An Analysis of the Factors Associated with the Decision to Franchise in the Restaurant Industry

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AN ANALYSIS OF THE FACTORS ASSOCIATED WITH THE DECISION TO FRANCHISE IN THE RESTAURANT INDUSTRY

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ABSTRACT

This study examines the association between restaurant industry firms’ decisions to franchise and firm characteristics suggested by agency and capital market theories. Motivating the inquiry is the observation that franchising has become an increasingly important and growing element in the restaurant industry (Franchising in the Economy, 1992).

Some restaurants rely heavily on franchising while others do not. Although researchers have offered many explanations for franchising, two explanations dominate the literature: agency theory and capital market explanations. Under an agency theory perspective, business unit managers are susceptible to excessive perquisite consumption and shirking behavior (agency costs) because of the high costs of monitoring and controlling managers’ behavior. However, agency costs are significantly reduced under franchising arrangements (Brickley & Dark, 1987). This is because the franchisee, a residual owner, suffers the negative consequences of inefficiencies.

Conventional wisdom from those engaging in franchising is that franchising is used as a viable tool for raising capital. There is some support for a capital market explanation of franchising in the literature (Justis, 1993; Martin, 1988; Oxenfelt & Kelly, 1969). In addition, industry practitioners advocate that the prime reason for undertaking franchising contracts is that franchising is a relatively lower cost approach to obtaining financial resources. For example, Ralph Guarino, president of Papa Gino’s, Inc., stated that one of their objectives is to “...gain market share without taking on a lot of debt” (Restaurants & Institutions, 1989).

The study sample is comprised of firms in the restaurant industry (SIC code #5812: Eating Places) with data available on Compustat PC Plus from 1990 through 1995. To investigate the relation between the ex-post decision to engage in franchising and hypothesized firm characteristics we estimate the following relation:

\[ FRAN = \alpha + \beta_1SZ + \beta_2DBT + \beta_3GRTH + \beta_4AG + \varepsilon \]

where \( FRAN \) is the decision to have franchised units or not, \( DBT \) is book debt to equity ratio, \( SZ \) is the log of total assets, \( GRTH \) is an indicator of firm growth potential measured as the percentage change in sales for the period, and \( AG \) is a proxy for agency costs (monitoring costs) measured by the geographical dispersion of business units.

The results of this study support the hypotheses that companies engaging in franchising contracts are larger and less leveraged and have higher geographic concentration.
as suggested by theory. However, contrary to prevailing arguments, growth rates for
sample firms engaging in franchising contracts are lower. While this study provides
some preliminary evidence of differences between firms that choose to engage in fran-
chising activities and those that do not, the study is being extended to include additional
measures of firm risk and value which are expected to distinguish between the two types
of organizational structure.