchised chains because competitive advantage is generally based on intangible assets. The franchisor supplies his franchisees with a proven and well-known brand name, license or business concept, a management and operating system, initial and on-going support and training. In exchange, franchisees co-operate providing dynamism to the chain, contributing to the update and spread of new know-how and competencies and making the necessary payments to maintain and increase chain value.

We have chosen to study the hotel industry in Spain. It is part of the service industry and a good example of the importance of intangible resources. Moreover, some chains distinctively rely on franchising as a means of growth while others only use company-owned outlets or other contractual arrangements.

The purpose of this paper is to try to explain how intangible assets can affect profitability of the chain. More specifically, first we conduct a means difference to test if the profitability of hotel chains that use franchising is statistically significant compared to those that do not.

Second, for chains that employ franchising, we try to discover through a regression analysis which are the drivers for this increased profitability. For this purpose we extract the independent variables from the resource perspective.

The remaining part of this paper is structured as follows. First, we present the variables employed, making reference to their description and expected influence over the dependent variable in the regression analysis. Next, we describe the process adopted for data collection and the methodology. After that, the following section describes the results obtained from the analysis and, lastly, we present the concluding remarks and needs for future research.

### **Variables and the resource perspective**

After analysing the significance of the difference in profitability between hotel chains that use franchising, we try to discover the origin of this increased economic performance. For this purpose, we employ the following independent variables:

**Market saturation.** This variable is measured through the variable labelled GROWTH, which is defined as the percentage increase in the number of outlets of the chain in Spain during the period from 2011 to 2012. Of course, low rates of growth in domestic market can be caused by other situations rather than saturation but it was the best proxy we found. Moreover, in the process of several interviews conducted with different franchisors, the general feeling they transmitted was that they were always willing to grow if market conditions allowed it, so if they did not increase the number of units it was because the target market was saturated.

The argument is basically that chains that compete in a more saturated market are more likely to exhibit lower rates of profitability. The growth rate in the number of units of the chain from 2011 to 2012 was calculated as the quotient of the difference between the number of units in 2011 and 2012 and the number of units in 2012.

The influence over the dependent variable –economic profitability- is expected to be positive. This way, our first hypothesis is the following:

*H1: the lower the growth rate and, therefore, the higher the saturation of the market, the lower the profitability of the chain*

**Trademark value and chain reputation.** To measure this item, we employed two variables: (1) TY, which reflects the number of years since the franchisor opened the first unit he owned (number of years between the year the firm was established and 2012) and, (2) SIZE measured as the total number of outlets of the chain. These two proxies have been employed in many empirical studies (Lafontaine, 1992; Norton, 1988; Lafontaine and Shaw, 1999; Affuso, 2002; González-Díaz and López, 2003) to account for the existence of one of the most valuable intangible resources; this is the brand value of the chain. Needless is to say that trademark or brand value is the key feature that determines chain success and take time to develop (Itami & Roehl, 1991).

Minkler and Park (1994) or Roh (2002) established that the adequate means of measuring intangible assets would be to employ the difference between market value and book value of the chain. Market value could be measured through Stock price and would reflect not only tangible assets but, also, intangible resources. However, given that it is not common for Spanish franchised chains to trade on the public stock exchanges, it would be difficult to obtain the market value of chains. For this reason we chose to estimate the value of these types of assets through different variables. Now, we will only make reference to trademark and reputation values; the remaining intangible assets (franchisor knowledge and franchisor monitoring capabilities) will be analysed below. The following hypotheses are:

*H2: trademark value and chain reputation, measured through the number of years the firm has been in business, are expected to have a positive influence on economic profitability.*

*H3: trademark value and chain reputation, measured through the total number of outlets of the chain, are expected to have a positive influence on the decision on economic profitability.*

**Franchisor knowledge and expertise to adequately transmit it.** Not only is franchisor know-how itself of special relevance in determining chain success, but so is the capacity or expertise to effectively and adequately transmit it to all franchisees. Through experience, the owner of the chain slowly accumulates specific and valuable know-how (Shane, 1996), thanks to practice on a daily basis (Bradach, 1997; Michael, 2000) and to constant interaction with his franchisees (Falbe, Dandridge and Kumar, 1999; Bradach, 1997).

To measure the level of franchisor knowledge and the degree of complexity associated with its transmission, we intended to collect information on the number of initial training weeks franchisees received when they joined the chain. However, it was only possible to have this type of data for a little over one third of the chains in the sample, so we chose to use another type of proxy. As in González-Díaz and López (2003), we used various variables to reflect this type of intangible resource. Specifically, we have included two variables: (1) the number of initial years during which the chain did not franchise any units (YNOTF), calculated as the difference, in years, between the year the chain was established and the year the firm was created, and (2) the entry fee established by the franchisor and that all franchisees must pay initially to join the chain –(CANON).

