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The Trend Toward Company-Operated Units in Franchise Chains

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An article in the JOURNAL OF RETAILING by Alfred R. Oxenfeldt and Anthony O. Kelly raised the issue of whether successful franchise systems would ultimately become wholly-owned chains.[1] The authors concluded:

> Hopefully, we have demonstrated that powerful forces at play on both franchisor and franchisee tend to bring about that result: namely, changes in objectives sought; diminishing alternative investment opportunities; the frustrations involved in operating through independent businessmen; and fundamental shifts in the capabilities and resources of each. Clearly, to arrive at definitive conclusions on this important issue, much empirical evidence would be needed.[2]

This article will provide empirical evidence to support the hypothesis of Oxenfeldt and Kelly. The data come from the recently completed study on the economic effects of franchising funded by a grant from the Small Business Administration.[3] The study focused on franchising in the three areas of fast food, convenience grocery, and laundry/dry cleaning. The data result from a probability sample of nearly one thousand completed questionnaires from franchisees, 151 franchise contracts provided by franchisors, and 146 completed questionnaires from franchisors.

1. Alfred R. Oxenfeldt and Anthony O. Kelly, "Will Successful Franchise Systems Ultimately Become Wholly-Owned Chains?" JOURNAL OF RETAILING, 44, No. 4 (Winter 1968–1969).

2. *Ibid.*, p. 38.

3. U. B. Ozanne and Shelby D. Hunt, *The Economic Effects of Franchising* (Washington, D.C.: The United States Senate, United States Government Printing Office, 1971).

FACTORS FAVORING FRANCHISED UNITS

Why do firms seek franchised units? The primary motivations appear to be six:

1. *Lack of Available Capital.* Firms often choose the route of franchised units because they simply do not have access to the capital required to expand via company-operated units. Many franchisors candidly admit that they would have preferred all company-operated units but that capital requirements dictated franchising:

> Hardee's would have preferred not to have franchised a single location. We prefer company-owned locations. Here again profits. But due to the heavy capital investment required we could only expand company-owned locations to a certain degree—from there we had to stop. Each operation represents an investment in excess of $100,000; therefore, we entered the franchise business.[4]

2. *The "Franchising Ethic."* A second reason some firms enter franchising is a belief in the "franchising ethic." Simply put, the "franchising ethic" says that franchised units combine the best of both worlds, access to the sophisticated business procedures of a large company (the franchisor), while retaining the drive and initiative of the independent owner-manager. Some franchisors do believe that there is no substitute for the owner-manager, and at least one small empirical study lends support to the proposition that franchisors can make more money out of a unit run by a franchisee than the same unit with a company manager because of the superior performance of the owner-manager.[5] However, as will be shown later, there is significant evidence contrary to the "franchising ethic," at least regarding the proposed benefits to the franchisor.

3. *Rapid Expansion.* Speed of expansion constitutes a third factor contributing to the development of franchise chains. Even if a firm has ample capital, it may not have the human resources necessary

4. Robert E. Bennett, "To Franchise or Not—How to Decide: Pro-Why, How, Advantages," in C. L. Vaughn and D. B. Slater (eds.), *Franchising Today: 1966–1967* (New York: Matthew Bender and Company, Inc., 1967), p. 20.

5. John P. Shelton, "Allocative Efficiency vs. 'X Efficiency': A Comment," *American Economic Review*, LVII, No. 5 (December 1967), 1252–258.

for rapid expansion via company-operated units. Some franchise chains (e.g., "Minnie Pearl Fried Chicken") have sprung up almost overnight.

4. *The Isolated Unit.* Managing several company-operated units in close physical proximity can provide significant economies of scale. Consequently, a firm may prefer to franchise a unit that is physically isolated. Careful observation of the "buy-backs" of several chains (e.g., McDonalds) shows a tendency to repurchase units in metropolitan areas where managerial economies of scale ought to occur.

5. *Low-Profit Units.* The overall profitability of the units of some franchise chains is so low that if the parent company installed company managers, the salaries of the company managers would absorb all of the "profit" of the units. Clearly, franchisees with these chains are merely "buying" a manager's job, since real "profit" for a franchisee begins only *after* he pays himself a salary for managing the unit.

A second aspect of the low-profit-unit motive is the simple fact that good, high-volume locations are scarce. Consequently, franchise chains may reserve their best locations for company-operated units and franchise the less desirable locations.

