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Franchising from the franchisee’s perspective

A review of the multi-unit franchising paradox

Marko Grünhagen and Robert A. Mittelstaedt

Abstract: The focus of this article is on the emergence and development of multi-unit franchising in the USA from the franchisee’s perspective. After a historical summary of the development of franchising from a marketing viewpoint, a typology of different franchisee types is provided, and the multi-unit franchising paradox is presented. The article offers a discussion of reasons why individuals might be enticed to become multi-unit franchisees. Emphasis is placed on entrepreneurship as a possible motive for sequential owners’ involvement as multi-unit franchisees. The article concludes by providing encouragement for future research to investigate the issue empirically.

Keywords: Franchising; multi-unit; single-unit; franchisee; review; motivations

Over the past two decades, the franchising industry has experienced a phase of renewed expansion and continued growth, spurred to a large extent by the advent of new forms of franchising. New industry segments, such as funeral homes and car repair garages, have adopted franchising as a means to conduct business based on its standardization promise, and the expansion into so-called ‘non-traditional’ sites, such as airports, colleges and hospitals, has allowed for another push in the growth of franchise systems. In the wake of globalization, which accounted for much of the industry’s expansion between the 1960s and 1980s, a major portion of the more recent increase in sales and unit growth can be attributed to the emergence of franchise owners who own more than the traditional single outlet (Kaufmann, 1992). In many cases, such multi-unit franchisees’ mini-chains extend across entire states, encompassing hundreds of outlets (Kaufmann, 1988; Bodipo-Memba and Lee, 1997). In contrast, Bond’s Franchise Guide (1998) provides figures that put the median size of entire franchise systems at only 64 outlets. With half of today’s retail goods being distributed through franchise systems, the trend towards multi-unit franchising has become a pervasive phenomenon.

However, ownership attention as the core advantage of franchising for the franchisor seems to get lost in a multi-unit ownership arrangement. In addition, franchise ownership of multiple outlets seems to represent, at best, an equivalent solution to other types of capital investment, and at worst, an inferior alternative in light of the stock markets’ continued surge paired with semi-dependence on the franchiser. A clear need exists for entrepreneurship researchers to understand the emergence of such important and pervasive institutions as the new breed of multi-unit franchise businesses; this article is considered a step in this direction.
Transfranchising from the franchisee's perspective

First, an overview of the history and broad characteristics of traditional franchising in contrast to the modern phenomenon of multi-unit franchising is provided. The ‘multi-unit franchising paradox’ will be examined, which will be followed by an offering of why multi-unit franchising might be of interest to this particular business arrangement. Hence, a distinct focus will be placed on the discussion as to why multi-unit franchising may exist from the franchisee's perspective, and on entrepreneurialism as a possible motive for sequential owners for their involvement as multi-unit franchisees. Multi-unit franchising seems to be such a pervasive phenomenon today that the question of why those involved engage in this endeavour seems not just warranted, but almost overdue. The franchising industry in the USA serves as the basis for the conceptual exploration of this paper, due to its advanced development compared with less mature franchise markets around the globe.

Historical overview

Franchising as a distinct form of distribution goes back to the early 1900s, when beer brewers in Europe entered into licensing and financing agreements with bars and taverns to distribute their products in exchange for a percentage of sales. That exclusive arrangement is a type of franchise and ale. In 1863, the Singer Sewing Machine Company instituted the first consumer product franchise system in the USA. During the 1890s, the automobile and soft drink industries adopted franchising as the primary means of distribution, and in the 1950s, petroleum producers followed (Hackett, 1976). The marketing and the economics literatures classify this ‘first generation’ of franchise systems, which was adopted early on and continues to the present, as ‘product and tradename franchising’. It is characterized by franchisees who simply distribute a product under a franchisee’s trademark (Preble and Hoffman, 1986).

