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THE IMPACT OF VALUE SIGNALLING ON FRANCHISING ACCEPTANCE

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Abstract: It is the determination of any franchisors to grow their business either by company-owned multi-units or through appointed franchisees. Both efforts have the pros and cons, opportunities and constraints. Many franchisors prefer to grow their business by emphasizing the advantages of their network size using franchised units- due to local knowledge advantage of the prospects, host-country government policy on franchise investment, risk-sharing and minimum capital they have to invest. With all the known advantages, the franchisors have to decide what strategies will attract prospective franchisees. On the other hand, potential franchisees may consider a number of different franchise chains. Therefore franchisors usually offer prospects a variety of services and contractual arrangements that they will consider valuable once the prospects franchisee become part of the network. Currently franchisees will often value the costly support services, either in the form of training and knowledge sharing, advertising and initial financial or investment assistance; hence the franchisor may deploy the same support services to attract prospects. Thus, this review focuses on the values that might signal or influence prospects towards the acceptance of a franchise brand/chain

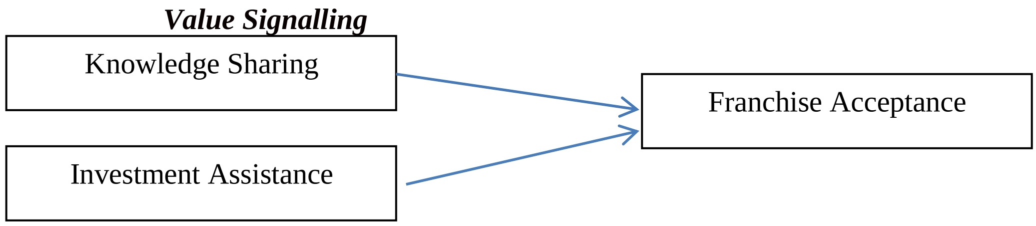
Keywords: Franchising, Training Support, Value Signalling, Value Creation

1. Introduction

In recent years, franchising has significantly increased in size and turnover throughout the globe. It has become a growth technique that being popularized by many companies like Howard Johnson, McDonald's and 7-Eleven (Nan Hua & Dalbor, 2013) – just to name a few. To support the growth, Tsang & Finnegan (2014) stated that franchisors have three main sources of capital –internal sources, capital markets and franchisees. For large and growing companies, franchisors operating in more abundant environments and they have more access to financing. In contrast, in resource scarce environments, franchisors would need to be more dependent to franchisees for expansion. Most franchisors depend on sales turnover to marginalize their growth; on the other hand franchisees focus on cost and margin (Wright & Winzar, 2014) prior to their setup and real operations. Lucia-Palacios *et al.* (2014) point out that franchisors must know what contractual arrangements are important in attracting prospective franchisees. In their recent research, they attempt to identify and evaluate factors that help to attract new partners. A data panel of US franchise chains has been utilised to analyse the influence of initial support and business assistance, earnings claims disclosure, sub-franchising and restriction of passive ownership on chain growth.

(Paswan *et al.*, 2014) highlight the importance of franchisors to "signal" the right value of its brand or chain to attract the prospective franchisees into their business. Many extensive research such as by Weaven *et al.*, (2014) and Right & Winzar (2014) have tended to be somewhat skewed towards the franchisors as the key player in attracting prospective, with franchisees and end customers seen as a passive operand resource, i.e. resources that are manipulated by the franchisor to create value. However, in a franchising network, like any other network, value creation is known created by all (franchisors, franchisees & customer) and each brings specific operant resource to bear on the value creation process (Paswan *et al*, 2014). This paper is tended to review two independent variables under Value Signalling, i.e. Knowledge Sharing (Lucia-Palacios *et al.*, 2014) and Investment Assistance (Tsang & Finnegan, 2014) that attract the prospect franchisees in accepting the franchise brand/chain for their future business, and as shown below in Table 1.

