DIGITAL CHANNELS AND ENCROACHMENT:

OWNERSHIP REDIRECTION IN FRANCHISE CHANNELS

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ABSTRACT

Adopting a dynamic perspective is crucial when considering distribution channels and digital revolution. We illustrate how the short-term acceptance of centralized e-commerce by franchisees, driven by imbalanced power dynamics in their relationships with franchisors, may not necessarily align with the broader, longer-term trends in the franchising industry.

A new wave of ownership reconfiguration and redirection may emerge within the industry: rather than being a manifestation of opportunistic behavior by franchisors, as previously projected in academic research during the mature stages of the franchising life cycle, it could now be a consequence of franchisees' limited involvement in e-commerce initiatives and decrease motivation to continue the relationship. Consequently, a higher proportion of stores within franchising networks may transition to direct operation by the franchisor. This shift raises questions about the behavior of multi-unit franchisees within this evolving landscape, warranting further investigation in future research.

Keywords: digital marketing, franchising, e-commerce, entrepreneurship, encroachment

Introduction: digital channels and ownership redirection in franchised channels

In this article, we scrutinize the long-term implications of e-commerce within the realm of franchising. The developed framework delves into the distinctions between the factors that initially prompt franchisees to embrace a franchisor-managed centralized e-commerce system in the short term and the enduring evolution of the franchisee-franchisor relationship. This divergence emerges from the growing influence of e-commerce, reshaping the role of physical stores and presenting a potential threat to franchisee investments over time.

Recent years have witnessed the proliferation of digital channels, which has introduced a novel challenge in both franchising research and managerial practice: the emergence of a new form of encroachment (Cliquet and Voropanova, 2016; Tahirov and Glock, 2022) as elucidated by Perrigot, Basset, and Cliquet (2019). When a franchisor develops a centralized e-commerce platform, franchisees often perceive it as a means for the franchisor to directly access customers who might have otherwise patronized franchisee establishments. E-commerce can in fact be structured to market products within territories previously assigned to franchisees or to individuals who previously interacted with franchisees.

Various strategies can be devised to engage franchisees within the e-commerce systems (Manaresi, 2023). Conversely, the decision to exclude franchisee participation can engender enduring repercussions on the ownership structure of monobrand channels. In such cases, franchisees may curtail their willingness to invest in the channel, prompting franchisors to assume a more significant role in managing a higher percentage of stores that are owned and operated directly.

Drawing inspiration from the work on ownership redirection by Dant, Paswan and Kaufmann (1996), we propose indices to gauge the novel wave of ownership redirection within the franchising domain. While prior research in this area primarily concentrated on franchisees' independent e-commerce, which is now a relatively rare phenomenon, or the short-term acceptance of franchisor-managed centralized e-commerce by franchisees, little attention has been devoted to exploring the enduring consequences of this latter decision. This oversight is particularly significant, especially considering that most franchisor-managed centralized e-commerce models do not substantially involve franchisees in the genuine substantive profit-making process.

In many instances, these schemes exclude franchised stores entirely, and when they do include them, customers are often presented with the choice between "click to home" (delivery to the customer's residence) and "click to store" (customers retrieve the product from a store). Furthermore, even in the case of "click to store", almost all of the sale's profit typically remains with the franchisor. The franchisee is told to have an opportunity to cross-sell other products to the same customer coming to the store to collect the e-purchased product: this seldom happens.

Traditional contexts for owership redirection in franchise channels

Ownership redirection in franchised channels pertains to the process through which ownership or management control of a franchise location transitions from one entity to another. Here are some common scenarios in which ownership redirection may occur in franchised channels, some of which have been extensively examined in academic research:

From one franchisee to another: This scenario often unfolds when a franchisee decides to sell their franchise to another individual or entity; the franchisor typically retains the right to approve or disapprove of the proposed buyer to ensure compliance with the franchisor's established standards and qualifications.