The franchise industry began a period of accelerated growth in the 1950s. After Howard Johnson had developed the first franchised restaurant chain in 1935, fast-food restaurants, hotels, entertainment and retail services integrated the franchising concept into their marketing strategy (Hackett, 1976). With these newer types of franchise systems, the main focus shifted from the traditional perspective of a distribution channel for a specific product to that of ownership of an entire business idea by the franchisor, and its rental to the franchisee (Caves and Murphy, 1976). This second generation of franchising is defined as ‘business format franchising’ in which the relationship between franchisor and franchisee ‘includes not only the product, service, and trademark, but the entire business format itself — a marketing strategy and plan, operating

transfers and standards, quality control, and continuing two-way communication’ (US Department of Commerce, 1988: 3). By the late 1960s, the initial rapid growth of franchising within the USA had levelled off due to a changing perception of market saturation and heightened competition. Consequently, franchisers began to expand beyond US borders. While in 1969 only 14% of the manufacturers on a new development in Franchise Association (IFA) had foreign operations (Hackett, 1976), today more than 20% of established franchise chains, approximately 400 companies, have globalized their franchises (Ryan, Lott, and Maskulka, 1997).

During the past decade or so, the face of the domestic franchise industry has changed dramatically. An ever-growing number of franchisees have established multi-unit operations within existing franchise systems, with various forms of multi-unit ownership emerging. The following section will provide an overview of some of the more important types of single-unit as well as multi-unit ownership.

Franchising characteristics and types

Much confusion still surrounds the concept of multi-unit franchising. The franchisee agrees to follow certain guidelines and operating standards, and pays an entry fee, royalties and various other recurring fees, in return for the franchisee’s advice and services regarding site selection, financing, advertising, litigation and so forth. A variety of franchise forms coexist under the same name. However, the traditional perception of franchising is the ‘mom and pop’ franchisee, who brings all of his/her energy and focus to bear on operating one outlet (Caves and Murphy, 1976).

In recent years, practitioners as well as researchers’ attention has been focused on another type of franchising, the trend towards multi-unit franchising. In contrast to the historic ‘mom and pop’ franchisee, an ever-growing number of franchise owners currently operate more than one outlet. Over the past few years, various studies have indicated the persistent importance of multi-unit franchising in the USA. Kaufmann and Dant (1996) found that 88% of the surveyed franchisors had multi-unit franchisees, while Kaufmann (1995) found that 83% of the surveyed new Mexican restaurants in 1994 were opened by existing franchisees. Within the McDonald’s franchise system, between 1980 and 1990, 61.5% of all new restaurants were opened by existing franchisees (Kaufmann and Lafontaine, 1994). Consequently, Kaufmann and Dant (1996: 346-347) conclude that ‘the typical location-based franchise system (for which the fast food franchise is the prime and model example) is populated with multi-unit franchisees.’ Further, based on the research studies of Klein and Kim, 1993 and 1995; Robicheaux, Dant, and Kaufmann (1994), it can be concluded that the multi-unit franchising sector is not only growing, but that a substantial portion of the industry’s growth can be attributed to the increasing popularity of multi-unit franchising.

Kaufmann and his colleagues (Kaufmann and Dant, 1996; Kaufmann and Kim, 1993 and 1995) identify three types of multi-unit franchisees, apart from the traditional single-unit franchisee. ‘Subfranchising’, often also denoted as ‘franchisee franchising’, is characterized by the franchisor’s permission to a franchisee to grant franchises on the franchisor’s behalf to third parties. Subfranchising as a distinct form of franchising is widely used in the international expansion efforts of franchisees. Often, a subfranchisor for one or even several countries is established who then, in turn, subfranchises to local franchisees who are responsible for opening up their units. The subfranchising function as an additional control layer, and largely assumes the tasks of the franchisee in both the geographically area for a share of the royalty payments. Subfranchising as well as corporate ownership of outlets by the franchisee have been in the past, and are still today among the most frequently observed forms of control in the international expansion process of US franchise systems (eg Alon and Rust, 2000). Either strategy allows the franchisor a great amount of control over its foreign operations, a

paramount objective for franchisors in light of the prevailing communication and strategic flexibility problems in global franchisor/franchisee relationships (Ryan et al, 1997).