<u>Table 1: Theoretical Framework</u>



2. Franchaise Acceptance

There is no set definition of franchising as it holds different meanings according to different researchers. A franchise system can be described as a continuing relationship in which the franchisor gives the franchisee the right to use trade name, trademarks, business models and training for a specific time. In return, the franchisor gets royalties out of sales from the franchisee (Kotabe *et al.*, 2011). The benefits are clear – the organization can capitalise on the winning business formula by expanding into international market with a minimum investment and tapping the franchisee's knowledge of local marketplace. Hua & Dalbor (2013) stated that as long as the franchise contract remains in place, franchisors receive revenues from franchisees along with royalties, advertising and marketing fees - all these will become the source of growth for them. Relationship development has become important in franchisor-franchisee arrangements and has implications for chain attractiveness (Altinay, *et al.*, 2014). A franchisor has to invest time and effort in the management of current franchised units since this is one of the most important quality signals that prospective franchisees value. Hodge *et al.*, (2013) point out that the number of franchised units signals a franchisor's reputation and viability. Not allowing passive ownership also signals a franchisor's commitment to the network (Forte & Carvallo, 2013). This restriction implies that franchisees have to manage the outlet actively and it restricts the attraction to those partners who want to be business managers, not just passive investors.

From the perspective of franchisees, potential franchisees have a number of ways to differentiate between franchise concepts attractiveness. According to Lee *et al.*, (2015) almost two-thirds of franchisees will first consider the industry sector, and then the franchisors. Once the industry choice is made, then they look for franchisors that have built and established trade name. Established chain with existing franchisees can offer quantitative and qualitative data about their business beyond how a franchisor fulfils its contractual obligations (Lola & Watson, 2013). As a result, according to Tsang *et al*. (2013), established businesses with a long history of profitability will encourage the strongest potential candidates to select the franchise network. In contrast, when franchisors do not have established business reputations or other information to communicate their value, candidates lack sufficient information to evaluate the business (Owen & Winzar, 2014). Since business partners will have more difficulty in valuing the business opportunity, they must be encouraged and induced to take a risk on the franchise concept. Tsang and Finnegan (2013) point out that accessibility to resources also influence chain acceptance. Key resources for franchisors initiating franchising would be access to financing and other resources (Owen & Winzar, 2014 & Perrigot *et al.*, 2015). The ability of marketplace to offer the financing facility would attract more prospects' acceptance (Hodge *et al*, 2013- either through government bodies, banking or other sources. To stimulate the franchising acceptance, a franchisor has to communicate its value to potential partners. The firms can design signals that reveal information about the franchise concept (Palacios *et al.*, 2014) and its potential for current and future creation even this is sometimes quite costly. However, it is quite surprisingly when most potential franchisees under study by Hodge *et.al.* (2013) were not concerned on due diligent that should be carried out by independent auditors or banking officers before accepting a franchising brand.

3. Value Signalling

Signalling, based on economic contracting theory, focuses on the externalities of market imperfections and informational asymmetries. In general, a firm that has relevant information to close a transaction must decide whether and how to provide that information (Hume & Winzar, 2014). The party at the other end of the transaction has to analyse the credibility and its level of trust in both the offering firm and the provided information. Signalling is used in many businesses, such as industrial organizations, as well as in finance and management (Tsang & Finnegan, 2013). CEOs signal the quality of a firm to attract investors via financial statements and employees try to signal their value in the recruitment process (Gregory, *et al.,* 2014). Weaven *et al.* (2014) propose a theoretical framework, where franchisor system (brand) value is derived from confides financial and operations information subsequent communication to potential franchisees “signalling” system valued through those specified attributes. For example franchise fee (high or low) and number of franchisor-owned outlets signal a level of high or low quality. They also discussed how ownership structure and subsequent funding can be used as signals to potential franchisees. Tsang & Finnegan (2013) find that pricing policy of the franchise ownership is an effective signal when information asymmetries are greatest. The lower up-front fees, royalties and investments requirements, the higher the possibility of franchise acceptance. Williams & Huggins (2013) dictate that by setting liberal pricing policies, a franchisor can increase the chance of finding acceptable business partners quickly and spurring network expansion. Park et *al.* (2014) add that firms can also establish policies and/or terms that links its success to the business partner’s success as a way of revealing their quality.

