REFGOV

Reflexive Governance in the Public Interest

Institutional Frames for Markets

Economic Rents and Multi-Unit Franchising Strategy

By Susana López Bayón
& Begoña López Fernández

Working paper series : REFGOV-IFM -49

European FP6 – Integrated Project
Coordinated by the Centre for Philosophy of Law – Université Catholique de Louvain – http://refgov.cpdr.ucl.ac.be
WP –IFM-49

ECONOMIC RENTS AND MULTI-UNIT FRANCHISING STRATEGY

Susana López Bayón
Universidad de Oviedo

Begoña López Fernández
Universidad de Oviedo

Contact details:

Susana López Bayón
Universidad de Oviedo
Facultad de CC. Económicas y Empresariales
Dpto. de Administración de Empresas
Avda. del Cristo s/n, 33071 Oviedo – Asturias.
Tfno.: 985 10 28 13 - Fax: 985 10 37 08
e-mail: sbayon@uniovi.es

Abstract

When franchisors wish to address different agency problems of their systems, they can theoretically use a variety of devices including profit-sharing, rents and multi-unit franchising. We use archival and primary data from a sample of Spanish franchised restaurants to explore the very existence of rents and the difference in the level of rents obtained by single-unit and multi-unit operators. If they do perform different roles in the system, the rents associated to their outlets could also be different. 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. Finally, we observe higher rents in multi-unit operators compared to single-unit franchisees, but this difference is not statistically significant in the case of *ex-ante* rents. This result is partially consistent with the contention that multi-unit franchisees operate those units more sensitive to quality defaults (free-riding).

Keywords:

Rents, multi-unit franchising, single-unit franchising, self-enforcement.*

* This research has received support from the MCYT, through grant SEJ2007-63706/ECON, and from the EU's Framework Programme for Research and Technological Development through grant CIT3-513420.

1. Introduction

Most academic literature on franchising has considered single-unit franchising as the prevailing form of expansion. Nevertheless, franchisors often exploit their particular business concept using different forms of franchising, that is, combining single-unit (SUF) and multi-unit (MUF) franchising (Garg, Rashedd and Priem, 2005). Indeed, several authors have outlined the widespread use of multi-unit expansion strategy (Kaufmann and Lafontaine, 1994; Bradach, 1995; Kaufmann and Dant, 1996 and Kalnins and Lafontaine, 2004; Grünhagen and Mittelstaedt, 2005; Weaven and Frazer, 2007).

Economic literature has pointed out that this multi-unit expansion strategy plays an important role as a self enforcement agreement between franchisors and franchisees (Bercovitz, 2003), because it reduces incentives for free-riding on the brand name and because it enhances downstream economic rent potential for franchisees. 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). Therefore, MUF will strength such safeguard just because it increases the expected value of *ex post* rents for the franchisee.

Given the instrumental role of economic rents in explaining MUF as an incentive mechanism, this paper addresses two research issues. Since it is an under-explored topic, we first examine whether or not franchisors leave downstream *economic rents* to franchisees. Secondly, we test whether or not these rents are significantly different among single-unit and multi-unit franchisees due to their different abilities and roles in the system.

To our knowledge, this is the first empirical study that explores the relationship between the value of economic rents and the multi-unit franchising choice. 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, our paper does not concentrate in a single successful company –i.e. McDonald's. But, unlike them, we obtain financial data at franchisee level, allowing us to analyse the relationship between rents and specific characteristics of the franchisees. Furthermore, there is no available research on this topic with Spanish data.

The empirical study is conducted in the 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 self-enforcing mechanisms in franchising and the role of multi-unit franchising expansion in developing such mechanisms. The third section describes the data. The fourth section presents the way in which rents were computed and it shows ours results. In fifth section we explore the differences between economic rents among single-unit *versus* multi-unit franchisees. Finally, we discuss these results in the conclusions.

2. Franchising and self-enforcing literature

Explanations for the existence of franchising from the franchisor perspective can be categorized into two broad and competing views. The first interprets franchising as a source of capital needed for expansion (Oxenfeld and Kelly, 1968; Caves and Murphy, 1976).