6. *Franchise Fees.* Almost all fast food franchisors charge a franchise fee, the mean of which this study found to be almost $9,000. These fees are normally nonrefundable according to most contracts.

The potential revenues to be collected solely in the form of franchise fees constitute a final (albeit unsavory) reason for franchising. A few "fast buck artists" enter franchising with little or no intention of actually *operating* a franchise chain, but simply to collect franchise fees from unsuspecting franchisees. The present study was not designed to empirically assess the extent of this practice.

Another unsavory practice occasionally associated with franchise fees might be called "churning." The franchisor sells an unprofitable unit to a franchisee for a healthy franchise fee. After a few months, the franchisee realizes that the unit will never be profitable and decides to "cut his losses" by selling it back to the franchisor at a fraction of his original investment. The franchisor is then free to sell the unit again to another unsuspecting franchisee and collect another franchise fee.

FACTORS FAVORING COMPANY-OPERATED UNITS

The factors favoring company-operated units appear to be five:

1. *Higher Profits Per Unit.* In certain instances, a franchisor can reap much greater profits from a company-operated unit than from a franchised one. For example, John Y. Brown, head of Kentucky Fried Chicken, has said, "We'll make more profit from 300 company-owned stores than we will from 2,100 franchise outlets." [6] Similarly, McDonald's received two-thirds of its revenues from company-operated units.[7] In addressing the Fifth International Management Conference on Franchising, John Jay Hooker commented:

> As all of you know, the name of the game is not really franchising. The name of the game is company stores. I was looking at some figures not too long ago and saw where a big company in America had 1,600–1,700 units, and only two hundred of those were company owned, but the two hundred company-owned units were producing 60 percent of the net after taxes. It becomes obvious to you, if two hundred company-owned units out of 1,600–1,700 overall units produce 60 percent of the net after tax profits, the real name of the game is owning the stores yourself.[8]

Similarly, Lawrence E. Singer, president of Royal Castle System, Inc., has noted "we make more profit, per company-operated unit, than we could possibly make in franchising. This fact has been acknowledged by many of the franchise operators. For this reason, we operate company-owned stores." [9] Finally, William Ware of PKI Foods, Inc. (Aunt Jemima's Kitchens) makes the same point:

> More profits can be gained from company-owned stores. A break-even analysis of operations in the $225,000 to $300,000 range shows this fact to be very true. Since our stores average $270,000 per unit per year and some clear between $50,000

6. "Franchising's Troubled Dream World," *Fortune* (March 1970), p. 121.
7. "The Chains Profit by Buying the Links," *Business Week* (June 27, 1970), p. 55.
8. John J. Hooker, "The Story of Minnie Pearl," in *Franchising Today* (Lynbrook, N.Y.: Farnsworth Publishing Company, Inc., 1970), p. 171.
9. Lawrence E. Singer, "To Franchise or Not—How to Decide, Con: Why Company-Owned Units" in C. L. Vaughn and D. B. Slater (eds.), *Franchising Today: 1966–1967* (New York: Matthew Bender and Company, Inc., 1967), p. 24.

> and $100,000, it becomes evident that our stores are more profitable than if franchised.[10]

Although the present research design did not yield comparative profit figures on franchised units vs. company-operated units, it did generate accurate information on a closely associated figure—sales per unit. In 1970 the mean fast food franchised unit had sales of $150,000, whereas the mean company-operated unit was 81 percent greater at $271,000.

2. *Greater Control.* A second factor favoring company-operated units is the need for control. Company ownership provides sanctions that simply are not available under franchising. As Robert E. Bennett, vice president of Hardee's Food Systems, Inc., puts it:

> Better management control is another reason that we have company-owned stores. I saw a recent situation where a franchise competitor wanted to change his prices and he went through considerable turmoil in order to convince his franchise operators to go along with the price increase. He ended up changing some of the prices, not all of them, and he is still working on the problem of raising prices. Policies, graphics, advertising, merchandising, quality control, remodeling repairs—how do you convince a franchise dealer that even if a store is only ten years old, he must invest more of his money for remodeling?
>
> There is more flexibility in company-owned stores. Our capacity to react more swiftly to the need for change, we find to be to our advantage in the company-owned store.[11]

3. *Legal Problems.* Legal difficulties alone may be sufficient to push many potential franchisors toward company-operated units. Not only are there the substantial legal costs of devising and negotiating franchise agreements, but also, franchisees are increasingly taking their franchisors to court to redress grievances, both real and imagined. Since the "Chicken Delight" class action suit,[12] rumblings

10. William Ware, "To Franchise or Not—How to Decide, Con: Why Company-Owned Units" in C. L. Vaughn and D. B. Slater (eds.), *Franchising Today: 1966–1967* (New York: Matthew Bender and Company, Inc., 1967), p. 29.