For franchisors, quality signalling definitely helps attract future franchisees. Based on services and contractual arrangements that increase the value of the franchise relationship with current franchisees, franchisors send quality signals that help franchisors create a competitive advantage (Forte & Carvallo, 2013) in the marketplace. Franchisors should offer initial support services to differentiate their firms from their competitors and to signal that they aim to take care of the whole system and the brand name, without a myopic emphasis on rapid expansion (Dada & Kirby, 2015). To signal this concern, Dada & Watson (2013) indicate that the franchisor can use the restrictions and controls on passive ownership and area developing agreements and sub-franchising to enter international markets. Instead of hiring managers to run the establishments in the system, franchisors should expand through owners/franchisees to reduce organizational uncertainty. Franchising firms have to consider the cost of signalling methods as well as the relative impact of each method since not all signals are created equal. According to Paswan *et al.* 2014 executives should maintain close contact with potential franchisees by regularly asking, by distributing formal questionnaires, tools and assistance prospective franchisees consider valuable. Franchisors should also consider the strength, frequency, and environment of the signal (Piot-Lepetit *et al.,* 2014).

Prospective franchisees should exercise due diligence in interpreting signals and evaluating the long-term viability of the chains. They must seek detailed information about the type of multi-unit ownership opportunities offered in order to understand the franchisor’s concern about the whole system (Lucia-Palacios *et al.,* 2014). This can help prospective franchisees make wise business decisions during periods of financial turbulence.For the purpose of this review, we focus on the knowledge sharing construct as proposed by Palacios *et al.,* (2014) and Weaven *et al.* (2014); and investment assistance forwarded by Tsang & Finnegan (2014).

3.1. Knowledge Sharing

Franchising is not just about selling products and services to customers. It is also about developing and perfecting the know-how associated with a business system and then selling that know-how to prospective franchisees. Franchisees, in turn, provide the vital local market knowledge along with capital and human resources. The goal is to synergistically capitalize on the know-how of the franchisor and franchisees (and the customer) and successfully apply the tried and tested business model offered by the franchisor in diverse markets (Park *et al.,* 2014). Furthermore, Piot-Lepetit *et al.* (2014) point out the key to franchise success seems to be managing (e.g. developing, perfecting, disseminating, and improving) an intangible resource (i.e. knowledge or know-how) across independent entities linked in a contractual relationship.

According to Hager (2013) knowledge sharing helps franchisors ensure that franchisees understand the business model, adhere to tried and tested scripts, and conduct operations effectively. This helps protect against the dilution of the franchise brand as the franchise "network" seems to offer a relatively safe business model with significant embedded knowledge (delivered through training and information) for the franchisee (Lucia-Palacios *et al.*, 2014), that typically is a small to medium enterprise. Perrigot *et al.* (2015) suggest that a franchise firms must develop mechanisms which allow for conversion of tacit knowledge to explicit knowledge, sharing this explicit knowledge, and conversion of the explicit knowledge into tacit knowledge. Further, processes and systems must be created to enhance the absorptive capacity of various players in the network. Fear of knowledge appropriation hazard should not hinder the knowledge-sharing process. Instead, franchisors should develop regimes of appropriable to protect against the negative effects of knowledge appropriation, and still allow for knowledge sharing within the network. Lucia- Palacios *et al*. (2013) indicates that although the franchise services improve relationship value for current franchisees, not all services and contractual arrangements attract prospective franchisees equally. Knowledge sharing and financial assistance emerge as two initial support services that franchisors can offer to new partners. Knowledge sharing through a long training period has the following benefits Park *et al.* (2014):

- Training enables franchisees to acquire valuable knowledge about the business and what is necessary to run the outlet efficiently.
- Training also increases the value that the franchisee provides to the network.

Therefore, franchisors should consider knowledge sharing an investment instead of only an initial cost.

Potential franchisees should be considered entrepreneurs who choose franchising because of risk-sharing advantages (Hager, 2013) connected with using a reputable brand in the marketplace. Franchisors should keep in mind that some potential franchisees may think about long-term results and have an entrepreneurial orientation. Such franchisees may provide value to the network by seeking chain improvements, innovations or market analysis. In this sense, the franchisor should consider offering a sub-franchising option to reduce the likelihood of losing those valuable partners (Piot Lepetit *et al.*, 2014).

