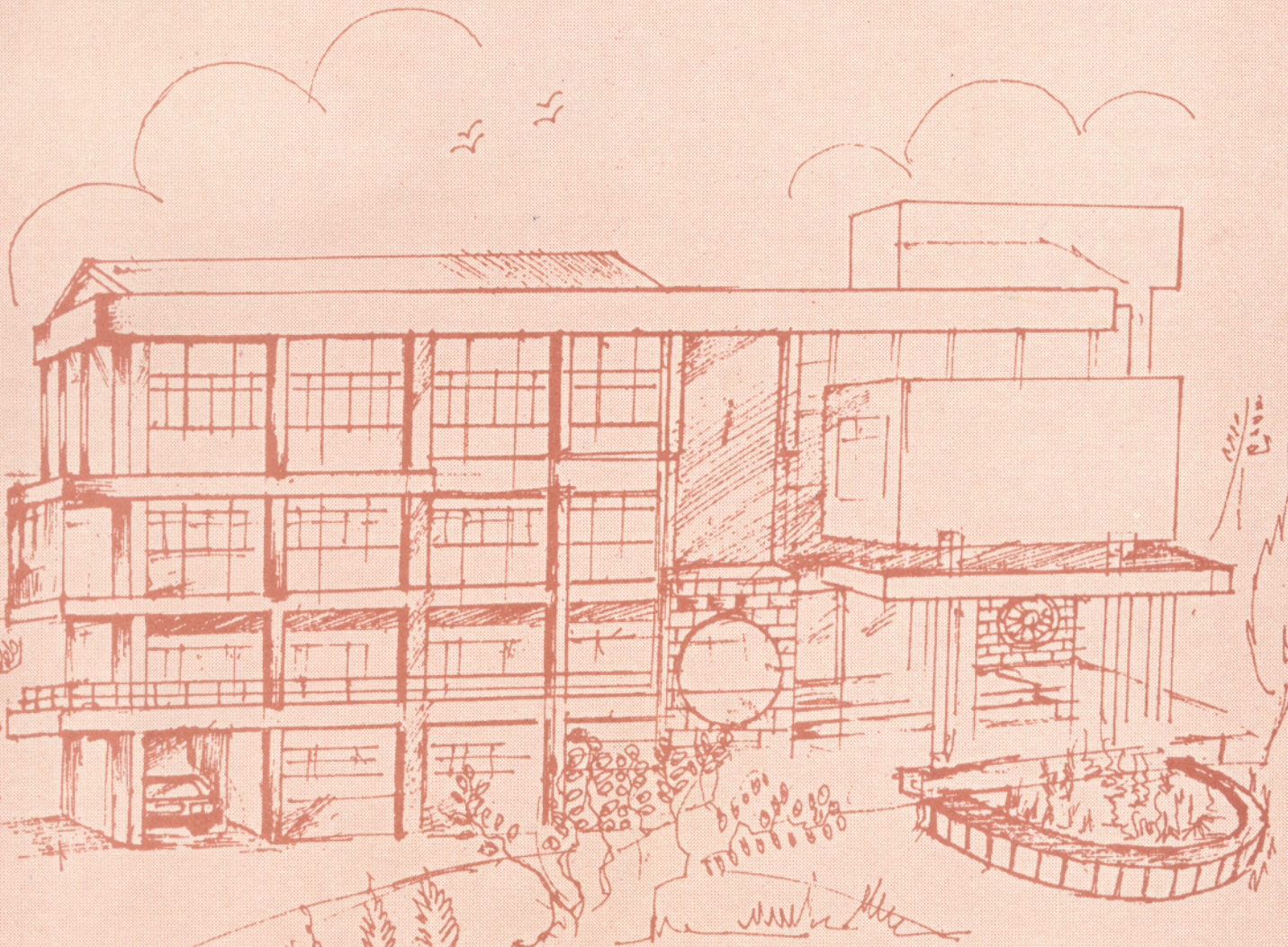




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Working Paper Series

Franchising as a Distribution Strategy A Conceptual Note



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Franchising: A Conceptual Note ¹

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The main purpose of distribution in any organization is to deliver value to consumers by *reach*, *frequency*, *size* and *visibility*. Providing to the consumers place utility, form utility and time utility is the intent behind any distribution strategy. Organizations have many ways of achieving these objectives. A manufacturing organization has the options of distributing in the following manner:

- Reaching the consumer directly (Zero level distribution)
- Starting branches that operate as distribution points (Vertically Integrated Distribution)
- Appointing agents to supply to customers directly (Single Layer Distribution)
- Appointing distributors to serve the customers through retailers or directly (Multi-Layer Distribution)
- Contracting with interested parties for carrying out the business subject to certain contractual agreement (Franchising)

In this note, the franchising is dealt with in terms of definition, the need for franchising as an option in distribution, how it compares with other methods of distribution, different types of franchising, different levels of franchising, flows and payoffs in franchising and finally a generic model of economics of a franchising arrangement.

Franchising

An old definition of franchising goes as follows:

“... selling based on any contract under which independent wholesalers, retailers and service institutions are organized to act in concert with each other or with manufacturers to distribute given products or services.”²

¹ This note is intended to serve as a simple aid for basic understanding of the concepts in successful franchising.

This definition is somewhat confusing since it fails to differentiate franchising from a contracted distribution chain. However, in recent times, the definition of franchising has been made much sharper, as shown below, where franchising is defined as,

“... a system or method of marketing a product or service. The franchiser develops a special product, service or system and gains national recognition...then grants a right or license to small independent businessmen throughout the country to merchandise this service or product under the national trademark and in accordance with a proven, successful format.”³

The crucial points to be noted are:

- a. The franchiser *has to* have a well-established brand name, of either a product or service. It can be a product whose formula is a secret (e.g., Coca Cola), a unique equipment (e.g., Tetrapak franchising to Hindpac⁴ till nineties), a unique process (e.g., NIIT, APTECH) or a name that guarantees certain standard of product / service (e.g., *Nilgiris*, Titan)
- b. S/he is ready to allow someone else to use the brand name and process on a contractual basis. The franchisee will get the benefit of the use of such name, process etc., and gain goodwill as well. The Franchisee will pay a fee (royalty) for such use.
- c. S/he is willing to expand distribution to other areas, where s/he expects a continuing business, which interest s/he is willing to share with someone else.

Franchising in business dates back to the nineteenth century, in Germany, when certain beer manufacturers allowed the local pubs to manufacture their varieties for a fee. However, formal concept of Franchising started with Isaac Singer, when he franchised his sewing machines to trainees to train other potential users, so as to create demand for his product, as also funds for production.⁵

Why Franchising?

From an organisation-theory view-point, one may ask the need for franchising, which is neither a market-based structure like traders and merchants dealing with a company's products nor an organisation that offers full control over the operations to the company. Also, the question of the extra benefits a franchising structure offers needs to be answered. We find a part of the answer in

² L.J.Konopa, “Franchising” in Victor P.Buell (Ed) *Handbook of Modern Marketing* 2/e, McGraw-Hill, 1986, p.102-13.

³ Friedlander, Mark P. Jr & Gurney, Gene, *Handbook of Successful Franchising*, Liberty Hall Press, 1990, p.20.

⁴ Hindustan Packaging Company Ltd. was known in short as *Hindpac*.

⁵ Source: Ramu, Shiva S., *Franchising*, Wheeler Publishing, 1997, p.10

Transaction Cost Economics (TSE), which predicts the emergence of vertical integration of an activity as an outcome of the failure of market forces. That is, when the market mechanism—reflected by the arm’s length free channel wherein merchants buy from the company without any future commitment—fails to provide certain benefits or ends up causing certain costs and wastages, TSE predicts that vertical integration occurs. However, this is taking the argument too far to the other side. Franchising offers a mid-path whereby the organisation’s need for control is taken care of, and simultaneously engages an entrepreneur to conduct the business with the company. Initially, economists believed that franchising occurred only to enable easier availability of capital for the franchiser. However, this thought has been questioned. Whereas moping up capital is, perhaps, an important consideration, it is not necessarily the most important consideration. Paul Rubin offers an alternative explanation.⁶ According to him, monitoring and control issues offer better explanation for the emergence of franchising. High degree of geo-dispersion of the business-units renders effective monitoring and control costly, if not impossible. If the organisation were to rely on wholly owned subsidiaries—branches or other own organisations—it would run the risks identified by agency theory, namely, those of the managers’ *shirking* their duty as well as demanding and enjoying high levels of *perquisites*. Since managers and employees are employed for a fixed salary, there is no incentive for achieving the company’s goals. Franchising provides the incentive for the franchisee to put in the best effort to earn profits, a share of which can be appropriated by the franchiser as royalty. However, this explanation should be accepted with caution. It is incomplete in the sense that franchising is not a simple alternative for monitoring and control. It has certain necessary conditions such as a popular brand name, the name offering sufficient entry barrier to competitors of the franchisee, and the name offers sufficient prospects to the franchisee for earning profit out of the franchise arrangement. What it offers to the company is the spatial pre-emption—meaning, through the franchisee, the company can pre-empt the competitors by starting off the business expansion quickly and growing it. Moreover, whereas the employees are those who wish to work for someone else, an entrepreneur is someone who likes to be in control and franchising arises out of this difference in attitudes of those who are equally capable of managing a business. In the context of distribution channel management, the manufacturer considers the two options of (a) forward integrating into retailing activities and (b) franchising.⁷ Franchising emerges as the natural option when the manufacturer does not possess the competencies to monitor and manage retail activities.