‘Multi-unit franchising’ as well as ‘sequential multi-unit franchising’ denote the types of franchising in which the franchisee himself/herself opens additional units under her/his own ownership and management. They are the prevalent types in franchising (Robicheaux et al, 1994), with sequential multi-unit franchising as the most common domestic form (Kaufmann, 1992). In area development franchising, the franchisee requires the franchisor him/herself to exercise the contractual obligation to open a specified number of outlets within a specified period of time. In sequential multi-unit franchising, the franchisor simply grants the franchisee the right to open additional units, with each subsequent outlet being legally governed by a separate franchise agreement. This franchise form is based on the desire by traditional single-unit franchisee to open additional units in order to grow their businesses, and for qualification for expansion is often based on the performance of existing units (Kaufmann and Dant, 1993). Both of these types of multi-unit franchising actively encourage the creation of mini-chains, in multiple units owned by the franchisor and operated by employee-managers of the franchisee.

Multi-unit franchising, either through incremental expansion by the franchisee one unit at a time, or through the contractual agreement to open multiple units contained in an area development contract, creates a collection of mini-chains within the franchise system. Both Kaufmann (1988) and Bodipo-Memba and Lee (1997) indicate that the multi-unit concept in some cases extends across entire states, and may encompass hundreds of outlets. Area development contracts force area developers to approach their assigned territory in a systematic fashion, thus accelerating the growth process. Area developers generally operate within a specified exclusive territory, which is defined in their contract with the franchisor. Hence, they forego competition with other franchisees and outlets owned by the franchisor (Justis and Judd, 1993). Sequential multi-unit franchisees, on the other hand, develop all of their units subsequently as money allows and opportunities arise, with overlapping trade areas between such franchisees frequently, individual area developers own more outlets that sequential multi-unit operators, as the expansion process for the sequential multi-unit franchisee is usually a slower one. The conflict prevention development franchising has spurred its growth in particular (Kaufmann and Kim, 1993 and 1995; Zeller, Achabal, and

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Brown, 1990). Consequently, the growth of multi-unit franchising as an aggregate is a result of various factors, among them:

(a) systemic and obligatory growth of area developers;
(b) prevention of territorial encroachment through
(c) incentives, both widespread growth of sequential owners.

In the subsequent section, the focus will be on the issue of why individuals engage in multi-unit franchising. Multi-unit franchisees have become such large and pervasive marketing institutions that this question seems warranted. In contrast to the traditional research perspective taken in marketing, in which the role of the franchisee has been scrutinized for the most part, the viewpoint of the franchisee is emphasized here.

The multi-unit franchising paradox

From a theoretical perspective the phenomenon of multi-unit franchising seems counterintuitive. The main reason for the existence of franchising in the literature from the franchisee's point of view has been attributed to the advantage of owner attention, as the increased profitability that a franchised outlet generates, based on the semi-independent owner's motivation compared with a company-owned outlet operated by a hired manager. Owner attention as the core justification from the franchisee's point of view is generally attributed to the formal contract of franchise agreement. The financial aspect of franchising is truly secondary to this argument, as in the case of the single-unit franchisee, owner attention as the core justification from the franchisee's point of view is general; however, it may be that the entrepreneurial spirit lives in multi-unit operators and, specifically, in those that develop sequentially.

To try to answer the general question, 'why multi-unit franchising?', three possible answers seem to emerge from the literature:

1. Single-unit franchisees may be so eager to get into business for themselves that they become risk-averse, and therefore prefer the relative lower cost of capital relative to a vertically integrated system. This argument is extended by saying that multi-unit franchisees are not different from single-unit franchisees in that respect, indeed, they are similar in this regard, except that they have more money to invest.

2. Multi-unit operators believe that, because they are entering in a bigger way, they can 'beat the system' by garnering advantages inherent in larger, geographically dispersed operations.

