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SUF vs. MUF in International Franchising: The Role of Trust, Transaction and Agency costs

verfasst von/submitted by

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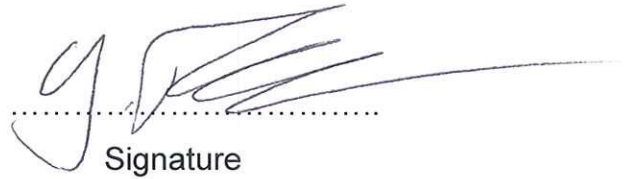
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## Statutory declaration

I, hereby, declare that I have authored this thesis independently, that I have not used other than the declared sources/ resources and that I have explicitly marked all material which has been quoted either literally or by content from the used sources.

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## Abstract

Franchising is commonly used to enter into foreign markets. There are various types of international franchising and it is interesting to identify reasons why a franchisor decides to use a certain governance mode. This paper investigates international franchising by highlighting trust, transaction cost and agency theory. In doing so, the influence of knowledge-based and general trust, transaction-specific investments and environmental and behavioral uncertainty is investigated on the franchisor's decision to enter foreign markets by means of either SUF or MUF. The latter is argued to incur a higher degree of franchisor control. In addition to the theoretical analysis of the topic, empirical research is conducted with 162 franchisors in total. Empirical findings suggest significant differences between the choice of SUF and MUF considering the franchisor's perception of partner transaction-specific investments. In accordance with this paper's theoretical explanations, franchisors choose MUF when partner transaction-specific investments are high. This might be explained by the increased need for control of MUFees incurring more responsibility and market power by owning several outlets. Furthermore, there is no significant influence of general and knowledge-based trust and environmental and behavioral uncertainty variables on the choice between SUF and MUF.

**Keywords:** International Franchising, SUF, MUF, Trust, Transaction Cost Theory, Transaction-Specific Investments, Agency Cost Theory, Environmental Uncertainty, Behavioral Uncertainty.

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## List of abbreviations

Single-Unit Franchising = SUF  
Single-Unit Franchisee = SUFee  
Single-Unit Franchisees = SUFees  
Multi-Unit Franchising= MUF  
Multi-Unit Franchisee = MUFee  
Multi-Unit Franchisee = MUFees  
United States of America = USA  
United Kingdom = UK

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First of all, I would like to thank Univ.-Prof. Mag. Dr. Josef Windsperger and Mag. Dr. Maria Jell-Ojobor of the International Management department at the University of Vienna for supporting me throughout the whole research project. I would also like to acknowledge Univ.-Prof. Dr. Oliver Fabel M.A., Dean of the Faculty of Business, Economics and Statistics at the University of Vienna.

Also, I would like to thank my colleagues participating in this research project. Together, we contacted franchisors in Germany, Austria, Italy, Spain, France, the UK, the Netherlands and the USA. It would have hardly been possible to get feedback from that many companies without them. Furthermore, the community among all participants has been very strong and everybody was happy to help each other.

Special thanks goes to all respondents of the survey for their efforts in filling out the questionnaire and, thus, contributing substantially to establish this master thesis.

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# 1. Introduction

## 1.1. Problem

Franchise companies have been and are becoming more and more important in the economy, which can be seen from the data of the German Franchise Association shown in table 1. Turnover figures in the German franchise sector amounted to EUR 73.4 billion (2014) compared to EUR 25 billion in 2003. In addition, the amount of franchisors has increased from 830 (2003) to 1,075 (2014), while the growth in franchisees increased 68% to an absolute figure of 72,400 in 2014. Furthermore, in Germany, there are 541,000 workers in the franchise sector, marking an increase of 39% compared to 2003.<sup>1</sup>

	2003	2014	Growth
<b>Workers</b>	390,000	541,000	39%
<b>Franchisees</b>	390,000	72,400	68%
<b>Franchisors</b>	830	1,075	30%
<b>Turnover (in billion €)</b>	25.0	73.4	166%

Table 1: Own representation based on Deutscher Franchise Verband e.V. (German Franchise Association)

This master thesis deals with the internationalization process of firms. By entering foreign markets, a firm may either act with its own personnel or enter into contracts with external persons in the local market who run the business on their own. The latter is referred to as franchising, which will be solely investigated in this study. The franchisor-franchisee relationship is characterized by a technological and business knowledge shift to the franchisee.<sup>2</sup> In doing so, the franchisee is allowed to use the franchisor's brand name, trademark, business system and corporate image in return for paying fees and royalties.<sup>3</sup> As a result, the franchisor has to be aware of risks regarding quality standards, effects of regulations in the host market and the protection of intellectual property.<sup>4</sup> Nevertheless, the general risk of foreign market

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<sup>1</sup> Deutscher Franchise Verband E.V.

<sup>2</sup> Baena (2013)

<sup>3</sup> Contractor, Kundu (1998a)

<sup>4</sup> Baena (2013)

entries can be reduced for franchisors compared to equity modes, as host franchisees are fully responsible for their franchise units.<sup>5</sup>

The challenge for the franchisor is to encourage franchise compliance with rules while not impeding franchisee visions. Moreover, the success of a franchise system depends on the degree of compliance of all franchisees by commonly exploiting market opportunities. Compliance issues are not necessarily present at the early stage, but they are a source of conflict arising over time. In the course of time, the franchisee recognizes strength and weaknesses and is familiar with the strategies of their counterpart. Additionally, there is a high propensity for franchisees to get the impression that they are responsible for the success of the unit through their own efforts. This leads to the franchisee's perception of the low contribution and efforts to success of their counterpart, which results in dissatisfaction and scrutinization of contract fairness. As a consequence, the relative knowledge-based power diminishes and the power might shift from the franchisor toward the franchisee, which might cause violations of compliance and commitments. The franchisor, thus, responds in turn, resulting in an aggravation of the conflicts. These responses represent the attempt to balance the ambitions of franchisees and their autonomy with the franchisor's purpose to comply with its standards and are more likely to occur as time goes by. This might lead to frustration on the franchisee side as they invest their own capital into a business where they face constraints. Violating constraints stipulated in franchise contracts results in penalty payments. As a result, it lowers the entrepreneurial spirit of the franchisee.<sup>6</sup>

The franchisor can decide whether to offer single-unit franchise (SUF) or multi-unit franchise (MUF) contracts. The latter refers to one franchisee operating several outlets, whereas the former refers to one franchisee managing one outlet.<sup>7</sup> The problem the franchisor is faced with in deciding between SUF and MUF represents trust toward the franchisee. Thereby, information gathering about the counterpart is important but there are also issues that will be dealt with in the following. The crucial aspect is to find a way to internationalize into foreign markets at a minimized cost.

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<sup>5</sup> Dunning et al. (2007)

<sup>6</sup> Davies et al. (2011)

<sup>7</sup> Dant et al. (2013)

## 1.2. Research question and goals

This paper investigates the influences of trust as well as transaction and agency costs on the franchisor's choice to enter foreign markets using either SUF or MUF. It is important to note that this paper perceives MUF as consisting of MUF by definition, and in addition to that, master franchising. There will be no distinction made in the following. This is in accordance with the interpretations of Bodey et al.,<sup>8</sup> Weaven and Frazer,<sup>9</sup> Garg and Rasheed,<sup>10</sup> Kaufmann and Dant<sup>11</sup> and Moritz.<sup>12</sup> The empirical study includes franchisors originating from the USA, Italy, France, Spain, Germany, Austria and the Netherlands. Trust theory as well as transaction and agency cost theoretical issues, like transaction-specific investments and behavioral and environmental uncertainty, will be investigated in the franchisor's choice between SUF and MUF. From that point of view, the franchisor will prefer the option with the lowest agency and transaction costs.<sup>13</sup>

By applying trust theory on the franchise relationship between franchisor and franchisee, general and knowledge-based trust are investigated in particular. Trust, in general, is defined as "[...] an expectation that partners, including potential partners, have goodwill and benign intent in their dealing with us."<sup>14</sup> The underlying assumption is that the parties involved have perfect information about each other's intentions. *Knowledge-based trust* is manifest if one party is convinced of the counterpart's goodwill based on actions and information of past interactions.<sup>15</sup> The term *general trust* is referred to the inclusion of bias. Therefore, a person exhibiting general trust perceives the world assuming the goodwill of human beings.

The research question is how general and knowledge-based trust, behavioral and environmental uncertainty as well as partner transaction-specific investments influence the franchisor's choice between SUF and MUF. By doing so, seven hypotheses are formulated.

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<sup>8</sup> Bodey et al. (2011)

<sup>9</sup> Weaven, Fraser (2003)

<sup>10</sup> Garg, Rasheed (2006)

<sup>11</sup> Kaufmann, Dant (1996)

<sup>12</sup> Moritz (2011)

<sup>13</sup> Williamson (1985)

<sup>14</sup> Yamagishi, Yamagishi (1994), p. 135

<sup>15</sup> Yamagishi, Yamagishi (1994)

Transaction cost theory deals with the question of how companies make governance choices, which is subject to the decision option with the lowest level of transaction costs. Transaction costs occur due to the bounded rationality of the parties involved. Moreover, complexity of environment, uncertainty and, therefore, information asymmetries are other influencing factors.<sup>16</sup> Agency theoretical issues deal with the adverse selection and moral hazard problem. In a franchise context, the theory considers the behavior between franchisor (principal) and franchisee (agent).<sup>17</sup>

In the course of answering the research question, it is expected that there will be an overall tendency toward MUF of the investigated companies as the majority of franchise outlets represent a part of an MUF system.<sup>18</sup> Similarly, Dant et al. consider MUF as the dominant mode, despite the fact there is less trust involved in multi-unit franchisee-franchisor relationships.<sup>19</sup>

The study will pose hypotheses based on the theory and, after evaluating the empirical research data, address whether the proposed hypotheses have been confirmed or not.

### 1.3. Methodology

The paper begins with a literature review of trust, transaction and agency cost theory. Afterwards, a framework with hypotheses is constructed to determine when franchisors prefer SUF over MUF and vice versa. This theoretical section is followed by a quantitative empirical research part in order to prove and evaluate the hypotheses. Data collection is conducted by a designed survey of the Management department of the University of Vienna conducted by Univ.-Prof. Mag. Dr. Josef Windsperger and Mag. Dr. Maria Jell-Ojobor. The survey is addressed to franchisors in their respective country of origin and deals with questions regarding the internationalization process. It has to be noted that franchisors without international

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<sup>16</sup> Peng, York (2001)

<sup>17</sup> Contractor, Kundu (1998a)

<sup>18</sup> Gomez et al. (2010),

<sup>19</sup> Dant et al. (2013)

outlets are excluded from the study. The empirical research comprises franchisors originating from eight countries, which are as follows: USA, UK, Italy, Germany, Austria, Spain, France and the Netherlands. The relevant data has been extracted from the replied surveys. Finally, based on the results, the hypotheses are confirmed or rejected and recommendations for further research are made.

#### **1.4. Structure of the paper**

The thesis consists of nine chapters. Chapter 1 introduces the topic, including the problem definition, research question and goals, methodology and structure. Chapter 2 deals with franchising in general and concludes with a distinction between SUF and MUF.

Chapter 3 concerns the theoretical background that sets the basis for the empirical research. Trust theory in connection with SUF und MUF will be investigated by focusing on general and knowledge-based trust. Furthermore, the influence of transaction cost and agency theory will be examined thoroughly.

Chapter 4 concludes the theoretical part with an illustrated concept of a franchisor's entry mode choice decision between SUF and MUF.

Chapter 5 deals with the methodology of research. It gives an overview of generated data collection and highlights relevant questions. Generated data will be evaluated and prepared via SPSS statistics program.

The results of the empirical study are demonstrated in chapter 6 and are evaluated afterwards. This study includes limitations, which are discussed in chapter 7. Furthermore, fields for future research are suggested.

Finally, the last chapter forms the conclusion by summarizing the results and answering the research question.

## 2. Franchising

### 2.1. Characterization

Franchising can be characterized as an organization type where “[...] the owner of a service concept (principal/ franchisor) enters into a contract with an unrelated party (agent/ franchisee) to use a specific business formatted service concept to sell services and goods under the franchisor’s trademark.”<sup>20</sup> It can also be characterized as a form of licensing including the authorized usage of an existing business system.<sup>21</sup> Franchising is an internationalization mode to enter into distant foreign markets with different income levels, consumer preferences and competition compared to the host market.<sup>22</sup> Moreover, it is defined as an organization form agreed upon by both parties with the target to successfully compete abroad. By doing so, both franchisor and franchisee share the common goal to maximize profits with different task allocation.<sup>23</sup> It also enables benefitting from economies of scale by applying standardizations in marketing, product development and purchasing throughout the franchise system.<sup>24</sup> The franchisor is looking to generate a competitive advantage by operating through a decentralized network. Franchising is able to create the same consumption experience at various locations and times by all franchisees using the system’s trademark and applying the system’s technology.<sup>25</sup> The willingness to grow—which can hardly be achieved by serving the matured home market alone—is one reason for franchisors to franchise internationally.<sup>26</sup> That is also why in most cases a franchisee is an entrepreneur located in the host market who has to invest their own funds.<sup>27</sup> The franchisees’ superior knowledge of the host market represents a crucial asset for themselves.<sup>28</sup> They run the business unit on their own, however, and do not hold ownership rights. What is more, franchisees

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<sup>20</sup> Fladmoe-Lindquist, Jacque (1995), p. 1238

<sup>21</sup> Anderson, Gatignon (1986)

<sup>22</sup> Akremi et al. (2010)

<sup>23</sup> Michael (2003)

<sup>24</sup> Cochet, Ehrman (2008)

<sup>25</sup> Michael (2003)

<sup>26</sup> Hoffman, Preble (2001)

<sup>27</sup> Michael (2003)

<sup>28</sup> Garg, Rasheed (2003)



borrow the business idea form the franchisor.<sup>29</sup> In addition, franchisees represent the residual claimants for revenues.<sup>30</sup>

Franchisees strive for autonomy and innovation.<sup>31</sup> Felstead defines autonomy as a degree when franchisees face no constraints or interference in decision making and operational activities.<sup>32</sup> Autonomy is determined by the franchisor's competence and integrity. The former deals with the franchisor's degree of willingness to support and help its counterpart to achieve aspirations and the goals stipulated and agreed upon in the franchise contract. Such goals represent ambition as well as the pursuit of economic success and career growth. The latter is related to procedural fair behavior in the franchisor-franchisee relationship comprising dignity, respect and consistency whose extent depends on the way striving for autonomy is received by their respective counterpart.<sup>33</sup>