From the franchisor to a new or existing franchisee: This type of divestment can occur for diverse reasons, as explored by Baroncelli and Manaresi (1997). It may be part of a franchisee replacement process stemming from the exit of an existing franchisee. For example, a franchisee might decide to leave the business due to retirement or personal circumstances. In such cases, the franchisor may temporarily manage the franchise location until a suitable replacement is identified, to then divest the store to a franchisee and focus on core operations and the development of the franchising network.

From a franchisee to the franchisor: A franchisor takeover can be done according the “ownership redirection hypothesis”, which has been posited as a later stage in the life cycle of a franchise network (Oxenfeldt and Kelly, 1968-1969). This theory suggests that franchising initially serves as a means for a franchisor to locate investors, and as the network matures, resources generated through the business may lead to the gradual internalization of operations and, if successful, the acquisition of previously franchised stores.

While resource scarcity and resource dependence explanations are intriguing, research has not consistently supported the notion that ownership redirection aligns with this theory, although specific contexts may witness such occurrences (Dant, Paswan, and Kaufmann, 1996). Franchisors usually choose to specialize in their role and utilize resources garnered from the business to expand further, including at the international level. A closer examination of what franchisees contribute to the business reveals that, expecially in the case of multi-unit frachisees, they offer strong efficiency and effectiveness, more than just financial resources, establishing, a mutual dependence rather than unilateral resource dependence (Bradach, 1995).

From resource dependence to interdependence theory

The resource scarcity and dependence theory, in its broader context, posits that organizations rely on external resources, encompassing both tangible and intangible assets, to not only survive but also thrive. In the realm of franchising, this theory aids in comprehending not only the raison d'être of franchising but also the intricate interdependence between franchisors and franchisees, each relying on the other to achieve their distinct objectives. When describing dependence contexts between franchisors and franchisees, it becomes apparent that dependence is not just one sided:

a. Franchisors typically establish stringent quality control standards that franchisees must adhere to.

b. Franchisors possess industry-specific knowledge, business acumen, and well-established operational systems that should be delivered to franchisees.

c. Franchisees derive substantial advantages from the recognized brand identity and reputation of the franchisor.

d. Franchisors often grant franchisees access to exclusive territories or markets.

e. Franchisors frequently have pre-established supply chains and procurement relationships, which franchisees rely on for access to essential products and services.

f. Franchisees are reliant on franchisors for guidance regarding legal and regulatory compliance.

g. Franchisors may innovate by introducing new products, services, or business strategies, from which franchisees can benefit.

h. Franchisors rely on revenue streams such as franchise fees, royalties, and other financial contributions from franchisees. The efficiency of franchisees in managing agency costs, along with their effectiveness in providing market insights in response to evolving consumer preferences and in executing the established business model consistently with high-quality standards and customer service, is critical for funding and managing the franchisor's operations, expanding the franchise system, and ensuring its success. Multi-unit franchisees are now recognized to be even better in providing the franchise all those benefits and making the franchise stronger, as they can provide inputs for new product development, understanding market trends, providing better customer service.

The preceding seven out of the eight contexts underscore the prevailing power balance in favor of franchisors, especially in the short term: this makes franchisees accept the existence of a centralized e-commerce platform, due to contractual obligations and specific investments made over time. The first seven points are still in the tradition of marketing mix marketing.

Yet, the most pivotal context of interdependence lies in the eighth and final point on the list—franchisor dependence on franchisees—which redefines it as an interdependent relationship. The ability of a franchisor to attract and retain good franchisees (and eventually develop them into multi-unit franchisees) is the lifeblood of a franchise channel; without it, such a channel would cease to exist. Here, we witness a shift towards the relationship marketing paradigm, a more appropriate framework for managing semi-integrated channels. This view borrows from industrial marketing analysis of long-term partnerships in the supply chain and distribution, with research from the American (Anderson, Narus, Narayandas, 2008) and the European (many studies, such as those from the IMP group: Turnbull, Ford, Cunningham, 1996) schools.

A new form of ownership redirection

Traditional explanations for the existence of franchising usually revolve around resource scarcity and agency theory, as noted by Castrogiovanni, Combs, and Justis (2006). Researchers have also endeavored to provide a dynamic analysis of the franchise channel based on these theories.

