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New criteria to select foreign entry mode choice of global franchise chains into emerging markets

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Abstract

Despite emerging markets are some of the fastest growing economies in the world and represent countries that are experiencing a substantial economic transformation, little is known about the factors influencing choices of foreign entry mode in those markets. Especially, regarding companies that franchise overseas. In an attempt to expand our knowledge of this topic, this paper presents an empirical assessment of the relationship between a set of different variables with the four possible modes of entry that franchisor companies can adopt overseas: i) direct franchising; ii) master franchising; iii) joint venture; and iv) direct investment. Besides the host market's political stability, economic potential and unemployment rate were proposed as independent variables, we controlled for other variables that may affect foreign entry mode choice: the geographical distance between the host and home country, the franchisor's international experience as well as the efficiency of contract enforcement in the host country.

1. Introduction

In recent decades, because of the opening of new markets around the world and the shift in competition from individual countries to a global level, firms have tried to pursue global or international marketing strategies (Aulakh, 2005). Firms are not only concerned about what foreign countries to enter, and what activities to perform in those

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markets, but also how to enter. Choosing one or another entry mode can have enormous strategic consequences for the firm (Chang and Rosenzweig, 2001). For firms, entry mode choice is an important strategic decision with far-reaching consequences for competitive advantage and performance (Gençturk, 2005). Furthermore, since each mode of foreign market entry involves different resource deployment patterns, levels of control, and risk/return tradeoff; firm's choice of a particular mode in serving a given host market is difficult to change without considerable loss of time and money (Baena, 2013). Therefore, the foreign entry mode choice is critical as it determines the degree of foreign involvement in host economies, level of foreign control of local operations, and their level of impact in the local economy (Contractor and Kundu, 1998a, 1998b).

Companies entering into foreign markets have to consider a number of strategic choices: Wholly owned subsidiaries (greenfields or acquisitions), joint ventures (majority or minority), and contractual entry modes management service contract, leasing or franchise. These different modes imply different levels of ownership and control (Erramilli and Rao, 1993; Contractor and Kundu, 1998a, 1998b). As stated, the entry mode choice is an important decision in international strategy because of its relationships to the performance and survival of a firm's foreign subsidiaries. As a result, this topic has received a lot of attention from international business researchers in recent decades (Alon, 2010). However, most literature has analyzed the non-equity versus equity, and equity versus joint venture decisions, but only a small number of studies have provided detailed classification of the contractual decision: The franchising scenario. The present study attempts to cover this gap by proposing and testing a model that explores the factors that determine the mode of entry adopted by franchising companies entering into emerging nations. In particular, we propose a set of different variables as those affecting the global franchising entry mode choice: i) direct investment; ii) joint venture; iii) master franchising; and iv) direct franchising.

According to the above discussion, it is worth mentioning that previous studies have tried to explore international business expansion through examining the effect of different factors on entry mode choice. However, the applicability of those results is largely limited to mature market economy contexts whereas few studies shed light on emerging markets (Baena, 2012). That is, compared with developed market economies, emerging economies have their own unique social, political, and economic contexts as well as firm characteristics, so an understanding of entry mode choices in emerging economy markets needs to be advanced (Zhang, Zhang and Liu, 2007). This is because emerging markets are some of the fastest growing economies in the world and represent countries that are experiencing a substantial economic transformation. Such economies are home to approximately 80 percent of the world's population and constitute the primary destinations for not only exports but for direct investment (Baena, 2009). Nevertheless, very little is still known about the entry mode choice in those economies.

Moreover, the scant theoretical and empirical attention given to global franchising has usually been examined from a U.S. and British base (Doherty and Alexander, 2006). This provides the need for a deeper explanatory model of international diffusion via franchising, as well as the necessity of exploring this issue focusing on other franchising system different from the U. S. model (Baena, 2012). In order to advance our understanding, this manuscript focuses on the global diffusion of the Spanish franchise system, which occupies the third position in Europe in terms of the number of franchisors (1,069) behind Turkey (1,843) and France (1,569), and the second position in terms of the quantity of franchisee outlets (64,822), only after Germany (66,400). Moreover, as of late 2012, Spanish franchisors have a presence in 118 foreign countries through 271 chains with a total of 17,081 outlets.

The remainder of this work is structured as follows. First, we detail the conceptual model and the eight hypotheses are developed. Then, we discuss the empirical analysis and describe the results. Finally, we describe the implications of these findings, and emphasize the main limitations of the study by recommending avenues for further research.