Both parties agree upon a franchise contract that gives franchisees the right to use the franchisor's (production) technology and trademark.<sup>34</sup> The contract also includes information of tasks the franchisor has to fulfill. Typically, managerial assistance is given to franchisees by on-the-job and institutional coaching. Furthermore, help with location choice and standard operating manuals is offered as well as continuous advice throughout the contract period. The franchisor's duties also include advertising<sup>35</sup> as well as help with the construction, design and layout of the franchise outlet, rent negotiations with local landlords, staff training and operation of equipment.<sup>36</sup> Additionally, it is the franchisor's task to do market research, find suitable suppliers and to obey specific local requirements in the foreign market.<sup>37</sup> The franchise contract includes a termination clause enabling the franchisor to break off the franchisor-franchisee relationship. It might also contain clauses governing issues like the prohibition to sell the franchise outlet by the franchisee or to establish an own

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<sup>29</sup> Felstead (1991)

<sup>30</sup> Bradach, Eccles (1989)

<sup>31</sup> Davies et al. (2011)

<sup>32</sup> Felstead (1991)

<sup>33</sup> Davies et al. (2011)

<sup>34</sup> Michael (2003)

<sup>35</sup> Rubin (1978)

<sup>36</sup> Jindal (2011)

<sup>37</sup> Königsberg (2008)

company in the same industry after the franchise contract expires.<sup>38</sup> Franchisees are formally independent, but often face strict uniformity restrictions stipulated in contracts.<sup>39</sup> That is why Rubin describes the relationship as similar to the relationship between a company and its employees.<sup>40</sup> However, the success of a franchise system is determined by the creation and implementation of rigid guidelines across all outlets.<sup>41</sup>

The franchisor is the owner of the trademark and technology, and charges the franchisee royalties on gross sales as well as a franchise fee. In contrast to other internationalization modes, franchising enables the franchisor to sell a whole business opportunity and entrepreneurship whose rules have to be obeyed by franchisees.<sup>42</sup> The reasons for choosing franchising as an organization form are, on the one hand, to raise capital and, on the other hand, the financial inability to enter foreign markets with equity modes. Moreover, it is argued that business expansion by franchising systems can be achieved faster compared to other organization forms.<sup>43</sup> Norton states that franchising represents an organization form “[...] to circumvent the entrepreneurial capacity constraint.”<sup>44</sup> It refers to constraints of organizational resources like capital, raw material, time efforts and human resources.<sup>45</sup>

According to an empirical study of franchisors originating from the UK and the US, the latter tend to favor franchising as a foreign market entry mode more than UK firms do. The reason is the higher perception of US franchisors to be able to accumulate franchise relevant knowledge.<sup>46</sup>

Control is a crucial factor in a franchise system and can be described as “[...] the ability to influence systems, methods and decisions.”<sup>47</sup> It should maintain the connection between input and output as well as objectives.<sup>48</sup> There are four

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<sup>38</sup> Rubin (1978)

<sup>39</sup> Dant et al. (2013)

<sup>40</sup> Rubin (1978)

<sup>41</sup> Davies et al. (2011)

<sup>42</sup> Michael (2003)

<sup>43</sup> Rubin (1978)

<sup>44</sup> Norton (1988a), p.107

<sup>45</sup> Norton (1988a)

<sup>46</sup> Dunning et al. (2007)

<sup>47</sup> Anderson, Gatignon (1986), p. 3

<sup>48</sup> Bouquin (1998)

interrelated factors affecting the control of a franchisor over its franchisees. First of all, the extent of control a franchisor has is determined by the level of completeness and description of the operational business in the contract. The more detailed and complete the contract, the more control the franchisor incurs. Secondly, control depends on the degree of the franchisor's ability to exert control on the operational business, which is determined by the specificity of the products and services provided to the consumer. In fast food chains, for instance, there is one predetermined way to produce a product and gives the franchisor a high degree of control. However, in other business fields it might be difficult to stipulate one specified way that can be applied to any possible situation. The third factor represents uniformity, which refers to the externality problem discussed in more detail in chapter 3. The higher the uniformity among the outlet owners, the higher the franchisor's control. The last factor influencing control refers to the franchisor's enforcement activities and monitoring. The quality can be evaluated by interviewing customers and conducting secret customer visits. By doing so, the franchisor will ensure uniformity of quality of products and services.<sup>49</sup> Additionally, the franchisor is able to generate economies of scale in monitoring activities. On the one hand, this can be achieved through a hierarchical structure of monitors by optimizing time efforts.<sup>50</sup> On the other hand, economies of scale can be generated by establishing routines and standardized processes for monitoring and performance evaluations.<sup>51</sup> As a result, opportunistic acting franchisees can be detected more easily.<sup>52</sup>

Control also significantly influences both risk and return. There are various organization forms with different levels of risk and return. Company owners tend to apply a risk-adjusted return perspective by focusing on reducing risk by decreasing resource commitment, i.e., control, in order to increase profits. Transaction-specific investments, free riding potential as well as external and internal uncertainty are influencing factors determining the degree of control that will be dealt with in more detail in chapter 3 and 4. According to the definition of Anderson and Gatignon, internationalization via franchising is classified as a non-equity entry mode with balanced interests between the franchisor and franchisee classified as medium

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<sup>49</sup> Felstead (1991)

<sup>50</sup> Shane (1996 b)

<sup>51</sup> Huszagh et al. (1992)

<sup>52</sup> Shane (1996 b)

control mode. High control modes represent wholly-owned subsidiaries or majority and, thus, dominant shareholders. On the contrary, low control modes are nonexclusive and/ or nonrestrictive contracts as well as minority equity positions. According to that, franchising can be located somewhere in the middle, because the franchise contract includes incentives for the franchisee to adhere to the franchisor's rules and system.<sup>53</sup> Furthermore, it represents a hybrid organization type lying between the opposed forms of the market and the firm.<sup>54</sup> Mathewson and Winter argue that franchise agreements can be assigned somewhere between “[...] price mediated exchange and centralized intra firm employment.”<sup>55</sup>

Regardless of risk associated with compliance, general risk of foreign market entries can be reduced by using franchising compared to equity modes since host franchisees are fully responsible for their franchise units.<sup>56</sup> In order to ensure compliance, the franchisor is able to supervise and monitor their counterpart's activities whether they are conducted in accordance with the system or not. In doing so, control is executed by day-to-day involvement and generated expertise of the franchisor over time.<sup>57</sup> Control is exercised regarding the amount and price of sold products and services, inventory, opening hours, insurance, personnel, outlet condition and, lastly, accounting and auditing. Organizations operating through company owned outlets tend to switch to franchise modes due to costs of managing day-to-day operations becoming too high. A reason for that might be control problems and, therefore, high control costs associated with day-to-day business. As a result, the franchisor delegates this task to franchisees reducing control efforts on company owner's side.<sup>58</sup> By contrast, there are also franchise systems that prefer to have a certain share of company owned outlets in their portfolio. One reason might be the opportunity to set benchmarks for franchisees in terms of performance or to curb the risk of uncertain environments or behaviors.<sup>59</sup>

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<sup>53</sup> Anderson, Gatignon (1986)

<sup>54</sup> Rubin (1978)

<sup>55</sup> Mathewson, Winter (1985), p. 503

<sup>56</sup> Dunning et al. (2007)

<sup>57</sup> Anderson, Gatignon (1986)

<sup>58</sup> Rubin (1978)

<sup>59</sup> Burton et al. (2000)

Franchisees not adhering to contractual agreements that might be beneficial for them but not for the whole franchise system are referred to as opportunistic acting franchisees. More precisely, outlet managers trying to reduce their own operating costs by not applying the technology (correctly) or not participating in common activities.<sup>60</sup> Generally, franchising is an organization type where imposed control, i.e., dependence and autonomy of the franchisee, coexist for the benefit of both parties.<sup>61</sup> Nevertheless, it is difficult for a franchise system to find a suitable balance between franchisor's control to prevent opportunism and franchisee's autonomy.<sup>62</sup> The situation becomes more complex when the franchise system is operating internationally.<sup>63</sup> What is more, these issues provoke and often result in conflicts between franchisors and the franchisees.<sup>64</sup>

Several trends and (market) developments have stimulated the emergence and importance of franchising. Such developments include market liberalizations around the world, democratic governments and improvement of information and communication technologies. In short, globalization enables firms to internationalize and expand successfully via franchising.<sup>65</sup> Franchising has to be considered a growing and specific retailing type with a huge impact on public policy. The fact that franchisors may also compete with their implemented franchisees through their company owned units demonstrates the behavioral complexity of this organization form.<sup>66</sup> However, this might lead to the failure of franchisees, which decreases the value of the franchise concept. There should be a common ground with the same visions of interests and targets. By doing so, franchisees following the rules and standards accompanying the objectives are able to reduce the risk of franchisee failure. In order to minimize risks, franchisors have to beware of the impact of trust and relational conflicts on the compliance of franchisees.<sup>67</sup>

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<sup>60</sup> Chen (2010)

<sup>61</sup> Dant, Gundlach (1998)

<sup>62</sup> Paik, Choi (2007)

<sup>63</sup> Walker (1989)

<sup>64</sup> Davies et al. (2011)

<sup>65</sup> Hoffman, Preble (1991)

<sup>66</sup> Dant et al. (2013)

<sup>67</sup> Davies et al. (2011)

## 2.2. SUF vs. MUF

As stated above, a distinction is made between SUF and MUF, whereby the latter entails MUF and master franchising. By establishing a franchise system, the franchisor has to decide whether to internationalize via SUF or MUF or a mix of the two.<sup>68</sup> According to a study by the German Franchise Association, the number of MUF outlets is growing compared to SUF ones. In particular, there were 20% fewer new ventures in 2014 compared to 2013.<sup>69</sup> Moreover, MUF is more popular with franchisors, whereas SUFees accredit the relationship to the franchisor as a more reliable interaction.<sup>70</sup> However, that is why SUFees tend to rely more on the franchisor's help in times when business is bad compared to MUFees. That also implies that the SUFee dependence on their franchisor is higher.<sup>71</sup>

The tasks of a franchisor operating with MUFees are similar to that of a franchisor issuing single-unit contracts.<sup>72</sup> Thus, on the one hand, franchisors are aware of specific local demands and needs on foreign markets, whereas, on the other hand, they try to maximize uniformity across all franchise outlets. Uniformity is recommended to strengthen and protect the trademark and facilitate performance comparisons.<sup>73</sup> One exception represents recruiting, training and screening of franchisees. Whereas in SUF the franchisor has to take care of this, the responsibility of finding and training suitable personnel is shifted to the franchisee in MUF systems. The lower level of scarcity of resources represents an advantage favoring MUF over SUF.<sup>74</sup> More precisely, MUFees seem to perform better because they have a higher capacity to gather resources and generate earnings to finance future investments. What is more, MUFees are able to profit from economies of scale. As a consequence, it is suggested that the franchisor is able to generate faster system growth by entering foreign markets through MUF compared to SUF.<sup>75</sup>

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<sup>68</sup> Griessmair et al. (2014), p. 2337

<sup>69</sup> Deutscher Franchise Verband E.V. (2014)

<sup>70</sup> Jindal (2011)

<sup>71</sup> Dant et al. (2013)

<sup>72</sup> Jindal (2011)

<sup>73</sup> Bradach (1997)

<sup>74</sup> Garg, Rasheed (2003); Norton (1988a)

<sup>75</sup> Bradach, (1995); Kaufmann, Kim (1995); Kaufmann, Dant (1996)

When it comes to franchise expansion plans, the franchisor has to decide whether to recruit new franchisees or give established franchisees additional outlets. Franchisors face difficulties in finding suitable new franchise partners. That is why prospective new franchisees are invited to participate in a test run in an existing franchise outlet. This process is not very efficient since it is very costly and only 1–2% had been approved and even less finally entered a franchise contract.<sup>76</sup> Another important aspect is the personal chemistry between franchisors and franchisees. A positive relationship inspires a successful outcome of the negotiation process. What is more, a good relationship leads to a common ground in terms of vision and goals, perception of risk and the organizational culture.<sup>77</sup> The main advantage in allocating an additional unit to an existing franchise partner is that the franchisor knows its counterpart already and can evaluate if he or she is a trustworthy partner for multiple outlets. As a consequence, risks and search costs can be reduced. More precisely, the human resource risk can be eliminated. The financial risk, however, remains omnipresent irrespective of whether the firm is recruiting new franchisees (SUF) or expanding through established ones (MUF).<sup>78</sup> In general, SUFees bear a higher risk compared to multi-unit outlet owners due to the fact MUFees are able to diversify risk among their outlets.<sup>79</sup>

It has to be noted that interactions are more frequent in a single-unit franchisor-franchisee relationship because they need more help. Consequently, the dependence on their franchisor is higher. A reason might be that single-unit franchisees do more operational day-to-day business. By contrast, the tasks of a multi-unit franchisee are rather to manage the units and to employ personnel for the day-to-day operational business. As a result, there are more frequent interactions between SUFees and their franchisors and, therefore, a stronger relationship between them.<sup>80</sup>

There are several types of MUF. Originally, single-unit franchise systems can become multi-unit ones when franchisees are permitted to run more than unit. This type is referred to as *incremental or sequential MUF*, which might be the result of

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<sup>76</sup> Bradach (1995)

<sup>77</sup> Brookes, Altinay (2011)

<sup>78</sup> Bradach (1995)

<sup>79</sup> Rubin (1978)

<sup>80</sup> Dant et al. (2013)

great performance of the franchisee operating a single-unit.<sup>81</sup> Another type of MUF is *master franchising*, which occurs when an independent franchisee supervises and takes responsibility of multiple units in an assigned geographic territory. This franchisee is then called a master franchisee due to the fact he or she operates a franchise chain as franchisor. Therefore, it is considered as a form of indirect franchising.<sup>82</sup> By using master franchising, the franchisor is able to enter foreign markets with low financial human resources and financial requirements. Furthermore, the franchisor's risk is minimized in case the master franchisee fails.<sup>83</sup> The master franchisee is compensated by a share of the franchise fee and the royalties based on gross sales both paid by the sub-franchisee. Consequently, the other share goes to the franchisor who demands "[...] its best efforts to the development and monitoring of sub-franchisees"<sup>84</sup> from the master franchisee. The latter is able to expand the number of outlets by the acceptance of the franchisor who only gets in touch with sub-franchisees under special circumstances when the master franchisee is dismissed, for instance.<sup>85</sup>