3.2. Investment Assistance

Many types of entrepreneurial support organizations are available to help entrepreneurs or franchisees address the challenges that arise during the start-up process. The assistance comes in form of financial investment, professional advice, training programs and setup support. However, the effectiveness of such assistance programs remains in questions (Yusuf, 2014). Some researchers have argued that assistance programs are not always uniformly effective as well as not evaluated for effectiveness (see e.g. Delanoe, 2013; and Gudov, 2013). Other evidence cited by Lougis & Nystrom (2014) further suggests that many programs do not work in terms of providing entrepreneurs with meaningful support. In contrast, Saeed & Sameer (2015) contend that initial investment assistance can have a positive impact on the performance and outcomes of new and small franchises/businesses. Others suggest that, when properly used, assistance from outside sources such as support programs can be of use to entrepreneurs (Abe *et al.*, 2015; Williams & Huggins, 2013). Xiang & Worthington (2015) suggest that help from outside financial consultants and fund managers are essential to the success of new and small businesses.

Research based on external assistance both in the USA and other countries has shown that use of investment assistance enhances start-up success, survival, performance, and growth. Abe *et al.* (2015) cite evidence from Japan and Korea that public advice, financial and training programs for entrepreneurs have, in general, had a positive effect on the success of new firms. Using a sample of Pakistan entrepreneurs, Saeed & Sameer (2015) find that extensive use of professional sources of information was related to greater likelihood of venture survival. Henry & Treanor (2013) similarly finds that use of outsider-based strategic planning had a positive impact on venture performance while Williams & Huggins (2013) conclude that inclusion of professional advisors, such as consultants, bankers, accountants, and lawyers, in the entrepreneur's support network positively impacts venture growth. Durkin *et al.* (2013) find that entrepreneurs in Ohio and South Carolina who obtained outside assistance from the Small Business Development Centre (SBDC) had higher than expected rates of survival. In another study of the SBDC program, previous researchers determine that entrepreneurs perceived outside assistance as having a positive impact on their business. Finally, a review of the literature also determined that 45 per cent of studies in the review sample identified lack of use of outside advisors as a contributing factor to start-up failure (Yusof, 2014).

The empirical research to date tends to suggest that investment assistance can effectively increase venture performance, but some argue that this effect may in part be due to selection. For example, some researchers argue that high ability entrepreneurs may select (or be selected) into using assistance programs (Hanafiah *et al*., 2014). There are two elements to this selection concern. First, entrepreneurs who seek assistance may be more dynamic and growth-oriented than those who do not. William & Huggins (2013) suggest that the former may be "more aware, better networked and more open new ideas" and therefore may be more likely to self-select into obtaining support for entrepreneurial assistance programs. Second, selection bias occurs when assistance programs employ administrative selection, where entrepreneurs must apply to participate in the program to receive support and the program's staffs then decides as to the suitability of the entrepreneurs. William & Huggins (2013) further argue that this selection procedure is designed to identify and select the best entrepreneurs, or at a minimum avoid the worst entrepreneurs. Given these arguments, failure to account for selection can lead to overestimating the impact of entrepreneurial assistance programs in encouraging and supporting entrepreneurship.

4. Conclusion

Franchisors must invest time and managerial attention to their current outlets to demonstrate quality and value. The quality of the system can be signalled through different support services. Hodge *et al.* (2013) find that franchisors targeting franchisees that are more experienced in terms of business management, technical expertise, or franchising should focus on developing proposals that promote brand strength and low relational cost in attracting incumbent franchisees. Conversely, franchisors targeting franchisees that are relatively inexperienced should concentrate on offering better relationship and investment support. Failure of the franchise system to deliver economic value could result in negative financial and reputational outcomes both for franchisors and franchisees. Communication and knowledge transfer facilitate learning between both parties (Forte *et al.*, 2013). Through learning, both parties assess each other's contributions to the partnership and undertake well-informed risk benefit analyses for their relational exchange. Hua & Dalbor (2013) through their ten years empirical testing span of 1980-2010 with quarterly data prove that franchising that supported by knowledge sharing and investment assistance programs is an effective mechanism to systematically and consistently become outperform in long term. The advantages of franchising outweigh the disadvantages towards the end are as per below:

- Creating qualified and motivated operators who have strong motivation to generate profits
- Developing human and financial resources that a firm need for rapid growth; and
- Establishing financially lucrative business models that improve return on investment while controlling for risk.

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