With regard to the first of these, YNOTF, longer periods are thought to reflect greater difficulties in completing adequately the franchise package, which could be due to increased

know-how needs. However, higher values for YNOTF can also indicate centralized decision making. If the franchisor did not franchise for many years it could be due to reluctance to delegate decisions that would have to be made locally or it could be due to incompetence hazards.

With regard to the second variable employed to measure this item, CANON, it represents the initial lump sum every new franchisee must pay to the franchisor to join the chain. It is basically established to allow franchisors to recover the initial selection and training costs due to the existence of new franchisees (Lafontaine y Kaufmann, 1994). Therefore, it should be higher when the transfer of intangible assets to franchisees is increased.

Because increased franchisor knowledge and expertise to transmit it indicate that certain intangible assets of the chain are more valuable, this should also have a positive effect over chain profitability. Therefore, the following hypotheses are established:

*H4: the longer the time period the chain initially remained without franchising any units (YNOTF), the higher the value of franchisor knowledge and, therefore, higher profitability is expected.*

*H5: higher initial lump-sum fees (CANON) are associated with higher values of necessary training and intangible transfer to franchisees and, therefore, should be positively associated with profitability.*

Summarizing, as stated above, we expect to find that the greater the importance and transfer of intangible resources from franchisors to franchisees, the higher should profitability be.

**Monitoring costs and capabilities.** The third type of intangible resources that can have a relevant influence over profitability is franchisor's supervision costs and skills.

In this sense, franchisor skills and experience required to select and to monitor franchisees to prevent them from behaving in an opportunistic manner and the cost associated with monitoring activities will depend on a variety of factors. In this paper, we have included the number of years the franchisor has been franchising and the proportion of franchised units.

First, the number of years franchising (YF), calculated as the difference, in years, between 2012 and the year the first franchised unit of the chain was opened will, most probably, have a positive effect over the franchisor's monitoring skills and experience (Hoffman and Preble, 2003; González-Díaz and López, 2003; Weaven and Frazer, 2003).

The second variable included to measure this item is the proportion of franchised units (%FRAN). The numerator of this quotient is the number of franchised outlets the chain has in Spain in 2012 and the denominator is the total number of chain units (both franchised and franchisor-owned) in Spain in 2012. This proportion may also contribute to quantifying franchisor skills related to monitoring franchisees. Moreover, franchisees need less control compared to employees of franchisor-owned outlets, given their different incentives structure. The latter implies that higher proportions of franchisees would drastically reduce supervision costs of the chain and, in this sense, increase profitability.

We expect findings to support a positive influence of YF and %FRAN over profitability of the chain. This is because increased monitoring capabilities entail lower associated costs which. So, the last three working hypotheses are:

*H6: the number of years the chain has been franchising (YF) can reflect franchisor monitoring experience and capabilities and, therefore, we should expect a positive influence on profitability.*

*H7: the proportion of franchised outlets (%FRAN) can ease informational hazards of local market conditions and, in this sense, increase profitability*

## **Sample**

Due to the non-existence of a ready to use Spanish database, the sample used in this paper was constructed basically using the information provided by the existing Annual Franchise Guidebooks published in Spain. Specifically, we have consulted guidebooks published by Tormo & Asociados, Franchisa, Barbadillo & Asociados and the Spanish Association of

Franchisors. This information was completed with data obtained from the phone survey and with data from the hotel official websites and public databases.

The sample includes data for the five-year period between 2009 and 2013 and includes 1207 observations.

When, for certain variables, the value was fixed as an interval (stated through a maximum and minimum value), we calculated the mean for each chain and this was the measure we used in analyses. It is also necessary to explain certain incongruence we found in data supplied in the various guidebooks. For some variables the different data sources provided contradictory data. To solve this problem and to reflect data adequately, we contacted the chain directly (by telephone, email or, in other cases, through the official web page) in order to determine the correct or true value for the variable.

### **Methodology:**

First we conduct a means difference analysis to discover if the differences in economic profitability between chains that employ franchising to grow (group 1) and those that do not (group 2) is statistically significant.

Given that the aggregation variable is categorical (2 groups: hotel chains that use franchising and those that do not), the samples are independent and that the variable to be analysed is continuous (economic profitability), the t-Student test for independent samples is used. We establish an  $\alpha = 0.05$ .

