

REFGOV

Reflexive Governance in the Public Interest

Institutional Frames for Markets

Does It Pay to Become a Franchisee? Analysis of Economic Rents in Restaurants

By Susana López-Bayón and Begoña López-Fernández

Working paper series : REFGOV-IFM - 28

Does It Pay to Become a Franchisee?

Analysis of Economic Rents in Restaurants

Susana López-Bayón¹

Begoña López-Fernández

Abstract

Economic rents attract new firms to enter a particular industry. These earnings as well as profit-sharing are both identified as the main incentive mechanisms in the economic literature in franchise relationships. Theoretically they could be complementary to address different incentive problems, that is, contractible and non-contractible or non-enforceable aspects of the relationship. Although the argument is appealing, it has been scarcely examined if rents do exist in franchising.

The purpose of this paper is to establish empirically, using financial data, the existence of both *ex ante* and *ex post* rents in restaurant franchises operating in Spain. Unlike previous studies, focused on a single chain or otherwise on mean data of the chain, we use financial data at the franchisee outlet level. Specifically, to compute and test the presence of economic rents, we had analyzed the balance sheets of a representative sample of 426 franchisees of 63 different franchise chains. We calculated the opportunity cost of franchisees using the mean earnings of the restaurant industry excluding franchisees. Our results show that franchised outlets receive both *ex ante* and *ex post* rents on average. This confirms the theoretical hypothesis of their presence in franchising. We have also observed significant differences according to the size of the franchisee. Accordingly with scale effects, smallest establishments have the least *ex post* rents and *ex ante* rents. Nevertheless, we cannot statistically confirm the differences in the rents perceived by multi versus single franchisees.

Keywords:

Rents, multi-franchising, self-enforcement.

¹ The authors are Associate Professors at the Department of Business Administration of Oviedo University, Spain, sbayon@uniovi.es and blopez@uniovi.es. This research has received support from the EU's 6th Framework Programme for Research and Technological Development through grant CIT3-513420.

1 Introduction

Entrepreneurs who wish to enter a new business can sometimes choose between becoming a franchisee or standing independent. To become a franchisee entails the opportunity of bearing fewer risks and operating a strong brand name with a proved value in the market. Nevertheless some authors believe that these advantages are in exchange for fewer returns (Williams, 1998). Supporters of this view suggest that there are information asymmetries and that franchisors have a greater bargaining power which allows them to gain at the expense of franchisees. As a result, franchisees will earn lower profits than their counterparts: the independent owners.

Franchising literature concerned with incentive issues gives an opposed approach. This literature stands up for the very existence of *ex post rents* in franchising contracts –i.e. an amount exceeding the sum of the marginal products of labour and capital, left downstream to the franchisee-. It claims for the importance of these returns as a self-enforcement mechanism that facilitates the governance of the chain (Bercovitz, 2000; Lafontaine and Raynaud, 2002).

In particular, businesses organized as networks of dispersed outlets must balance two demands: to elicit sales effort of local managers (when individual action is costly to observe) and to guarantee system uniformity in order to get a valuable brand name. Both are normally conflicting objectives because they are induced for different, and often divergent, mechanisms. Firstly, high powered incentives bring about more diligent workers and prompt the search of innovative solutions to get better individual results. But these valued incentives could be achieved at the expense of chain value –i.e. they promote negative externalities on other group members because franchisees do not always respect homogeneity standards. Self-enforcement mechanisms arise specifically to address these free riding problems (Lafontaine and Raynaud, 2002). They operate by leaving sufficient *economic rents* downstream with the agent so the threat of termination of the relationship in case of misbehaviour ensures the agent’s performance (Klein 1996, Klein and Leffler, 1981).

In franchise networks free ride problems are particularly important, so the presence of rents becomes an imperative issue. This is because many outlets are operated by franchisees that are owner-operators. Therefore, they have a residual claimant status in their outlet, whereas their interests are not perfectly aligned with the franchisors’ concerns on all the system, given rise to coordination and free ride problems. To sum up, it seems “necessary” that franchisors pay rents; instead of designing penalties, in order to promote good performance in their franchisees.