As a consequence, master franchisees represent an independent sales organization of the franchisor's brand allowing the master franchisee to buy and sell franchise units and support its sub-franchisees like the franchisor does with its franchisees in a traditional MUF system.<sup>86</sup> The main advantage for the franchisor is the shift of the whole franchise system to a local partner in the host market. Thus, the master franchisee takes responsibility of the success and can use its superior knowledge of the culture, legal system, laws and language by entering foreign markets. What is more, the responsibility of managing, operating and developing the franchise chain passes over to the master franchisor. By doing so, the master franchisor helps the franchisor to overcome the lack of local market knowledge and forwards information on which adaptations should be made. The franchisor takes account of the risk borne by the master franchisor and its resource commitment and highly important market knowledge by granting more strategical and operational control to the latter. The master franchisor pays a franchise fee to the franchisor for permission of establishing

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<sup>81</sup> Garg, Rasheed (2003)

<sup>82</sup> Königsberg, Rosenstein (1991)

<sup>83</sup> Königberg (2008)

<sup>84</sup> Jindal (2011), p. 551

<sup>85</sup> Jindal (2011)

<sup>86</sup> Weaven, Frazer (2003)



a franchise chain in the host market. The high fee for the exclusive right to serve the host market results in lower royalties as well as lower fees for establishing new master franchise outlets. The remuneration of the master franchisor consists of the main share of residual income generated by its sub-franchisees.<sup>87</sup>

Control measures of franchisors represent inter-organizational processes for communication, decision making and coordination purposes and targets on maintaining quality and financial control. Master franchising, for instance, consists of a formation stage, which comprises the time from recognizing the need for a partner up to and including the negotiation process. The type of control in this phase is operational and relational with decentralization characteristics in quality control, whereas financial objectives are decided and supervised centrally. Furthermore, as regards the relationships, this stage has positive but limited relational ties. The development stage starts at the time of implementation of the franchise agreement. Financial and quality control as well as decision making is centralized at this stage. Regarding the type of control, this phase can be characterized as operational and relational as well as contractual and operational. Furthermore, relational ties are tested between both franchisor and master franchisee, who consider themselves as isolated. The maturity phase is reached when firms collaboratively work for the purpose of the trademark and increase its value. Control can be either operational or relational. In contrast to the previous stage, quality and financial control are decentralized. Moreover, decision making is exercised in a participatory way as in the formation stage. Regarding the relationship, there is no inherent distinction between the parties any more. As a result, both parties act as one entity with enhanced and strengthened relational ties.<sup>88</sup>

*Area development* represents a third type of MUF where the independent area developer owns and operates more than one franchise unit granted by the franchisor. The ownership of units by the area developer represents one difference in comparison to master franchising. Outlet managers are able to establish their own independent mini-hierarchy by obtaining the lower level of hierarchy from the franchisor. The franchise agreement determines the number of franchise units in a

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<sup>87</sup> Königberg (2008)

<sup>88</sup> Brookes, Roper (2011)

certain period of time. Like master franchisees, area developers are obliged to give their best efforts and are responsible for the detection and acquisition of further franchise units. Moreover, similarly, decisions on that are subject to acceptance of the franchisor. One difference between a master franchisee and an area developer is that the latter has to pay franchise fees. More precisely, he or she has to incur a share of the franchise, except for the first unit. Furthermore, regarding compensation, area developers have ownership and decision rights and receive residual income. As a result, area development franchisors obtain a higher degree of control over their outlet managers compared to master franchisees, who have less control over their units due to the fact that sub-franchisees incur the remaining claim on cash flow after the master franchisees' claims are satisfied. As a consequence, opposed to district managers, there is less need for monitoring and supervising efforts of the franchisor choosing area development franchising.<sup>89</sup>

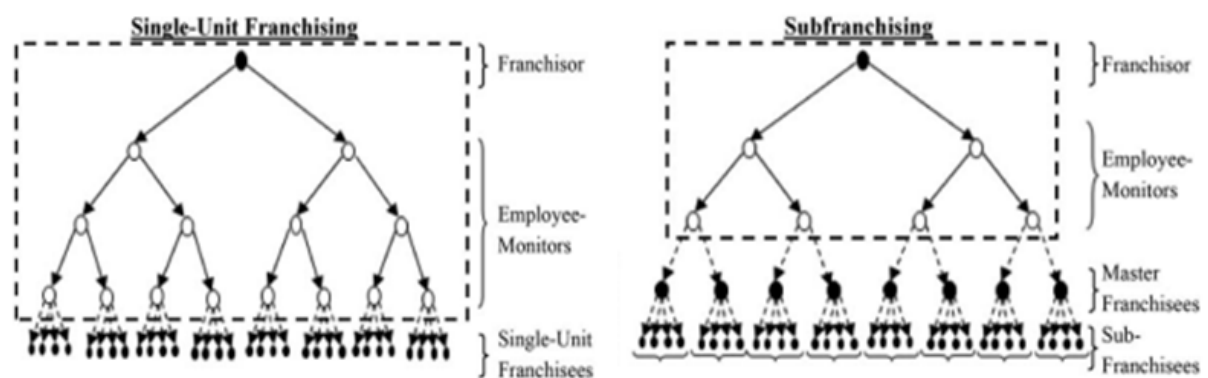


Figure 1: Structural differences between SUF and master franchising, retrieved by Jindal (2011), p. 552.

This paper is going to investigate franchisors in their decision between SUF and MUF. SUFees compared to MUFees tend to be more dependent on their franchisor since they lack capabilities, capital and business experience. Furthermore, SUFees cannot properly assess how their business works. Therefore, the strategy, experience and financial benefits of the franchisor are considered very important by the SUFees.<sup>90</sup> Moreover, expansion is not motivating or considered important as a decision criterion for entering franchising, which is why they are satisfied with operating one outlet.<sup>91</sup> From the franchisor's point of view, compared to SUF

<sup>89</sup> Jindal (2011)

<sup>90</sup> Dant et al. (2013)

<sup>91</sup> Weaven, Frazer (2006)

systems, franchise systems operating with MUF provides the franchisor with superior controlling methods over its businesses.<sup>92</sup>

Bradach suggests performance differences between SUF and MUF illustrated in table 2. Three performance categories are distinguished and demonstrated by arrows, namely *low performance*, *medium performance* and *high performance*. Accordingly, SUF features low performance in unit growth and system wide adaption. The opposite is true in considering MUF. More precisely, it is suggested that the facilitation of system-wide adaption proposed by the franchisor increases by the number of franchise outlets. The reason for that implies the fact the multi-unit franchisor, by its nature, has to convince fewer franchisees to adapt to changes compared to single-unit franchisors.<sup>93</sup> Lack of financial funds might be a reason for opting multi-outlet franchisees because they have more financial assets for investments compared to SUFees.<sup>94</sup> Both SUF and MUF show medium performance considering uniformity. On the one hand, MUF tend to overlook details due to their size, which is why SUF boasts higher performance with regard to uniformity.<sup>95</sup> On the other hand, performance difference is equalized between the MUF and SUF by the higher propensity of the SUF to free ride.<sup>96</sup>

It is argued that “[...] MUF enables the franchisor to exercise a higher degree of control compared to SUF.”<sup>97</sup> Especially, franchisors having strongly advertised brands tend to operate with higher control modes, i.e., MUF. The reason is that free riding is more likely under a strongly advertised brand, which is why a higher control mode is necessary.<sup>98</sup> On the contrary, Sashi and Karuppur suggest that a valuable brand name might imply a reduced probability of franchisee opportunistic behavior because they depend on the franchisor’s ongoing marketing activities as well on the brand itself in order to achieve their own goals. In addition, franchisees are supposed to be discouraged to act opportunistically by legal and financial penalties.<sup>99</sup> In any case, entering international markets with MUFees leads to optimized monitoring

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<sup>92</sup> Doherty, Alexander (2005)

<sup>93</sup> Bradach (1995)

<sup>94</sup> Hussain, Windsperger (2015)

<sup>95</sup> Bradach (1995)

<sup>96</sup> Rubin (1978); Gomez et al. (2010)

<sup>97</sup> Hussain, Windsperger (2015)

<sup>98</sup> Anderson, Gatignon (1986)

<sup>99</sup> Sashi, Karuppur (2002)

costs in terms of effectiveness and efficiency due to the fact the franchisor has to control fewer franchisees since those partners own more than one outlet.<sup>100</sup>

Considering local responsiveness, SUF outperforms MUF because the SUFees can solely focus on customer needs on the local market, whereas MUFees have to consider other aspects as well. More precisely, MUFees cannot easily adjust due to different local needs in every market. They are also less effective than their counterpart is in this regard. However, the absence of local differences in a region and the recruiting of marketing personnel specifically for the local market increases low performance of MUF due to its size, up to medium performance in this category. As a consequence, MUF is able diminish the performance gap in relation to SUF. Based on the superior performance of MUF considering all categories, franchisors favor MUF over SUF.<sup>101</sup> This is also in accordance with findings from Weaven and Frazer.<sup>102</sup> According to Kalnins and Lafontaine, ownership of multiple franchise units in a geographical area is correlated with synergy effects and leads to a lower propensity to free ride.<sup>103</sup> As a consequence, it is proposed that firms serving international markets tend to favor MUF over SUF.









Criteria	Performance of	
	SUF	MUF
System wide adaption		
Unit growth		
Uniformity		
Local responsiveness		

Table 2: Performance differences by categories between SUF and MUF, retrieved by Bradach (1995), p. 67.

<sup>100</sup> Hussain, Windsperger (2015)  
<sup>101</sup> Bradach (1995)  
<sup>102</sup> Weaven, Frazer (2006)  
<sup>103</sup> Kalnins, Lafontaine (2004); Hussain et al. (2012)

## 3. Theoretical background

### 3.1. Transaction cost theory

Coase defined transaction costs as costs “[...] of using the price mechanism.”<sup>104</sup> Transaction costs occur due to the bounded rationality of the parties involved.<sup>105</sup> Simon characterizes bounded rationality and argues that “[...] the capacity of the human mind for formulating and solving complex problems is very small compared to the size of the problems whose solution is required for objectively rational behavior in the real world.”<sup>106</sup> Furthermore, transaction costs are related to uncertainty and/ or complexity due to the fact that bounded rationality only occurs if at least one out of these two phenomena significantly occurs.<sup>107</sup> Moreover, complexity of environment, uncertainty and, therefore, information asymmetries are other influencing factors of transaction costs.<sup>108</sup> As a consequence, the firm is considered as adaption and incentive construct.<sup>109</sup>

According to Milgrom and Roberts, transaction costs consist of coordination and motivation costs. The former is based on bounded rationality, whereas the latter is the result of opportunistic behavior.<sup>110</sup> Opportunism describes the phenomenon of agents acting and behaving in a self-interested way. That will be highlighted in more detail in chapter 3.2.<sup>111</sup>

There are two different interdependent types of transaction costs, namely ex ante and ex post. Ex ante transaction costs entail time and effort consuming costs of drafting, negotiating and safeguarding a contract. Ex post transaction costs might occur as adaption costs after an agreement or as haggling costs by overcoming or renegotiating ex ante agreements. Furthermore, it also includes costs of mediation,

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<sup>104</sup> Coase (1937), p. 390

<sup>105</sup> Peng, York (2001)

<sup>106</sup> Simon (1957), p. 198

<sup>107</sup> Williamson (1975)

<sup>108</sup> Peng, York (2001)

<sup>109</sup> Williamson (1991)

<sup>110</sup> Milgrom, Roberts (1992)

<sup>111</sup> Williamson (1975)

trails and bonding in order to ensure the implementation of agreements.<sup>112</sup> The main determinants of transaction costs are asset specificity, frequency and uncertainty, which will be dealt with in the following sub-chapters.

Transaction costs can be divided into search and information costs, bargaining and decision costs as well as policing and enforcement costs, better known under agency costs.<sup>113</sup> The target function is to minimize transaction costs despite the occurrence of bounded rationality of the acting parties and an appropriate protection for opportunistic behavior.<sup>114</sup> However, bounded rationality restricts the opportunities of control. As a result, a company expansion is suggested to be made by adding hierarchical levels. In this paper's context, the franchisor would look for higher control modes by expanding internationally which in that case would be MUF compared to SUF.<sup>115</sup>

Transaction cost theory perceives franchising as a hybrid organizational form lying somewhere between the poles of vertical integration and independent operations.<sup>116</sup> Moreover, it deals with the franchisor's ownership strategy incurring the lowest amount of transaction costs.<sup>117</sup> Williamson suggests four interdependent transactions costs related to internationalizing into foreign markets by using franchise modes that will be described in the following. These are *search costs*, *property rights protection costs*, *monitoring costs* and *servicing costs*.<sup>118</sup>

First of all, the search for and evaluation of potential franchisees incurs costs.<sup>119</sup> Search costs mainly occur at an early stage and include expenses in identifying and evaluating prospective franchisees in the foreign market. Additionally, there are also negotiating costs. A high investment in the search for franchisees increases the probability of finding a high quality franchise partner. As a result, servicing costs and the risk of opportunistic behavior can be reduced.<sup>120</sup> It is true that franchisee

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<sup>112</sup> Williamson (1985)

<sup>113</sup> Dahlman (1979)

<sup>114</sup> Clement, Schreiber (2010)

<sup>115</sup> Williamson (1975)

<sup>116</sup> Baena (2013)

<sup>117</sup> Hussain, Windsperger (2015)

<sup>118</sup> Williamson (1975)

<sup>119</sup> Williamson (1975)

<sup>120</sup> Burton et al. (2000)

agencies representing the franchisor's will as well as the acceptance of unsolicited applications for franchise partnerships on the franchisor side are able to reduce ex ante costs. Nevertheless, search costs represent sunk cost to franchisors in any case.<sup>121</sup>

Also, the franchisor has to bear costs in order to protect its property from misuse.<sup>122</sup> In the course of the foundation of a franchise system, franchisors are willing to secure their properties by registrations with authorities, which becomes complex and costly when dealing with foreign country expansions. The reason is that protection measures for each entered market cause sunk costs for each respective market. This transaction cost type also consists of costs to ensure that acquired property rights are not violated by other companies. In order to protect property rights after the franchise contract ends, franchise contracts entail clauses stipulating that franchisees are not allowed to run a similar business in the same area after the termination of contract. What is more, it may also be contractually regulated that the franchisee must not establish a similar business for a certain time period after the franchise contract has ended. However, the threat cannot be completely eliminated for the franchisor.<sup>123</sup>

