
Managing for consistency in franchises

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Agenda

- Franchising
 - Overview of franchising in the US
 - How franchises create value
- Consistency
 - Value of consistency
 - Achieving consistency
 - Potential dark side of consistency
- Implications for addiction clinics

Franchise definition

- *An agreement or license between two parties which gives a person or group of people (the franchisee) the rights to market a product or service using the trademark and operating methods of another business (the franchisor) in exchange for a fee (typically an upfront fee plus royalties on sales).*

Some features of franchises

- Two formats:
 - **Product/Tradename:** Franchisee sells the franchisor's products in a supplier-dealer relationship. Franchisor licenses the use of its trademark but may not provide a system for running the business
 - Auto dealers, Gasoline stations, Bottlers
 - **Business format:** Franchisee not only sells the franchisor's product or service with the franchisor's trademark, but also operates the business according to a system provided by the franchisor. The franchisor provides training, marketing materials and an operations manual to the franchisee.
- Franchisee is cross between
 - Owner:
 - Perfect incentives (profits)
 - Employee
 - Bound by operational restrictions
 - Monitored by franchisor for compliance
- Fee structure
 - Up-front fee
 - Royalties (% of sales—typically 5 to 7%)

Early franchises were means to distribute proprietary products

- Manufacturers set up networks for distribution and service of complex products
- Local investor lays out capital and assumes distribution risk—allows rapid geographic coverage
- Fragmentation ensures distribution channel never achieves bargaining power
- Examples:
 - Post civil war: Singer Sewing Machines
 - Early 1900s: auto dealers, beverage bottling
 - 1930s: gas stations

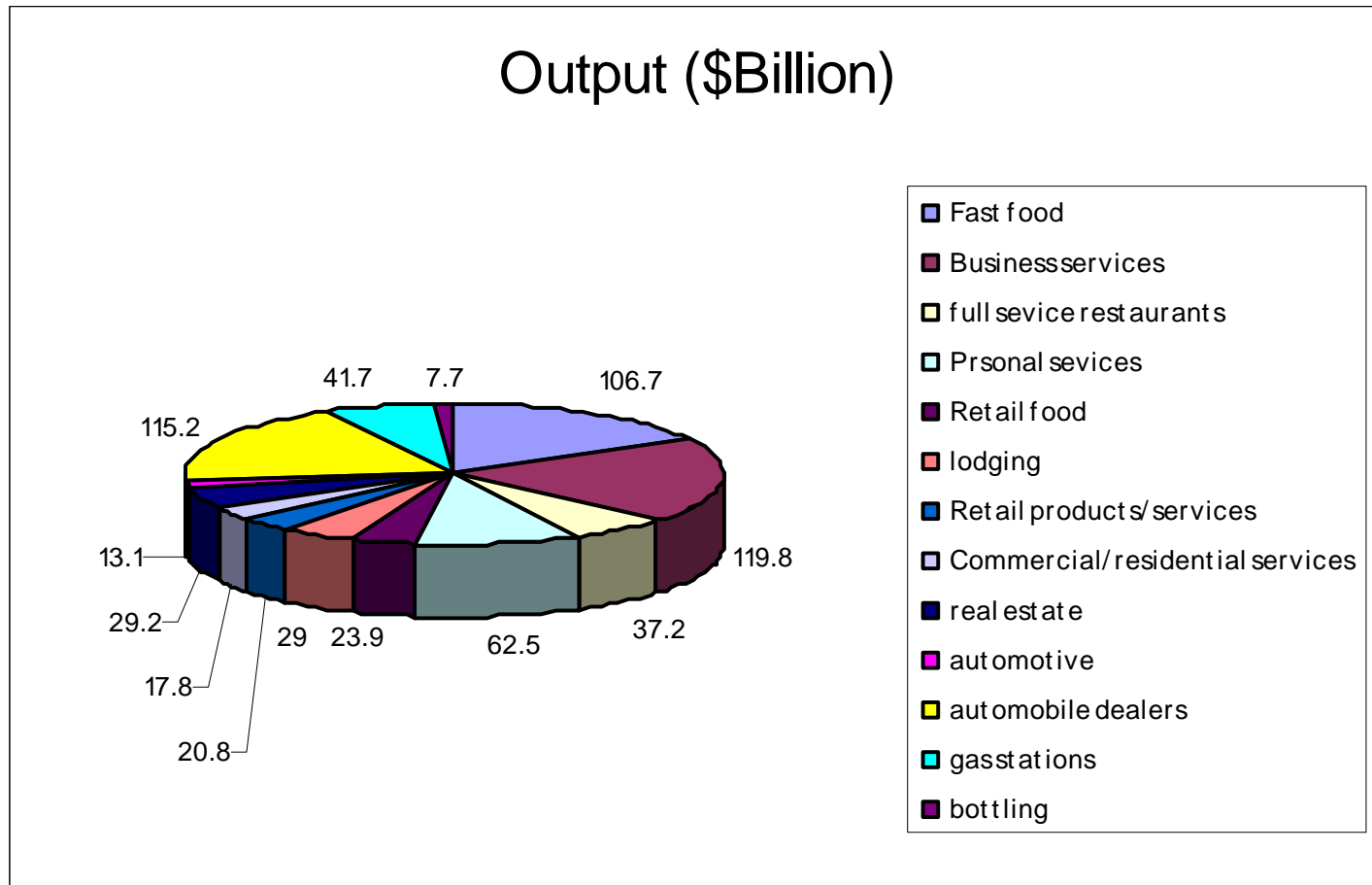
Franchising shifts with after automobile creates “national markets/brands”