2. Literature Review and Hypotheses

Franchising is an organizational form chosen by entrepreneurs where multiple units operate under a common trademark and a common production system in different places (Michael, 2003). Under this business-format, a franchisor grants a franchisee the rights to use its brand name, products and business system in a specified manner of a specific period of time and industries (Brookes and Altinay, 2011). In return, the franchisee pays the franchisor a royalty based on gross sales. Profits after expenses including royalties are received by the franchisee as compensation (Alon, 2001).

This business format has experienced colossal growth during the last two decades both in the United States and abroad (Baena, 2011). In particular, franchising has become a major form of distribution wielding a significant economic impact through the world. Currently, franchise systems account for more than 40.9% of all retail trade in the U.S. (Dant, Grunhagen and Windspeger, 2011) and nearly 70% of these US franchised systems operate internationally as well. Indeed, franchise is touted as the fastest growing form of retailing in the world (Dant, Perrigot and Cliquee, 2008). However, although in recent years there has been increasing attempts to examine the scope of franchising from an international standpoint (Quinn and Doherty, 2000), little is known about the factors influencing the four modes of entry franchisor can adopt:

   a) Direct investment. This implies setting up a new establishment from scratch or the purchase of a local firm.
   b) Establishing a joint venture with a local partner.
   c) Direct franchising. That is, selling the business on an individual basis to buyers called franchisees in the host country.
   d) Master franchising. Sometimes, franchisors transact with some form of intermediary who purchases from the franchisor entrant the right to develop their own network of outlets in the host market. Those agents called master franchisors are allowed by the franchisor to sub-franchise and sell the format on to independent sub-franchisees. As a result, the master franchisor effectively adopts the role of franchisor in the host market.

Among the multiples approaches to this issue, the transaction cost analysis (TCA) has been the most widely used theory in studies of multinational companies' entry mode choice (Sharma and Erramilli, 2004; Baena, 2011). It views the firm as a governance structure and proposes that firms will choose an entry mode having the lowest transaction cost (Chiao, Lo and Yu, 2010). This theory then posits that firms internalize those activities that they can perform more efficiently, and outsource others that external providers can perform at a lower cost (Chang and Rosenzweig, 2001). Thus, the choice of entry requires a comparison of the coordination cost associated with the internationalization, and the transaction costs arising from the search for, negotiation with, and control of a local market partner (Puck, Holtbrügge and Mohr, 2008). Consequently, an interdependent set of transaction costs associated with franchising-out into host markets can be envisaged: i) monitoring costs; ii) researching costs to identify and evaluate potential franchise buyers in the target market; iii) property right protection costs to forbid contracted parties from operating a similar business in a given territory and/or time once the agreement finishes; and iv) servicing costs to transfer the franchisor's technology and know-how to franchisees.

Later, we develop a framework based on TCA to infer the variables constraining the foreign entry mode into emerging markets, based on a franchisor and host country level perspective.

2.1. Political Stability

Frequent changes in government policies may require firms to frequently alter their practices. For instance, policies relating to the use and legal protection of foreign brand names or imported raw materials may be changed.

However, political uncertainty can lead to frequent changes in industrial and economic policies, and increase the risk of performing business operations in a country. More specifically, and depending on the degree of political uncertainty, different organizational forms may be employed (Alon and McKee, 1999). In addition, political instability may affect import restriction or the remittance of royalties to the home country, significantly influencing the profitability of the foreign operation (Fladmoe-Lindquist, 1996).

Based on the above discussion, we argue that franchisors prefer expanding their business in nations that are politically stable by using their own resources (via joint venture of direct investment), instead of entering the foreign nation via direct franchising or master franchising. Conversely, when political stability is high, firms are more likely to use collaborative ventures (Kotabe, 2005), rather that wholly owned subsidiaries (Akhter and Robles, 2006) to minimize exposure of critical assets (Lu, 2002). So, based on the previous arguments, we propose the following:

H1: The expansion of franchising across foreign countries possessing high political stability is negatively associated with the propensity for low equity and control entry modes (i.e., direct franchising and master franchising).

2.2. Host Market Potential

The importance of a viable economy and available income is crucial to the growth of any business activity. In particular, as economies become more affluent, there is a greater shift to services which, as shown by Hoffman and Preble (2001), provide more opportunities for firms to expand.