The purpose of this study is to examine whether or not franchisors leave *economic rents* with franchisees in a wide set of franchise systems of the Spanish restaurant sector. To this end, we analyze the financial data of 426 franchisees belonging to a total of 63 chains. Our aim is not only to elucidate if franchise affiliates are more or less profitable than their non-franchised counterparts. We also try to get statistical data at the outlet level, as an important starting point to deepen in the analysis of economic rents as an incentive device.

The existence of rents in franchise systems has received previous empirical support from the works of Kaufmann and Lafontaine (1994), who examined McDonald’s franchisees, and Michael and Moore (1995), who studied the earnings of the average franchisee in seventy franchise systems. As well as Michael and Moore, we do not concentrate in a single successful company –i.e. McDonald’s. The large number of chains represented in our study guarantees that our results could be more easily extrapolated to the sector. But, unlike Michael and Moore, we obtain data at franchisee level, allowing us to analyse the relationship between rents and specific characteristics of the franchisees. Furthermore, there is no data on this topic available in Spain to our knowledge.

Finally, we chose restaurant sector because franchising is prominent in it, and these businesses are labour intensive. This fact enhances the role of the local owners because labour is very difficult to control from afar

and their behaviour is largely non-contractible. As a result, it is most likely that economic rents play an important contractual role in the relationship.

The rest of the paper is organized as follows. The next section describes briefly the economic rationale of rents, *ex post* and *ex ante*, as a safeguard mechanism in franchising. The third section describes the data. The fourth section presents the way in which rents were computed and it shows our results. Finally, we discuss these results in the conclusions.

2. Rents as a disciplinary device

Rents are the portion of the earnings that exceeds the minimum necessary to make attractive to an entrepreneur to enter a particular industry. That is, rents are profits in the economic sense, the amount that exceeds the opportunity cost of franchisee in this context. Rents can be classified between *ex ante* and *ex post* rents considering whether they are pre-contractual or post-contractual. *Ex ante* rents exist before the contract and *ex post* rents are developed inside the relationship. In the franchising context, that means that the franchise fee that the franchisee pays at the beginning does not pay the net present value of the *ex post* rent stream he is going to perceive.

$$\text{Ex ante rents} = \text{Ex post rents} - (\text{franchise fee and specific investments})$$

$$\text{Ex post rents} = \text{Operating profit} - \text{Opportunity cost of franchisee (as the mean of the operating profits of comparable firms in their industry, in terms of size and period, excluding franchisees)}$$

Ex post rents are an incentive that may complement the one provided for the sharing system based on royalties (Mathewson and Winter, 1985). They increase the opportunity cost of not putting effort. If the franchisee becomes opportunistic upon becoming a franchisee, then he will risk not only current rents, but also the full rent flow of his establishment if the franchise relationship was to terminate.

Theoretically franchisors could demand hostages to franchisees instead of giving them rents to promote efficiency. However, if franchisees have binding wealth restrictions, that implies that franchisors will have to solve their incentive issues with premiums instead of penalties. In that case we will observe queues of prospective franchisees willing to gain those supra competitive earnings (Mathewson and Winter, 1985).

Economic rents discipline agents because if they do exist, benefits of preserving the relationship exceed short term gains from an opportunistic behaviour (Klein, 1980; Klein and Leffler, 1981). The payment of rents raises the cost of termination to the franchisee. That means that motivation power depend on the possibility to loose rents, that is, a disciplinary device must exist that allows franchisor to make a credible contention that he will terminate the relationship if he detects an opportunistic behaviour (Klein, 1995).

The most compelling disciplinary device would be termination, but franchisor can also graduate the rents he leaves to franchisees controlling franchisee growth. Incentives for high performance are likely reinforced in franchised units through a tournament as an additional compensation device. In this sense, Kaufmann and Dant (1996) argue that franchisors deliberately manage the process by which additional franchises are granted, rewarding “good” franchisees with additional units.