- Manufacturers create fast food franchises as means to expand equipment sales:
 - Chicken Delight-A.L. Tunick’s oil cooker
 - McDonald’s-Ray Kroc ice cream mixer
 - Burger King-General Equipment’s automated broiler
- Follows bottling model of making money by selling inputs to franchisees
 - 1924 A&W Root Beer
 - 1935 Howard Johnson
 - 1944 Dairy Queen
- Problem with these ventures is that they were “open loop”
 - Sell territories quickly to gain cash
 - View franchisees as the customer (for the equipment and food inputs)
 - Ignore implications of branding for end consumer

Franchising an important factor in US economy

- 760,000 establishments
 - 3.7% annual growth (1992 to 2001)
- \$624.6 billion output
 - 40.9% of US. Retail (in 1992)
- 9.8 million employment
 - Same as manufacturing sector

Most commonly franchised industries



Franchisor View:

Why franchise Vs own units?

- Why vertically integrate (company own)?
 - Tighter control
 - Higher returns
- Why franchise?
 - Source of financing
 - Source of managers
 - local knowledge/local contacts
 - Distant or remote locations
 - Profit incentives of owner-managers replace other controls
 - More local innovation
 - Because of the profit incentive and lower control

Franchisee View:

Why franchise Vs independent

- Why franchisee?
 - Superior routine (documented in operations manual)
 - Turn key operation
 - Brand name (immediate demand boost)
 - Training
 - On-going assistance
 - Scale economies (purchasing, legal, R&D)
 - Reduced Risk (3% failure rate Vs. 62%)
 - (Discipline)
- Why independent?
 - More freedom (no monitoring, no restrictions)
 - No royalties

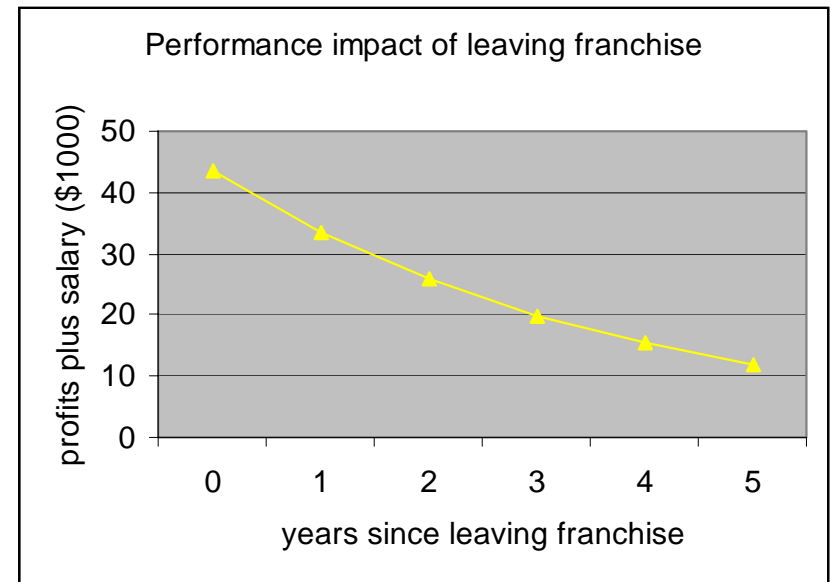
Franchisee View:

Longer term considerations

- Perceived value of franchise to the franchisee appears to be formula, training and risk reduction
 - No longer important after 3 or 4 years
- 50% of franchisees in one industry reported they would exit the franchise if they could
 - Am I getting value for royalties?
 - Do I still need the franchisor?