The second view explains franchising as a response to agency problems of geographically dispersed units. This argument has been widely accepted as the core justification of franchising (Caves and Murphy, 1976; Rubin, 1978; Mathewson and Winter, 1985; Brickley, Dark and Weisbach, 1991; Lafontaine, 1992; Shane, 1996). Under this view, franchising reduces monitoring costs throughout the system. In particular, franchisees as semi-independent owners have every reason to be more motivated than hired managers. This higher motivation diminishes *adverse selection* and *shirking* hazards –but it comes at the cost of an increase in free-riding problems–:

- On the one hand, in a growing system, prospective employees have an incentive to lie about their skill levels in order to be hired. When it is costly to find out the employee's actual ability, *adverse selection* becomes a problem. Offering franchisees residual claims rather than wages solves this hazard, because those who have the highest skill levels will be the most likely to want to tie their compensation to their own effort.

- On the other hand, to ensure that employees put forth the optimal level of effort –i.e. do not *shirk*-, the employer can monitor their behavior. However, when retail outlets are geographically dispersed, the cost of monitoring the managers of those outlets becomes too high. In theory, franchising relieves this shirking problem by making the franchisee an owner-manager. As owners, franchisees have a claim on the profits generated by their franchised outlets (net of the fees they pay to their franchisors)–. This residual claimancy right provides them with high-powered incentives to invest greater effort and maximize those residual profits (Jensen, 1983; Lafontaine and Raynaud, 2002).

However, franchise relationships remain exposed to another exchange hazards different from shirking and adverse selection: *hold up* and *free riding*[1] (Rubin, 1978; Klein, 1980; Williamson, 1985).

Actually, franchisors must balance two demands in their systems: to elicit sales effort of local managers and to develop and maintain the brand name of the products and services shared by all units of the company (Bail and Tao, 2000). The high powered incentives induced by profit sharing could come at the expense of goodwill –i.e. franchisees could free-ride on other units withholding effort or reducing costs while counting on other franchisees to invest in quality to maintain the brand in order to maximize their private results (Lafontaine, 1992; Bercovitz, 2004; Garg, *et al.* 2005). In sum, the franchisee´s status as residual claimant is precisely what promotes his tendency to free-ride on the brand (Lafontaine and Raynaud, 2002; Bercovitz, 2004).

These contractual hazards can be mitigated through the selection of the governance form. In franchise relationships it involves (Bercovitz, 2003, 2004): (1) The selection of the degree of vertical integration of the franchise system (Brickley and Dark, 1987; Norton, 1988; Lafontaine and Shaw, 2005); (2) The specification of the contractual terms to be included in the franchise contract (Lafontaine, 1992; Brickley, 1999; Bercovitz, 2003); and (3) The adoption of contractual and relational elements to create an support self-enforcing agreement

---

[1] Whereas the risk of *hold-up* has received relatively little attention, *free riding* has been a particular concern in franchise literature. Hold-up requires unanticipated contingencies that could leave to opportunistic contract renegotiation (i.e. ownership redirection). But, as it is pointed out by Bercovitz (2000), in practice these contingencies are relatively rare in the franchise field.

mechanisms (Klein 1980, 1995; Dnes, 1992; Lafontaine and Raynaud, 2002). Although these mechanisms are complementary, this paper will focus on the self-enforcement ones.

Self-enforcing agreements

Self-enforcing agreement literature maintains that performance can be assured without a third party intervention, if the long-term gains to preserve the relationship outweigh the short-term gains to cheating (Klein 1980, 1996; Klein and Leffler, 1981; Telser, 1981; Williamson, 1985). In line with this argument, it is argued that franchisee misbehavior can be controlled through self-enforcement mechanisms (Klein, 1995; Mathewson and Winter, 1985; Bercovitz, 2000, 2003). In fact, these mechanisms arise to address non-contractible problems and, specifically, *free-riding* that stems from the franchisee's status as a residual claimant (Lafontaine and Raynaud, 2002).