⁶ Paul H. Rubin (1978), “The Theory of the Firm and the Structure of the Franchise Contract,” *Journal of Law and Economics*, Vol. 21 (April), reprinted in Hoy & Stanworth (2003).

⁷ Here, for simplicity’s sake—without compromising on the rigour of argument—we do not consider the other two types of channels, *viz.*, arm’s length channel and administered channel.

Such an arrangement gives him (i) the control he needs in retailing and (ii) the freedom from the risks arising out of *bad management*,⁸ since the franchisee's goals align with the franchiser's except in the share of profits.

Another factor specific to distribution channel is the buying behaviour and therefore the type of products where there is a greater chance of franchising than the others. Porter⁹ classifies consumer goods into *convenience goods* and *non-convenience goods*, the former implying low importance assigned by consumer to the buying process and the latter implying higher importance to buying process. Bucklin¹⁰ had classified the goods in to three categories: *convenience goods*, *shopping goods* and *speciality goods*. Shopping goods are those for which the consumer is yet to form a brand-preference map whereas speciality goods are those the consumer has a clear brand-preference map and therefore will go that extra mile to get his/her preferred brand. These two categories fall under Porter's non-convenience goods. Intuitively, it is easy to understand that franchising is possible only when the brand-identity is very strong. Secondly, even if the brand-identity is very strong, when consumers clearly identify one brand to be superior to others, if the product-category falls under "convenience goods", then the brand name is not a saleable business proposition to an entrepreneur. This is because, the owner of strong brand in convenience goods category cannot expect the consumers to converge at one point to buy his brand-basket. The consumer will rather pick up the available brand and walk away than to go an extra mile searching for his/her preferred brand. Therefore, it is close to impossibility to think of soaps, shampoos & detergents, biscuits, edible oil, butter, pulse-flour, milk powder, battery cells and such items of day-to-day usage, giving an opportunity to the manufacturer to consider franchising as a distribution option. On the contrary, apparels, watches, branded ornaments, technical education, specialized fast food—that provides an experience and ambience—and ice-cream are product categories where the consumer does not mind spending time and energy travelling that extra mile. These categories provide an opportunity to the manufacturer to think of franchising.

Where does Franchising fall in Channel Structure Scale?

Channel structures can be divided among two extremes, *viz.*,

⁸ *Bad management* arises due to the inability to prevent the employees from shirking their duties and to prevent the managers from perquisite-taking.

⁹ Michael E. Porter (1974), "Consumer Behaviour, Retailer Power and Market Performance in Consumer Goods industries," *The Review of Economics and Statistics*, Vol. LVI(4), November, pp. 419-436.

¹⁰ Loid P. Bucklin (1963), "Retail Strategy and the Classification of Consumer Goods," *Journal of Marketing*, January.

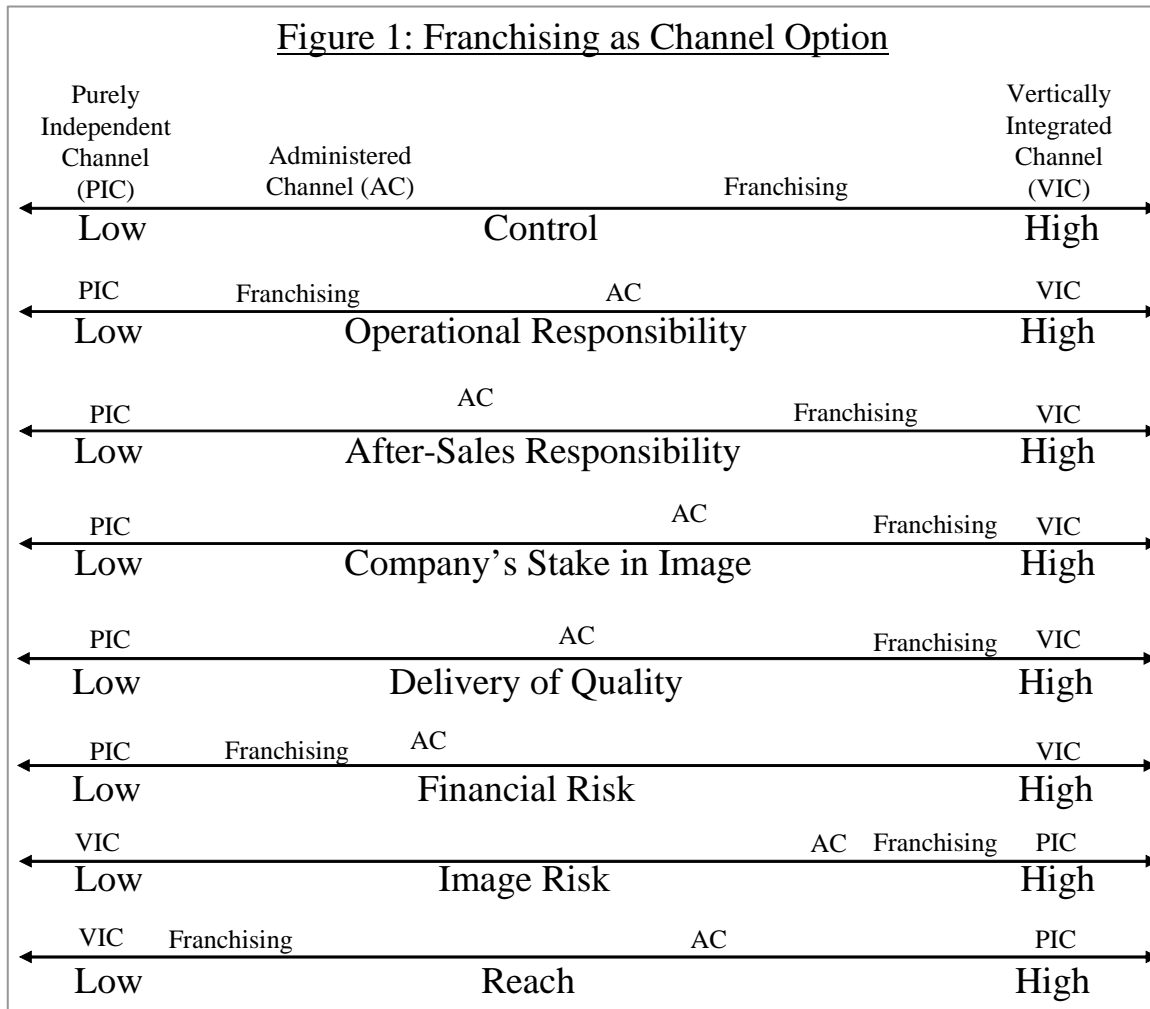
- *Purely Vertically Integrated Channel*, such as a company owns all the outlets. Till recently, many public sector organizations / co-operatives in dairy sectors owned most of their outlets. This type of channel has the advantage of high controllability through established systems, procedures and rules. However, the channel outlets face a great disadvantage, namely, lack of independence to decide locally and, equally significantly, the problems posed by agency theory, those of *shirking* and *perquisite-seeking*.¹¹
- *Administered Channel*, such as seen in FMCG and consumer-durable industries, where the company “appoints” distributors—with or without explicit written contract and area-allocations—through whom retailers and consumers are reached. The distributor and the company have tacit understanding of roles to be played by each and the systems are adhered to more by trust and referent power than by rules and authority.
- *Purely Decentralized Channel*, such as many of the companies in trading commodities, where the dealing is at arm's distance. The *modus operandi* in this case is to sell to the buyer organization and the issue is over. There are no relationship-issues involved in this type of channels. The greatest advantage in this channel is the amount of independence enjoyed by the channel members in decision-making. It also is advantageous to the company, *viz.*, the after-sales responsibility does not lie with it. However, for the company, the channel is highly disadvantageous, since it offers no scope for control in the channel.