A large consumer market with growing income rate is an appealing target market for any company searching for growth. This is especially true when the market is still relatively untapped, the demand for foreign products is evident, and the population is rather concentrated (Anttonen, Tuunanen and Alon, 2005). More specifically, the host market economy constitutes a primary driver in company expansion into foreign markets. That is, strong economic development in the host country usually implies less exposure to political and economic risk in such a market (Herrmann and Datta, 2002). As a result, franchisor companies willing to enter into nations with high per capita income may be willing to invest their own resources via joint venture or direct investment, and do not require the alliance with a local partner franchisee or master franchisee. Hence, we make the following propositions:

H2: The expansion of franchising across foreign countries possessing high market potential is negatively associated with the propensity for low equity and control entry modes (i.e., direct and master franchising.

2.3. Unemployment Rate

Economic literature assumes that potential entrepreneurs make choices in order to maximize net benefits regarding their livelihoods. Individuals then become entrepreneurs and franchisees, when their utility including but not limited to monetary rewards is maximized. That is, only when expected utility rises, will more individuals be attracted to franchising (Alon and McKee, 1999). Specifically, it can be argued that as opportunity cost increases, the attractiveness of being a franchisee declines. On the contrary, as opportunity cost falls, the attractiveness of being a franchisee increases. With this choice, opportunity cost means the wages and other benefits associated with alternative forms of employment (Michael, 2003). Thus, alternatives to being a franchisee or master franchisee are working for a wage or being self-employed in an independent business. In consequence, franchising may be considered as an alternative to other employment. In short, as stated in Cooper and Gimeno (1992), individuals may be "pulled" or "pushed" out of wage labor and into entrepreneurship. Therefore, based on this discussion, we propose the following:

H3: The expansion of franchising across foreign countries possessing high unemployment rate is positively associated with the propensity for low equity and control entry modes (i.e., direct franchising and master franchising).

3. Methodology

3.1. Sample and Data Collection

As stated in the Introduction section, data on international franchising activity was obtained from the Spanish franchise system. Data on these companies was obtained from the Spanish Franchising Association. We obtained data on 2,836 outlets established abroad by 63 Spanish franchisor companies across emerging nations in January 2012. The list of emerging markets was elaborated by following the survey MSCI Annual Market Classification, which used the World Development Indicators. This list comprises a total of 21 countries: Brazil, Chile, China, Colombia, the Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, the Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. Spanish franchisors were doing business in all of these nations in early 2012.

3.2. Dependent Variable

The goal of this study is to assess the relationship between a set of different independent variables and the foreign entry mode chosen by franchisor companies when doing business in emerging markets. In doing so, we have

developed four dependent variables to assess the mode of entry Spanish franchisors adopted. In particular, we proceed as follows:

a) Direct Franchising (DIRECTFRAN) measures the total number of franchisee outlets established via direct franchising by each franchisor in each of the foreign nations of operation.

b) Master Franchising (MASTERFR) comprises the total number of franchisee outlets established via master franchising by each franchisor in each of the foreign nations of operation.

c) Joint Venture (JOINTVENT) measures the total number of franchisee outlets established via joint venture by each franchisor in each of the foreign nations of operation.

d) Direct Investment (DIRECTINV) was assessed by considering the total number of franchisee outlets established via direct investment the franchisor company owns 100 per cent of the franchisee outlet by each franchisor in each of the foreign nations of operation.

3.3. Independent Variables

Emerging country characteristics where Spanish franchisers had, at least one franchised outlet, were measured as follows. The level of political stability (POLITSTAB) was assessed by using the International Monetary Fund (IMF). The host market potential (INCOME) was computed by using the gross domestic product per capita as a proxy variable, as suggested in recent studies (Alexander, Rhodes and Myers, 2006; Alon, 2010). Finally, the World Bank Report were used to measure the unemployment rate of each nation (UNEMPLOY).

3.4. Control Variables

We also controlled for the geographical distance between the host and the home country. Regarding geographical distance (GEODIST), it was determined by computing the kilometer distance between Spain the home country of the franchisers considered in this paper and the 21 foreign host countries. In some cases, we were not able to know the exact physical location of the franchisees outlets considered in this work. Thus, our measure of geographical distance was drawn from the kilometer distance between the capital of the franchiser's home country Madrid, by default and the capital of the emerging nation where the franchised outlet is located.