Self enforcement operates by leaving sufficient *economic rents* downstream with the agent (franchisee) so that the threat of termination of the relationship in case of misbehavior ensures the agent's performance (Klein and Leffler, 1981; Klein, 1996). Accordingly, there are two key elements required to effectively build self-enforcing franchise arrangements (Bercovitz, 2003): (1) a procedure that creates *downstream relation-specific rents* higher than those arising from cheating–. (2) A disciplinary device that credibly threatens with the termination of the relationship (and thus with the loss of the downstream rents) in case of misbehavior. Such device usually is coupled with the franchisee monitoring by the franchisor and the franchisor ability to terminate the franchise contract. Next we focus on the first of these elements.

Downstream rents are simply the difference between the net present value of returns that the franchisee earns as a result of being associated with the franchised chain and the returns he could gain in his best alternative –i.e. his opportunity cost-. This value also includes the expected rent associated with the possibility of gaining future additional outlets and with the probability of contract renewal (Kaufmann and Lafontaine, 1994; Michael and Moore, 1995; Lafontaine and Raynaud, 2002). These economic rents can also be classified between *ex ante* and *ex post* rents, considering whether they are pre-contractual or post-contractual.

Ex-post rents are developed inside the relationship and they simply refer to the amount of gains that exceed the opportunity cost of the franchisee. Ex-ante rents exist before the contract and they are computed as the net present value of the ex-post rent stream less the franchise fee.

As stated by self-enforcement literature, ex-post rents can serve as an incentive mechanism. However, it is more difficult to justify the existence of ex-ante rents –i.e. the franchisor might actually take out those rents from the franchisees via an up-front franchise fee–. A possible explanation rests on the franchisees´ wealth or liquidity constrains, which prevents the up-front extraction of the full net present value of ex-post rents (Mathewson and Winter, 1985; Kaufmann and Lafontaine, 1994). That is, ex-ante rents are simply the price the franchisor must pay to make use of self-enforcement.

To date, however, empirical studies that evaluate the existence of downstream rents in franchise systems are rare. In fact, they have only been documented by Kaufmann and Lafontaine (1994) –who studied McDonald's chain– and Michael and Moore (1995) – who studied the average franchisee gains in seventy franchise systems–.

Multi Unit Franchising

Most of the above theoretical explanations of the franchising phenomenon were developed around the prototypical SUF model. However, MUF –i.e. the ownership of two or more outlets by a single franchisee within the same franchise system– seems to negate the primary advantage of franchising (the mitigation of shirking hazards), as it promotes the use of outlet managers with no ownership interest in the chain. That is, the beneficial incentives that stems from the owner-manager status are weakened since the multi-unit franchisee must hire employee-managers to oversee operations in his mini-chain.

This relative disability of MUF, as compared to SUF, is puzzling considering that the use of multi-unit expansion is so widespread (Kaufmann and Dant, 1996). In response to this question, some researchers have pointed out and/or empirically checked various benefits of MUF compared to SUF (Kaufmann and Kim, 1995; Kaufmann and Dant (1996); Bercovitz, 2003; Weaven and Frazer, 2007). In particular, previous studies have highlighted that MUF

has advantages addressing the challenges of system-wide adaptation, system uniformity and/or growth (Bradach, 1995, 1998; Garg *et al*., 2005).

Franchisors' concern in maintaining *system uniformity* –i.e. maintaining brand name capital– provides an interesting explanation of why MUF may be preferred (Bradach, 1998). Multi-unit franchisees tend to mimic franchisors operations and management practices in their mini-chains (Dant and Nashr, 1998), helping the fulfillment of the chains' uniform standards. Additionally, MUF as compared with SUF reduces attempts to free-ride –a problem that clearly hurts uniformity–, because when a franchisee owns numerous outlets, he will internalize the consequences of his detrimental actions more than it does SUF (Kalnins and Lafontaine, 1996; Bercovitz, 2003). In this line, Bercovitz (2003) has also emphasized the role of MUF in the development of self-enforcing arrangements to prevent free-riding.