11. Bennett, "To Franchise or Not," p. 25.

12. Harvey Siegel and Elaine Siegel, *et al.*, v. Chicken Delight, Inc., *et al.*, and Vance E. Shephard and Ben Zachary, *et al.*, Intervening Plaintiffs, CCH 73, 146 (D. C. v. Cal., April 1970); BNA ATRR No. 458 (April 21, 1970) A-1, X-1.

abound of new suits against franchisors. The franchisees of over two dozen fast food franchise chains have formed individual franchisee associations and a fledgling national association has been formed, The National Association of Franchised Businessmen, headquartered in Washington, D.C.

4. *New Restrictive Legislation.* The possibility of new restrictive legislation may push some franchisors toward company-operated units. Such legislation may severely curtail franchisors' rights to terminate a franchise and may substantially increase the amount and kinds of information that franchisors must show potential franchisees. Similar "full disclosure" type legislation has already passed the legislature in California.

RESULTS

The study yielded three kinds of evidence concerning company-operated units: the aggregate trend of the fast food franchising industry toward company-operated units, the relationship between the size of the franchise system and the percentage of company-operated units and the relationship between the age of the franchise system and the percentage of company-operated units. The aggregate data in Table I illustrate the rapid growth in fast food franchised units during the past decade. The number of fast food franchised units grew from 16,200 in 1960 to over 38,000 in 1970. The number of company-operated units rose from 200 in 1960 to 4,000 in 1970. Consequently, the percentage of total units that was company-operated increased steadily from a low of only 1.2 percent in 1960 to 9.5 percent in 1970, and the figure is expected to be 11.3 percent at the end of 1971.

Aggregate data, as in Table II, do not necessarily imply that individual franchise systems are increasing their percentage of company-operated units. The trend in Table I might possibly result from the entry into franchising of fast food chains which already had large numbers of company-operated units. Disaggregated data, such as Tables II and III provide additional evidence.

Table II shows the relationship between the size (franchised units plus company-owned units) of the franchise system and the percentage change in company-operated units between 1968 and 1971. Since the primary hypothesis is that lack of capital is the major factor influencing firms to franchise, and since access to capital should increase with size of the system, larger systems should show a greater tendency toward increasing the percentage of company-operated units than smaller systems. The numbers in parentheses in Table II show the expected number in each cell under the null hypothesis that the two variables are not related. With a significant chi square of 7.4, Table II indicates that among the 95 fast food franchise systems for which we had complete data, the larger franchise systems were disproportionately increasing their percentage of company-operated units.

In addition to size, the age of the franchise system should be positively associated with access to capital for expansion. Therefore, if lack of capital is the primary motivator for franchising, then older, successful systems should be concentrating on developing company-operated units. Table III indicates that, as predicted, the older franchise systems show a disproportionate tendency to increase the percentage of units which are company-operated.

SOURCE OF COMPANY-OPERATED UNIT EXPANSION

Franchise chains can expand their company-operated units either via new construction or by buying back units from their franchisees. Although considerable attention has been focused on "buy-backs," [13]

TABLE I

Fast Food Franchised and Company-Operated Units

Type	1960 *	1968	1969	1970	1971 †
Franchised	16,200	31,100	35,000	38,100	41,000
Company-operated	200	2,200	2,900	4,000	5,200
Total	16,400	33,300	37,900	42,100	46,200
Company-operated as percent of total	1.2%	6.6%	7.7%	9.5%	11.3%

* All figures are as of December 31 of that year.

† Projected estimate provided by franchisors.

13. "Food Franchiser's Merry Go Round," p. 122, "Franchising's Troubled Dream World," *Fortune*, p. 121, and "The Chains' Profit by Buying the Links," *Business Week*, p. 55.

most of the actual expansion has been by new construction. The data indicated that in 1969 there were 360 franchised units converted to company operation by fast food franchisors and 150 company-operated units converted to franchise operation, leaving a net change from franchised to company-operated of 210 units. Therefore, about 30 percent of the increase in company-operated units in 1969 resulted from "buy-backs," whereas 70 percent came from new construction.