The possibilities for terminating a franchise agreement depend on the legal system, thus franchisor should choose the volume of rents he leaves to franchisees and the frequency of supervision in order to minimize the post contractual cost of enforcing an appropriate effort of franchisees (Lafontaine and Raynaud, 2002).

Many franchisors offer individual licences in their franchise systems and discretionally decide if they offer additional licences to their outstanding franchisees². Additionally, franchisor can renew the contract if franchisee also agrees. The result is that franchising rents arrive not only from the conditions of the present contract but also from renewal chances or the possibilities of gaining additional licences.

Growth is an important issue for franchisees because sales income does not use to cross a threshold and once they reach that amount it is necessary to open new outlets in order to increase profits.

There are only a few empirical studies concerning rents in franchising, but their existence has been documented. Kaufmann and Lafontaine (1994) found ex post rents for the mean restaurant of the chain, and Michael and Moore (1995) found rents in the majority of the 70 chains they analyzed. Both papers examined the earning claims that some franchisors offer to their prospective franchisees in the pre-contractual information (UFOC documents).

3 Data sources

The study analyzes the existence of rents in franchising and its relationship with some system conditions. Our equations are estimated on data from the restaurant industry in which franchising is prominent. We search rents among 63 chains in the table service, fast food, bars, ice-cream and cafeterias market segments of the restaurant industry. The analysis of a specific industry controls to some extent for variation in competitive conditions and production and monitoring technology, at the cost of smaller samples.

Our variables come mainly from the secondary data provided by the Sistema de Análisis de Balances Ibéricos (SABI) database for information corresponding to financial statements of franchised business. We also used this database to obtain financial data on the rest of the sector in order to estimate the opportunity cost of franchisees. The data of nonfranchising competitors was pooled according to their size similar to that of the franchised counterparts. Finally, we chose year 2003 among all possible (1999-2004) because it provided the largest sample.

Previous studies have used the earning claims included in the disclosure documents of the franchisor in order to establish empirically that there were rents left downstream at franchises. UFOC documents can be based on historical data or they can be based on projections³. Both the two empirical studies on rents in franchising use actual historical operating data, but Kaufmann and Lafontaine (1994) employ mean data of

² There is a similar disciplinary device in the discounts applied in automobile distribution contracts depending on the volume they sell in the outlets (Arruñada, Garicano and Vazquez, 2001).

³ “Uniform Franchise Offering Circular is offered to potential franchisees to explain the terms and conditions of the franchise contract and to describe de franchise system to the franchisee. When this includes earning claims they must be accurate. That claim states o suggests to the prospective franchisee any past or potential level of sales, costs, profits, or growth”: “they must be relevant to the location of the prospective franchisee, all assumptions used must be disclosed, and the franchisor must retain and produce on request to the prospective franchisee, the Federal Trade Commission and the state administrators all the data necessary to substantiate them” (Kaufmann and Lafontaine, 1994). Nevertheless, historical data are even more accurate to know the rents of the outlet.

company-owned outlets and Michael and Moore (1995) employ mean data of the chain without distinguishing between franchised and company-owned outlets. The utilization of these mean data can misrepresent conclusions since both parts of the dual distribution can have different results⁴. The use of actual financial data obtained by each franchised outlet increases the validity of conclusions eliminating the imprecision of estimations.

First of all, we had to identify the franchisees that were operating in the restaurant sector in Spain. On the one hand, we had lists of all the outlets of the different chains but without distinguishing between company-owned and franchise outlets. On the other hand, it is possible to use several searching criteria in the SABI database, such as the name of the firm, its tax ID number or the telephone number.

It was not possible to use the name of the firm because it is not identical to the brand. Besides, it is forbidden for franchisees to show to their customers a particular name, different to the brand, in order to protect homogeneity of the chain. Due to this restriction, we used the tax ID number when available and the telephone number otherwise⁵.