Current franchisees qualification for expansion is more often based on the performance of existing units[2]. If only better franchisees are granted with additional outlets, multi-unit expansion would act as a carrot to prevent misbehavior. That is, the sole promise of multi-unit expansion should provide the franchisor with an important means of influencing franchisee behavior (Bercovitz, 2003).

As it has been underlined, the existence of *downstream economic rents* is a central element in the creation of self-enforcement mechanisms. In fact, MUF will strength such mechanisms just because it increases the expected value of ex post rents for the franchisee: If he is forced to leave the system, franchisee not only loose the ex post rents accruing to his current outlet but also the ex post rents he would have gained if he had been granted additional units.

Given that economic rents are instrumental in explaining the role of MUF and that empirical works on this topic are very scarce, the first objective of this study is to empirically evaluate the existence of such rents in franchise chains. Therefore it is proposed:

H1: There exist positive economic rents, ex-ante and ex-post, in franchise chains.

---

[2] This happens in the event of *sequential or incremental MUF* but not necessarily in case of *area development of master franchising* –in which a franchisee is granted the rights to multiple units from the outset- (Kaufmann, 1992; Kaufmann and Dant, 1996)

Even more, the self-enforcement role of MUF could be reinforced if it proves that economic rents (at the outlet level) are higher in multi-unit operators than in the single-unit ones. That is to say, the rents of owning two outlets are expected to be more than twice those ones stemming from only one outlet (Kaufmann and Lafontaine, 1994; Bercovitz, 2003). Indeed, it could be theoretically argued that the level of rents is higher in multi-unit franchisees. To this end, it is helpful to go back to MUF advantages.

Apart from preserving system uniformity, previous studies have analyzed multi-unit strategy as an efficient method of securing rapid *system growth* (Norton, 1988; Kaufmann and Dant, 1996; Garg, *et al.* 2005). This is because MUF operators overcome *resource scarcity* and *adverse selection* problems by tapping previously qualified managerial source –specifically in case of sequential multi-unit expansion–. Also, multi-unit operation provides potential synergies to franchisees, so that subsequent units may make outlets more profitable. Consequently, it can be expected that multi-unit franchisees, compared to single unit ones, will have greater ability to extract higher economic rents from their outlets. Therefore it is proposed:

H2: Economic rents at the outlet level will be higher for multi-unit franchisees compared to single-unit operators.

3. Data sources

We rely on three complementary data sources in this paper. The first one is a list of the outlets operating in the restaurant industry in Spain, along with the corresponding characteristics of their respective franchise systems –age, franchise fee, royalties and contract duration– usually mentioned in professional franchise guides (Tormo, 2003). We chose the restaurant industry because franchising is prominent there and results could be more easily compared to previous studies. The analysis of a specific industry has the advantage of controlling to some extent for variation in competitive conditions and production and monitoring technology, at the cost of smaller samples. Our final dataset comprise 22 chains in the restaurant industry[3].

[3] It includes the table service, fast food, bars, ice-cream and cafeterias market segments.

Second, we have the financial statements of franchised business provided by the *Sistema de Análisis de Balances Ibéricos (SABI)* database that contains the official business Balance Sheets and Income Statements of Spanish firms. We also used this database to obtain financial data on the rest of the industry in order to estimate the opportunity cost of franchisees. Finally, we chose the year 2003 among all possible (1999-2004) because it provided the largest sample.

Third, we conducted a telephone survey to find out single-unit or multi-unit form of each franchised outlet of the sample.

As already mentioned, there are only two previous empirical studies on rents in franchising, Kaufmann and Lafontaine (1994) and Michael and Moore (1995). Both of them use actual historical operating data. On the one hand, Kaufmann and Lafontaine (1994) employ mean data of company-owned outlets. On the other hand, Michael and Moore (1995) use the mean data of the franchise system shown in the earning claims included in franchise offering circulars (UFOC)[4], without distinguishing between franchised and company-owned outlets. Nevertheless, the utilization of these mean data can misrepresent conclusions since both parts of the dual distribution (i.e. franchised and company-owned outlets) can have different results[5].

---

[4] "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 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). UFOC documents can be based on historical data or they can be based on projections, Michael and Moore (1995) employed those based on historical data.