Answer is YES!

- Former franchisees abandon elements of the existing routine (compliance drops 8% per year)
- Former franchisees slower to adopt new innovations in the industry (compliance drops 11% per year)
- Within 5 years their performance is comparable to independents, i.e., they no longer recoup the royalties



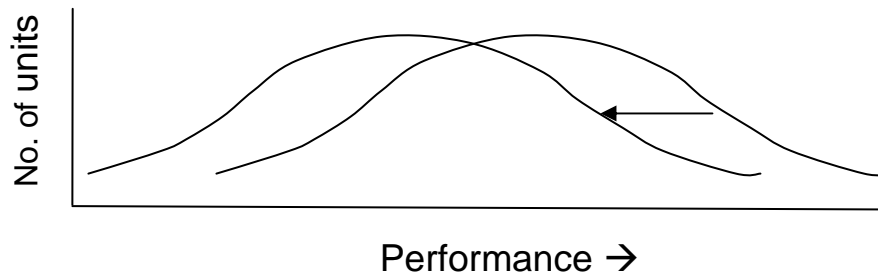
Value of consistency in franchising

- Consistency valuable in stimulating demand
 - Risk averse customers prefer a known quality
 - to unknown but potentially higher quality
 - Transfer experience from one location to expectations in another location
 - Of greatest value when traveling between locations
- Value of brand is function of scale
 - This reflects the size of loss from brand decay
 - Firm has incentive to make investments in consistency
 - Firm will remedy problems

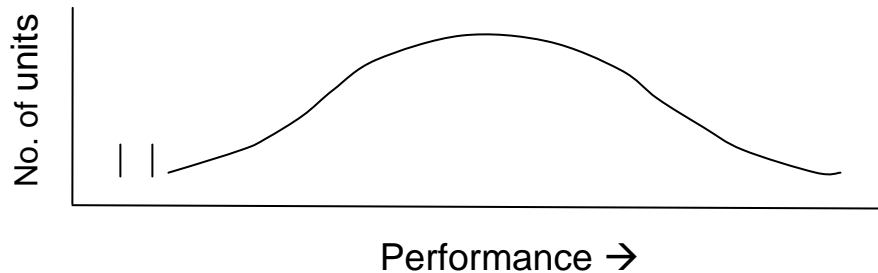
Value of consistency in addiction clinics

- NOT to provide assurance that clinic in St. Louis is comparable to one in Philadelphia
- RATHER:
 - Signal that chain has incentives to maintain quality
 - Ability to aggregate data across clinics:
 - Large scale statistics give *patients* and *funding agencies* confidence in expected quality
 - Give confidence to *potential clinic owners* of likely quality they can expect to achieve in their clinics
 - Ability to analyse/improve performance
 - Detect environmental changes affecting all clinics
 - Ability to detect changing performance in any single clinic
 - Controlled test of new procedures

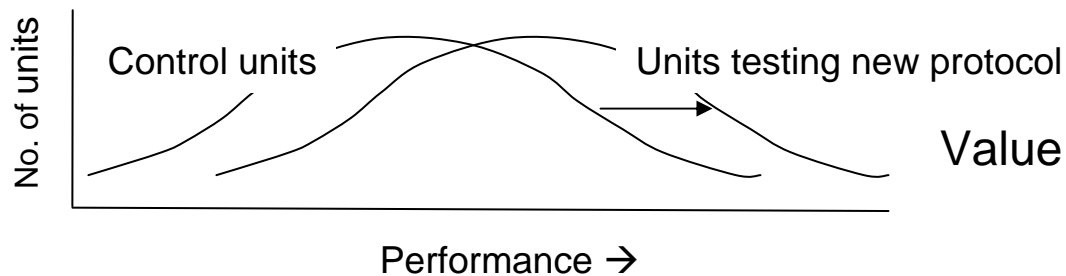
How consistency facilitates performance analysis