A telephone list of different outlets was obtained from de “yellow pages” and the Web site of franchisors. We search those numbers in the SABI database. These telephone numbers were the numbers of the restaurants, but they were not necessarily the same as the ones of the franchisees headquarters (which appear in SABI), so we didn’t identify the corresponding firm of many numbers of our list. Nevertheless, this method has the advantage of guaranteeing that all the outlets of the sample are franchisees because franchisor headquarters certainly have a different telephone number than the restaurants.

That initial sample was examined for duplicate records by comparing telephone numbers of different brands because some firms operate different restaurant brands⁶. Some other franchisees have a diversified portfolio because they have another business different to restaurants. We exclude all these firms from the study because we cannot differentiate the income gained by each activity.

Finally, we eliminated those firms that haven’t been opened at least 13 months by the end of 2003 because they haven’t a complete year financial statement.

Once we had the financial information of our reduced sample, we were also interested in the number of outlets operated by each firm to control rents by business growth, i.e. multifranchisee status. We telephoned

⁴ For example, Krueger (1991) has shown that units manager by franchisees have lower payroll costs than units managed by employees. Additionally, Yin and Zajac (2004) studied a large restaurant chain and they found that franchisees promote more flexible strategies and local adaptation than company-owned outlets which, in turn, result in different service ranks and different costs and profitability.

⁵ The tax ID number is a better searching criterion because it is compulsory to include it joined to the name and the financial information of the firm, but there is no secondary information about these codes. We only had a few ones pooled by the researchers from the tickets they got at the restaurants.

⁶ We found one firm that had Burger King and Telepizza establishments, another one that had Pizza Hut and Kentucky Fried Chicken outlets and, finally, seven firms that had Rodilla and Cantina Mariachi restaurants simultaneously.

the firms in our database to get values for this variable, but we got a low response rate for this item. In the phoning process, additional records were rejected for various reasons (diversified business not identified before, redirection of the outlet, etc) resulting in a final list of 63 chains and 426 franchisees as we show in the following table.

Table 1: Chains present in the study

Chain	N	%	Chain	N	%
McDonald's	150	(35,2%)	Rodilla	2	(0,5%)
Telepizza	43	(10,1%)	Ribs	2	(0,5%)
Burger King	28	(6,6%)	Plantaciones de origen	2	(0,5%)
Lizarrán	27	(6,3%)	Pizza Hut	2	(0,5%)
Pans & Company	15	(3,5%)	Oh mamma mía	2	(0,5%)
Pizza Sapri	7	(1,6%)	La mafia se sienta a la mesa	2	(0,5%)
Domus hoteles	7	(1,6%)	Jamaica Coffee Shop	2	(0,5%)
Dehesa Santa María	7	(1,6%)	Gino Ginelli	2	(0,5%)
Cañas y Tapas	7	(1,6%)	Ben&Jerry	2	(0,5%)
Pasta City	6	(1,4%)	Txoko	1	(0,2%)
Haagen Dazs	6	(1,4%)	Tea Shop	1	(0,2%)
Chocolatería Valor	6	(1,4%)	Tapas Bar	1	(0,2%)
Café de Indias	6	(1,4%)	Subway	1	(0,2%)
Tapelia	5	(1,2%)	Sports Bar	1	(0,2%)
Pizza Jardín	5	(1,2%)	Rock&Ribs	1	(0,2%)
Kentucky Fried Chicken	5	(1,2%)	Pokin's	1	(0,2%)
Il caffè di Roma	5	(1,2%)	Patatín company	1	(0,2%)
Bierwinkel	5	(1,2%)	Pacha	1	(0,2%)
Pizza Móvil	4	(0,9%)	Ñam ñam rapad	1	(0,2%)
Gambrinus	4	(0,9%)	La botellita	1	(0,2%)
Cantina Mariachi	4	(0,9%)	La Bámola, restaurante italiano	1	(0,2%)
Bracafé	4	(0,9%)	Kroxan	1	(0,2%)