[5] For example, Krueger (1991) has shown that units managed 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.

Unlike those studies, this paper uses actual financial data obtained for each franchise outlet in order to compute rents. This approach increases the validity of conclusions, because it eliminates the imprecision of estimations. Additionally, our database only considers franchisee firms with an exclusive dedication to a single franchise brand, and excludes the company-owned establishments. We also exclude firms with diversified portfolios, because we cannot differentiate the income corresponding to each activity. Besides, we eliminated those firms that have not been opened at least 13 months by the end of 2003 because they have not a complete year financial statement.

In order to get information about the multi-unit franchisee status, we conducted a telephone survey. Franchisees were telephoned and asked after three questions: 1. the SUF or MUF franchisee form; 2. in case of multi-unit franchising, the number of licences or operated outlets; 3. the number of outlets operated under the same trade name. We got a low response rate for these items, so that the final data base that includes multi-unit franchising information contains 22 chains and 151 franchisees as shown in Table 1.

Table 1: Chains present in the study

Chain	N	%	Chain	N	%
Bocatta	2	1,3	McDonald's	72	47,7
Burger King	15	9,9	Pans & Company	3	2,0
Cañas y Tapas	3	2,0	Pasta City	3	2,0
Dehesa Santa María	2	1,3	Pizza Jardín	1	0,7
Dunkin Donuts	1	0,7	Pizza Móvil	1	0,7
El diablito	1	0,7	Pizza Sapri	2	1,3
El Racó	1	0,7	Prada a tope	3	2,0
Foster's Hollywood	1	0,7	Tagliatella	3	2,0
Kentucky Fried Chicken	1	0,7	Tapas Bar	1	0,7
La mafia se sienta a la mesa	3	2,0	Tapelia	3	2,0
Lizarrán	11	7,3	Telepizza	18	11,9

Total: 22 chains and 151 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.

Table 2: Descriptive statistics

	Employees	Operating Profit	Opportunity cost [(1)]	Financial cost	Nº of franchised outlets per franchisee	Franchise Fee	Contract duration
Mean	31,63	89.306	77.242,94	0,1718	2,53	38230,42	15,73
Median	25,5	68.803	60.574,07	0,0580	2	51000	20
Stand. Dev.	27,81	94.344,39	62.874,94	0,6167	2,35	16128,96	5,30
N	144	151	(1)	114	148	151	151

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

4. *Calculation of ex* post *rents in multi-unit and single-unit franchising*

This section examines the existence of both *ex post* and *ex ante* rents paid to the average franchisee. These data will be the input to study the relationship between the value of the rents left downstream by the franchisor and the possible differences according to the SUF or MUF form of organization.

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 –i.e. the amount that exceeds the opportunity cost on the franchisee in this context–. As pointed out, rents can be classified between ex ante and ex post rents.

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

EPR = Operating Profit – Franchisee Opportunity Cost

As the opportunity cost of franchisees we considered the mean operating profits of comparable firms in the restaurant industry, in terms of size and period. The link between EPR and *ex ante* rents, hereafter EAR, is the following:

EAR = NPV (EPR) – Franchise Fee

That is, EAR are computed as the net present value of the *ex post* rent stream, less the franchise fee. The following items were 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, OP was computed as a franchisee operating income, as defined by the following formula:

OP = Sales – (Operation costs + Labour costs +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 the business *balance sheet* and *income statement* provided by SABI. We explicitly excluded from this sectorial data all the franchise firms identified in our sample[6] and those firms founded in 2003, resulting in a final list of 20.549 companies. The mean franchisee operating profit obtained (89.309€) is clearly larger than the mean industry operating profit (29.320€), and this

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

difference is statistically significant. This preliminary result aims towards the existence of economic rents on franchisees.

- *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 ratios, while the second one makes several specific assumptions about capital and labour opportunity costs (Kaufmann and Lafontaine, 1994; Michael and Moore, 1995). 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 franchisees´ 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 of labour. 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. Nevertheless, 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" reported in 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 rents[7].