It is the franchisor's responsibility to ensure that all actions are executed in a proper way in order to curb free riding.<sup>124</sup> During the whole franchise contract, the franchisor is faced with monitoring costs.<sup>125</sup> This is closely connected to property protection costs as it describes costs based on the protection of the franchise system as well as the intellectual property. However, monitoring costs can rather be ascribed to surveillance of the franchise format. The franchisor spends financial assets on the protection of the trademark and brand that is supposed to convey quality of goods and services across borders. The action to sustain and protect the brand incurs ongoing costs of monitoring.<sup>126</sup>

It has to be noted that costs, time efforts and complexity increase as the company grows. And, what is more, it cannot be diminished by delegating monitoring tasks to

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<sup>121</sup> Burton et al. (2000)

<sup>122</sup> Williamson (1975)

<sup>123</sup> Burton et al. (2000); Williamson (1975)

<sup>124</sup> Alchian, Demsetz (1972)

<sup>125</sup> Williamson (1975)

<sup>126</sup> Burton et al. (2000)

managers since they have to be monitored as well. However, franchising is able to reduce costs and risks of free riding by allocating residual claimant rights to franchisees. By doing so, the franchisor is, on the one hand, creating incentives to make franchisees act in the interests of the franchisor and, on the other hand, it is reducing the entrepreneurial capacity constraint, which gives franchisees more creative freedom. As a result, the responsibility of monitoring is shifted to franchisees who have no incentive to shirk on monitoring since they would, otherwise, miss out on profits.<sup>127</sup>

It is suggested that this organization type is much more effective, especially for large companies, than hiring managers to supervise the monitoring. One reason might be the fact that the overall goals of franchisors and franchisees are more convergent compared to the goals of franchisors and external managers.<sup>128</sup> Since franchisees obtain a certain share based on overall turnover, they are keen on raising the present value of their outlet.<sup>129</sup> Nevertheless, performance of franchisees has to be controlled, which incurs ex post monitoring costs. Franchisors supervise their outlets conducted by either internal or external employees by doing inspection visits, quality control of products and services as well as revision of accounts and other control mechanisms.<sup>130</sup>

Williamson distinguished between remuneration and hostage effects. The former is referred to franchisee restrictions in the signed franchise agreement.<sup>131</sup> The reason is that “[...] the franchisor will be able to terminate the agreement almost at will [...],”<sup>132</sup> whereas the franchisee is bound to the contract.<sup>133</sup> From another point of view, the franchise contract strengthens the position of franchisors in order to prevent them from free riding and franchisees’ opportunism.<sup>134</sup> Another aspect is the franchise fee, which also results in the perception of a hostage effect.<sup>135</sup> Furthermore, asset specificity restricts the franchisee as well, which will be dealt with in more detail in

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<sup>127</sup> Garg, Rasheed (2003)

<sup>128</sup> Garg, Rasheed (2003)

<sup>129</sup> Mathewson, Winter (1985)

<sup>130</sup> Burton et al. (2000)

<sup>131</sup> Williamson (1983)

<sup>132</sup> Rubin (1978), p. 224

<sup>133</sup> Rubin (1978)

<sup>134</sup> Rubin (1978); Garg, Rasheed (2003)

<sup>135</sup> Burton et al. (2000)



chapter 3.1.1.<sup>136</sup> Finally yet importantly, the hostage effect becomes obvious in the franchisee dependency on technical improvements, sub supplies, potential tied purchases and trainings.<sup>137</sup> The remuneration effect is related to a franchisee incentive to enter and stay in the franchise system. It represents a certain share of the outlet's profits that the franchisee receives.<sup>138</sup>

The fourth cost type is servicing costs, which consists of knowledge and technology transfer to franchise partners in the host country. The franchisor has to establish a way that franchisees can properly replicate the business as stated in the contract. In addition, this has to be done for each and every market except the markets that are very similar. Servicing costs also include support and assistance services as well as training and instructions for the franchise outlet owners.<sup>139</sup>

It is argued that transaction costs can be reduced by the need of negotiating fewer franchise contracts in MUF systems compared to SUF ones. This is because a separate contract needs to be negotiated for each SUFee, whereas contracts made with MUFees cover the regulation of several outlets with a single counterpart.<sup>140</sup>

### 3.1.1. Asset specificity

This term refers to a certain level a firm-specific asset can be used and reproduced by competitors with its full initial production value. *Asset specificity* also includes the extent to which assets can be used for alternative purposes. It does not deal with ex ante issues alone since it also covers ex post governance structure effects.<sup>141</sup> Asset specificity is suggested to generate additional revenues and savings in production at the same time. Moreover, these benefits are not higher than costs for governance expenses that are inevitable in order to protect asset specificity.<sup>142</sup> Furthermore, no distinction is made between non-contractible and contractible assets.<sup>143</sup>

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<sup>136</sup> Williamson (1983)

<sup>137</sup> Burton et al. (2000)

<sup>138</sup> Mathewson, Winter (1985)

<sup>139</sup> Williamson (1975)

<sup>140</sup> Williamson (1975); Bradach (1995); Garg, Rasheed (2003)

<sup>141</sup> Williamson (1989)

<sup>142</sup> Williamson (1993)

<sup>143</sup> Williamson (1979); Klein et al. (1978)

Asset specificity might lead to bilateral dependence, which will be investigated in this paper as if partner transaction-specific investments will cause a perceived dependency between franchisor and franchisee.<sup>144</sup> More precisely, it refers to resources characterizing a relationship and describing a company's ability to differentiate its products and strategies from others (e.g., competitors).<sup>145</sup> In order to adapt and use specific assets such as technology, the franchisee has to make investments adjusted to the franchisor alone.<sup>146</sup> There might be some transmission problems by transferring firm specific assets to different foreign markets. Due to increased costs of protection, there is a higher likelihood that company owners favor equity modes by entering foreign markets.<sup>147</sup> Asset specificity might also be created by intangible assets such as relationships between workers and customers as well as work experience since these aspects might also increase performance of the firm.<sup>148</sup> What is more, "[...] the value of an intangible asset is derived by capitalizing its stream of earnings, and is presumably maximized by the entrepreneur who combines it with other inputs."<sup>149</sup> Technical knowledge would be an example of that. As a result, Anderson and Gatignon argue that generated knowledge related to specific assets such as training and operating processes have to be secured by higher control modes. According to that, a high degree of asset specificity is correlated to MUF.<sup>150</sup>

Human capital is only one example for asset specificity and develops through learning by doing over time. Location specificity is crucial for a company since sequential activities in close proximity can be accomplished more cheaply. As a result, transportation and inventory costs can be reduced. Physical specific assets represent machines, plants and production technology necessary for the production of goods. Investments in plants or technologies for a specific customer in order to enhance production efficiency is referred to dedicated assets. Brand name capital can also be a specific asset for a company.<sup>151</sup> As a result, the exploitation efficiency

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<sup>144</sup> Williamson (2008); Williamson (1993)

<sup>145</sup> Zhao et al. (2004)

<sup>146</sup> Brouthers, Hennart (2007)

<sup>147</sup> Sashi, Karuppur (2002)

<sup>148</sup> Anderson, Weitz (1986)

<sup>149</sup> Caves (1976), p. 573

<sup>150</sup> Anderson, Gatignon (1986)

<sup>151</sup> Brouthers, Hennart (2007)

of specific assets determines the organization mode of the franchise system.<sup>152</sup> A franchisor might decline to penetrate foreign markets with specific assets and prefer to allow franchisees take over and manage to obtain knowledge and technology, for instance.<sup>153</sup> Asset specificity is closely related to partner transaction-specific investments, which will be highlighted in chapter 4.

### 3.1.2. Uncertainty

In a general manner, *uncertainty* is defined as “[...] an individual’s perceived inability to predict something accurately.”<sup>154</sup> Uncertainties might harm the transaction process as a whole and lead to adaptations that incur transaction costs.<sup>155</sup> It is caused by obtaining too little information from the counterpart. Information asymmetry represents the status of uneven distribution of information among the parties involved.<sup>156</sup> This leads to information impactedness, which “[...] exists when true underlying circumstances relevant to the transaction, or related set of transactions, are known to one or more parties but cannot be costlessly discerned by or displayed by others.”<sup>157</sup> The occurrence of information impactedness is related to a first mover advantage by one of the parties due to the fact the other party has a shortage in task-, firm- and transaction-related experience. This superior knowledge can be used as a strategic resource in the business relationship.<sup>158</sup>

Furthermore, there are internal and external uncertainties a firm has to take into account by entering foreign markets. External uncertainty refers to an individual who is not able to realize the influence of future events concerning the organization.<sup>159</sup> Internal uncertainty describes the inability to attribute the performance of the firm to its organization members, despite applying output measures. As a result, performance of internal agents cannot be assessed accurately.<sup>160</sup> Uncertainty can

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<sup>152</sup> Dunning et al. (2007)

<sup>153</sup> Anderson, Gatignon (1986)

<sup>154</sup> Milliken (1987), p. 136

<sup>155</sup> Williamson (2008)

<sup>156</sup> Philips (1988)

<sup>157</sup> Williamson (1975), p. 31

<sup>158</sup> Williamson (1975)

<sup>159</sup> Milliken (1987)

<sup>160</sup> Anderson, Gatignon (1986)

also be divided into primary and secondary uncertainty. The former is related to a certain state or circumstance. Unpredicted consumer behavior would be a practical example of that. Secondary uncertainty results from a lack of communication among the parties where decisions and plans cannot be anticipated.<sup>161</sup> As a part of the empirical research, external and internal uncertainty is investigated by behavioral and environmental uncertainty variables.

### 3.2. Agency theory

Agency costs represent the sum of the principal's expenses on monitoring its agent(s), the bonding expenditures of the agent(s) and all expenditures related to residual loss.<sup>162</sup> These costs are related to ex post transaction costs as discussed in in the following sub-chapters.<sup>163</sup>

Agency theoretical problems occur when there is a conflict of objectives between principal and agent as well as when there is outcome uncertainty. These problems arise, especially in fields where two parties are dependent on each other and evaluations of the counterpart cannot be easily made.<sup>164</sup> These problems are typical for a franchisor-franchisee relationship.

The inherent problem franchisors fear is free riding due to the fact that misconduct on the franchisee side cannot be assigned properly while the latter is selling products and services under the brand's name. Some franchise systems establish franchise contracts in order to curb agency costs, which is beneficial for the franchisor. At the same time, franchisees are granted to use their local market knowledge to produce goods and services, which is supposed to result in a higher level of efficiency for both franchisor and franchisee. Franchisors benefit from a partner with local market knowledge and franchisees benefit from an established business model.<sup>165</sup> It is argued that franchisees expend full effort because their profits are determined by

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<sup>161</sup> Koopmans (1957)

<sup>162</sup> Jensen, Mekling (1976)

<sup>163</sup> Williamson (1985)

<sup>164</sup> Eisenhardt (1989)

<sup>165</sup> Mathewson, Winter (1985)

sales figures.<sup>166</sup> However, as Rubin suggests, franchisees do not expend full effort due to lack of ownership rights, which refers to vertical agency costs.<sup>167</sup> More precisely, it is the franchisee having incentives to make decisions on products or resources that are not in the interest of the franchisor. As a result, the franchisor has to counteract with control measures, which in turn increase agency costs. Horizontal agency costs describe the situation in which franchisees harm other franchise outlets by free riding which is related to customer mobility. A customer who has had a bad experience at one outlet might avoid entering another outlet at any other location. As a result, those outlets suffer on account of the cheating franchisee and might be encouraged to act in the same way.<sup>168</sup> It is the franchisor's task to detect cheating partners as it affects its profits, too. As a consequence, the higher the control and observation measures, the higher the propensity for opportunistic behavior to be detected and, as a consequence, the lower the likelihood of franchisee opportunism.<sup>169</sup>

Since usually both parties in a franchise relationship are unequal, it is inevitable to consider the dependence theory. Because the franchisor is the bigger party and the franchisee the smaller one, there is a dependence asymmetry. As stipulated in the contract, franchisees work exclusively for the franchisor and its brand. Also, the franchise contract says franchisees have to make system specific investments. Furthermore, they depend on the provision of support and management services, training and marketing measures. In turn, the franchisor is dependent on its franchisees in terms of development and growth of the brand as well as how the brand in the host market is represented by them. Since the franchisor receives franchise fees and royalties based on sales, he or she depends on the franchisee to successfully run the business. Additionally, the franchisor faces the risk of transferring local market knowledge to host markets.<sup>170</sup> The franchise contract is supposed to protect both brand and company from opportunistic behavior of existing, and, should also reduce problems in the course of adding new franchisees to the system.<sup>171</sup> Agency problems resulting from selecting the right partner in the

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<sup>166</sup> Garg, Rasheed (2003)

<sup>167</sup> Rubin (1978); Mathewson, Winter (1985)

<sup>168</sup> Mathewson, Winter (1985)

<sup>169</sup> Shane (1996b)

<sup>170</sup> Dant et al. (2013)

<sup>171</sup> Doherty, Alexander (2006)

internationalization process as well as perceived risk can be reduced by generated experience in franchising.<sup>172</sup>

Besides uncertainty about the counterpart's behavior, agency theory also deals with the problem of risk sharing, which arises due to different risk attitudes of the parties involved.<sup>173</sup> Whereas franchisees are considered to act in a risk averse way, franchisors are risk neutral due to the fact that they can reduce risk by diversification through different control modes, for instance. Risk can be diversified by working with various independent franchisees (SUF), which means the franchisor is not dependent on a small number of franchisees (MUF).<sup>174</sup> Another problem is inefficient risk bearing among the parties. Firstly, franchisees with less diversified risk might under invest in franchise outlets because they face the total risk and, simultaneously, require more funds compared to holders of diversified risk portfolios who have to pay attention to systematic risk issues only. MUFees are considered to be diversified risk holders, which is why the risk of under investment is higher for SUF.<sup>175</sup> Moreover, SUFees face constraints in raising capital.<sup>176</sup> Thus, "[...] a single-unit franchisee is less likely to be able to influence the adaptation of such investments to local conditions than would a multi-unit franchisee."<sup>177</sup> Secondly, the problem associated with compensation expectations is suggested to be lower in MUF compared to SUF because multi-unit franchisors with their diversified portfolio have more opportunities, i.e., franchise units, to cover marketing and sales expenses, for instance. That is why MUFees would rather accept a lower compensation per unit compared to SUFees,<sup>178</sup> since the latter has an undiversified portfolio and would, therefore, ask for a risk-adjusted compensation.<sup>179</sup> As a consequence, MUF systems are suggested to have fewer problems with inefficient risk bearing.<sup>180</sup> Furthermore, it is argued that MUF systems can manage agency issues in a more effective way compared to SUF ones.<sup>181</sup>