Bocatta	4	(0,9%)	Foster's Hollywood	1	(0,2%)
Tagliatella	3	(0,7%)	Flanela helados	1	(0,2%)
Prada a tope	3	(0,7%)	El diablito	1	(0,2%)
Pizza World	3	(0,7%)	Dunkin Donuts	1	(0,2%)
Kurz Gut	3	(0,7%)	Doñana Tapas	1	(0,2%)
Fresco	3	(0,7%)	Cafés la Mexicana	1	(0,2%)
El templo del café	3	(0,7%)	Bruno Caruso	1	(0,2%)
El Racó	3	(0,7%)	Bocatas calentitos	1	(0,2%)
Beer Station	3	(0,7%)	Antojito	1	(0,2%)
Tony Romas	2	(0,5%)			

Total: 63 chains and 426 franchisees

Table 2 shows a summary of the main descriptive statistics obtained for each of the variables that entered into the study. The way in which Operating Profit and Opportunity Cost were measured is discussed below. We only have 84 valid cases for the number of franchised outlets per franchisee because this was the primary information we obtained by phoning franchisees. Sometimes we had a wrong number, the outlet had been redirected or they did not want to answer, so our sample was again reduced.

Table 2: Descriptive statistics

	Employees	Operating Profit	Opportunity cost ⁽¹⁾	Financial cost	Nº of franchised outlets ⁽²⁾	Franchise Fee	Contract duration
<i>Mean</i>	28,92	101645,73	74900,32	0,3357	3,33	33305,02	13,87
<i>Median</i>	18,00	56017,50	60574,06	0,0553	2,00	33635,00	10,00
<i>Stand. Dev.</i>	35,088	175970,00	119854,19	2,96	3,01	17700,17	5,93
<i>N (valid cases)</i>	397	376	397	283	84	417	421

⁽¹⁾ Mean value of "Operating Profit" for the Spanish Restaurants (excluding self-employed businesses).

⁽²⁾ If she is a multi-franchisee.

4 Calculation of *ex post* and *ex ante* rents

In this section we examined the existence of both *ex post* and *ex ante* rents paid to the average franchisee in our sample. Previously, as a preliminary evidence of the presence of rents, we have also analysed the possible differences between the profitability of the franchise-affiliate firms and their counterparts (independent firms), in the Spanish restaurant sector. Finally, we examined the relationship between the value of rents and two basic characteristics of franchisees: their size and their position as a single or multi-franchisee.

Following Michael and Moore (1995), we calculated *ex post* rents, hereafter EPR, as follows:

$$\text{EPR} = \text{Operating Profit} - \text{Franchisee Opportunity Cost}$$

The link between EPR and *ex ante* rents, hereafter EAR, is the following:

$$\text{EAR} = \text{NPV}(\text{EPR}) - \text{Franchise Fee}$$

EAR are computed as the net present value of the *ex post* rent stream, less the franchise fee. The following measures are used to compute the components of the EPR:

Operating profit

Operating profit (OP) here refers to the difference between *revenue* and the *cost of the goods or services sold*, before depreciation, interests and taxes. In other words, we computed a franchisee operating income as defined by the following formula:

$$\text{OP} = \text{Sales} - (\text{Operation costs} + \text{Labour costs} + \text{Selling and Administrative costs})$$

Sales refer to the “net value of sales”, namely, regular incomes by the franchisee less any allowance for returns or discounts. The figure “Cost of goods sold” was computed by summing up the following cost concepts:

Operation costs –i.e. costs associated with the consumption of commodities, materials and ingredients. Labour costs –i.e. wages and salaries associated with direct labour as well as payroll taxes. Selling and administrative costs –i.e. other operating expenses. Last figure includes occupancy costs, legal and accounting expenses, licenses and permits and costs associated with auxiliary expenditures (office supplies, etc.). Occupancy costs are rent expenses on office space, buildings, land and so on. The periodical amounts paid by the franchisee to the franchisor, royalty and advertising fee, are also included in this item.