Franchising falls somewhere between the two extremes of pure integration and pure decentralization, offering significant amount of control to the franchiser and sufficient independence to the franchisee to decide on the marketing-mix variables within the terms of the contract. Thus, considering various aspects of channel management, franchising falls between two extremes as shown in Figure 1. The explanations for what is shown in Figure-1 are as follows:

Control: Purely Independent Channels (PICs) do not lend themselves to much control by the manufacturers. This is because such channels are characterised by commodity-trading, near perfect competition or oligopoly, where brand differentiation is almost void. Merchant dealers can buy at will from any manufacturer¹² based on the best price and terms of trade. There is no brand-loyalty; nor is

¹¹ *Shirking* by an employee occurs when s/he does not carry out the job s/he is expected to do in the absence of monitoring. This adds to supervising/monitoring cost of the organisation. *Perquisite-taking* occurs when the employee bargains for a high salary and fringe-benefits such as club-membership, leave-with-pay and social security benefits that do not commensurate with the productivity of the employee.

¹² In this section of this note, manufacturer is used instead of franchiser so as to enable application to all types of channels.



there seller-loyalty. The actions of the merchants cannot be controlled. On the other extreme is Vertically Integrated Channels (VICs) which are represented by manufacturer’s branches in various geographic locations. These are governed by systems and regulations formulated by the corporate headquarters and therefore controls are much easier. Franchising provides the leverage to the manufacturer by contractual agreements the control that is needed, followed up by the legitimate power it gives to enforce the control through monitoring systems and supervision. However, since control has a cost, the degree to which it can be enforced is less than what VIC offers.

Operational Responsibility: This denotes the responsibility of the manufacturer in carrying out the day-to-day operations in delivery of value to the consumer. In a PIC, the merchant-dealer takes the stock at his risk and therefore the manufacturer is completely absolved of any responsibility afterwards in delivering it to the final consumer. On the other hand, in a VIC, the manufacturer is responsible for the delivery to the final consumer since he does not engage any other middlemen. Franchising falls between the two extremes, since the business format, quality-stipulations, method of delivery and

systems are provided to the franchisee; however, the specific activity is performed by the franchisee and the manufacturer does not hold the responsibility of the operations.

After-Sales Responsibility: Since in PIC, the goods are sold to the merchant-dealer, the after-sales responsibility—which is the post-purchase services/assurance that the consumer may expect—falls on the dealer. On the other extreme, the manufacturer's branch holds the entire responsibility of post-sales services/assurances since there is no other middlemen involved in the transaction.¹³ Franchising falls closer to VIC since it operates on behalf of the manufacturer and therefore the consumers expect the franchiser to be responsible for the support if the franchisee is not competent to carry it out.

Company's Stake in Image: In the case of PIC, the market is oligopolistic and the product is highly undifferentiated. Therefore, there is no stake in the form of brand-image, since such a market-structure normally witnesses price-driven sales in addition to the terms of trade. However, on the other extreme, VIC witnesses high stake since the branch is selling its own brand and the association between the brand and the company in the minds of the company will be instant, especially when there is quality-related dissatisfaction. The same applies to franchise also, where the franchisee's delivery affects the manufacturer's image heavily, since the consumers do not distinguish between the manufacturer and the franchisee.

Delivery of Quality: The explanation for this is much the same as in the case of company's stake in the image. Franchising falls almost along-side VIC in this aspect.

Financial Risk: The manufacturer's financial risk is the least in a PIC since the sales are over at its dock and payment is normally collected in advance. The risk is very high in VIC since the goods and payment are handled by the branches—though systems are normally set in place, misappropriation is a high possibility in VIC. In the case of franchising, the franchisee holds all financial risk, since the capital and other investments are his. Therefore the manufacturer's financial risk is very low, except for such investments by the manufacturer in buildings, layouts and signs, in case he does.

Image Risk: The argument here is much the same as in the case of company's stake in image. These two are highly correlated.

Reach: PIC offers maximum reach prospects since the merchant-traders normally have contacts in most distant markets. Franchising falls well below PIC since the manufacturer cannot appoint many

¹³ However, it should be noted that in the case of a packed, branded good—however oligopolistic or competitive the market may be—the responsibility for the content in the pack may still remain with the manufacturer as per the laws of the land.

franchisees in a small area, so as to ensure satisfactory ROI to the franchisee. VIC on the other extreme is too low in its ability to ensure reach since the cost of direct reach is always prohibitive. Franchising can achieve reach-levels somewhat closer to the VIC only.

Types of Franchising

There are many types of franchises. However, two types significantly stand out, *viz.*, Product Franchise *and* Business Format Franchise. The various types of franchising are as below.

- *Product Franchise:* Contracting with interested parties and giving them the rights to sell the finished product in the received condition. E.g., Bharat Petroleum, Indian Oil and Hindustan petroleum outlets vending petrol. In addition, showrooms of Maruti Udyog, Park Avenue, Louis Phillippe come under this category. A recent and classic example is the Titan showroom.
- *Production Franchise:* Contracting with interested parties to manufacture a *product*¹⁴ with certain specifications and distribute in a specified locality. Soft drink bottling companies engage in this method frequently, where they provide the franchisee the secret concentrate and allow them to bottle the products for distribution in specified areas.
- *Process Franchising:* Contracting with interested parties to market specified products in a specific manner. Such contracts normally provide a recipe for the product but not the product itself. E.g., KFC, Nilgiris Departmental Stores.
- *Business Format Franchising:* Contracting with parties for marketing a service, by specifying the ambience, systems, employment, support materials etc.

Though the list is not exhaustive, it covers the main options available. Further, many a time, we may find it difficult to slot a franchise arrangement into a specific category, though most of the service franchises will broadly fit into a Business Format Franchising

Product Franchise

The first type of product franchising is where the franchiser allows the franchisee to use its brand name for selling the franchiser's product. The product, without the brand name, is not otherwise differentiable. For example, petroleum dealers in our country deal in their franchiser's product under the franchiser's brand name, such as Indian Oil, Bharat Petroleum or Hindustan Petroleum. While the product is vended to the public in unbranded form, the organization's title under the franchiser's

¹⁴ In this specific paragraph, *product* denotes tangible goods. Otherwise, we use the term to include services too.

brand name lends the franchisee the much-needed credibility for reliability and consistency of quality among the consumers. This type of franchising can be called *distribution franchising*.

The second type of franchising involves the franchisee being provided the input for producing and distributing the output in the franchiser's brand name. For example, *Pepsi* has tied up with bottling companies in India for bottling the product under its brand name. The franchiser supplies the formula to the franchisee, with specifications about the quality of the final output (bottled cola) and allows the bottler to distribute the output within a specified area. This system is known as *manufacture franchising*, mentioned earlier as *production franchising*.

Business Format Franchising

Under Business Format Franchising (BFF), the franchiser allows the franchisee to replicate the well-established business systems of the franchiser to carry out business. This is used mostly in services. An exception is in *retail format franchising*, where we find organizations like *Nilgiris* allowing franchisees to use their shop name, subject to the check on their products sold, quality-specification, shop-layout etc. *Nilgiris* insists on its franchisees' getting only those brands that are approved by them. In this way, the franchiser also ensures economy of scale in purchase.

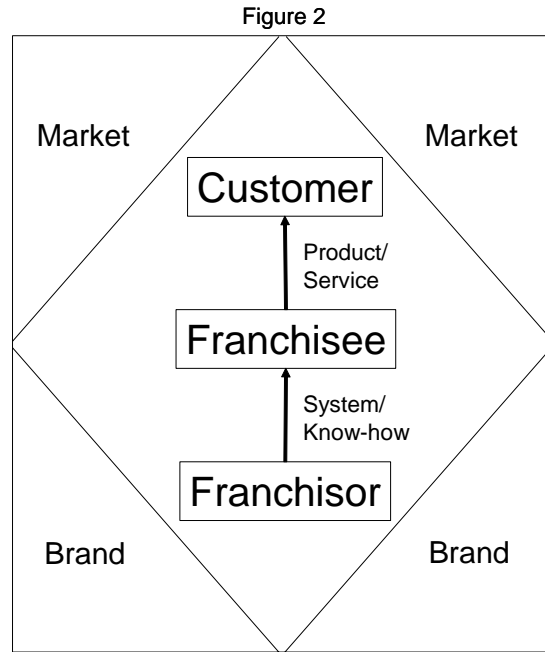
The second type of BFF is where the franchiser is in a service business. The franchisee is allowed to use the well-established brand name of the franchiser to start and establish the franchisee's business. Examples of this form in India are *NIFT* and *Aptech* professional computer courses. These institutes make their franchisees to invest in the land, building, layout and décor, allow them to use the brand names of the franchiser, provide course materials prepared by them and train their personnel to deliver the courses as per the standards set by the franchiser. This enables the franchiser to maintain the standards all over the country uniformly, thus not diluting the brand-image.