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<sup>172</sup> Eroglu (1992)

<sup>173</sup> Eisenhardt (1989)

<sup>174</sup> Fladmoe-Lindquist, Jacque (1995)

<sup>175</sup> Garg, Rasheed (2003),

<sup>176</sup> Hussain, Windsperger (2015)

<sup>177</sup> Garg, Rasheed (2003), p. 341

<sup>178</sup> Garg, Rasheed (2003)

<sup>179</sup> Brickley, Dark (1987)

<sup>180</sup> Garg, Rasheed (2003)

<sup>181</sup> Gomez (2010); Jindal (2011)

### 3.2.1. Adverse selection and moral hazard problem

Both *adverse selection* and *moral hazard* are agency theoretical problems and are dealt with in this chapter in particular. Generally, adverse selection is related to agents deliberately pretending to have skills and abilities that they, in fact, do not have.<sup>182</sup> Moreover, it refers to problems that the franchisor is not able to accurately assess the skills of franchise partners and their employees. However, in some cases it might be beneficial since franchise partners in foreign countries are better able to recruit suitable employees.<sup>183</sup> Thus, adverse selection can be described as a pre-contractual issue.<sup>184</sup> It is stated that franchisees are not likely to act opportunistically in finding suitable employees since they are interested in their own business doing well.<sup>185</sup>

Franchisors look for highly qualified franchisees to increase their brand value. However, this causes adverse selection problems since it “[...] creates an incentive for the less qualified to misrepresent their abilities to obtain employment.”<sup>186</sup> Garg and Rasheed argue that “in the case of IMUF, applicants’ knowledge that a local recruiter is involved, who is simultaneously a residual claimant, would serve to discourage opportunistic misrepresentation of abilities.”<sup>187</sup> Knowing that the franchisor’s income is connected to the franchisee’s performance makes the latter think that the counterpart exerts higher control in the selection process, so that misrepresentation is more likely to be detected. As a consequence, compared to SUF systems, franchisors operating with MUFees are able to reduce the adverse selection problem because the number of contacts is lower. Another adverse selection reducing effect is the responsibility shift in terms of recruiting, training and screening tasks toward the franchisee in MUF.<sup>188</sup>

According to Gilles et al., franchisors look for suitable franchisees with management experience as well as knowledge sharing skills. Franchisees will be rewarded by the

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<sup>182</sup> Eisenhardt (1989)

<sup>183</sup> Contractor, Kundu (1998a); Fladmoe-Lindquist, Jacque (1995)

<sup>184</sup> Bergen et al. (1992)

<sup>185</sup> Contractor, Kundu (1998a); Fladmoe-Lindquist, Jacque (1995)

<sup>186</sup> Shane (1996a), p. 219

<sup>187</sup> Garg, Rasheed (2003), p. 338

<sup>188</sup> Garg, Rasheed (2003)

option of unit expansion in the course of a tournament. The competition stimulates franchisee motivation and reduces agency problems.<sup>189</sup> The problem of choosing the right franchise partner remains, because the principal does not know the agent's business behavior, which is referred to as the moral hazard problem. Issues arise when the agent does not invest sufficient efforts, and the principal is not able to supervise the performance of its counterpart. The principal cannot be sure if he or she can blame the agent or other circumstances, not referring to the agent itself, for poor performance figures. Knowing that, agents might be encouraged to perform poorly and to shirk. In franchising agreements, however, the franchisee's income is based on its own performance and, therefore, franchisees are anxious to increase turnover by minimizing costs. As a result, the agent is supposed to act in the principal's sense whose monitoring expenses decrease.<sup>190</sup> Nevertheless, it cannot be ruled out that irrational incentives arise to act in an opportunistic fashion. This can be classified under behavioral uncertainty.<sup>191</sup>

Moral hazard occurs when there is a connection of "[...] inharmonious incentives with uncertainty."<sup>192</sup> Opposed to adverse selection problems, moral hazard is related to post contractual issues.<sup>193</sup> At least one party has to bear the risk of uncertainty in the course of agreeing on a contract. The concerned party will put a risk premium on the price or agreement. However, this might lead to opportunistic behavior by the counterpart. As a result, the partner's behavior has to be supervised which leads to an increase in monitoring costs.<sup>194</sup> Post contractual opportunism is caused by the fact that consequences in terms of efficiency cannot be assessed and evaluated properly before the contract is signed which is why the person concerned tries to achieve one's aim at the expense of others.<sup>195</sup> Problems resulting from moral hazard, like the occurrence of free riding, can be reduced by experience ratings and ex post auditing.<sup>196</sup>

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<sup>189</sup> Gillis et al. (2011)

<sup>190</sup> Fladmoe-Lindquist, Jacque (1995)

<sup>191</sup> Rubin (1978)

<sup>192</sup> Williamson (1975), p. 84

<sup>193</sup> Bergen et al. (1992)

<sup>194</sup> Williamson (1975)

<sup>195</sup> Milgrom, Roberts (1992)

<sup>196</sup> Williamson (1975)



### 3.2.2. Shirking and free riding

The *free riding* problem arises when the agent behaves in a beneficial way for himself or herself without incurring the respective costs. It is true that there are some free riding reducing effects like the remuneration and hostage effect, however, franchisees still tend to free ride.<sup>197</sup> Franchisees might report wrong sales figures and high expenditures, which would then reduce overall profits.<sup>198</sup> In addition, franchisors might have to suffer increased residual claim demands from their counterpart caused by franchisees' shirking. An example would be savings on operating costs. In doing so, franchisees use alternative products with lower quality and, therefore, lower operating costs.<sup>199</sup>

Opportunistic behavior in the form of free riding can also be caused by the existence of brand name capital, stimulating customers to think that there is no quality difference between different franchise outlets. Considering the brand name capital of a franchisor, *shirking* is related to the free riding problem. Franchisees may shirk on quality without suffering a drop in sales because the brand name leads the consumer to believe the quality is good. More precisely, the franchisee benefits from the brand name by not adhering to standardized agreements stipulated in the franchise contract.<sup>200</sup> In case a franchise outlet produces below-standard products by trying to save costs, the dissatisfaction of customers effects the whole franchise chain and causes bad reputation.<sup>201</sup> The reputation of a strong brand name enables franchisees to free ride, which increases monitoring costs to detect them for the franchisor.<sup>202</sup> The free riding franchisee benefits by the reputation of the brand and, at the same time, saves costs for inferior quality products or services. As a result, the profits are increasing despite the costs for the negative effects of inferior quality that are borne by the whole franchise system. Other franchise outlet owners might be encouraged or forced to follow suit since sales figures drop and costs have to be saved to economize profitably. As a consequence, the whole chain faces a downward trend.<sup>203</sup>

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<sup>197</sup> Anderson, Gatignon (1986)

<sup>198</sup> Burton et al. (2000)

<sup>199</sup> Fladmoe Lindquist, Jacque (1995)

<sup>200</sup> Garg Rasheed (2003)

<sup>201</sup> Burton et al. (2000)

<sup>202</sup> Garg Rasheed (2003)

<sup>203</sup> Felstead (1991)

In order to maintain a good reputation, the franchisor can work against opportunistic behavior by controlling and policing operations.<sup>204</sup>

A franchise outlet that mainly serves one-time customers incurs a low probability that free riding franchisees will be punished by the franchisor. The reason is that the reduction of quality of products and services does not affect the sales figures of the cheating outlet. Therefore, the franchisor has to create incentives for such types of franchisees to maintain quality standards, despite the fact that repeat customer purchases are not likely to happen.<sup>205</sup> To circumvent opportunism and make the cheating franchisee to suffer from its behavior, the franchise outlet should be located in areas with potential repeat consumers.<sup>206</sup>

It is also argued that an incentive like franchisee's residual claimancy is not sufficient to neglect or abandon monitoring at all. There are different points of view in terms of priority, time horizon and remuneration type between franchisors and both SUFees and MUFees which might lead to conflicts. Whereas franchisors prioritize brand name capital, SUFees prioritize on profitability and MUFees on both. As regards time horizons, franchisors and MUFees prefer a long-term view, whereas SUFees have a short-term view. In terms of remuneration, franchisors attain a certain percentage of sales on top of franchise fees, whereas both SUFees and MUFees want to be remunerated by net profits.<sup>207</sup> The differences between franchisors and SUFees is suggested to be higher compared to MUFees due to higher system specific investments of the latter. Thus, MUFees are more likely to take care and protect the brand name because they might suffer higher damages due to the higher number of outlets compared to a SUFee with one outlet.<sup>208</sup> The usage of SUF implies a reduction of shirking due to the SUFee's nature of being a residual claimant. In contrast to Dant and Nasr, Gomez et al. argue that control is replaced by the incentive of residual claimancy. However, it has to be noted that this is only true for SUF.<sup>209</sup> Nevertheless, operating with SUF bears the problem of free riding since SUFees are able to exploit benefits based on reduced operating costs by only

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<sup>204</sup> Burton et al. (2000)

<sup>205</sup> Garg Rasheed (2003)

<sup>206</sup> Bradach, Eccles (1989)

<sup>207</sup> Dant, Nasr (1998)

<sup>208</sup> Garg, Rasheed (2003)

<sup>209</sup> Gomez et al. (2010)

suffering a relatively low extent of negative effects, such as loss of clients and damages in brand reputation.<sup>210</sup> Thus, based on the higher amount of investments made by MUFees, free riding problems can be diminished by the franchisor's usage of MUF.<sup>211</sup> It can be concluded that "shirking (a hierarchy problem) is reduced by SUF (a market solution) at the expense of generating the potential for free riding (a market problem)."<sup>212</sup>

According to Klein, there is another approach to counteract free riding or opportunistic behavior in general. It is argued that the franchisor has to create monetary incentives for franchisees not to free ride, which is referred to as *bonding*. This payment has to be bigger compared to the amount the franchisee would benefit from by acting opportunistically. In case the payment outweighs the benefits of opportunistic behavior, there is no incentive for franchisees to free ride any more. It is true that this measure incurs costs; however, franchisees are forced to pay back the amount in case they act opportunistically. Due to the fact it is the money of the franchisor at stake, there is also no incentive for him to cheat or act opportunistically.<sup>213</sup> Considering the distinction between SUF and MUF, there is less propensity for MUFees to act opportunistically due to the fact that they have much more assets at stake compared to a single outlet owners.<sup>214</sup> In addition, there is a higher information flow from franchisees to franchisors in MUF due to the convergence of objectives in terms of keeping value of brand name, which results in a lower propensity to free ride compared to SUF.<sup>215</sup>

### 3.2.3. Geographical distance

Time and distance enhance uncertainty between principal and agent.<sup>216</sup> Moreover, geographical distance negatively affects the level of internationalization the firm wants to achieve.<sup>217</sup> Monitoring costs increases with increasing geographical and

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<sup>210</sup> Brickley, Dark (1987)

<sup>211</sup> Gomez et al. (2010)

<sup>212</sup> Gomez et al. (2010), p. 464

<sup>213</sup> Klein (1995); Shane (1996b)

<sup>214</sup> Garg, Rasheed (2003)

<sup>215</sup> Dant, Nasr (1998)

<sup>216</sup> Gomez et al. (2010)

<sup>217</sup> Alon (2006b)

cultural distance. The former arises when branches and headquarters are physically far away from each other. In connection with a decentralized organization of a business, this might increase the principal's lack of information about what its agents are doing.<sup>218</sup> It is concluded that the greater the distance of franchise outlets to its headquarters, the higher the propensity for the usage of franchise modes.<sup>219</sup> More precisely, assuming geographical and cultural differences between franchisor and franchisee, Nasr argues that the franchise mode (SUF or MUF) with the lower likelihood of obstacles in information flow is the preferred one.<sup>220</sup> In that respect, franchise modes are preferred by company owners because they can synchronize the behavior and actions of franchisees with theirs. By doing so, the costs of self-selection and moral hazard are shifted from the franchisor to the franchisee. As discussed previously, franchisors are faced with the problem of opportunistic behavior of their partners. Gomez et al. state that "[...] the geographical concentration of the units of the network reduces the problem of shirking because the proximity of the units makes the task of monitoring easier and less costly, since economies of scale can be achieved for control purposes."<sup>221</sup> But, high geographical concentration is correlated to increased free riding problems. In that context, high geographical distance among the units reduces free riding problems, because opportunistic behavior would primarily harm the franchisee itself.<sup>222</sup> Based on that, Martin argues that franchising is rather applied to geographically dispersed locations.<sup>223</sup>

Generally speaking, franchisees are better off monitoring their actions because they are responsible for bad performance resulting from shirking.<sup>224</sup> Due to pioneering developments in the field of electronic communications in recent years, monitoring costs have decreased significantly. The use of the Internet and cell phones, for instance, eases communication, especially when there is a huge distance between the franchisor and the franchisee.<sup>225</sup> Nevertheless, in spite of the technological developments, the costs of managing far away distant franchise outlets could

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<sup>218</sup> Gomez et al. (2010)

<sup>219</sup> Brickley, Dark (1987)

<sup>220</sup> Garg, Rasheed (2003)

<sup>221</sup> Gomez et al. (2010), p. 468

<sup>222</sup> Gomez et al. (2010)

<sup>223</sup> Martin (1988)

<sup>224</sup> Fladmoe-Lindquist, Jacque (1995)

<sup>225</sup> Hoffman, Preble (2004)

increase due to lack of experience.<sup>226</sup> Consequently, it is argued that lack of experience is decreasing with the increase of generated international experience.<sup>227</sup>

Considering SUF and MUF in this context, it is suggested that adverse selection problems are lower for MUF compared to SUF when the geographical distance is low. Therefore, there is a higher likelihood that franchisors opting for MUF when the geographical distance between the outlets is low<sup>228</sup> and in cases markets are contiguous<sup>229</sup> and demographically similar.<sup>230</sup> Due to the fact that MUF have been granted outlets at more than one location, they are located closer to potential and well-suited candidates throughout the region and, therefore, could save recruiting costs. These costs are a part of search costs.<sup>231</sup> The risk of selecting the right partner and moral hazard issues can be mitigated by using MUF due to its incentive enhancing effect.<sup>232</sup>