The industry database was pooled according to the firm size[8]. As a result, we obtained four standard industry profits (i.e. 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 data. 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 rent calculation are supportive of Hypothesis 1 (see Table 3). Subtracting the industry standard operating profit from the franchisee operating profit yields a positive average ex post rent of 12.063,06 €. Moreover, a 50,99% of franchisees did earned positive ex post rents according to our data. The range of values for MUF and SUF rents is also reported in Table 3.

We explored for differences among these categories performing a Mann-Witney U test. This non-parametric test was appropriate because our populations were not normally distributed. Accordingly to Hypothesis 2, MUF gained on average larger ex post rents than those gained by SUF and this difference is statistically significant, as it is shown in Table 3. Before discussing these results, next section carries on the computation of ex ante rents.

---

[7] 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.

[8] 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 3: Ex post rents (annual)

Franchisee Status	N	Mean (€)	St. Dev.	Median (€)
Single-unit franchisee	65	1.525,21	57.723,21	-6.456,07
Multi-unit franchisee	86	20.027,71	93.213,02	12.236,93
Total	151	12.063,05	80.185,46	956,47
U Mann-Whitney 2.343	W Wilcoxon 4.488		Z = -1,699	Sig. 0,089

5. Ex ante rents in single unit versus multi-unit franchising

The computation of EAR was made by discounting ex post annual rents back to the present, and subtracting the franchise fee from the resulting figure[9].

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 (17,18%), so we decided to use the median of the new ratio that yielded a 5,8% rate, much more similar to bank rates in Spain in 2003.

With these data we calculated the ex ante rents reported in Table 4. Following Kaufman and Lafontaine (1994) and Michael and Moore (1995), it was assumed that sales remained constant in 2003€ over the life of the contract. 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.

Results regarding ex ante rents are also supportive of Hypothesis 1. Ex ante rents do exist: On average, EAR are positive and 47,02% of the firms in our sample gained them.

[9] We subtracted the franchise fee as many times as establishments the franchisee had in the same firm.

Table 4: Ex ante rents

Franchisee Status	N	Mean (€)	St.Dev.	Median (€)
Single-unit franchisee	65	-563,94	607.090,32	-91.594,17
Multi-unit franchisee	86	174.861,69	1.066.787,01	72.110,26
Total	151	99.347,35	899.851,63	-18.561,59
U Mann-Whitney: 2.422		W Wilcoxon: 4.567	Z: -1,402	Sig. 0,161

Table 4 shows the results of the Mann-Whitney U test we performed on ex-ante rents to explore for differences between MUF and SUF. As it happened with ex post rents, ex ante rents are on average larger for multi-unit franchisees, but in such a case the difference is not statistically significant.

In order to further analyse this lack of significance, we explored for differences between both groups (multi-unit and single-unit franchisees) in terms of sales, size and age.

Table 5 shows the results of the non-parametric test performed on the *net value of sales*. Some multi-unit franchisees operate more than one outlet under the same firm. In such a case, sales could be overstated because of their size[10]. To take into account this potential bias these franchisees were excluded from the database.

The statistical test is significant and confirms that multi-unit franchisees do obtain larger revenues than their counterparts.

Table 5: Net Value of Sales

Franchisee Status	N	Mean (€)	St.Dev.
Single-unit franchisee	64	775.005,70	480.192
Multi-unit franchisee	48	1.439.506,85	1.306.049
Total	112	1.059.791,91	854.698,5
U Mann-Whitney: 683	W Wilcoxon 2763		Z -5,0152 Sig 0,000

[10] Note that computation of *economic rents* takes this "size effect" into account considering different opportunity costs according to the firm size (i.e. number of employees).

This result could reflect the fact that franchisors may select candidates for MUF able to get high revenues. It is also possible that they may grant locations with higher prospective revenues to multi-unit operators. This finding is appealing since it suggests that franchisors reserve the more visible units –i.e. the larger ones- to the multi-unit franchisees, probably because they posses distinctive advantages. As long as MUF better prevents free-riding compared with SUF, more visible outlets are better run by these experienced and motivated franchisees. Garg *et al*. (2005) suggest that different franchisors could pursue different goals in terms of growth, local adaptation, local responsiveness and system adaptation. Analogously, a franchisor could target these objectives with different intensity depending on the specific location of his outlets.