The third type of BFF is *dealership franchising*. This is a combination of dealership of the product of the franchiser *and* the business format as designed by the franchiser. Examples of this type are the automobile dealership in India, where the showrooms are designed as per the specification by the manufacturer. The entire method of carrying out business, including the tie-up with financing companies such as banks or NBFCs is schemed uniform all over the country, as per the design of the franchiser. The franchisee virtually functions like an extended arm of the manufacturer. Similar franchising arrangements can be seen in the showrooms of readymade garments such as *Van Heusen* or *Park Avenue*. Another classic example is the *Titan* and *Tanishq* showrooms. Thus, it can be seen that the aspect of franchising is to enable standardization of the format and quality to promote the sale of the product under the deal. An age-old example of this format is the *Bata* showrooms in

India. In recent times, *Arrow*, *Reebok* etc. have witnessed growth in business through franchised outlets.

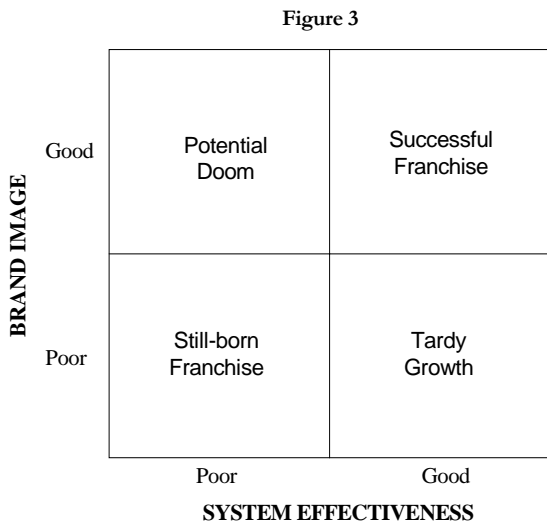
Basic Franchising Model

Franchising involves two parties, the franchiser¹⁵ and the franchisee. The fundamental understanding is that there is a business proposition, backed by a brand name that can be marketed to the benefit of both the franchiser and the franchisee. In this joint effort, there is a division of labour between the two parties, as shown in Figure-2, where the franchiser takes the responsibility of brand-building, system development and technical know-how, while the franchisee takes the responsibility for delivering the



Source: Pramod Khera, *Franchising: The Road Map to Rapid Business Excellence*, p. 10

product / service to the consumer. In other words, the brand building is the domain of the franchiser while the market-development rests with the franchisee. It is this understanding that is crucial to the successful building of a franchiser-franchisee relationship for growth.



Source: Pramod Khera, *Franchising: The Route Map to Rapid Business Excellence*, p.25

As mentioned earlier, the two dimensions of a successful franchise arrangement are brand and systems. When the brand image has not been established, even the best of the systems find it difficult to grow business quickly. It leads to extremely slow business growth, since the brand's credibility is yet to be established, which is a slow process, an unacceptable proposition in franchising. On the other hand, when the systems are poorly developed, even the best of the brand image can be squandered and destroyed over time. This is explained in Figure-3. It is easy to see that unless both the brand image and the

¹⁵ The phrase is spelt in Britain as *franchiser* and in the US as *franchisor*.

systems are well developed, the franchiser-franchisee relationship will not succeed for mutual benefit and growth.

When one aspect is developed and other is not, the arrangement may succeed in the short run, but it may not linger over a long period. This is because of the following reasons:

- A good brand, coupled with a bad system will be susceptible for abuse by the franchisee. The franchiser will not be able to monitor and check such abuses. This will kill the brand in due course.
- A bad brand, thanks to an excellent system, may succeed in the short run due to the hypes and euphoria created. Nevertheless, the customers' dissatisfaction will kill the brand in due course.

Levels in Franchise Arrangements

There are different types of arrangements in franchising. They are:

1. Master Franchisee
2. Sub-Franchiser
3. Area Developer

Master Franchisee: The master franchisee is assigned a large geographic area, such as a country, by the franchiser. The role of the master franchisee is to identify, evaluate and appoint franchisees within the area and assign territories to them. The role of the franchiser is to provide technical support and training to the franchisee. The master franchisee earns a commission on his sales to the franchisee while the franchisee earns his commission from the sales he makes to the final consumer. Both the master franchisee and the franchisee pay a royalty to the franchiser for the arrangement.

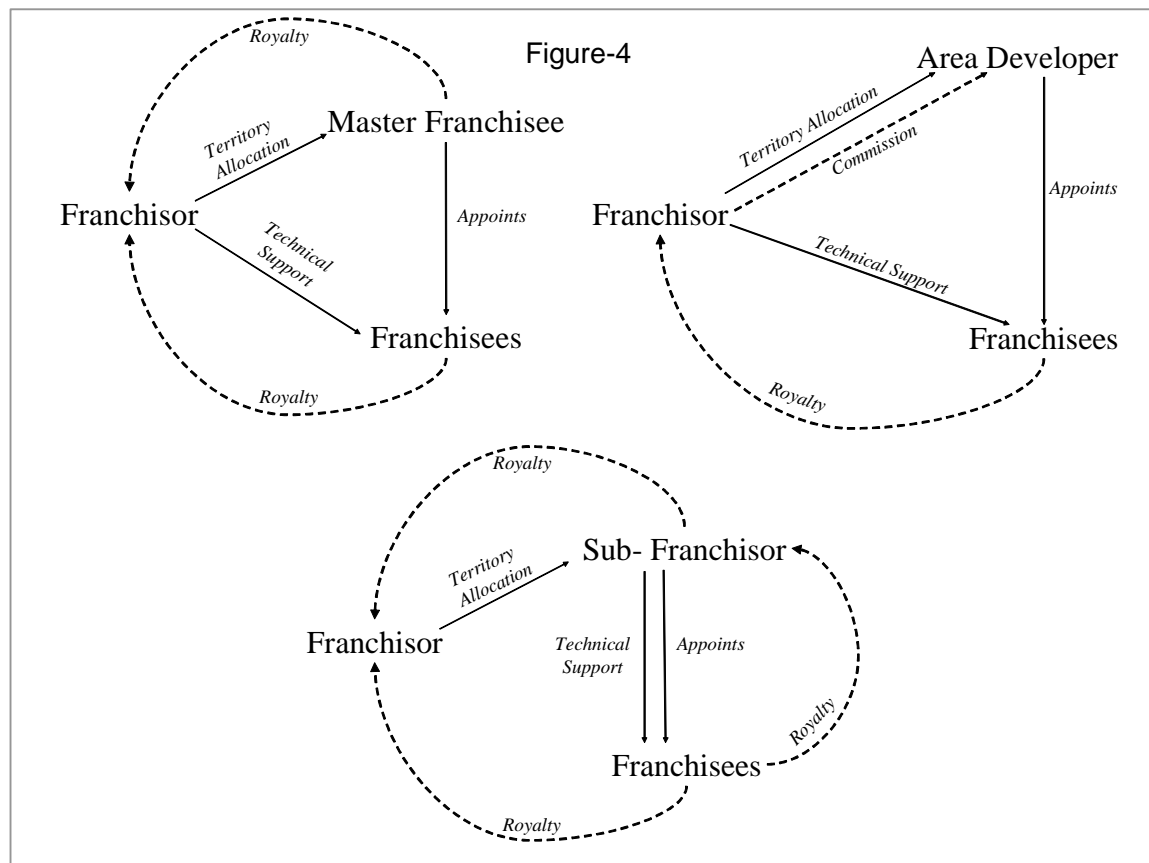
Sub-franchiser: A sub-franchiser is also assigned a large territory by the franchiser. However, unlike the master franchisee's case, the sub-franchiser not only appoints franchisees but also provides technical support and training to the franchisees. For this purpose, the sub-franchisee is either chosen on the basis of his/her technical competence in the business area or provided intense training by the franchiser to carry out his/her role effectively. Both franchisee and the sub-franchiser pay royalty to the franchiser. The sub-franchiser also receives royalty from the franchisee.

Area developer: The area developer is assigned a large territory to engage others as franchisees. This is carried out by the area developer on a per-engagement-commission-basis. Once the franchisee is appointed by the area developer, the franchiser provides technical support and training. The franchisee pays royalty directly to the franchiser. The three systems mentioned here are explained in Figure-4.

Flows in a Franchise Channel

As in any channel, franchise channel too has certain flows. The flows are distinct at two different stages. This aspect of flows in a franchise channel is explained in detail in the next page. While understanding the flows, it is important to view a channel as a system and therefore the importance of the feedback loop is an essential part of the system.