In dynamic terms, resource scarcity has been viewed as a challenge that a franchisor might gradually overcome, ultimately leading to the reacquisition of franchised stores. According to this notion, as franchising matures, it becomes less essential for the franchisor, who could, over time, have amassed adequate resources to reduce their dependence on franchisees.

Furthermore, in the long run the proliferation of multi-unit franchising as a prevalent form within mature franchising has raised concerns about the resurgence of agency problems within multi-unit franchises. These agency issues, once sought to be avoided through franchising, could re-emerge as complications within multi-unit franchising. If multi-unit franchisees encountered agency problems, it would undermine the efficiency of the franchise channel, potentially causing franchisors to increase franchisor-operated stores. However, none of these dynamic perspectives, suggesting a diminishing significance of franchising, has consistently materialized, as highlighted by Dant, Weaven, Baker, and Jeon (2013).

A novel form of ownership redirection is currently emerging, influenced by the franchisees' willingness to continue investing in existing stores. Even with some differences specific to single-unit vs. multi-unit franchisees, the common thread remains the allure of a compelling business opportunity. If a particular franchise is not perceived as a robust business prospect, franchisees may opt to switch to a different franchise or not enter a new franchise (Weaven and Frazer, 2006).

Consequences of a less attractive franchise

The short-term acceptance of a franchisor-managed centralized e-commerce system has been the subject of study (Kremez, Frazer, Thaichon, 2019). Some franchisors, in justifying the implementation of their e-commerce, argue that, even without direct involvement from franchisees, it enhances brand awareness, offers an additional avenue for local market communication, and generates increased sales for all stakeholders, including individual stores.

While franchisees acknowledge the inevitability of e-commerce due to market trends ("the way the market is moving" as per Kremez, Frazer, Thaichon, 2019, p. 163), their willingness to accept a centralized e-commerce system hinges on the substantial power imbalance and the existence of specific investments made by franchisees, that cannot be easily transferred to another business. The model developed to illustrate franchisor strategies for increasing acceptance rates with minimal conflict revolves around variables within the non-coercive power source category (French and Raven, 1959; Lusch, 1976).

This context of power asymmetry compels franchisees to accept e-commerce involvement despite harboring various fears and concerns. These concerns, in order of significance as identified by Kremez, Frazer, and Thaichon, include sales-related apprehensions, the fear of the unknown, operational concerns, competition-related fears, and others. The rollout of e-commerce in franchise channels occurred when e-commerce was still in its infancy. However, with e-commerce constant growth and shifts in consumer behavior driven by the COVID-19 pandemic, the landscape is evolving.

Over time, particularly during contract renewal negotiations, multi-unit franchisees, on which further research is needed, are likely to request a more substantial role in the profit and business aspects of e-commerce. Failure to accommodate this request may lead many franchisees to seek alternative investment opportunities. In case that happens, franchisors can maintain some brick-and-mortar retail presence, crucial in most markets, only by repurchasing franchise stores and expanding the network with a higher proportion of directly operated outlets.

To gauge the extent of ownership redirection, longitudinal studies can utilize indices developed by Dant, Paswan, and Kaufmann (1996) who were testing the Oxenfeld and Kelly hypothesis, including:

- Units' share of company-owned outlets in the system.
- Average sales of franchisee-operated outlets relative to the system average.
- Average sales of company-owned outlets relative to the system average.
- Franchisee units converted to franchisor units as a percentage of the total units from the previous year.
- Percentage of franchisee units whose contracts were not renewed in the year.
- Percentage of franchisee units whose contracts were terminated in the year.

Variables to measure franchisees' willingness to invest or keep investing and a new research hypothesis

Below, we present findings (Weaven and Frazer, 2006) pertaining to 16 distinct types of incentives that motivate franchisees to either initiate or sustain a franchise relationship. They all converge on a central theme—the presence of a business opportunity. We endeavored to categorize them based on their fundamental essence, profit opportunities and entrepreneurial incentives.