### 3.2.4. Cultural difference

Hofstede developed four dimensions that culture can be divided into. These are uncertainty avoidance, power distance, individualism and masculinity. Uncertainty is omnipresent for all human beings and leads to fear. Technology, law, religion are ways to deal with an uncertain future.<sup>233</sup> More precisely, “[...] technology includes all human artifacts; law, all formal and informal rules that guide social behavior; religion, all revealed knowledge of the unknown.”<sup>234</sup> In an organizational context, ways to cope with uncertainty represent rituals, technology and rules. Rituals in organizations are not able to make the future more foreseeable; however, they are capable of reducing fear and stress of uncertainty. Meetings held in organizations represent a ritual characterized by the company’s own language, liturgy as well as ‘dos’ and ‘don’ts.’ As a result, business practices might be different compared to the home

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<sup>226</sup> Alon (2006b)

<sup>227</sup> Fladmoe-Lindquist, Jacque (1995)

<sup>228</sup> Gomez et al. (2010)

<sup>229</sup> Hussain, Windsperger (2015)

<sup>230</sup> Kalnins, Lafontaine (2004)

<sup>231</sup> Garg, Rasheed (2003)

<sup>232</sup> Gomez et al. (2010)

<sup>233</sup> Hofstede (1991)

<sup>234</sup> Hofstede (2001), p. 146

country. Technology is able to reduce uncertainty by implementing standardized processes and, therefore, increasing predictability. However, this is only true for a short-term view since malfunctions of these automated processes can be harmful and costly for the organization. Rules are suggested to reduce internal uncertainty by making people's behavior more predictable. Thereby, it has to be noted that people act both rationally and irrationally. It is also stated that rules might limit the people's autonomy considerably. There is a high degree of authority of rules in countries characterized by a high degree of uncertainty avoidance. Authority of rules has to be distinguished from authority of persons, which is referred to as power distance.<sup>235</sup>

Power distance differs from country to country, but is basically based on human inequality in terms of wealth, prestige and power. Also, power distance is important in every organization to ensure a smooth decision-making process and manifests itself in superior-subordinate relationships. Mulder states that the more power a person might have over another person, the higher the level of satisfaction. Moreover, the more powerful party tries to enhance the power distance to their less powerful counterpart. This effect is strengthened by the prevailing power gap between the two parties. The lower the gap the higher the tendency of the less powerful party to reduce it.<sup>236</sup>

The third dimension represents individualism and illustrates "[...] the relationship between the individual and the collectivity that prevails in a given society."<sup>237</sup> The social norms and values of major groups in the country determine the relationship. In some countries, individualism is appreciated, whereas in other countries it is not accepted. As a result, norms determine the relationship between the organization and the individual. Beside the influence on the person itself, there are also political, religious and educational influences. In collectivistic countries, there is a higher dependency of employees on the employer, who in turn takes responsibility for their employees. On the contrary, there is a conflict between the value of people and norms in individualistic societies. From an organizational point of view, the mix of individualism and collectivism is also determined by company size and history, prevailing company culture as well as the educational level of employees. As a

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<sup>235</sup> Hofstede (1991)

<sup>236</sup> Hofstede (1991); Mulder (1977)

<sup>237</sup> Hofstede (1980), p. 148

consequence, the level of collectivism and individualism has an impact on employees justifying to deal with employer requirements. Furthermore, the prevailing level influences the appointment of top management positions.<sup>238</sup>

Masculinity is the fourth dimension in Hofstede's framework and deals with differences between males and females in the social environment.<sup>239</sup> It is argued that "[...] the predominant socialization pattern is for men to be more assertive and for women to be more nurturing."<sup>240</sup> This is true for high masculine cultures. Stereotypes differ from country to country and evolve through interaction in school, contact with peer groups and by media reporting. Masculine objectives are supposed to be inherent in the business environment and promote men, whereas feminine objectives occur in hospitals and promote women. This traditional point of view might harm organizations because vacancies could be filled with more suitable personnel or tasks could be done more efficiently by neglecting sex stereotypes.<sup>241</sup>

Cultural differences could lead to increased monitoring costs and are defined as the differences in culture between the franchisor's home and the foreign host country.<sup>242</sup> Differences might occur in religion, ethics as well as preferences, habits and tastes.<sup>243</sup> Moreover, communication efficiency is affected as well as the proper flow of information between the two parties.<sup>244</sup> Selecting and supervising personnel in cultural distant markets is stimulating franchising usage due to adverse selection problems of company owners using equity modes, on the one hand, and the familiarity of the local partner with the host labor market, on the other hand.<sup>245</sup> Information flow costs increase due to cultural differences.<sup>246</sup> The language differences represents one of the main problems in a franchisor-franchisee relationship because process descriptions and training methods have to be translated. Moreover, the franchisor has to be aware of possible problems when

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<sup>238</sup> Hofstede (1991)

<sup>239</sup> Hofstede (1991)

<sup>240</sup> Hofstede (1980), p. 176

<sup>241</sup> Hofstede (1980); Hofstede (1991)

<sup>242</sup> Fladmoe-Lindquist, Jacque (1995)

<sup>243</sup> Jell (2012)

<sup>244</sup> Johanson, Vahlne (1977)

<sup>245</sup> Shane (1996b); Martin (1988)

<sup>246</sup> Demirbag et al. (2009)

cultural norms hit business strategy and implementation.<sup>247</sup> Admittedly, serving a distant market leads to higher transaction costs due to higher propensity of information asymmetry and opportunistic behavior.<sup>248</sup> Nevertheless, in a franchise system, the franchisor shifts the cultural risk to its franchise partners in the host market. As a result, franchisees bear the risk of fit of culture and business.<sup>249</sup> Anderson and Gatignon argue the same by specifically claiming that cultural distance problems could be eliminated through entering foreign markets without specific assets. By doing so, the risk is shifted to franchisees who have to create substitute assets on their own. However, if asset specificity is high, which implies that it is hard to replicate key assets for franchisees, it harms both franchisor and franchisee since efficiency decreases.<sup>250</sup>

Cultural distance stimulates external uncertainty due to an unpredictable environment.<sup>251</sup> When the cultural distance between home and host market is high, franchisees might have to adjust the product range as well as marketing and sales activities tailored to local market conditions. Franchisees in the local market can assess the specific market needs more easily and accurately because they know the culture and inhabits better than the franchisor does.<sup>252</sup> It is argued that the higher the cultural distance between home and host market, the higher the selection, supervision and control costs.<sup>253</sup> As a result, in case the culture in the franchisor's country is similar to that of the franchisee, only a few adaptations have to be made.<sup>254</sup> The degree of cultural distance affects the level of control mode. It is argued that the higher the cultural distance, the higher the propensity of lower control modes (SUF). However, if asset specificity is high, the franchisor tends to favor higher control modes (MUF).<sup>255</sup>

### 3.3. Trust

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<sup>247</sup> Fladmoe-Lindquist, Jacque (1995)

<sup>248</sup> Demirbag et al. (2009)

<sup>249</sup> Fladmoe-Lindquist, Jacque (1995)

<sup>250</sup> Anderson, Gatignon (1986)

<sup>251</sup> Anderson, Gatignon (1986)

<sup>252</sup> Sashi, Karuppur (2002)

<sup>253</sup> Demirbag et al. (2009)

<sup>254</sup> Hoffman, Preble (2004)

<sup>255</sup> Anderson, Gatignon (1986)



Both trust and contracts are suggested to facilitate exchanges among parties. However, it remains unclear to what extent trust can be complimentary or even a substitute for contracts. In theoretical constructs with perfect competition, trust becomes obsolete since both parties have perfect information about each other and contracts can be perfectly specified. In case one party cheats on their counterpart, there are plenty of potential other parties with whom contracts can be entered. Since there is perfect information, everyone will notice it when one party cheats on their counterpart. As a consequence, there is no incentive to act opportunistically since the reputation of the parties represent a capital asset. As a result, in a perfect world with the underlying assumptions, trust would not be necessary for all types of exchanges.<sup>256</sup>

In a realistic world with imperfect competition and information, however, trust is required among the interdependent parties involved to achieve personal and organization aims.<sup>257</sup> Gulati states that “[...] trust can substitute for hierarchical contracts in many exchanges and serves as an alternative control mechanism.”<sup>258</sup> This is especially true when trust leads to cooperation between two parties representing a cheaper and more effective protection compared to hierarchical contracts. Among others, Bradach and Eccles also claim that interpersonal trust relationships are inherent in every economic exchange and outweigh rational choice thoughts. Trust represents a kind of expectation reducing the concerns of the parties involved that the counterpart may act in an opportunistic manner. Moreover, it is suggested that transactions are determined by authority, price and trust rather than markets and hierarchies.<sup>259</sup> Williamson comments on that by saying that this implication is valid for exchanges within families only.<sup>260</sup>

In any case, a trustor has to be convinced of the counterpart’s behavior in the future, which incurs potential risk. Risk is referred to as uncertainty of outcomes as well as vulnerability arising from the relationship.<sup>261</sup> A person has to be reliable in order to be considered as trustworthy. Reliable in that sense means to do the right thing related

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<sup>256</sup> Thomas (1993)

<sup>257</sup> Mayer et al. (1995)

<sup>258</sup> Gulati (1995), p. 93

<sup>259</sup> Bradach, Eccles (1989)

<sup>260</sup> Williamson (1993)

<sup>261</sup> Doney et al. (1998)

to matching normative expectations as well as technical competences. Normative expectations are referred to the importance of both output and processes and procedures, resulting in that certain output, at the same time. The determinants impacting trust are not stable—they depend rather on the task and context.<sup>262</sup> In contrast to that, Parsons suggests four characteristics that are necessary to establish trust between two parties. The first aspect represents the common ground of values of both parties. Secondly, those common values have to be capable of being converted into common goals. Thirdly, both parties must be equally involved in the process. The fourth condition is competence and integrity.<sup>263</sup>

Doney et al. suggest five dimensions of trust development interrelated in practical usage, namely the calculative, prediction, intentionality, capability and transference process. The calculative process arises due to the trustor's assumption of trustees trying to act self-interested and opportunistic by nature.<sup>264</sup> Consequently, the trustor weighs the costs of opportunistic behavior against benefits of cooperative behavior of the trustee.<sup>265</sup> Evaluating the counterpart's behavior in the past and projecting it into the future is referred to the prediction process. By doing so, trustees' actions in the past are considered and checked whether they were in accordance with what the trustee communicated. This enables the trustor to verify the counterpart's predictability. The higher the trustor's perceived degree of predictability of trustee behavior, the higher the trust.<sup>266</sup> The intentionality process targets on the trustor's evaluation of the trustee's intention based on what was communicated and executed accordingly.<sup>267</sup> Trust develops when trustees act on goodwill by seeking to increase value of the brand and targeting on achieving common goals, such as profits.<sup>268</sup> As a result, "[...] a behavioral assumption to an intentionality process is that individuals are geared toward each other – not themselves."<sup>269</sup> As a prerequisite for trustor's trust, both trustor's expectation of their counterpart and trustee's capability to comply with arrangements and requirements are considered in the capability process. The transference process deals with trust development through the integration of a known

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<sup>262</sup> Critin (1993)

<sup>263</sup> Parsons (1969)

<sup>264</sup> Doney et al. (1998)

<sup>265</sup> Lindsold (1978)

<sup>266</sup> Doney et al. (1998)

<sup>267</sup> Lindsold (1978)

<sup>268</sup> Mayer et al. 1995; Doney et al. (1998)

<sup>269</sup> Doney et al. (1998), p. 606

third party verifying trustworthiness of the trustee. Thereby, trust evaluation is passed on to other parties whose trustworthiness needs to be assured in the first place.<sup>270</sup> This is likely to occur in strong tie networks where trust can be transferred conveniently.<sup>271</sup>

Mostly, previous literature has investigated trust in an employer-employee and buyer-seller relationship or inter-organizational scope, whereas there is less research regarding how franchisors establish and maintain the trust of their counterpart.<sup>272</sup> From a franchisor's point of view, trust in general is defined as "[...] an expectation that partners, including potential partners, have goodwill and benign intent in their dealing with us."<sup>273</sup> The underlying assumption is that the parties involved have perfect information about each other's intentions.<sup>274</sup> Uncertainty among franchisor and franchisee decreases by building up trust among the interdependent parties.<sup>275</sup>

Trust is based on the franchisor's integrity and competence. Brand reputation as well as successful franchise systems signal competence<sup>276</sup> and integrity arises from interactions and proper behavior in accordance with the underlying contract.<sup>277</sup> Due to lack of franchise benchmarks and experience, franchisees rather have to focus on integrity by verifying trust. The relationship is evaluated by considering the decision making process in case there are no obvious or tangible outcomes.<sup>278</sup> Dant et al. claim that trust depends on frequency of interactions between franchisor and franchisee.<sup>279</sup> As a result, the degree of trust a franchisee has in its counterpart is suggested to be important in order to curb opportunism and free riding. What is more, franchisee's trust level influences its position and attitude toward the franchise relationship.<sup>280</sup>

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<sup>270</sup> Doney et al. (1998)

<sup>271</sup> Granovetter, (1985)

<sup>272</sup> Croonen, Band (2013)

<sup>273</sup> Yamagishi, Yamagishi (1994), pp. 135

<sup>274</sup> Yamagishi, Yamagishi (1994)

<sup>275</sup> Davies et al. (2011)

<sup>276</sup> Davies et al. (2011)

<sup>277</sup> Scheer, Stern (1992)

<sup>278</sup> Davies et al. (2011)

<sup>279</sup> Dant et al. (2013)

<sup>280</sup> Dickey et al. (2007)

Trust is very important and a prerequisite for the success of the franchise system, which means beneficial outcome for both parties. More precisely, the success depends on intra organizational and interpersonal trust. Trust ensures that both parties adhere to contractual agreements.<sup>281</sup> Moreover, monitoring costs can be reduced when both parties trust each other.<sup>282</sup> More precisely, trust diminishes anxiety of opportunism and behavioral uncertainty, which is why control and monitoring measures are required to a lesser extent. Since franchisees are supposed to act honestly and share information with the franchisor, trust is able to make control and monitoring obsolete even in situations where performance is hard to evaluate. As a consequence, there is a negative relationship between the level of trust and the need for control.<sup>283</sup> In contrast to that, Williamson states that franchisors relying on the adherence of franchisees are associated with risk regardless of the latter promising to tell the truth.<sup>284</sup> In case the franchisee does not trust the franchisor any more, the former might act opportunistically. A dissatisfied franchisee might harm the company in terms of poor sales figures and leads to difficulties in the recruiting process.<sup>285</sup> One particular reason is that opportunistic behavior caused by lack of trust damages the franchise brand.<sup>286</sup>

When trust is high in a franchisor-franchisee relationship there is no need to shift decision rights to the franchisee as an incentive measure in case franchisee performance is hard to evaluate. As a result, besides behavioral uncertainty, there is also an instant effect of trust on a franchisee's decision making.<sup>287</sup> A high level of trust also implicates that "[...] franchisors increase the delegation of operational decisions to franchisees, as environmental uncertainty increases."<sup>288</sup> Therefore, high trust mitigates harmful effects caused by environmental uncertainty. Due to the fact that SUFees are suggested to have more intense contact with their franchisor, trust is supposed to be higher in SUF systems compared to MUF relationships.<sup>289</sup> In addition, high level of trust between franchisor and franchisee leads to lower agency

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<sup>281</sup> Davies et al. (2011)

<sup>282</sup> Davies et al. (2011)

<sup>283</sup> Mumdziev, Windsperger (2013)

<sup>284</sup> Williamson (1993)

<sup>285</sup> Davies et al. (2011)

<sup>286</sup> Baucus et al. (1996)

<sup>287</sup> Mumdziev, Windsperger (2013)

<sup>288</sup> Mumdziev, Windsperger (2013), p. 179

<sup>289</sup> Dant et al. (2013), p. 479

costs the franchise system has to bear.<sup>290</sup> Moreover, trust affects the franchisor's knowledge transfer mechanisms. There is a positive relationship between the tacitness of knowledge, the usage of high-level information richness (HIR) knowledge strategy and the usage of a personalization strategy by the franchisor. HIR is referred to seminars, visits and trainings, whereas low information richness (LIR) consists of e-mails, reports and databases.<sup>291</sup> Trust also stimulates information sharing between the two parties and reduces relational risk.<sup>292</sup> Based on an empirical study conducted in Austria, it is argued that "[...] if trust reduces relational risk, more trust reduces the use of HIR-knowledge-transfer mechanisms and increases the use of LIR-knowledge-transfer mechanisms."<sup>293</sup>

Trust can be divided into general and knowledge-based trust. The distinction will be highlighted and dealt with in chapters 4.1. and 4.2.