We also controlled for two variables that may affect foreign entry mode choice. They were the franchisor's international experience, and the efficiency of contract enforcement in the host country. The international experience of franchisor companies is usually defined as the geographical spread of franchising within a foreign country Hoffman and Preble, 2001. Therefore, it was assessed by examining the number of franchised outlets each franchiser company has located abroad (OUTLETS). However, this measurement has one weakness in that it does not reveal the degree of international expansion. As a result, it is possible that certain franchiser companies have different franchised outlets operating abroad, but all of them located in the same foreign country. In this case, the international expansion of such a company would be very narrow (Contractor and Kundu, 1998a, 1998b). In order to deal with this problem, a second variable was established, defined as the number of foreign countries (COUNTRIES) in which each of the Spanish franchiser companies considered in this manuscript were doing business in early 2012.

Finally, the efficiency of contract enforcement in the host country was measured by following the evolution of a sale of goods dispute and tracking the time, cost, and number of procedures involved from the moment the plaintiff files the lawsuit until actual payment. In particular, we used three different indicators developed by Doing Business Index from data published in 2008 by the World Bank Group, as suggested in Djankov et al., (2003). Those variables are the following:

• Number of procedures from the moment the plaintiff files a lawsuit in court until the moment of payment (PROCEDURE);

• Time in calendar days to resolve the dispute (DAYS), and

• Cost in court fees and attorney fees, where the use of attorneys is mandatory or common, expressed as a percentage of the debt value (COST).

4. Results

The analysis of the hypotheses proposed in this study was conducted by first, calculating the descriptive statistics. Subsequently, hypotheses were tested by using OLS regression analysis. The four OLS regression analyses conducted in this study are reported in Table 1. All of them were found significant at the 0.00 level. This suggests that collectively, the set of independent variables and the different control variables included in each model assist in explaining the foreign entry mode choice of global franchisors in emerging markets.

Table 1: Regression Analyses Models 1-4

VARIABLES	Model 1			Model 2		
	Regression Coefficient	T-Ratio	P-value	Regression Coefficient	T-Ratio	P-Value
POLITSTAB	-4.39	-4.87	**p=0.00**	-0.70	-0.94	p=0.35
INCOME	-2.41	-1.95	p=0.61	-1.20	-1.45	p=0.15
UNEMPLOY	0.34	2.31	**p=0.02**	0.35	2.86	**p=0.00**
GEODIST	-0.03	-2.62	**p=0.01**	0.00	2.81	**p=0.00**
OUTLETS	0.00	0.37	p=0.17	0.00	0.00	**p=0.04**
COUNTRIES	0.04	1.10	p=0.21	0.00	0.08	**p=0.03**
PROCEDURE	0.03	0.19	p=0.69	-0.11	-0.75	p=0.44
DAYS	-0.00	-2.01	p=0.20	0.00	1.76	**p=0.07**
COST	0.17	2.22	**p=0.03**	-0.13	-2.15	**p=0.06**
	Dependent Variable: DIRECTFR Multiple Correlation Coefficient: 0.67 R^2: 0.59 Adj. R^2: 0.49 F = 6.05 **p= 0.00**			Dependent Variable: MASTERFR Multiple Correlation Coefficient: 0.64 R^2: 0.52 Adj. R^2: 0.29 F= 3.05 **p= 0.00**		
VARIABLES	Model 3			Model 4		
	Regression Coefficient	T-Ratio	P-value	Regression Coefficient	T-Ratio	P-Value
POLITSTAB	0.97	1.07	**p=0.08**	1.72	3.21	**p=0.00**
INCOME	0.56	0.49	p=0.61	0.48	0.81	p=0.41
UNEMPLOY	-0.17	-1.28	p=0.20	-0.03	-0.28	p=0.67
GEODIST	0.00	3.38	**p=0.00**	0.00	-0.35	p=0.72
OUTLETS	0.00	-0.67	p=0.50	0.04	1.22	**p=0.04**
COUNTRIES	0.04	1.39	p=0.16	0.04	2.12	**p=0.03**
PROCED	-0.09	-0.68	p=0.49	-0.07	-0.68	p=0.51
DAYS	-0.00	-1.56	p=0.61	0.00	2.21	**p=0.02**
COST	-0.07	-1.14	p=0.26	-0.00	-0.93	p=0.35
	Dependent Variable: JOINTVENT Multiple Correlation Coefficient: 0.59 R^2: 0.41 Adj. R^2: 0.28 F = 3.03 **p= 0.00**			Dependent Variable: DIRECTINV Multiple Correlation Coefficient: 0.57 R^2: 0.55 Adj. R^2: 0.45 F= 5.20 **p= 0.00**		

Regarding Model 1 (direct franchising as a dependent variable), the R2 is 0.59 and the adjusted R2 is 0.49. This suggests that variables considered in this model collectively explain near 50% of variation in global franchising diffusion contained in the sample. As shown in Table 2, political stability (POLITSTAB), unemployment rate (UNEMPLOY), geographical distance (GEODIST), as well as the efficiency of contract enforcement in the host country measured by the time in calendar days to resolve the dispute (DAYS), significantly affect the choice of direct franchising as entry mode. Consequently, results support H1 and H3 at the 0.00 and 0.05 confidence level, respectively.