Shock to industry



Some units having trouble

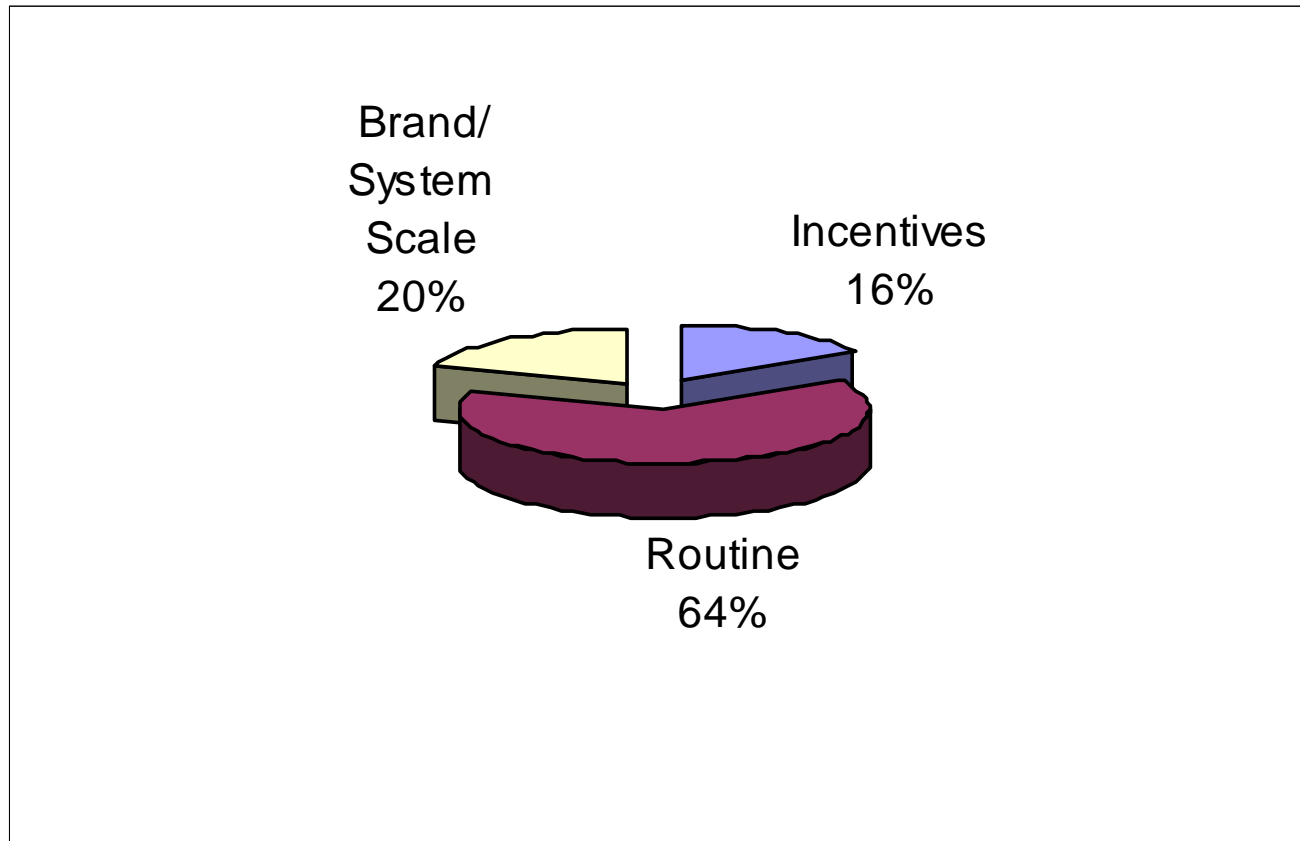


Value of experimental protocol

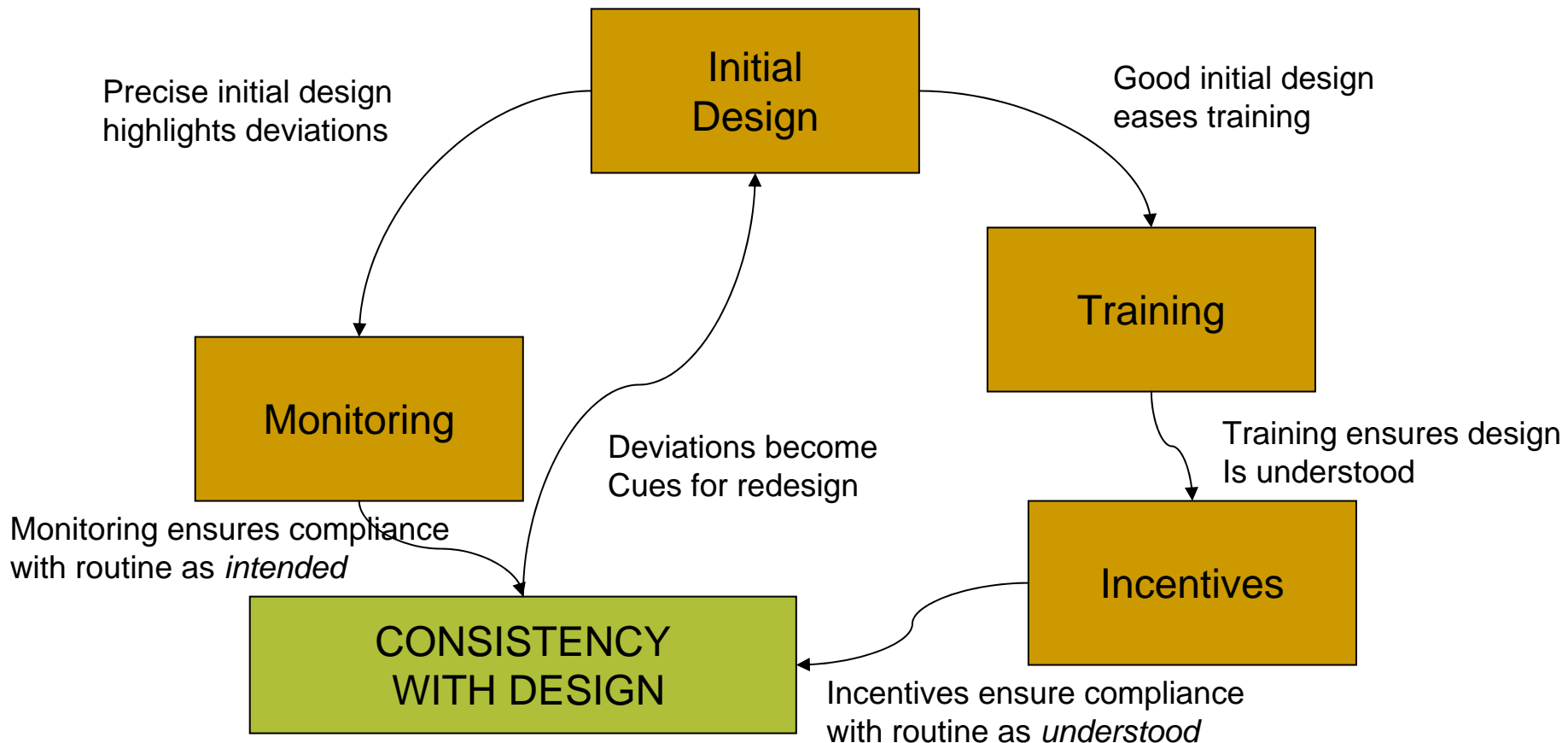
How do franchises achieve consistency?

- Initial design of routine
- Training
 - Initial training at a new unit
 - Recurring training
 - New employees
 - New methods
- Incentives
- Monitoring

The relative importance of each mechanism in achieving unit efficiency



Mechanisms are reinforcing



Initial Design

- One of the biggest concerns with routines is their transfer
 - In the case of franchising from headquarters to franchisees
- Transfer issues tend to stem from:
 - Properties of knowledge, e.g., tacitness
 - Fit with the receiver
 - Can they understand it
 - Do they value it
 - Can it be integrated with existing operations
- Design process has potential to address these issues up front
- Moreover “Learning before doing” facilitates “Learning while doing”
 - A well articulated initial design (one with low variance) focuses attention on small deviations

Training

- Initial training of franchisee
 - At headquarters
 - At an existing unit
 - On site at opening of the franchisees own unit
- Recurring training of new employees
- Annual franchisee meetings

Incentives

- Most obvious incentive is profits
 - Managers are owners and thus will use profit maximizing logic
 - Risk: Sometimes profit maximizing behavior comes at the expense of the chain
 - Most likely at “freeway exit type” locations
 - Franchisee adds water to ice cream mix
 - Saves cost (maximizes profits)
 - Doesn't affect his sales because customer doesn't know about the water until after purchase
 - But customer avoids going to other units in the chain because of the bad experience