FUTURE TREND FOR COMPANY-OPERATED UNITS

Will successful franchise chains ultimately become wholly-owned chains? If "wholly-owned" implies literally "100 percent," then the answer is probably no. Three factors mitigate against a franchise chain buying back *all* its franchised units:

1. Once a large franchise system is set up, extrication by the franchisor can be difficult. Franchise contracts typically cover long periods of time (we found the median length to be 15 years) and frequently the franchisee has an option to renew. If franchisees do not wish to sell their units, there is little a franchisor can do short

TABLE II

Size of Fast Food Franchise System vs. Trend in Company-Owned Units

	Trend for Company-Owned Units			
Size *	Increasing †	Same ‡	Decreasing ¶	Total
1–24	18 (20)	9 (13)	33 (27)	60
25 and greater	13 (11)	12 (8)	10 (16)	35
Total	31	21	43	95

Chi square = 7.4 $p < .05$ (2d.f.)

* Includes both franchised and company-owned units as of the end of 1968.

† Shows the number of franchise systems whose percent change was greater than or equal to 1 percent where: percent change = (percent company-owned in 1971) − (percent company-owned in 1968).

‡ Number of systems whose percent change was < 1 percent but > -1 percent.

¶ Number of systems whose percent change was ≤ -1 percent.

TABLE III

Age of Fast Food Franchise System vs. Trend in Company-Owned Units

	Trend in Company-Owned Units			
Age of System	Increasing *	Same †	Decreasing ‡	Total
Five years or less	9 (15)	5 (10)	31 (20)	45
Five years and older	22 (16)	16 (11)	12 (23)	50
Total	31	21	43	95

Chi square = 16.0 $p < .005$.

* Shows the number of franchise systems whose percent change was greater than or equal to 1 percent where: percent change = (percent company-owned in 1971) — (percent company-owned in 1968).

† Number of systems whose percent change was < 1 percent but > -1 percent.

‡ Number of systems whose percent change was ≤ -1 percent.

of unethical, and perhaps illegal, coercion. Legislation may make coercive termination techniques specifically illegal.

2. A second factor mitigating against 100 percent company-operated units would be the existence of physically isolated franchised units for which supervision from the home office might be uneconomical.

3. Finally, all franchise chains have at least some units that have low profitability. There would be no reason for a franchisor to buy back these units except a strong desire to get out of franchising altogether.

Although most franchise chains will probably not become 100 percent company-operated, the percentage of units that are company-operated will undoubtedly continue to rise. When we asked franchisors what would be the "ideal" percentage of units that should be company-operated, the mean response was 42 percent. Since the "ideal" percentage is almost four times higher than the actual percentage, if franchisors have access to the necessary capital, they will probably continue to concentrate their efforts on company-operated units.

Other evidence that the trend will continue comes from the franchisees themselves. Thirteen percent of our sample of franchisees indicated that their franchisors had expressed interest in buying back their franchises. A Kruskal-Wallis "H" test, which was significant at the 0.005 level, showed that the franchisors were primarily seeking to buy back the more profitable units.[14]

THE SOCIOECONOMIC CONSEQUENCES OF THE TREND TOWARD COMPANY-OPERATED UNITS

The fact that many firms are apparently "using" franchising as a vehicle to obtain the necessary capital to expand via company-operated units is not of itself undesirable. The procedure is actually conceptually similar to a corporation selling common stock to raise capital for expansion. In the first case the buyer gets a franchised unit and the right to a part of the profits from the unit and in the second case the buyer gets a share of stock and the right to a part of the profits from the total corporation. Since selling equity is frequently not a viable alternative for the small firm, franchising often becomes the best way for small firms to capitalize on a unique concept and grow. Increasing the alternative ways to finance growth would seem to be desirable from society's perspective.

Franchising as a means to raise capital for expansion has socially undesirable consequences when franchisors treat their franchisees unfairly. Two such unfair practices would be coercing franchisees to sell their franchises and misleading potential franchisees as to the expected profits and risks from franchised units. From the potential franchisee's point of view, the complete absence of company-operated units in a large franchise chain could well mean that the units are so low in profitability that the franchise chain cannot *afford* to have company-operated units.

14. Sidney Siegel, *Nonparametric Statistics* (New York: McGraw-Hill Book Company, Inc., 1956), pp. 184–94.