All this computations have been conducted for franchisees as well as for the whole restaurant industry. As mentioned, we developed industry figures using information from business *balance sheet* and *income statement* provided by SABI. We explicitly excluded from this sectorial data all the franchise firms identified in our sample⁷ and those firms founded in 2003, resulting in a final list of 20.549 companies. In table 3 we

⁷ As pointed out by Michael and Moore (1995), if rents are paid and franchisees are mixed with independent firms, the industry profitability will be overstated. Therefore results will be biased

report franchisee operating profit for the sample as a whole and for the industry. In our data the mean franchisee operating profit is clearly larger than the mean industry operating profit and this difference is statistically significant. This preliminary result aims towards the existence of rents on franchisees.

Table 3: Franchisee and Industry (apart from franchisees)

Operating profit ^{(1) (2)}			
Governchoice	N	Mean	Standard Dev.
<i>Franchisee</i>	406	95.680 €	171.311
<i>Independent (industry)</i>	20.579	29.320 €	801.553
U de Mann-Whitney	2392538,000		
W de Wilcoxon	214150448,000		
Z	-14,767		
Sig. asintót. (bilateral)	,000		

Grouping_variable:

Governchoice = 1 if it is a franchisee / 0 if it belongs to the industry (independent firms) database.

A non parametric test has been conducted because our populations were not normally distributed.

Franchisee Opportunity Cost

In order to compute the franchisee opportunity cost there are two basic approaches. The first one uses a comparison based on industry financial statements and ratios⁸, while the second one makes several specific assumptions about capital and labour opportunity costs⁹. We assumed that franchisee's alternative occupations are to perform the same task as owner operators (as independent entrepreneurs). Therefore, we used the first approach, comparing their operating incomes to the industry standard ones to compute ex post rents. This procedure entails the following assumptions:

First, it is assumed that firms in the same industry require similar investments and similar managerial talent, so industry financial records contain compensation for risk and a market opportunity cost for labour.

against the existence of rents. We only could extract from industry database the 498 franchisees initially identified. Therefore, the bias remains to some extent.

⁸ See Michael and Moore (1995).

⁹ See Kaufmann and Lafontaine (1994) and Michael and Moore (1995).

However, there exists some evidence that franchisees require higher investments levels than their counterparts (Williams, 1993). If higher investments yield higher sales or lower costs, the operating profit of franchisees would be higher. But their depreciation cost will be also higher than that of their non franchising peers (while it is not considered in the computations). Consequently operating profit and ex post rents will be overvalued.

Second, in order to calculate the operating profit both for franchisees and for independent firms, it was used the “labour costs” account of their profit and loss statements. In Spanish books this item does not separate manager’s monetary remunerations from other labour expenses. Therefore it includes compensations paid to the partners and proprietors (i.e. franchisees) who assume the position of managers.

Finally, it is assumed that land and property are rented in the same fashion in franchised businesses and in non-franchised ones. If landowners prevail in the comparison figure, costs will be shifted from operating costs (i.e. occupancy) to depreciation costs (not included in the computations), overstating the operating profit of non-franchising firms and underestimating franchise rents¹⁰.

The industry database was pooled according to the firm size¹¹. As a result, we obtained four standard industry profits (i.e. four opportunity costs) belonging to micro, small, median and large firms. In all cases, the franchisee was matched to a comparison category by size. This way, we controlled for scale and investment levels, presuming that firms with the same dimension made similar investments. Furthermore, we observed significant differences in the operating profit among these categories in the industry file. We had not classified the rents by chain or brand name because of the insufficient number of cases available in several chains (see table 1).

The results of the ex post rents calculation is reported in Table 4. Subtracting the industry standard operating profit from the franchisee operating profit yields a positive average ex post rent of 25.970 €. Moreover, a 41,8% of franchisees did earned positive ex post rents according to our data. We excluded the group of large firms because it had only two firms and they had very abnormal results, so they could misrepresent actual data. The range of values for different business sizes is reported in Table 4.