Model 2 considers entries through master franchising (MASTERFR) as a dependent variable. As shown, the R2 and the adjusted R2 are 0.52 and 0.29 respectively. As expected, results show that all variables with the exception of the host market's political stability (POLISTAB), and economic potential (INCOME), significantly affect the choice of master franchising as entry mode in emerging markets. This allows us to accept H3 at the 0.00 level. Moreover, the effect of the franchisor's international experience (OUTLETS and COUNTRIES) as well as the efficiency of contract enforcement in the host country (DAYS and COST), were significant at 0.05 and 0.1 level, respectively.

Concerning global franchising via joint venture (JOINTVENT), Model 3 explains near 60% of the choice of such a mode of entry the R2 and the adjusted R2 are 0.59 and 0.41, respectively. As shown in Table 3, the effect of political stability (POLITSTAB) was found to be statistically significant, which allows to support H1 at the 0.1 level. Moreover, Table 2 reveals a significant association between the geographical distance (GEODIST) and the likelihood of entering the emerging market via joint venture.

Regarding Model 4, it analyses the effect of the proposed independent variables and other control variables in the choice of entry into foreign countries via direct investment (DIRECTINV). The R2 and the adjusted R2 are 0.57 and 0.55, respectively. It indicates that on average the tested model explains more than 50% of the selection of such a mode of entry in global franchising. Specifically, in conjunction with political stability (POLITSTAB), both international experience (OUTLETS and COUNTRIES), and efficiency of contract enforcement in the host country measured by the time to resolve the dispute (DAYS) were significant and positively related with the choice of direct investment as mode of entry in emerging markets. Therefore, H1 was supported at a 0.00 level.

Finally, concerning the statistical significance of the regression coefficients found in the four models tested in this study, it must be mentioned that sample size has a direct and considerable impact on power (see, e.g., Hair et al, 1998). As a result, once we have a sample size of 2,836 outlets established abroad by 63 Spanish franchise chains across emerging nations in January 2012 via direct franchising, master franchising, joint venture or direct franchising, the regression coefficients R^2 obtained in the four models were significant despite all of them showing a value below 60%. This explains why results obtained from the Fisher-Snedecor test concluded that the four models were collectively significant at the 0.00 level.

5. Discussion and Conclusion

Our results offer several firm conclusions regarding the suggestion that in conjunction with franchisor's international experience, the geographical distance between the host and home country and the host country's market potential, unemployment rate, political stability, as well as the efficiency of contract enforcement may drive behind the expansion of global franchising in emerging markets. While the four models presented herein are significant as a whole, results at the variable level are mixed. On the one hand, the negative coefficient of geographical distance found in Model 1 supports and emphasizes the idea that as physical distance increases, so too will transaction costs, especially those related to researching and selecting franchisees or transferring technology and raw materials from franchisers to franchised units. Therefore, like any other alternatives, direct franchising has its limitations and may not be suitable for firms engaged in geographically distant markets. In addition, findings obtained in this study highlight the fact that direct franchising may be appropriate for entering emerging markets with significant political instability, as well as substantial levels of unemployment rate, and efficiency of contract enforcement.

In addition, Models 1-4 reveal a significant relationship between this variable and international expansion via direct franchising as well as joint venture and direct investment. Specifically, results illustrate the positive association between both joint venture and direct investment with political stability. Conversely, as discussed in this study, most international franchisors do not venture abroad via direct franchising if political instability exists. Moreover, by using our results, we may conclude that franchisors with little international experience might do well to expand via master franchising into emerging countries that are either high in contract enforcement or geographically close to their own domestic markets. This facilitates the international expansion process of their businesses in a way that does not involve equity investment. Furthermore, the present study proves that franchisors with high international experience are likely to enter into emerging markets via direct investment if they are politically stable, and the number of days to resolve a contractual dispute is low.

Finally, regarding the obtained findings, it's worth mentioning that no evidence was found on per capita income or efficiency of contract enforcement -measured by using the number of procedures-.

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