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<sup>290</sup> Palmatier et al. (2007)

<sup>291</sup> Gorovia, Windsperger (2013)

<sup>292</sup> Mumdziev, Windsperger (2013)

<sup>293</sup> Gorovia, Windsperger (2013), p. 1128

## 4. Influences on the choice between SUF and MUF: Theoretical concepts

### 4.1. Knowledge-based trust

If the parties' perception of goodwill of each other is strong and can refer to previous actions and information accumulated by past interactions, it is called knowledge-based trust. Moreover, the parties are certain that their counterpart is not going to cheat, even though there might exist incentives to do so.<sup>294</sup> More precisely, successful trustful interactions lead to both parties' perception that the counterpart is not willing to harm or exploit oneself.<sup>295</sup> As a result, the parties "[...] are more willing, by sharing more sensitive information, to place oneself in situations where another's opportunism, if affected upon, would be more damaging."<sup>296</sup>

Knowledge-based trust does not take into account reputation, norms and assumed trustworthiness by assessing the counterpart. What is more, trust develops by the increasing number of interactions between the two parties.<sup>297</sup> Regarding the franchisor-franchisee relationship in knowledge-based trust, continuous repeating interactions will increase the knowledge of the trustor about the trustee.<sup>298</sup> Positive interactions result in perceived fairness and credibility as well as augmented trust and reputation. Consequently, the franchisor will remain with established and trusted franchise partners and expand via MUF rather than to give single unit franchise contracts to new business partners.<sup>299</sup> The reason is that the franchisor has no experience in working with the new partner and fears difficulties.<sup>300</sup> It is argued that "[...] knowledge-based trust has a positive impact on MUF, due to its screening effect."<sup>301</sup> As a consequence, the following hypothesis is proposed:

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<sup>294</sup> Yamagishi, Yamagishi (1994)

<sup>295</sup> Whitener et al. (1998)

<sup>296</sup> Droege et al. (2003), p. 52

<sup>297</sup> Droege et al. (2003)

<sup>298</sup> Yamagishi, Yamagishi (1994)

<sup>299</sup> Griessmair, et al. (2014)

<sup>300</sup> Bradach, (1995)

<sup>301</sup> Griessmair et al. (2014), p. 2

H1: A high level of knowledge-based trust is correlated to a high propensity for a franchisor to favor MUF over SUF.

## 4.2. General trust

Contrary to knowledge-based trust, general trust involves bias and is not restricted to particular objects.<sup>302</sup> Thus, “[...] general trust as a positive cognitive bias plays a role when sufficient knowledge of the partners are lacking. It helps one to move out of familiar relations.”<sup>303</sup> As a result, general trust is used and needed when the party did not have interactions with their exchange partner in the past or if the party wants to establish relations to new business partners.<sup>304</sup> In contrast to knowledge-based trust, general trust is argued to be less resilient because two parties are willing to forgive minor abuses of trust.<sup>305</sup>

A high level of general trust in a franchisor-franchisee relationship leads to the franchisor’s perception of low relational risk. As a result, there is a low level of monitoring and agency costs by choosing new franchise partners for single outlets. What is more, there is a tendency to fewer controls on the part of the franchisor over the franchisee. More precisely, there is a negative correlation between general trust and MUF as a control tool. Because the franchisor is not willing to increase control, monitoring and agency costs by choosing franchisees with multi-units, a high level of general trust relates to SUF usage.<sup>306</sup> Hence, the following hypothesis is formulated:

H2: The higher the level of general trust, the higher the propensity for a franchisor to use SUF.

## 4.3. Partner transaction-specific investments

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<sup>302</sup> Yamagishi, Yamagishi (1994),

<sup>303</sup> Yamagishi, Yamagishi (1994), p. 139

<sup>304</sup> Yamagishi, Yamagishi (1994)

<sup>305</sup> Droege et al. (2003)

<sup>306</sup> Griessmair et al. (2014)

Transaction partners create specificity by making investments with unique tangible or intangible resources tailored to the transaction.<sup>307</sup> Those investments represent a potential source of competitive advantage and support the business doing well.<sup>308</sup> Furthermore, it has, at least, a low or even zero value for parties outside the partnership. But, specific investments might also be disadvantageous as the franchisee is locked in the relationship and barriers to exit are high. Partner transaction-specific investments always involves risk due to the fact that associated costs are sunk costs. Moreover, the franchisor is able to use or exploit the value of the investment in an opportunistic manner.<sup>309</sup> Opportunistic behavior could arise due to information asymmetry and contractual incompleteness.<sup>310</sup> Jell-Ojobor and Windsperger suggest that the control mode depends on the symmetry of transaction-specific investments between franchisor and franchisee.<sup>311</sup> As a result, the exchange relationship improves and cooperative behavior is stimulated due to mutual dependency.<sup>312</sup> Mutual exchanges lead to advantages for both sides compared to transaction-specific investments mainly made by one party alone. But, this is only true when the risk incurred by the disclosure of transaction-specific investments in connection to both costs and efforts, is mutually rewarded by a credible commitment without striving for opportunism.<sup>313</sup>

High transaction-specific investments made by a franchisee leads to a bonding effect because resulting quasi rents outweigh monetary benefits of acting opportunistically.<sup>314</sup> However, Rokkan et al. claim that whether the parties act opportunistic or in goodwill depends on their relationship. In case of a solidary relationship between franchisor and franchisee, the bonding effect is significantly dominant. Additionally, a long future time horizon of cooperation strengthens the effect to act in goodwill. Vice versa, non-solidary relationships provoke opportunism as well as a short-time horizon because there is no incentive to act in goodwill and both parties tend to focus on increasing their individual payoff at the expense of their

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<sup>307</sup> Zhao et al. (2004)

<sup>308</sup> Ghosh, John (1999)

<sup>309</sup> Rokkan, et al. (2003); Williamson (1985)

<sup>310</sup> Jell-Ojobor (2012)

<sup>311</sup> Jell-Ojobor, Windsperger (2014)

<sup>312</sup> Rokkan et al. (2003)

<sup>313</sup> Williamson (1983)

<sup>314</sup> Mumdziev, Windsperger (2013)



counterpart.<sup>315</sup> The bonding effect enhances the importance of the franchise contract and, therefore, the propensity that franchisees behave in accordance with contractual agreements.<sup>316</sup>

Transaction-specific investments on the franchisee side are crucial to set measures to promote and develop the brand in the host market. Moreover, the franchisee has to incur expenditures for branded furniture and equipment. Furthermore, time and money for establishing a supplier network and customer relationships have to be invested<sup>317</sup> and advertising costs for the new business launch have to be covered by franchisees.<sup>318</sup>

It is the franchisor's responsibility to transfer the system specific assets to the host market. In order to make sure that there is no decrease in value by transferring the assets, the franchisor might implement transaction-specific communication tools, training, adaption services and instruct standardized processes.<sup>319</sup> Mumzdiev and Windsperger argue that the franchisor benefits by the fact that the "[...] self-enforcing effect of transaction specific investments in turn decreases the costs related to controlling and monitoring franchisees, thereby reducing the franchisor's need to exercise more control over franchisees' actions."<sup>320</sup> However, on the contrary, this thesis claims that the higher the system specificity, the higher the transaction-specific investments and, therefore, the higher the required commitment of the franchisor. Resulting from higher investments and commitments, the franchisor is supposed to be afraid of free riding and under-investment issues from the counterpart and, thus, preferring higher control modes.<sup>321</sup> As a consequence, this paper suggests the following hypotheses:

H3: Higher transaction-specific investments lead to a higher tendency toward MUF.

#### 4.4. Behavioral uncertainty

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<sup>315</sup> Rokkan et al. (2003)

<sup>316</sup> Klein (1995); Ghosh, John (1999)

<sup>317</sup> Heide, John (1988)

<sup>318</sup> Mumzdiev, Windsperger (2013)

<sup>319</sup> Jell-Ojobor (2012)

<sup>320</sup> Mumzdiev, Windsperger (2013), p. 174

<sup>321</sup> Heide, John (1988)

Sources of behavioral uncertainty are a partner's strategic nondisclosure, deliberate withholding or concealment of information.<sup>322</sup> This can be referred to as opportunistic behavior leading to agency problems resulting from information asymmetry and uncertainty.<sup>323</sup> It is the franchisor's internal uncertainty since he or she faces difficulties in assessing performance to its franchisees.<sup>324</sup> Behavioral uncertainty is claimed to enhance "[...] the franchisor's opportunism risk that arises in the form of dishonest and detrimental behavior of franchisees, such as cheating, shirking, or distortion of information."<sup>325</sup> Geographical distance is supposed to strengthen behavioral uncertainty problems.<sup>326</sup> In order to curb behavioral uncertainty, franchisors have to implement control measures that incur monitoring costs.<sup>327</sup> In case there is high behavioral uncertainty, firms tend to internationalize by vertical integration.<sup>328</sup> Admittedly, franchising is able to reduce monitoring costs. However, monitoring costs resulting from behavioral uncertainty are still omnipresent in both SUF and MUF. Entering foreign markets, in particular, is characterized by facing international competition and challenges in transferring the franchise system and brand.<sup>329</sup> Furthermore, it is suggested that opportunistic behavior can be more diminished in MUF as opposed to SUF by higher franchisee motivation.<sup>330</sup> Additionally, MUF systems can alleviate harm caused by problems between the franchisee and its established chain through superior monitoring and coordination abilities.<sup>331</sup> What is more, MUF systems have a higher monitoring efficiency and effectiveness due to fewer outlets that need to be monitored as opposed to monitoring efforts associated with numerous SUFees.<sup>332</sup>

This thesis argues that MUF systems will face lower problems in finding suitable partners, ensuring quality control, prevention from opportunistic behavior and performance evaluation compared to SUF systems. The reason is the higher

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<sup>322</sup> Williamson (1985)

<sup>323</sup> Doherty, Quinn (1999)

<sup>324</sup> See Chapter 3.1.1.

<sup>325</sup> Mumdzhev, Windsperger (2013), p. 172

<sup>326</sup> Rubin (1978); Mathewson, Winter (1985); Brickley et al. (1991)

<sup>327</sup> Williamson (1985); Mumdzhev, Windsperger (2013)

<sup>328</sup> Sutcliffe, Zaheer (1998)

<sup>329</sup> Jell-Ojobor (2012)

<sup>330</sup> Hussain, Windsperger (2011)

<sup>331</sup> Weaven, Frazer (2003)

<sup>332</sup> Hussain, Windsperger (2015)

involvement and own responsibility of MUFees in this fields since their profit depends on the established chain's performance.

H4: The higher the behavioral uncertainty in the host market, the higher the tendency of franchisors to favor MUF over SUF.

#### 4.5. Environmental uncertainty

Environmental uncertainty is related to external uncertainty<sup>333</sup> and emerges when economic exchange becomes unpredictable.<sup>334</sup> These circumstances are not foreseeable at the time the contract is signed by both parties.<sup>335</sup> In particular, environmental uncertainty is referred to country risk, such as economic unforeseen changes, political instability and currency changes.<sup>336</sup> More precisely, there might be differences in infrastructure, change of demand, competition structure and difficulties in assessing the turnover.

There might also be political risks involved when the host market government switches from polite to impolite laws and legislations as regards inflows of foreign investments. This would result in high costs due to political unpredictability, which is why firms tend to prefer franchising in entering such markets. Reasons might be that corporate assets are not considered as secure in the foreign market and adaptations cannot be made easily. Lack of intellectual property protection in the host country causes severe damage to the franchise system by imitators. Furthermore, in a worst-case scenario, expropriations might become an issue in cultural distant markets.<sup>337</sup> Since changes would result in a direct impact to the firm's profitability, franchisors prefer to shift that risk to local partners and require them to bear the investment risk as well.<sup>338</sup> The main issues a franchisor faces in political volatile host markets are local regulation of franchise contracts as well as franchise brand protection.<sup>339</sup>

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<sup>333</sup> See Chapter 3.1.1.