Training someone with the routine, and providing perfect incentives isn't sufficient

- McDonald brothers sold 15 licenses for \$1000 between 1952-1954
 - Building blueprints
 - 15 page operating manual
 - One week on-site training
 - Right to use the McDonald's name
- After that free to operate as they wished
 - Some added menu items
 - Some changed building
 - Some changed name
 - Few exhibited attention to detail/cleanliness
- None became successful

Why experience with routine and perfect incentives isn't sufficient

- 7% of the variance of using practices is explained by franchisors enforcement
 - 25% explained by knowing about the practice
 - 3% explained by agreeing with its usefulness
- Why don't owner-managers use practices they know about and agree are useful:
 - Economic arguments: "too time consuming"
 - Alternative approaches: "don't need a good location, I have a fax"
 - Hubris: "We prefer to select our customer base, not the other way around"
- What happens when owner-managers deviate
 - Some have abnormal returns
 - On average, they fall below expected performance

Firms need monitoring and controls

■ Monitoring:

- Monthly financials
- Unscheduled inspections

■ Controls

- Threat of losing unit
 - ...and accordingly initial investment
 - Need to carefully define the conditions for losing unit
- Threat of not being able to get additional units (McDonalds)

Ray Kroc was the first one to refine the control aspects of franchising

- His experience selling the multi-mixer to Dairy Queen highlighted problems of inconsistency without central controls
- Important because McDonalds focus was on retail NOT on pushing manufacturer's product
 - Wanted brand name that stood for same service and quality across country
 - Conforming to operating standards was bedrock principle
 - Quality
 - Service
 - Cleanliness
 - Value
- His approach to avoiding inconsistency
 - No territorial franchises
 - Dilute royalties (and therefore incentives)
 - Also dilute controls
 - Licenses for second store depend on performance in first store
 - Make money on royalties rather than product sales to franchisees

Something more elegant: Self-monitoring BancOne

- Geographic expansion strategy via acquisition
- Key mechanism for managing is “uncommon partnership”
 - Centralized information
 - Local decision making
- “Uncommon” because typically information and decisions are co-located
 - firms are either centralized or decentralized