3. The same 'experts' who have argued that multi-unit operators do not have a lot of money payments to the franchisee. Other opportunities exist for potential multi-unit franchisees to invest their money, such as the securities or real estate markets, may appear equally profitable, given the variable returns across franchise systems. Hence, alternatives to multi-unit franchising might represent equally enticing investment options. The fact that multi-unit franchising has emerged as the dominant phenomenon in the US franchising industry despite the mentioned drawbacks is considered here the 'multi-unit franchising paradox'. It seems as if, for the potential franchisee and the franchisee, the multi-unit franchising concept might be part of a considered set of alternative options. By no means, however, does multi-unit franchising seem to present itself as the clear superior choice. The three questions in Box 1 are suggested to provide overarching themes and guidance to the basic question of what is the justification of multi-unit franchising from the franchisee's point of view? The third suggestion will be pursued further, while the first two suggestions are meant to encourage further research.

Why multi-unit franchising?

(1) Perhaps for the same reasons as single-unit owners, with the only difference being more than one unit. Most of the franchisee's motivation compared with a company-owned unit operated by a hired manager. 

(2) Perhaps the belief prevails that, being bigger than single-unit operators, multi-unit operators might not be subject to 'fogged the game'.

(3) Perhaps it is a completely different 'philosophical orientation' in which franchisees might consider themselves more entrepreneurial than others.

Entrepreneurship as a motivator

The franchising literature has borrowed from fields such as entrepreneurship (Knight, 1984) and psychology (Felstead, 1991; Mescon and Montanari, 1981) to suggest various reasons for entering into the franchise business from the single-unit franchisee's perspective. Franchisee owners frequently vehemently deny that their franchise engagement is based on the monetary earning potential. The opportunity to become one's own boss and the hands-on work experience as a type of entrepreneurial self-fortuitously, bolstered by the perceived security of the franchisee's proven business format, tradition and expertise, is a common justification for single-unit operators (Elango and Fried, 1997). The fact that the financial aspect of franchising is truly secondary is supported by the fact that it is often previously highly paid executives who leave their jobs to become franchisees. Most of the research (Anderson, Condon, and Dunkelberg, 1992; Knight, 1984; Mescon and Montanari, 1981) is inconclusive in terms of distinguishing franchisees from independent entrepreneurs based on previous self-employment experience. However, recent research (see also Ginsberg and Buchholtz, 1989) for a comparison of entrepreneurs with non-entrepreneurs. One issue that has not been researched, however, is the distinction of entrepreneurial motivation for multi-unit franchisees versus single-unit operators.

As described earlier, an area development contract entails the obligation to complete the entire mini-chain by the end of the contract period. Hence, in contrast to the single-unit franchisee, area developers have to start their development with a very good estimate of the total investment to be incurred. Because (1990) reports that the Federal Trade Commission (FTC) defines a franchisee as a 'sophisticated investor' if she invests more than $1.5 million in a franchise, area development franchisees are at the forefront of the investment. Area development franchisees, who are on the outside of the franchise, see an opportunity to make a worthwhile investment. Although a sequential multi-unit franchisee expands on the basis of established market opportunities paired with sufficient earnings, the process is one that implies rigorous. As a new opportunity to expand opens up, a sequential multi-unit franchisee will decide on a case-by-case basis whether or not to take advantage of it. Livesey (1982: 12) calls an individual who 'perceives a market opportunity and assembles the assets necessary to exploit it' an 'entrepreneur'. Palmer (1970/72) points out that entrepreneurs tend to work harder because of financial incentives, but that it is their intrinsic motivation which drives them. This appears to be in accordance with many sequential owners' strongly held beliefs that a continued presence in their stores is mandatory for persistent success. In addition, the entrepreneurship literature often describes the motivation of entrepreneurs as a type of emotional fulfillment stemming from a long-held desire to become an entrepreneur. To own one's own business, and to be one's own boss, appear for many entrepreneurs as life-long dreams, which finally become fulfilled through the opening of their own enterprise. Therefore, a 'entrepreneurial motivation' is to believe that franchisees attract from two sources, job involvement and emotional fulfillment. It is suggested here that, particularly for sequential multi-unit franchisees, such an entrepreneurial motivation might be the driving force behind their involvement as multi-unit owners.