We further examine possible differences between single-unit and multi-unit franchisees regarding their age in table 6. As we can see, multi-unit franchisees are older on average than their single-unit counterparts. This result supports the idea that additional outlets are granted to more experienced operators. Furthermore, the lack of statistically significant differences in ex-ante rents between single-unit and multi-unit franchisees does not seem to be due to opening problems, because both groups are more than three years old on average.

Table 6: Age (years)

Age (years)	N	Mean	St.Dev.
Single-unit franchisee	65	3,92	3,19
Multi-unit franchisee	86	5,63	4,18
U Mann-Whitney: 2.128	W Wilcoxon 4.273	Z -2,52 Sig. 0,012	

6. 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. In fact, approximately a half of the firms earned both ex-ante and ex-post rents.

In accordance with incentive hypotheses, this result supports the argument that 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.

The existence of downstream rents is also an appealing result 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. In short, the existence of rents makes the entrepreneurs´ decision to enter into a franchise contract consistent with wealth-maximization.

Our findings also reveal that ex-post rents per outlet are significantly higher for MUF compared to SUF. This result is coherent with the contention that the experience and motivation of multi-unit operators could reduce their operating costs and enlarge their profits. Ex-ante rents, however, do not statistically differ between MUF and SUF. That is, MUF earn larger rents on an annual basis, but there are not significant differences when we consider the long run and we discount specific investments (franchise fee).

Finally, our results indicate that multi-unit franchisees obtain larger revenues and operate larger outlets, in terms of number of employees, than their single-unit counterparts. This may reflect that franchisors could reserve more visible stores to the candidates that they have identified as the best. Usually, they grant additional outlets to those franchisees that better accomplish franchising standards, so they could be the suitable applicants to run the *flag-ships* of the chain.

In summary, this study offers new insights into the MUF phenomenon and its use as a means to support self-enforcement agreements. It provides a singular empirical test of the existence of downstream rents and their relationship with the multi-unit franchising strategies. Nevertheless, 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, re-equipment periods, and so on. Finally, we should record more detailed data about the specifics of multi-unit franchising at franchisee level.

7. References

Bai, C. and Tao, Z. (2000): "Contract Mixing in Franchising as a Mechanism for Public-Good Provision", *Journal of Economics & Management Strategy*, vol. 9, nº1, spring, pp. 85-113.

Bercovitz, J.E.L. (2003): "The Option to Expand: The Use of Multi-Unit Opportunities to Support Self- Enforcing Agreements in Franchise Relationships", *Working Paper*.

Bercovitz, J.E.L. (2004): "The Organizational Choice Decision in Business Format Franchising, in Windesperger, Cliquet, Hendrikse and Tuunanen (Eds.), *Economics and Management of Franchising Networks,* pp. 38-68, New York: Springer-Verlag.

Bradach, J. (1995): "Chains within Chains: The Role of Multi-Unit Franchisees", in Kaufmann and Dant (Eds.), *Franchising: Contemporary Issues and Research*, New York: Haworth, pp. 65-81.

Brickley, J.A. and Dark, F.H (1987): "The choice of organizational form: the case of franchising", *Journal of Financial Economics,* vol. 18**,** pp. 401–420.

Brickley, J.A.; Dark, F.H and M. S. Weisbach (1991): "An Agency Perspective on Franchising", *Financial Management,* Spring, pp. 27-35.

Caves, R.E. and Murphy, W.F. (1976): "Franchising Firms, Markets and Intangible Assets", *Southern Economic Journal,* vol. 42 (2), pp. 572-586.

Dant, R.P. and Nash, N.I. (1998): "Control Techniques and Upward Flow of Information in Franchising in Distant Markets: Conceptualization and Preliminary Evidence", *Journal of Business Venturing,* vol. 13 (1), pp. 3-28.

Dnes, A.W. (1992): "Unfair Contractual Practices and Hostages in Franchise Contracts", *Journal of Institutional and Theoretical Economics,* vol. 148 (3), pp. 484-504.