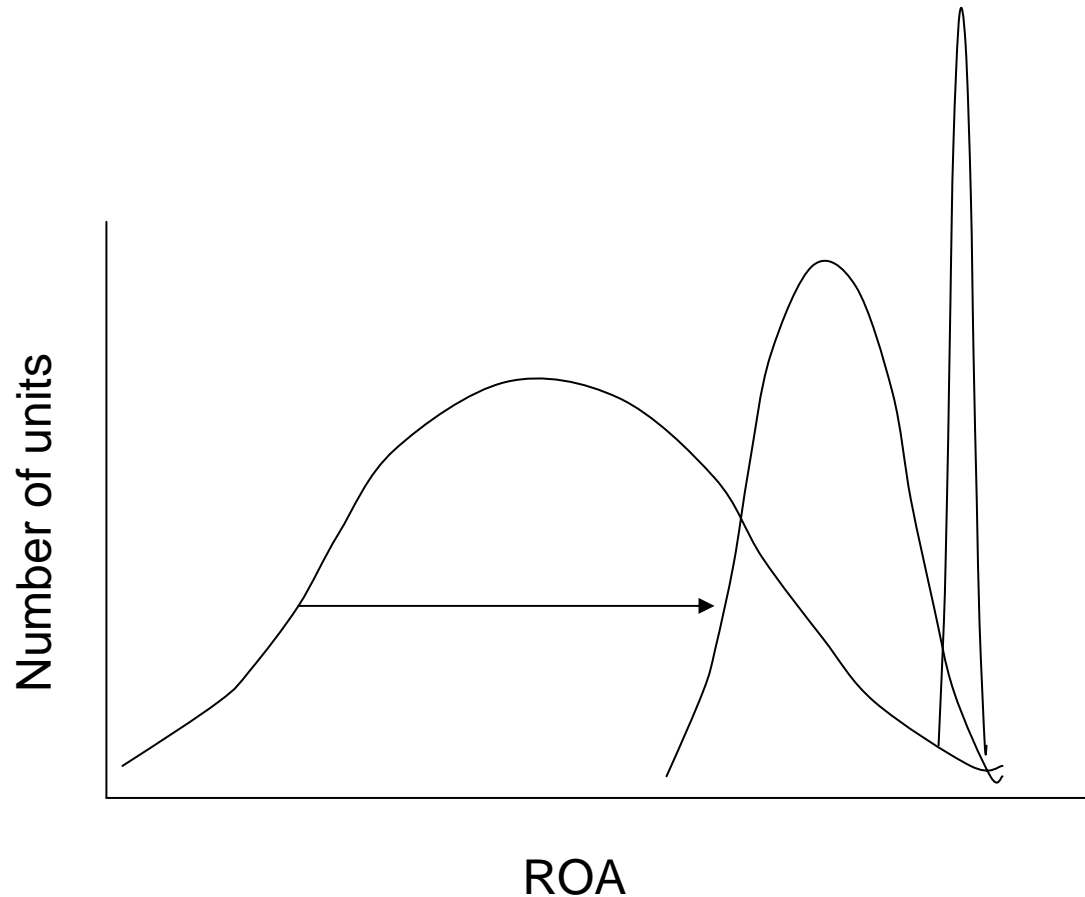
How information is leveraged

- Monthly peer reports
- Each bank knows exactly its rank relative to other banks
- The worst bank must contact one of the best banks and learn from it how to improve

Banc One MICS Full Year peer comparison Report for Large Banks

Bank	Net income	ROA	ROE	net interest margin	non-interest expense/revenue
Dayton	139388	2.22	25.01	10.18	48.01
Arizona	134236	2.12	24.18	8.65	49.03
Chicago	121580	1.97	22.22	7.08	49.47
Cincinnati	90128	1.93	22.14	7.05	49.61
Cleveland	56010	1.89	21.54	6.95	49.97
Akron	54304	1.68	21.28	6.75	51.23
Columbus	47204	1.68	21.15	6.36	55.79
Dallas	43112	1.65	21.00	6.34	57.69
Midcities	34701	1.53	20.30	6.26	58.73
Denver	31319	1.41	19.95	6.08	58.81
Fort worth	23722	1.41	18.26	5.76	60.83
Houston	18894	1.39	17.76	5.73	61.57
Youngstown	18073	1.36	16.99	5.69	62.31
Indianapolis	14805	1.30	16.92	5.66	63.76
Lexington	14411	1.29	15.85	5.33	63.96
Lima	11896	1.26	15.39	5.27	67.58
Austin	11375	1.17	13.10	5.14	68.30
Milwaukee	10300	1.05	11.72	5.10	68.51
Rockford	7305	0.88	8.56	5.08	68.97
TOTAL	882763	1.62	19.79	6.46	56.65

What happens in the limit?



Other dark side to monitoring: Hospital report cards*

- Hospital report cards intended to give patients better information for making health care choices
- Unintended consequences:
 - Hospitals and physicians changed behavior
 - Refused to treat patients who most needed care, because they were most likely to hurt success statistics
 - Gave treatments to “healthy” patients to boost success statistics

* Dranove, Kessler, McClellan, Satterthwaite, “Is more information better? The effects of report cards on health care providers”

Implications for addiction treatment clinics: licenses versus franchises

	Licensee	Franchisee
Brand	will represent approach	will represent approach PLUS outcomes
Initial routine	comparable	comparable
Improvement in routine	will lack data on outcomes	can exploit outcomes data from all units
Consistency	will have high variance (no controls)	should have narrow variance (monitoring, learning across units)
Growth of system	harder to attract new owners without outcome data	will have full distribution of possible performance
Government endorsement	difficult to get without outcomes data	has outcomes AND they improve over time

Other advantages to franchise/chain

- Headquarters takes care of compliance (regulations/reporting)
- Central purchasing provides quantity discounts
- Headquarters (because the payoff occurs over several units) has incentives to innovate
- An industry association or supplier can provide one and two, but can't monitor and has no incentive to innovate

Summary

- Value of consistency
 - Stimulates demand
 - Risk averse customers prefer lower mean and small variance to higher mean with wider variance
 - But also facilitates continuous improvement
 - So will have higher mean
- Mechanisms for achieving consistency
 - Good initial design
 - Training
 - Incentives
 - Monitoring and controls
 - Data and anecdotal evidence (McDonald's experience vs early fast food) suggest this is most important component
 - Good system not only controls performance, but facilitates improvement in performance (BancOne)
- Be careful of unintended consequences (hospital report cards)