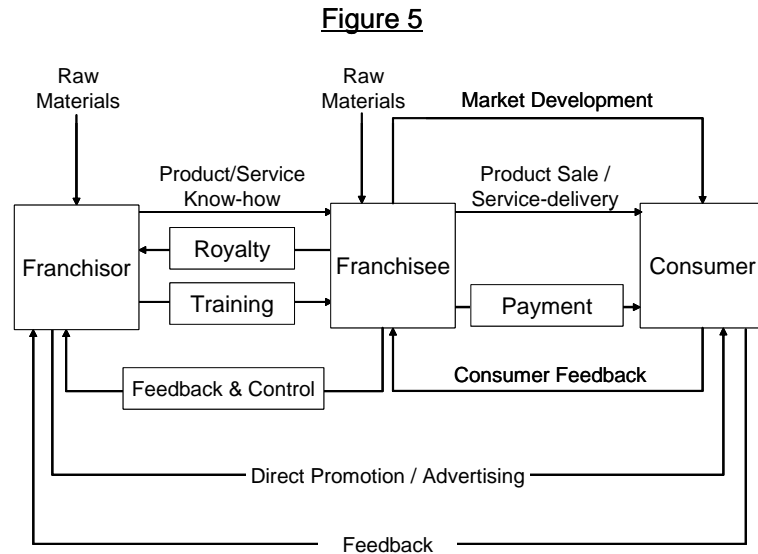
1. **Franchiser and Franchisee:** In this stage, the downward¹⁶ flow consists of raw materials, finished product, technical know-how, systems, brand image, advertising and support material, feedback about the franchisee's performance and control. Upward movement consists of advance payment, security-deposit, royalty, training, comments to franchiser about the market-response, difficulties etc.
2. **Franchisee and Consumer:** In this stage, the downward movement consists of sales of



¹⁶ *Downward* movement denotes franchiser-to-franchisee-to-consumer, whereas *upward* movement denotes the reverse.

products or services, delivery, installation, on-site training and information about new products and developments. The upward movement consists of payment, opinions and enquiries.

3. Certain aspects of flows are specific to the terms of agreement. These are local promotions, market intelligence, franchisee's employee-performance evaluation etc. In some cases, the franchiser may control these flows. In certain other cases, these can rest with the franchisee.



Source: Pramod Khera, *Franchising: The Route Map to Rapid Business Excellence*, p.25.

Payoffs in a Franchise Channel

It is pertinent to ask the question: *why should anyone come forward to be a part of a franchise arrangement?* The answer to this question will throw light on the payoffs for the franchiser and the franchisee.

For the franchiser, the arrangement offers the following advantages:

- Easier generation of capital for business development
- Control of workforce without legal tangles in labour-strife, additional overheads, social security etc.
- A charged-up franchisee with a desire to make profits, thus willing to develop the brand

For the franchisee, the arrangement offers the following benefits:

- ✓ A ready and tested format of business with a well-developed brand name. Thus, the franchisee does not have to go through the rigmarole of brand-development struggle.
- ✓ The pride of being an entrepreneur in a successful line of business
- ✓ A know-how on a platter

It is due to this combination of benefits to both the parties, franchising is becoming an acceptable form of channel structure world over.

Though there are benefits to both the parties, invariably, the franchiser, the owner of a brand name and the business format, has an upper hand in the contract. A significant reason for this is the availability of entrepreneurs willing to take up the franchise whereas the available successful formats are limited. Due to this, the franchiser is able to dictate by demanding a down payment at the time of signing of the contract and/or a royalty on sales.

The tendency of the franchiser to seek a hefty down payment initially is high when the business is about a service and tracking of the quantum of service vended is difficult for the franchiser. However, seeking such hefty down payment has a disadvantage for the franchiser, as the potential franchisee may get suspicious about the intentions of the franchiser (once the contract is signed). On the other hand, when a franchiser offers to take a reasonably high percentage as royalty, it conveys to the franchisee the franchiser's confidence in the business. Therefore, in reality, the franchiser likes to give the feeling to the franchisee that the deal is fair and equal and therefore a balance is struck between the down payment and royalty.

Economics of Franchising

The economics of franchising involves, essentially, the question of pay-off sharing by the franchiser and the franchisee. In a simplified manner, Paul H. Rubin demonstrates the economics of franchising as follows:¹⁷

(a) A franchise generates \$ 25000 per year for the next 10 years. The cost to the franchisee of manning the franchise—meaning the salary to a competent person to manage the franchisee's unit—is \$12000 per year. The interest rate is 6% in the capital market. The franchisee feels that he should be compensated by at least another 4% for the risk he is assuming. What is the maximum one-time fee the franchisee will be willing to pay to the franchiser?

The question is answered by finding the present value of the earnings net of the present value of the expenses. Or, we take the net earnings every year (\$13000) and find out its present value by discounting it on the sum of the cost of funds and the risk-premium, which is 10%. Here, we assume that both the revenues and the expenses are considered as occurring at the end of the year. So, we calculate the following:

¹⁷ Rubin, Paul H., "The Theory of the Firm and the Structure of the Franchise Contract" in Hoy, Frank and John Stanworth (Ed), *Franchising: An International Perspective*, Routledge, 2003, p. 53-54. The figures are suitably changed to serve the purpose of developing it deeper.

$$PV = \sum_{i=1}^{10} \frac{13000}{(1.10)^i}$$

This works out to \$79879, which is the *maximum* fees the franchisee will be willing to pay to the franchiser.

(b) Suppose the franchisee has to invest, in the beginning, in assets specific to the franchise worth \$25000 how does the maximum fee he is willing to pay change?

Since this \$25000 is incurred in the beginning, its present value remains the same. This amount is deducted from the above figure of PV of cash-inflows and therefore \$54879 is the revised amount which is the maximum the franchisee will be willing to pay as one-time fee.

(c) Suppose, in addition, the franchiser will charge a royalty of 10% on the franchisee's profit every year, how will the maximum one-time fee the franchisee will be willing to pay change?

Franchisee's earning per year is \$13000. Of this, \$1300 will be paid as royalty (10%) to the franchiser. So, his net earning is \$11700 per year. This is discounted over 10 years at 10% which is \$71891. From this, the initial investment of \$25000 in assets is taken away and we get \$46891 as the maximum amount the franchisee will be willing to pay as one time fee.

(d) Suppose, in addition to the above, the franchiser insists that there will be a renewal fee of \$1000 every year, how does it change the maximum one-time fee the franchiser will be willing to pay at the beginning of the contract? The renewal fee has to be paid at the end of the previous year.

Since all the cash-flows have been assumed to occur at the end of the year, the second year's renewal fee is paid at the end of the first year and so forth, the net earning at the end of first nine years is $(\$11700 - \$1000) = \$10700$ and for the tenth year, it is \$11700. These are discounted at 10% to get the PV, which is \$66132. From this, we deduct Rs.25000, which is the initial investment in assets, and get \$41132 as the maximum amount the franchisee will be willing to pay as initial fee.

(e) Suppose, in addition to the scenario in (d) the franchiser is willing to provide \$25000 as a loan to be returned at the end of the tenure. However, this loan will carry an interest of 4% per annum. From their experience, the franchiser assures you—credibly—that the assets you invest in can be liquidated at the end of the tenth year at original cost (\$25000). How will the maximum amount the franchisee will be willing to pay as one-time fee change?

Since in this case, there is no need for the initial investment of \$25000, the annual net cash inflow will be $10700 - (25000 \times 4\%)$ for the first nine years and $11700 - (25000 \times 4\%)$ for the tenth year. The discounted value of this inflow is \$59988. This is the amount the franchisee will be willing to pay, maximum, as initial one-time fee to the franchiser (See Table 1).

(f) Suppose, in addition to the scenario (d) the franchiser offers the franchisee two training alternatives: (i) an one-time training in the beginning in the entire business process of the franchise that will be charged to the franchisee at cost, which is \$6000; and (ii) a gradual training programme that is offered in four phases, in year-1, year-4 and in year-7 that will be charged to the franchisee at cost, of \$2200 each. The two questions are: which option should the franchisee accept? What happens to the maximum amount the franchisee will be willing to pay as the initial one-time fee for obtaining the franchise?

Under option (i), only the first year's cash-inflow reduces by \$6000 and the rest remains the same as in (d) above. The present value of the revised flow is \$54533. Under option 2, the cash-inflow changes in year-1, year-4 and year-7, reducing in each case by \$2200. The revised present value of the cash-inflow, then, is \$55356. Therefore, the better option is to take up the training alternative (ii). The maximum amount the franchiser will be willing to pay as initial fee is \$55356.