Past and future research

Multi-unit franchising has emerged as the current 'hot' trend in the domestic franchising industry. The academic literature on multi-unit franchising in marketing, however, is still in its embryonic stage (Table I), and has only emerged over the past few years, mainly based on work by Kaufmann, Lafontaine and their colleagues (Kalnins and Lafontaine, 1996; Kaufmann and Dant, 1996; Kaufmann and Kim, 1993 and 1995; Kaufmann and Lafontaine, 1994; Rohleicuaux, 1994). Most of this research has focused on the franchisee's perspective. The empirical testing of multi-unit franchising research is just emerging, and has so far answered questions that are very limited in their scope, such as issues of growth or system-wide adaptability (see Table I). Bradach (1995), Kaufmann and Dant (1996) and Kaufmann and Kim (1993 and 1995) found that the franchisee's perspective, particularly the first two suggestions are meant to encourage further research.

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Table I

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<th>Study</th>
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| Kaufmann and Stanworth (1995), Peterson and Dant (1990) and Stanworth and Kaufmann (1996) provide some of the few academic attempts to organize perceived advantages from the franchisee's perspective. These studies, however, only engage with the single-unit franchise context. The literature on multi-unit
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Kalnins and Lafontaine
Kaufmann and Kim
can only be developed gradually, and this article is
franchisee's perspective, and her/his motivation to
multi-unit franchisees see certain advantages as salient
meant to encourage research in this direction.
need to combine
plausibly conjecture that asserting a
has neglected to a large extent the
franchising systems.
Survey of 160 International Franchise Association
Area development franchising and subfranchising are associated with higher growth rates
franchisee's perspective has received very little
understanding of their respective motivations. It seems
that such a study could be conducted, for example, in the
fast-food industry, which has not only served as a
simple for most of the published research on
franchising, but also seems to provide the required
variety of ownership patterns to compare area develop-
dermal and sequential operators. The frequent use of
the fast-food industry in the franchising studies ought
to prove valuable, as new findings could be validated in the
face of price studies. Considering the recent rise in
proliferation of entrepreneurship-related research across
business disciplines, the exploration of the emergence of
such pervasive marketing institutions as franchise
businesses of different types appears to warrant attention
by scholars of entrepreneurship and franchising issues in
particular.

Conclusion
To summarize, it has been argued that multi-unit
franchisees in general, and sequential multi-unit opera-
tors in particular, represent a growing proportion of the
franchising industry. From the franchisee's perspective,
multi-unit franchisees do not seem to make a lot of
conceptual sense, except that they seem to allow for
greater growth of the system. However, sequential multi-
unit operators do not seem to represent that same
advantage since sequencing is a strategy most often
found in relatively well established systems. In addition,
the franchisee's perspective has received very little
attention in the academic franchising literature. Given
that franchise systems inherently give the franchisee
only limited control of her/his own business, no opportu-
nity to retrieve any goodwill that the business may
develop, and cost a significant percentage of the gross
revenue in the franchise agreement. This point has to ask why anyone
would ever become a franchisee. This phenomenon is
known as the "multi-unit franchising paradox" in this
context.
Some have argued that franchisees are "buying jobs"
While that may be true for a single-unit owner, it does
not answer the question for the area developer who,
possesses a franchise. This argument is one that has to ask why anyone
would ever become a franchisee. This phenomenon is
known as the "multi-unit franchising paradox" in this
context.

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need to combine qualitative efforts in order to gain a
better comprehension of multi-unit franchisee

motivations, with quantitative measures to explore the
similarity and distribution of the phenomenon of a
'driving philosophy' among franchisees.
Research on the franchisee's perspective has been
considered in the past by the entrepreneurs and the
certainties. Furthermore, most empirical
research on franchisees, and on franchising in general,
wanted to restrict the operation of
one particular franchise system (Kaufman, 1988;
Kaufman, D.J. and Lafontine, 1994). Future research in
this area needs to address these issues in an effort to
enhance the generalizability of findings across system bounda-
ries, while convincingly franchisee respondents of the
value that their contributions might provide to a deeper
understanding of their respective motivations. It seems
that such a study could be conducted, for example, in the

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