We explored for differences among these categories and we performed Kruskal-Wallis on ex-post rents across three different sizes. This non-parametric test was appropriate because our populations were not normally distributed. It yielded a significant Chi-squared value of 4,733 that showed the existence of overall differences in ex-post rents.

¹⁰ For example, Kaufmann and Lafontaine (1995) reports that McDonald’s typically owns the land or the building in which their business is housed, and it leases the others from third parties.

¹¹ Following the criterion of the European Commission, micro, small and medium companies correspond to firms with less than 10, 50 and 250 workers, respectively.

Table 4: Ex post rents (annual)

Firm Size	N	Mean (€)
Micro (<10)	88	1.116,89
Small (10-49)	208	34.260,42
Median (50-249)	55	34.384,38
Total	351	25.970,36
Kruskal-Wallis	Chi-squared: 4,733	Sig. 0,094

Ex ante rents

Using the above definitions and estimates, we calculated ex ante rents for the 345 firms for which detailed information on franchise fee and contract duration was available. The computation of EAR was made by discounting ex post annual rents back to the present with a 5.53 percent discount rate, and subtracting the franchise fee from the resulting figure¹².

To calculate the discount rate, we could not use the capital cost of the firms because they are not publicly traded. We tried to proxy this cost through the cost of debt computed as interest expenses divided by all the debt. The resulting mean interest rate was smaller than that of the Aaa corporate bonds, so, we only considered long-term debt in our ratio. We made the assumption that most of short-term debt was trade credit that has no explicit cost. The new mean was then abnormally high (30%), so we decided to use the median of the new ratio that yielded a 5,53% rate, much more similar to bank rates in Spain in 2003.

With these data we calculated the ex ante rents reported in Table 5. We assumed that sales remained constant in 2003€ over the life of the contract as it was considered by Kaufman and Lafontaine (1994) and Michael and Moore (1995). Also rents were presumed to stop at the end of the contract, with no renewal or extension, so both factors contributed to estimate rents conservatively.

Ex ante rents do exist for almost all franchisee sizes and, moreover, 37,6% of the firms in our sample gained them.

¹² We subtracted the franchise fee as many times as establishments the franchisee had in the same firm.

Table 5: Ex ante rents

Firm Size	N	Mean (€)
Micro (<10)	84	7.625,00
Small (10-49)	204	299.485,75
Median (50-249)	55	325.116,19
Total	343	232.119,5
Kruskal-Wallis	Chi-squared: 6,248	Sig: 0,044

Table 5 shows the results of the Kruskal-Wallis test we performed on ex-ante rents. It yields a significant chi-squared of 6,248 that confirms again that both small and median firms earn significantly larger rents than micro firms, that nevertheless do earn ex-ante rents as well.

Our next step was to explore if these rents were different when the firm was a multifranchisee. We have seen that franchisors could graduate rents offering additional licences discretionally to discipline their franchisees. Theoretically, rents could be larger in multi-franchisees due to the experience and motivation of these agents, which could reduce operating costs and enlarge profits. As pointed out by Kaufmann and Lafontaine (1994) and Bercovitz (2003), the rents of owning two outlets are expected to be more than twice those one gets from only one outlet.

As we show in Table 6, typical multifranchisees gained both ex-ante and ex-post rents, and they are larger than those gained by individual franchisees. Nevertheless we performed a test to determine whether these differences were significant or not, and the hypothesis was rejected.

Table 6: Rents in multifranchising

	Is she a multi-franchisee?	N	Mean	Standard Dev.
<i>Ex post rents</i>	Yes	71	27.823,7587	248678,580
	No	28	21.549,5066	68452,369
<i>Ex ante rents</i>	Yes	71	341.273,8218	2533243,981
	No	28	210.600,6159	793846,724

These results are puzzling since it seems that franchisors leave both ex-ante and ex-post rents to the typical franchisee that enters their systems, but the premium does not increase significantly with the number of

licenses. We have to further investigate this point because multifranchisees in our data have establishments with different ages that could affect results, but we do not know these differences.