Garg, V.K., Rasheed, A.A. and Priem, R.L., (2005): "Explaining Franchisors' Choices of Organization Forms within Franchise Systems", *Strategic Organization*, vol. 3(2), pp. 185-217.

Grünhagen, M. and Mittelstaedt, R.A. (2005): "Entrepreneurs or investors: Do multi-unit franchisees have different philosophical orientations?", *Journal of Small Business Management*, vol. 43 (3), 207-225.

Jensen, M. (1983): Organization Theory and Methodology. *Accounting Review,* 50: 319-339.

Kalnins, A. and Lafontaine, F. (2004): "Multi-unit ownership in franchising: Evidence from the fast-food industry in Texas", *RAND Journal of Economics*, vol. 35 (4), Winter, 747-761.

Kaufmann P.J., Dant R (1996): "Multi-unit Franchising: Growth of Management Issues", *Journal of Business Venturing*, vol. 11(5), pp. 343-358.

Kaufmann, P.J. and Kim, S.H. (1995): "Master Franchising and System Growth Rates", *Journal of Marketing Channels,* 4, pp. 49-64.

Kaufmann, P.J., Lafontaine, F. (1994): "Costs of Control: The Source of Economic Rents for McDonald's Franchisees". *Journal of Law and Economics* XXXVII, October, pp. 417-453.

Klein, B (1980): "Transaction Cost Determinants of Unfair Contractual Arrangements", *American Economic Review*, vol. 70 (May), pp. 356-362.

Klein, B. (1995): "The Economics of Franchise Contracts", *Journal of Corporate Finance*, vol. 2, pp. 9-37.

Klein, B. (1996): "Why hold-ups occurs: The self-enforcing range of contractual relations", *Economic Inquiry,* vol. 34, pp. 444-463.

Klein, B. and Leffler K.B. (1981): "The Role of Market Forces in Assuring Contractual Performance", *Journal of Political Economy*, vol. 89(4), pp. 615-641.

Lafontaine, F. (1992): "Agency theory and franchising: Some empirical results", *RAND Journal of Economics,* vol. 23, pp. 263-283.

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.

Lafontaine, F and Shaw, K. (2005): "Targeting Managerial Control: Evidence from Franchising", *RAND Journal of Economics*, vol. 36, pp.131-150.

Mathewson F, Winter R (1985): "The Economics of Franchise Contracts", *Journal of Law and Economics,* vol. 28, pp. 503-526.

Michael S.C. and Moore H.J. (1995): "Returns to Franchising", *Journal of Corporate Finance,* 2, pp. 133-155.

Oxenfeldt, A R. and Kelly, A.O. (1968): "Will successful franchise systems ultimately become wholly owned chains?", *Journal of Retailing*, vol. 44 (4), pp. 69-87.

Rubin, P.H. (1978): "The Theory of the Firm and the Structure of the Franchise Contract", *Journal of Law and Economics,* vol. 21 (April), pp. 223-233.

Shane, S. (1996): "Hybrid Organizational Arrangements and their Implications for Firm Growth and Survival: A Study of New Franchisors", *Academy of Management Journal,* vol. 39(1), pp. 216-234.

Tormo y Asociados (2003): *Franquicias*, Selina Olmedo, Madrid.

Tesler, L. (1981): "A theory of Self-Enforcing Agreements", *Journal of Business,* vol. 53, pp. 27-44.

Weaven, S. and Frazer, L. (2007): "Expansion Through Multiple Unit Franchising: Australian Franchisors Reveal their motivations", *International Small Business Journal*, vol. 25, pp. 173-205.

Williams, DL (1999): "Why Do Entrepreneurs Become Franchisees? An Empirical Analysis of Organizational Choice", *Journal of Business Venturing,* vol. 14(1), pp. 103-124.

Williamson, O.E. (1985): *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*, Free Press, New York.

Yin X., Zajac E.J. (2004): "The Strategy/Governance Structure Fit Relationship: Theory and Evidence in Franchising Arrangements", *Strategic Management Journal,* vol. 25, pp. 365-383.