Profit related incentives:

- Brand/trademark value
- Expected financial returns
- Reduction of risk associated with proven concept
- Future product and service additions

Entrepreneurial related incentives:

- Easy method of self employment
- Initial training

— Franchisor expertise
— Minimization of work/family conflict
— Opportunity to expand subsystem unit holdings
— Transferability of business unit
— Operational freedom and control of local marketing
— Provision for family employment
— Ongoing training, support and R&D
— Corporatised and standardised management systems
— Involvement in decision making
— Proven business concept

The introduction of a centralized e-commerce system overseen by the franchisor allow us to propose an hypothesis according to which such a move from the franchisor would diminish the incentives for potential franchisees to join the franchise, and for existing franchisees to uphold or renew their franchise agreements.

Some preliminary findings

In-depth interviews were conducted with 20 franchisees operating in different product franchises in Italy, half from multi-unit franchises and half from single-unit franchises: all of them revealed that a centralized e-commerce system, managed solely from the franchisor or with limited involvement from franchisees in the profit structure, renders the franchise less appealing; this decreases the willingness to renovate the contract and to keep investing in the format.

There are several reasons for this. Firstly, it introduces greater uncertainty regarding perceived store profitability. E-commerce is a rapidly expanding sector, while traditional retail has not experienced the same level of growth in recent years. Consequently, the historical figures often presented by franchisors at franchise exhibitions and in promotional materials become less reliable as indicators of future performance.

From an entrepreneurial standpoint, this poses a challenge. Both single and multi-unit franchisees seek a degree of autonomy; they don't wish to function solely as employees but aspire to nurture their entrepreneurial ambitions, looking towards the future. The implementation of a centralized e-commerce system by the franchisor lead franchisees to believe that their entrepreneurial drive and opportunities will become less enticing. Additionally, as they gain experience in the business, franchisees become more adept entrepreneurs, affording them the option to explore alternative business ventures.

Limitation of this research, managerial reccomendations, and conclusion

The main limitation of this research is that it reports about qualitative and preliminary results, mainly from one side of the channel. Additional quantitative research is essential to gauge the pace and trajectory of the long-term transformation of franchise channels. Franchises may become less appealing if a centralized e-commerce system managed by the franchisor fails to engage franchisees through a robust profit-sharing arrangement that underscores their pivotal role in the entrepreneurial journey of franchise digital marketing.

As a consequence of this diminished attractiveness of franchise channels, several outcomes may materialize. These include a higher proportion of franchisee units whose contracts are not renewed annually, an increased number of franchisee units facing termination each year, and a rise in franchisee units transitioning into franchisor-owned units. These dynamics would need to establish a new equilibrium characterized by a significantly higher percentage of units directly owned and operated by the franchisor.

We already know that the strategy of running a much larger percentage of directly operated stores is not something that franchisors would like. This was evident from the failure of the ownership redirection hypothesis that long ago had been derived from resource dependence theory; the idea was that at a later stage of the life cycle franchisors, by having more resources, would perceive to need less the franchise structure and would opportunistically buy out the franchised stores. This did and does not happen: franchisors specialize in their role and prefer dedicating resources to international expansion rather than running a heavy national direct physical channel. If often happens the opposite (Baroncelli, Manaresi, 1997).

Promises to franchisees that a centralized franchisor e-commerce would make the brand stronger are difficult to maintain, in a context of increasing encroachment; this is particulary true for multi-unit franchisees who have a larger vision of the business and more to lose from such a franchisor initiative. Thus, the main managerial reccomendation is that franchisors should implement various strategies to actively engage franchisees and involve them in a real, even in the short term, profit sharing scheme, as outlined by Manaresi (2023).

The theoretical conclusion that can be drawn from this research is that ownership redirection could emerge again as a solution, but this time not as a positive move for franchisors, but against their will, as they would be pressured by the circumstances to make the network of stores survive; fewer franchisees would also mean fewer entrepreneurial small ventures.

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