Generalisation of the model of economics of franchising

The numerical demonstration shown above can be generalised using simple algebra. Let us consider a franchise whose planning horizon is n years. The franchise generates (net of variable costs) annually an amount of x . Let us say the cost of managing the franchise is y per year, the cost of borrowing from the capital market per year is c and the risk premium that the franchisee expects is r . We are interested in finding out *the maximum initial one-time fee the franchisee willing to pay* for obtaining the franchise. The present value of the yield for the franchisee from the franchise is¹⁸

$$PV_1 = \sum_{i=1}^n \frac{x - y}{(1 + c + r)^i} \quad (1)$$

¹⁸ The present value of yield of the first year is $(x-y)/(1+c+r)$, of the second year is $(x-y)/(1+c+r)^2$ and so forth; thus the present value of the yield of the n^{th} year is $(x-y)/(1+c+r)^n$.

This is the upper bound of the initial, one-time fee the franchisee will be willing to pay for obtaining the franchise.

Now, let us say that the franchiser wants, f , an annual renewal fee—in addition to the one-time fee mentioned above—which is collected at the end of the previous year, then, what happens to the upper bound of the initial one-time fee? In such a case, the renewal fee is deducted from the contribution. However, this renewal fee will be payable only till the end of the $(n-1)^{\text{th}}$ year and not at the end of the n^{th} year. Therefore, the PV of the franchise during the life time of n years is split into two parts as follows:

$$PV_2 = \sum_{i=1}^{n-1} \frac{x-y-f}{(1+c+r)^i} + \frac{x-y}{(1+c+r)^n} \quad (2)$$

This is the upper bound of the initial one-time fee the franchisee willing to pay for obtaining the franchise.

Suppose, in addition to the above, the franchise-arrangement requires an initial investment of v in the infrastructure requires for running the franchise-operations, what happens to the upper bound for the initial one-time fee? Since such investment is incurred at the beginning of the contract, its present value remains the same. Therefore, we merely need to deduct the amount of v from (2) above and get the following:

$$PV_3 = \sum_{i=1}^{n-1} \frac{x-y-f}{(1+c+r)^i} + \frac{x-y}{(1+c+r)^n} - v \quad (3)$$

This is the upper bound for the initial one-time fee that the franchisee will be willing to pay to the franchiser to obtain the franchise. Suppose at the end of the n^{th} period, the franchisee can sell the assets at cost (meaning, at the value of v). This value has to be considered at its present value and so the calculation of PV changes as follows:

$$PV_{3A} = \sum_{i=1}^{n-1} \frac{x-y-f}{(1+c+r)^i} + \frac{x-y}{(1+c+r)^n} - v + \frac{v}{(1+c+r)^n}$$

That is,

$$PV_{3A} = \sum_{i=1}^{n-1} \frac{x-y-f}{(1+c+r)^i} + \frac{x-y}{(1+c+r)^n} + v \left[\frac{1}{(1+c+r)^n} - 1 \right] \quad (3A)$$

Suppose the franchiser also demands an annual royalty, which is a share of the profit (π) earned by the franchisee, indicated by a ratio k , then how will the upper bound for the initial one-time fee change? From the above, we see that profit-formula will be different for the periods from 1 to $n-1$ from that for the n^{th} period. This is shown as follows:

$$\pi_i = \begin{cases} x-y-f & \text{for } i=1\dots n-1 \\ x-y & \text{for } i=n \end{cases} \quad (4.a)$$

If we need to pay a ratio of k on this value, then the *net profit* (after paying royalty), which is denoted by ϕ , is calculated as follows:

$$\phi_i = \begin{cases} (x-y-f)(1-k) & \text{for } i=1\dots n-1 \\ (x-y)(1-k) & \text{for } i=n \end{cases} \quad (4.b)$$

The present value the net profits earned will then be as follows:

$$PV_4 = \left[\sum_{i=1}^n \frac{\phi_i}{(1+c+r)^i} \right] + v \left[\frac{1}{(1+c+r)^n} - 1 \right] \quad (4.c)$$

That is,

$$PV_4 = \left[\sum_{i=1}^{n-1} \frac{(x-y-f)(1-k)}{(1+c+r)^i} \right] + \left[\frac{(x-y)(1-k)}{(1+c+r)^n} \right] + v \left[\frac{1}{(1+c+r)^n} - 1 \right] \quad (4.d)$$

This is the upper bound of the initial one-time fee that the franchisee will be willing to pay for obtaining the franchise.

Now, suppose the franchiser says that he will provide a loan for the entire amount of investment to be made in the infrastructure, which is to be returned at the end of the franchise. Also, the franchiser will charge an interest of γ which is less than the market-cost of capital c , how will this change the upper bound of the initial one-time fee?

Firstly, since the cost of the loan offered by the franchiser is less than the market-cost of capital, we assume that the franchisee will accept the loan. Since there is no initial investment on assets, there will be no cash-outflow to the tune of v . The investment in assets is made from the loan, which is repaid at the end of the n^{th} period by selling the assets at cost. However, the cash outflow every year will increase by the interest amount (γv). The present value of the net cash-inflow will be as shown in (5) in the next page.

$$PV_5 = \left[\sum_{i=1}^{n-1} \frac{[x - y - f - \mathcal{W}](1-k)}{(1-c+r)^i} \right] + \left[\frac{(x - y - \mathcal{W})(1-k)}{(1+c+r)^n} \right] \quad (5)$$

This, in essence, captures the upper bound of the initial one-time fee the franchiser can charge the franchisee for the franchise.

Now, suppose, the franchiser offers to train the franchisee in running the business effectively as an entrepreneur and educate him on control processes, monitoring systems and employee-motivation, which are essential and specific to the franchise. The franchiser offers two options: (i) A one-time training programme in the beginning of the contract, that will be charged to the franchisee on cost, of α ; and (b) a gradual training programme of which the basic module is offered in the beginning of the contract and the rest at an interval of m years over the planning horizon, which will be charged to the franchisee on cost, which is β_j per training, where j denotes the serial number of the training programme starting from 1, $1+m$, $1+2m$ and so on. β_j is considered to be different for different programmes depending on the cost of each. For simplicity's sake, let us assume the (a) the number of days the franchisee will spend on the training is the same in both the programmes; and (b) the franchisee is equally capable of comprehending the subject of training in both the cases. Under what conditions will the franchisee choose one programme over the other? What happens to the upper bound of the initial one-time fee the franchisee will be willing to pay to the franchiser for obtaining the franchise?

Case (i)—when the training is conducted in the beginning of the contract, an amount of α , which will be the additional cash outflow in year-1. The present value of this amount remains the same, since it is incurred at the beginning of the contract. So, the PV of the franchise changes as follows:

$$PV_{6A} = \left[\sum_{i=1}^{n-1} \frac{[x - y - f - \mathcal{W}](1-k)}{(1-c+r)^i} \right] + \left[\frac{(x - y - \mathcal{W})(1-k)}{(1+c+r)^n} \right] - \alpha \quad (6.a)$$

Case (ii)—when the franchisee is trained once initially in basic aspects and then gradually trained in higher concepts at an interval of m years over the horizon, an amount of β will be the additional cash-outflow in the years 1, $1+m$, $1+2m$, $1+3m$... $1+\lambda m$ each, where λ is the integer¹⁹ of (n/m) . As was mentioned earlier, the first year's training cost (β_1) is incurred in the beginning of the contract and so

¹⁹ In simple language, this means that if (n/m) equals, say, 12.47, then we only consider 12 and leave out the decimals. In the current context, $n > m$ and it is not necessary that n is perfectly divisible by m and therefore what this implies is that year- n is the outer bound for the periodic trainings and if the year of training falls short of it, then the previous respective year denoted by the integer is the last training conducted within the planning horizon.

its present value is β_1 . The present value of this cash outflow denoted by $PV_{C.T}$ (the term ‘‘C.T’’ denoting Cash outflow due to Trainings) in account of the periodic training programmes is calculated as follows:

$$PV_{C.T} = \beta_1 + \frac{\beta_{1+m}}{(1+c+r)^m} + \frac{\beta_{1+2m}}{(1+c+r)^{2m}} + \frac{\beta_{1+3m}}{(1+c+r)^{3m}} \dots + \frac{\beta_{1+\lambda m}}{(1+c+r)^{\lambda m}}$$

This rewritten as,

$$PV_{C.T} = \frac{\beta_1}{(1+c+r)^0} + \frac{\beta_{1+m}}{(1+c+r)^m} + \frac{\beta_{1+2m}}{(1+c+r)^{2m}} + \frac{\beta_{1+3m}}{(1+c+r)^{3m}} \dots + \frac{\beta_{1+\lambda m}}{(1+c+r)^{\lambda m}}$$

which is,

$$PV_{C.T} = \sum_{j=0}^{\lambda m} \frac{\beta_{1+jm}}{(1+c+r)^{jm}}$$

Using this value, we calculate the net present value of the franchise by rewriting 6.a as follows:

$$PV_{\delta B} = \left[\sum_{i=1}^{n-1} \frac{[x-y-f-\gamma](1-k)}{(1-c+r)^i} \right] + \left[\frac{(x-y-\gamma)(1-k)}{(1+c+r)^n} \right] - PV_{C.T}$$

That is,

$$PV_{\delta B} = \left[\sum_{i=1}^{n-1} \frac{[x-y-f-\gamma](1-k)}{(1-c+r)^i} \right] + \left[\frac{(x-y-\gamma)(1-k)}{(1+c+r)^n} \right] - \left[\sum_{j=0}^{\lambda m} \frac{\beta_{1+jm}}{(1+c+r)^{jm}} \right] \quad (6.b)$$

To answer the question *which alternative the franchisee will choose*, is when the cost of one time training is *less than* the present value of the recurring cost of periodic training, then the former will be chosen; if the former is *more than* the latter, then the latter will be chosen; if they are equal, the franchisee will be indifferent between the two alternatives. That is, by comparing (6.a) and (6.b),

If $\alpha < \sum_{j=0}^{\lambda m} \frac{\beta_{1+jm}}{(1+c+r)^{jm}}$, then one time training in the beginning of the franchise will be preferred.