5 Conclusions

This paper, using an original and detailed dataset, shows the existence of both *ex post* and *ex ante* rents in franchise outlets operating in the Spanish restaurant sector. Consistent with incentive hypothesis, these franchise chains seem to use economic rents to self-enforce franchisee behaviour. That is, franchisors leave rents coupled with the threat of termination to save on supervision costs related to non-contractible issues such as quality, cleanliness, etc.

This result is also appealing for practitioners because it confirms franchising as an advantageous organizational alternative for those interested in restaurant business. Not only the franchise-businesses seem safer than the independent ones, but also franchised outlets seem to be more profitable. Summing up, the existence of rents makes the entrepreneurs' decision to enter into a franchise contract consistent with wealth-maximization.

However, franchising does not assure rents for all firms. Our average franchisee does not always earn rents in any chain.

We have also found that franchisee rents are related to the size of the firm. Compared to micro firms, rents are larger in small and medium companies. This may be explained by acknowledging that managing the franchised business is complex and subject to scale and learning process.

Nevertheless, the data do not support entirely the claim that the multi-unit franchising (the ownership of two or more units by a single franchisee) enhances downstream rent for the franchisee –i.e. given operational economies, franchisee returns should be greater for each subsequent units. Despite results have shown that rents at the outlet level are larger in multi vs. single franchisees, this difference is not statistically significant. In conclusion, the role of multi-unit franchising in the creation of self-enforcement mechanisms, by raising rent expectations, has not been confirmed.

Our data have some limitations that we expect to correct in the future. First, we do not have information on specific investments but the franchise fee, which could lead to overestimate *ex ante* rents. Second, it would be desirable to add information on contractual conditions that directly affect rents, such as termination clauses, renewal, transferring conditions, reequipment periods, and so on. Finally, we should record more detailed data about the specifics of multi-franchising at franchisee level.

6 References

- Arruñada B, Garicano L Vázquez L (2001) Contractual Allocation of Decision Rights and Incentives: The Case of Automobile Distribution. *Journal of Law, Economics and Organization* 17 (1, spring): 256-283.
- Kaufmann PJ, Dant R (1996) Multi-unit Franchising: Growth of Management Issues. *Journal of Business Venturing*, 11(5):343-358.
- Kaufmann, PJ, Lafontaine F (1994) Costs of Control: The Source of Economic Rents for McDonald's Franchisees. *Journal of Law and Economics* XXXVII, October: 417-453.
- Klein B (1980) Transaction Cost Determinants of Unfair Contractual Arrangements. *American Economic Review* 70, May: 356-362.
- Klein B (1995) The Economics of Franchise Contracts. *Journal of Corporate Finance*, 2: 9-37.
- Klein, B. (1996): Why hold-ups occurs: The self-enforcing range of contractual relations. *Economic Inquiry* 34: 444-463.
- Klein B Leffler KB (1981) The Role of Market Forces in Assuring Contractual Performance. *Journal of Political Economy* 89(4): 615-641.
- Krueger AB (1991) Ownership, Agency and Wages: An Examination of Franchising in the Fast Food Industry. *Quarterly Journal of Economics* 106: 75-101.
- Lafontaine F, Raynaud E (2002) The Role of Residual Claims and Self-Enforcement in Franchise Contracting. NBER Working Papers No 8868: National Bureau of Economic Research.
- Mathewson F, Winter R (1985) The Economics of Franchise Contracts. *Journal of Law and Economics* 28: 503-526.
- Michael SC (2003) First Mover Advantage through Franchising. *Journal of Business Venturing*, 18: 61-81.
- Michael SC, MOORE HJ (1995) Returns to Franchising. *Journal of Corporate Finance* 2: 133-155.
- Williams DL (1999) Why Do Entrepreneurs Become Franchisees? An Empirical Analysis of Organizational Choice. *Journal of Business Venturing* 14(1): 103-124.
- Yin X, Zajac EJ (2004) The Strategy/Governance Structure Fit Relationship: Theory and Evidence in Franchising Arrangements. *Strategic Management Journal* 25: 365-383.