The first step is to state the null hypothesis and an alternative hypothesis (being “ $\mu_1$ ” the average profitability of hotel chains that use franchising and “ $\mu_2$ ” the mean profitability of chains that do not employ franchising)

Null hypothesis:  $\mu_1 = \mu_2$  □ (both mean values are equal)

Alternative hypothesis:  $\mu_1 > \mu_2$  □ (mean values for the first group is higher than mean values for group 2).

Then, we use regression analysis (method of maximum likelihood) to discover which variables can explain economic profitability in franchising chains. We use the independent variables described in the section above.

We use the SPSS statistical package for both the means difference and regression analysis.

### **Results**

First, for the means difference test, it is necessary to check for normality and equal variances. Given that the sample includes less than 30 observations for each group, normality is checked through the Shapiro-Wilks test and significance is 0.157 and 0.138, respectively, Because both levels of significance are larger than 0.05, we cannot reject the null hypothesis of normality.

To confirm that variances for both groups are equal, the Levene test exhibits the following results.

Since  $.699 > .05$ , the null hypothesis is accepted and, therefore, equal variances cannot be rejected. Therefore, we can proceed with the mean difference test:

Levene			
F	sig	t	sig
0.152	0.699	.443	0.0.023

Results for the means difference test exhibit a P-value of 0.023. Since 0.023 is less than the significance level (0.05), we cannot accept the null hypothesis. Therefore, economic profitability of both groups is different and this difference is statistically significant.

Given that data analysis shows that average profitability for group 1 is 0.0501 and for group 2 is 0.0489, we can say that results indicate that chains that use franchising exhibit higher rates of economic profitability and that this effect is statistically significant at the 0.05 level.

Results for the regression are displayed in the following table:

Variable	Model
GROWTH	32,345*** (2,657)
TY	26,927*** (3,383)
SIZE	5,714* (2,167)
YNOTF	-15,463 (7,862)
CANON	9,565*** (19,738)
YF	2,029** (3,076)
%FRAN	3,956** (1,097)
N = 1207	
Maximum likelihood function (log-Hausman test)	-76,945 35,567***
***, **, * significant at 99%, 95% y 90%, respectively	

Regression results show that GROWTH, TY and CANON are significant at 99% level. YF and %FRAN are significant ant 95%. SIZE is significant at 90% and that the remaining variables are not significant to explain the differences in chain profitability. All these variables have the expected sign.

Therefore, GROWTH – the increase in the number of units of the chain- has a positive effect over profitability. This is, chains with higher growth rates, tend to exhibit higher rates of profitability. Or, put in another way, market saturation limits economic performance.

Trademark value and chain reputation also has a significant positive effect over profitability. TY –the total number of years since the franchisor opened his first outlet- and SIZE –the total number of outlets of the chain- both have a significant and positive effect over profitability

Franchisor knowledge and expertise to adequately transmit it receives partial support. Only CANON –the initial lump sum the franchisee pays to join the chain- has a positive and significant effect over profitability. YNOTF –the number of initial years during which the franchisor does not use franchising at all- is not significant and exhibits a negative influence.

The last variable, monitoring costs and capabilities, is significant to explain economic performance. Both YF –number of years the franchisor has been franchising new outlets and %FRAN –the percentage of franchised units of the chain- have a positive and significant effect over profitability.

### **Conclusions**

The basic objective of this paper is to discover if hotel chains that use franchising to expand activities present higher rates of profitability. For this purpose, we use relevant variables commonly used in the franchising literature to explain the difference between profitability of hotel chains that employ franchising as an organizational form and those that do not.

The sample of hotel chains is divided into two groups –chains that use franchising and those that do not- and a means difference test is performed to determine if economic profitability is

statistically different for both groups. Results show that the use of franchising enhances performance.

Second, a regression analysis is performed to discover the independent variables that are statistically significant in order to explain economic profitability of franchising chains.

From a resource perspective, Influence of market saturation, chain brand name and reputation, franchisor know-how and monitoring capabilities have been analysed.

H1(+), H2(+), H3(+), H5(+), H6(+) and H7(+) are supported. Therefore, Regression results show that GROWTH, TY and CANON are significant at 99% level. YF and %FRAN are significant at 95%. SIZE is significant at 90% and that the remaining variables are not significant to explain the differences in chain profitability.

This constitutes a preliminary analysis. New variables are needed (sales, advertising costs, geographical dispersion in Spanish domestic market,...). A more fine-grain analysis should include specific information at the outlet level.

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