If $\alpha > \sum_{j=0}^{\lambda m} \frac{\beta_{1+jm}}{(1+c+r)^{jm}}$, then recurring training will be preferred.

And if, $\alpha = \sum_{j=0}^{\lambda m} \frac{\beta_{1+jm}}{(1+c+r)^{jm}}$, then the franchisee will be indifferent between the alternatives.

Further, to answer the question about the upper bound of the initial one-time fee, we can state the following:

If $\alpha < \sum_{j=0}^{\lambda m} \frac{\beta_{1+jm}}{(1+c+r)^{jm}}$, the upper bound for the initial one-time fee is given by 6.a.

If $\alpha > \sum_{j=0}^{\lambda m} \frac{\beta_{1+jm}}{(1+c+r)^{jm}}$, the upper bound for the initial one-time fee is given by 6.b.

Disadvantages of Franchising

Like any other methods of distribution, franchising has its own shortcomings. Success of a franchise arrangement is neither automatic nor unconditional. As mentioned earlier in this paper, a successful brand name is a *sine quo non* for successful franchising. However, it is not a sufficient condition. The basic idea of franchising is to gain spatial pre-emption over competitors by leveraging on a successful brand name through local entrepreneurs willing to invest and carry out the business according to the franchisor's format. However, if the brand is in a category where the factors leading to such success are neither unique nor inimitable, then the head-start for the franchisee is short-lived. Similarly, a successful brand name does not offer franchising opportunity in a product category that falls under convenience goods since consumers will prefer to buy such products at the most convenient outlet at their own convenience rather than travelling all the way to the franchisee's outlet. However, an ice-cream manufacturer or the owner a successful restaurant chain can expect to leverage on his brand name and have franchisee outlet carryings his brand name prominently (e.g, Nirulas in Delhi, Baskin Robbins in many cities). The success in this case due to the fact that the brand name not only carried a guarantee about the product quality but also offers the commitment about the experience one gets in the place of consumption, namely the outlet itself. This can be better understood if one asks the question: *why can AMUL not engage franchisee outlets for its products despite excellent brand name and brand loyalty?* The reason is that whereas Amul's brand loyalty stands for its product quality and the value for money it offers, it does not in anyway relate to shopping experience as such. Moreover, the products are mostly convenience goods of low-price category that warrants wider distribution, thus lacking in its ability to offer exclusivity to the franchisee for ensuring adequate volume of business.²⁰

²⁰ Readers are advised to read Shane (2005) for a lucid assessment of various conditions that are either suitable or unsuitable for an organisation to franchise their brands.

Agency Model of Franchise's Survival²¹

Even if the conditions necessary for a franchisee's success exist in so far as the brand name and the type of product-category is concerned, there are certain inherent factors to the franchise that make the survival of a franchise short-lived. Agency Theory deals with the control mechanisms suitable to prevent the agent from acting opportunistically. *Opportunism* is defined as a deep condition of self-seeking that contemplates guile²², and agents are prone to acting opportunistically. Agency theory is directed at a relationship in which one party (the principal) delegates work to another (the agent) who performs that work. Agency problem arises when the goals of the two parties' conflict and/or when it is difficult or expensive for the principal to verify what the agent is doing. Such conflict arises mainly due to self-interest—amounting to opportunism of the agent, at times—bounded rationality of the principal and risk aversion of both parties, especially the principal. To thwart the problem, agency theory suggests control or co-ordination mechanisms that focus on either behaviour of the agent or the outcome of his behaviour.²³ Given the cost of information acquisition, combined with bounded rationality of the principal—which denotes his limitations in assimilating information to arrive at conclusions—agency theory suggests ways and means of controlling agent's behaviour in line with the goals of the principal. Agency theory has been used extensively in research for analysing the contracts and the control mechanisms in franchise arrangements.

Agency model has been used for finding the survival of franchise arrangements. Whereas franchising enables an organisation to overcome its employees' *shirking* and *perquisite-taking*, there are other problems explained by agency theory that still persist. It has been researched and found that *adverse selection*, implying selection of a franchisee who does not possess the requisite competencies to handle the franchise—either in terms of professional competence or in terms of financial ability—leads to early demise of the franchise. Given the lack of ability on the part of any franchiser to verify the claims of an aspiring franchisee, adverse selection always looms large in a franchise arrangement. Secondly, *role activeness*, by which we mean that the franchisee manages the franchise himself, and does not appoint a manager to run the show. If a manager is appointed, then all the advantages gained by the franchise in terms of adverse selection and moral hazard are lost by their re-entry. Thirdly, *initial fee* charged by the franchiser, if it is high, gives an impression of risk aversion on the

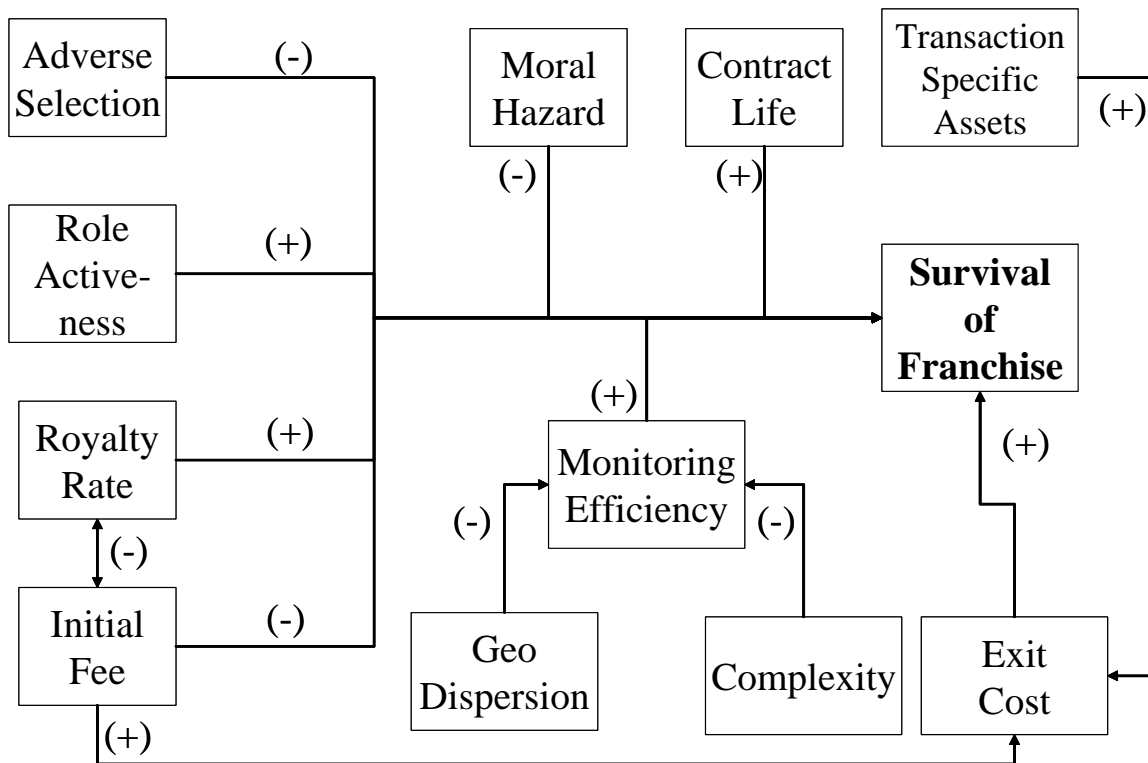
²¹ Much of this section is based on Shane (1996).

²² Williamson, Oliver E., "The Logic of Economic Organisation," in Oliver E. Williamson and Sidney G. Winter (Ed), *The Nature of Firm*, Oxford University Press, 1993, p. 92.

²³ Eisenhardt, Kathleen M. (1989), "Agency Theory: An Assessment and Review," *Academy of Management Review*, Vol. 14 (1), p. 58.

franchiser's part and thus leads to suspicion in the mind of the franchisee, leading to early demise of the franchise. A high initial fee can also convey to the franchisee that the franchiser does not trust him—the act of high fee is to safeguard against any opportunism by the franchisee—and therefore the relationship may start with distrust. However, high initial fee can also have a positive impact on the survival of franchise through high exit cost, which in turn, leads to longer survival of the franchise.²⁴ Fourthly, annual royalty rate, if it is high, makes the franchisee see the confidence that the franchiser has in the business-potential, and therefore leads to a positive outlook to the franchise, thus leading to its long life. An interesting aspect here is the relationship between initial fee and royalty. Intuitively, this relationship ought to be negative, since if a high initial fee is charged, then the franchisee should be allowed to get much of the share in the profit for which s/he has accepted the franchise. Also, calculation of ROI, involves consideration of initial fee as an investment, in the denominator whereas royalty is considered a periodically recurring expenditure, a negative value in the numerator. For a given expected ROI, either we increase the denominator and reduce the negative value in the numerator or we reduce the denominator and increase the negative value in the numerator. This can also be verified in the present values shown from 4.a through 6.b in the above generalised model. Fifthly, *moral hazard*, which, according to agency theory, is the shirking of duties by the franchisee, causes early demise of the franchise due to deterioration of the quality of the product/service output of the franchise. Moral hazard occurs when one party to the agency contract modifies his behaviour such that it increases the costs to the other party both in the form of loss of quality-image to the brand and in the form of additional monitoring that it requires. This is accentuated by information-asymmetry tilted against the franchiser *and* high cost of gathering information. Sixthly, the duration of the franchise-contract, if it is high, makes the franchisee believe that the franchiser is interested in the continuance of the franchise-arrangement and therefore leads to a positive outlook of the franchisee which leads to longer life of the franchise. Seventhly (a) geo-dispersion of franchisees reduces the franchiser's ability to monitor franchisee's behaviour and (b) complexity of the franchise arrangement/contract also reduces franchiser's ability to monitor franchisee's behaviour effectively. Thus, both these, through reduced *monitoring efficiency*, reduce the life of the franchise. Lastly, *exit cost* for both the parties, if they are high, causes them to stick with the contract and prevent them from shirking their duties, and thus leads to longer life of the franchise.

²⁴ This interesting reasoning was presented by my colleague Dr. Lakshmi Sharma during a discussion, that the relationship between initial fee and franchise's survival can be positive, since a high initial fee can cause positive price-quality association in the mind of the franchisee; this means that the franchisee may be induced to believe that s/he is joining an elite club and the franchiser is confident that the business potential of the franchise is very high. In such a case, a high initial fee has a positive relationship with the survival of the franchise, since it also acts as an exit barrier, having sunk enormous investment in the franchise.

Figure 6: Agency Model of Franchising

Drawing by author suitably adapting from Shane, 1996

The exit cost for the franchisee is increased by costlier transaction specific assets as well as high initial fee. If the franchiser invests in certain infrastructure of the franchisee, then, the exit cost for the franchiser increases as well, in addition to the normal transaction costs such as time, money and efforts spent in identifying the franchisee, negotiation and training. In addition to these, exit cost can be escalated by contractual clauses that stipulate high penalty for withdrawal from the franchise within a specific period. This is shown in Figure-6.

Eventual Takeover of Franchisees

It is an understandable fear that once a franchisee—by virtue of his local contacts and assets—successfully establish a business, there may be a temptation for the franchisor to buy out the outlet and own it. However, is this apprehension real? What are the factors that cause such temptations? Oxenfeldt and Kelly²⁵ identify such temptations as follows:

²⁵ Oxenfeldt, Alfred and Anthony Kelly, “Will Successful Franchise Systems Ultimately Become Wholly-owned Chains?” in Hoy & Stanworth—Ed. (2003), *Franchising: An International Perspective*, Routledge, p. 214-226.

- a. The franchisor has the best knowledge in identifying the most potentially successful franchise among the lot
- b. The franchisor has the first (pre-emptive) opportunity to buy potentially strong but currently weak franchise(s)
- c. The franchisor has better knowledge about what the franchise is really worth, than his competitors and therefore he has the best bargaining power to buy out at a more favourable term than others
- d. The franchisor also possesses the capacity to annoy the franchisee into selling out the franchise.

Essentially, it is possible to imagine that a franchisor may follow a strategy of “using” a franchisee for (i) securing the initial capital, (ii) avoiding investment risks (iii) gaining knowledge about the actual business potential in a geographic area and (iv) entering the market directly once the brand name has been strongly established so that he gets business above the level of breakeven. If one looks at these possibilities in isolation, one may well feel that the franchisor-franchisee relationship is embedded with potential exploitation of the latter by the former. However, in reality, such risk of potential exploitation is mitigated by many factors:

- A. The franchisor’s taking over a franchisee is wrought with the risk of offending the local suppliers of raw materials—which will nullify the cost-advantage that the franchisee was getting and therefore the profits
- B. Being a local employer, a franchisee will be in a better position to offer lower salaries than a national level operator. Absorbing them by the franchisor will eliminate the cost-advantage that the franchisee was enjoying, since the employees will expect pay and perks on par with others in the same organisation. Any smart moves to manipulate them to accept lower pay will be counter productive in future as experienced employees may move to competitors’ organisations for better pay and perks. Such eventuality will certainly cause negative word-of-mouth publicity for the franchisor as an employer.
- C. If such takeovers are a one-off strategy, it may still work. However, in the current context of globalisation, a franchisor’s reputation of being a future shark will (i) disable him in getting franchisees easily and (ii) the local player—the potential franchisee—will make sure that any such take-over moves in future are avoided by insisting on stringent contractual clauses and threats of legal suits.

- D. When a potential franchisee is aware of such practices of the franchisor, the former may insist on the latter's investing substantially in transaction-specific assets so as to have a hold on the franchisor and prevent him from acting in a manner that is detrimental to the franchisee.
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Recommended Readings

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Table 1

Calculations of Present Values under Various Clauses of Contract in a Franchise (Example)

Yr	Earning in Franchise per year	PV @ 10%	Annual Wage for Running Franchise	PV @ 10%	Comment	Net earning per year	PV @ 10%	Less 10% Royalty to Franchisor	PV @ 10%	When \$1000 renewal fee is to be paid	PV @ 10%	When loan of \$25000 is taken	PV @ 10%	Training option 1 \$ 6000 initially one-time	PV @ 10%	Training option 2 \$ 2200 in yr-1, yr-4 & yr-7	PV @ 10%
1	25000	22727	12000	10909	Here, I have considered the salary or earning to occur at the end of the year. So, the first year's salary or earning is discounted for one period, by a factor of 1.06 to calculate the PV	13000	11818	11700	10636	10700	9727	9700	8818	3700	3363.6	7500	6818.2
2	25000	20661	12000	9917		13000	10744	11700	9669	10700	8843	9700	8017	9700	8016.5	9700	8016.5
3	25000	18783	12000	9016		13000	9767	11700	8790	10700	8039	9700	7288	9700	7287.8	9700	7287.8
4	25000	17075	12000	8196		13000	8879	11700	7991	10700	7308	9700	6625	9700	6625.2	7500	5122.6
5	25000	15523	12000	7451		13000	8072	11700	7265	10700	6644	9700	6023	9700	6022.9	9700	6022.9
6	25000	14112	12000	6774		13000	7338	11700	6604	10700	6040	9700	5475	9700	5475.4	9700	5475.4
7	25000	12829	12000	6158		13000	6671	11700	6004	10700	5491	9700	4978	9700	4977.6	7500	3848.7
8	25000	11663	12000	5598		13000	6065	11700	5458	10700	4992	9700	4525	9700	4525.1	9700	4525.1
9	25000	10602	12000	5089		13000	5513	11700	4962	10700	4538	9700	4114	9700	4113.7	9700	4113.7
10	25000	9639	12000	4627		13000	5012	11700	4511	11700	4511	10700	4125	10700	4125.3	10700	4125.3
TOTAL		153614		73735			79879		71891		66132		59988		54533		55356
		Net Present Value		79879	less 25k	54879		less 25k	46891	less 25k	41132						

I gratefully acknowledge the help of Dr. Lakshmi Sharma in devising this example in a manner that is comprehensible to the students.