<sup>334</sup> Geyskens et al. 2006; Anderson, Gatignon (1986)

<sup>335</sup> Geyskens et al. 2006

<sup>336</sup> Herring (1983)

<sup>337</sup> Fladmoe-Lindquist, Jacque (1995)

<sup>338</sup> Hoffman, Preble (1991); Fladmoe-Lindquist, Jacque (1995)

<sup>339</sup> Fladmoe-Lindquist, Jacque (1995)

Furthermore, cultural distance between home and host markets cause environmental uncertainty.<sup>340</sup> Both MUF and SUF face language problems in culturally distant markets. It is true that the culture is inherent to the transferred franchise concept.<sup>341</sup> However, the management system has to be adapted to the culture in the host country. Furthermore, the respective norms have to be projected on, and manifested in training measures. Admittedly, an MUFee in a different cultural environment is able to exploit country and especially culture and customs specific knowledge.<sup>342</sup> Since MUFees have the recruiting responsibility in the local market, they are able to exploit and further develop cultural knowledge and are more likely to verify employees and unit owners better than SUF systems recruiting from their home country. As a result, a local recruiter with knowledge of the local culture reduces opportunistic behavior, whereas SUF systems have to suffer a higher amount of adverse selection and opportunism problems. However, it has to be noted that MUFees have to possess managerial and financial resources as well.<sup>343</sup>

It is true that a franchisor using SUF has to coordinate these tasks with each outlet in each cultural distant market on its own. In that respect, the “combination of managerial resources and cultural expertise helps the process of local adaptation to be done more effectively and efficiently in IMUF than in ISUF.”<sup>344</sup> Nevertheless, in turn, this implies that SUFees have to operate with stronger entrepreneurial skills and spirit compared to MUFees.<sup>345</sup> What is more, due to the stronger entrepreneurial skills, SUFees are able to react on changes in the host market more quickly.<sup>346</sup> Therefore, the higher the environmental uncertainty, the higher the need for those skills. By definition, environmental uncertainty describes the franchisor’s difficulty in foreseeing developments in the market of the franchise units located abroad. The higher the environmental uncertainty, the higher the stimulating effect of incentives for immediate and prompt reactions to market variations which is supposed to be likelier in SUF systems than in MUF ones. Furthermore, SUFees are better able to

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<sup>340</sup> See Chapter 3.2.4.

<sup>341</sup> Fladmoe-Lindquist, Jacque (1995)

<sup>342</sup> Garg, Rasheed (2003)

<sup>343</sup> Garg, Rasheed (2003)

<sup>344</sup> Garg, Rasheed (2003), p. 338

<sup>345</sup> Garg et al. (2005)

<sup>346</sup> Sorenson, Sørensen (2001)

exploit foreign market opportunities more efficiently, which is also advantageous to the franchisor.<sup>347</sup> SUF systems are said to be more flexible and able to make adaptations when there are changes in environmental circumstances. What is more, a high local responsiveness is necessary in case of high environmental uncertainty, which is likelier to occur in SUF compared to MUF.<sup>348</sup> More precisely, environmental risks are pushed toward the SUFees who have to get along with it. As a result, the uncertainty problem is solved by the nature of SUF.<sup>349</sup>

By applying a factor analysis with all environmental uncertainty related items in the questionnaire, two factors evolved which can be summed under cultural and institutional uncertainty, and market uncertainty. The latter deals with competition, sales and market share related uncertainty in the host country whereas the former covers all other items dealt with in this paper. This study claims that both environmental uncertainty factors will lead to the same outcome, as a consequence. Therefore, following the approach of Hussain et al., it is hypothesized:

H5: Franchisors tend to favor SUF when cultural and institutional uncertainty is high.

H6: Franchisors tend to favor SUF when market uncertainty is high.<sup>350</sup>

To summarize, figure 2 illustrates and provides an overview of all generated hypotheses in one chart.

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<sup>347</sup> Garg et al. (2005)

<sup>348</sup> Hussain, Windsperger (2015)

<sup>349</sup> Garg et al. (2005)

<sup>350</sup> Hussain et al. (2012)

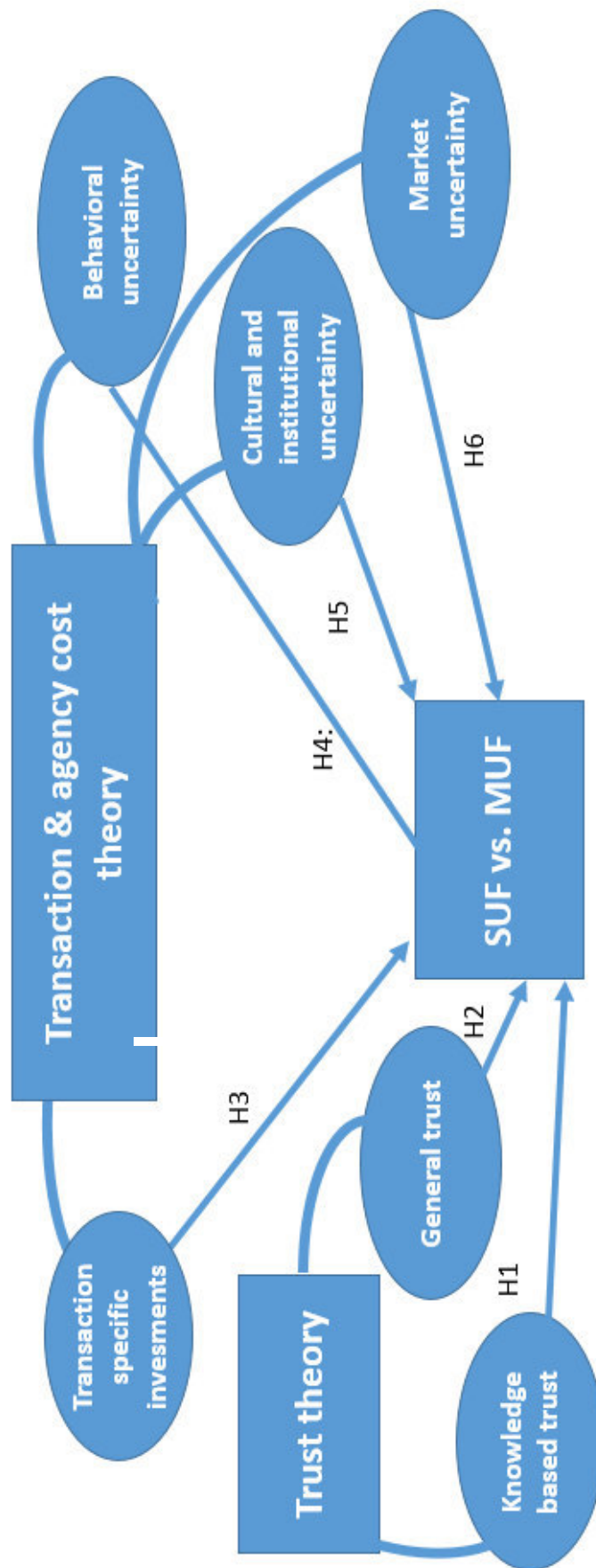


Figure 2: Overview of theoretical concepts

## **5. Methodology of empirical research**

### **5.1. Data collection**

More than 10 students participated in the international franchising project working on contacting franchisors originating from Germany, the Netherlands, the UK, Spain, France, Italy, Austria and the USA, asking for contact persons to fill out the questionnaire. Franchise companies were detected in cooperation with national franchise associations. The 16-page questionnaire was provided and sent out to the franchisors by the Economic Sciences faculty of University of Vienna. The questions are subdivided into categories and consist of multiple choice, single choice and open questions. The questions are categorized into specific categories, such as trust, transaction-specific investments, environmental and behavioral uncertainty, control and decision rights. The respondents had to answer on questions according to a 7-point Likert scale ranging from 'not applicable at all' (1) to 'applies completely' (7). After the successful pre testing stage suggesting an average processing time of 20 minutes, the questionnaires were sent out to the companies in November–December 2014. The initial response rate was very low, which is why there was a need for follow-up activities. From January to May 2015, franchisors who did not submit their questionnaire were contacted again and kindly reminded by the students via telephone and e-mail to send in the forms. Finally, a 162 responses overall were received. The filled-out questionnaires were connected and imported into the analytical statistics program SPSS. Each question is related to a certain code consisting of letters and numbers projected in the SPSS data set showing each answer of a franchisor in one respective row. According to the research question of this thesis, the outcomes were filtered based on the franchisor's dominant mode of internationalization.

### **5.2. Variables**

Since all research questions of this paper follow the same scheme, SUF and MUF always represent dependent variables and, therefore, are supposed to be outcome of

some effect. It has to be noted that master franchising and MUF systems have been subsumed under MUF (new value = 0). SUF is encoded as value 1.

Original value	Internal
MUF	0
SUF	1

**Table 3: Dependent variable encoding**

The level of measurement of the dependent variables is a categorical one. Moreover, due to the sole distinction between SUF and MUF, it is binary coded. The dependent variables depend on changes in the independent variables and can be considered as cause of some effect. In the questionnaire, independent variables are metric, interval scaled according to a 7-point Likert scale and, therefore, belong to the continuous variable classification.<sup>351</sup> The questionnaire deals with these independent variables by requesting the respondents to evaluate statements highlighted right below.

General and knowledge-based trust, partner transaction-specific investments as well as behavioral and environmental uncertainty are independent variables. Before the analysis can be started, the capturing and categorization of the independent variables has to be demonstrated. Therefore, a principal component factor analysis was applied to identify clusters or groups among the items. By inserting all items of every variable in one factor analysis, there was no useful and reasonable splitting into factors. More precisely, factors appeared including both general trust and knowledge-based trust items. As a consequence, a factor analysis needed to be made for each variable separately. Variables were assigned to factors that will be used in the following SPSS evaluation and set the basis for the regression analysis and hypotheses response.<sup>352</sup> The items in the following factor analysis tables are ranked according to increasing amount of loadings. It has to be noted that items with loadings on all factors lower than 0.5 were removed.<sup>353</sup>

Starting with the independent variable trust, the factor analysis delivers two reasonable factors. There are three items that can be summarized under knowledge-

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<sup>351</sup> Field (2013)

<sup>352</sup> Field (2013)

<sup>353</sup> Kaiser (1974)



based trust. Franchisor’s knowledge-based trust was investigated by means of the following questions. The first question refers to if the franchisor perceives a foreign partner with whom he or she has a longer relationship would be more likely to help him or her when needed. The second question is related to if the respondent feels more secure when he or she works with a foreign partner he or she knows well than with someone he or she does not know. Thirdly, the franchisor has to evaluate whether there is a positive connection between trusted partners and long lasting business relationships. Besides items which were excluded due to loadings lower than 0.5, there are four items loading on one factor referring to general trust. General trust was measured by questions requesting franchisors to judge the following statements from 1 to 7. The first item deals with the subjective perception whether most people are considered as trustworthy. Similarly, the second one requires the franchisor’s evaluation whether most people are trustful of others. Thirdly, respondents were asked if they perceive most people as good and kind. The last question in this section represents a self-reflection of the franchisor’s evaluation of their own trustfulness (see table 4).

Items	Factor	
	1	2
General trust: Most people are trustworthy.	.908	.128
General trust: Most people are trustful of others.	.862	.095
General trust: Most people are basically good and kind.	.793	.066
General trust: I am trustful.	.761	-.043
Knowledge-based trust: As a franchisor, I feel more secure when I work with a foreign partner I know well than with someone I don’t know.	.067	.843
Knowledge-based trust: The foreign partners I trust are those with whom I have long-lasting relationships.	-.148	.822
Knowledge-based trust: Generally, a foreign partner with whom I have a longer relationship is likely to help me when I need it.	.315	.567

Extraction method: Principal component analysis.

Rotation method: Varimax with Kaiser normalization.

a. Rotation converged in 4 iterations.

**Table 4: Rotated component matrix: Trust**

Cronbach’s alpha	Number of Items
.857	4

**Table 5: Reliability statistics: General trust**

Cronbach's alpha	Number of Items
,605	3

**Table 6: Reliability statistics: Knowledge-based trust**

Considering Cronbach's alpha, it can be seen that internal consistency is good for general trust ( $\alpha = 0.857$ ) and equivocal for knowledge-based trust items ( $\alpha = 0.605$ ) based on the classification of George and Mallery.<sup>354</sup>

Factor analysis made with franchisee transaction-specific investments leads to all factors loading on one factor. Furthermore, Cronbach's alpha demonstrates an acceptable level ( $\alpha > 0.7$ ) of interrelations among the items.<sup>355</sup> Responding to question number one, the franchisor has to state if he or she perceives the partner has made significant investments in tools, equipment and procedures dedicated to the franchise relationship. Secondly, he or she has to evaluate if they think the franchise partner has committed substantial time and money in employees' training of the franchise relevant practices and processes. The third question deals with the franchisor's judgement concerning whether franchisees would lose much of their investments made to develop the local franchise network if they decided to cancel the franchise relationship (see tables 7 and 8).

Items	Factor
	1
Partner transaction-specific investments: Franchisees have committed substantial time and money in employees' (or sub-franchisees') training of franchise specific practices and processes.	,881
Partner transaction-specific investments: Franchisees have made significant investments in tools, equipment and procedures dedicated to the franchise relationship.	,854
Partner transaction-specific investments: Franchisees lose a lot of their investment made to develop the local franchise network, if they decided to terminate the cooperation.	,646

Extraction method: Principal component analysis.

a 1 component extracted

**Table 7: Component matrix: Partner transaction-specific investments**

Cronbach's Alpha	Number of Items
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<sup>354</sup> George, Mallery (2002)

<sup>355</sup> George, Mallery (2002)

.783	3
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**Table 8: Reliability statistics: Partner transaction-specific investments**

Carrying out factor analysis with behavioral uncertainty results in all items loading on one factor. Cronbach's alpha shows a good level ( $\alpha > 0.8$ ) of internal consistency among the four items.<sup>356</sup> Behavioral uncertainty is examined by the following four questions. The first one refers to the evaluation problem of qualification of foreign partners. The second question deals with the monitoring issues of the franchise product and service quality in foreign markets. By responding to the third question, the franchisor has to evaluate the problem of monitoring misuse of proprietary knowledge by foreign partners. The last question refers to performance assessment issues of franchise partners (see tables 9 and 10).

Items	Factor
	1
Behavioral uncertainty: It is difficult to monitor the franchise product/service quality in foreign countries.	.911
Behavioral uncertainty: It is difficult to assess the performance of foreign partners.	.859
Behavioral uncertainty: It is difficult to monitor the misuse of proprietary knowledge by foreign partners.	.790
Behavioral uncertainty: It is difficult to evaluate the qualification of foreign partners.	.789

Extraction method: Principal component analysis.

a. 1 component extracted

**Table 9: Component matrix: Behavioral uncertainty**

Cronbach's Alpha	Number of Items
.863	4

**Table 10: Reliability statistics: Behavioral uncertainty**

Inserting all environmental uncertainty related variables into one factor analysis results in a split of variables into two factors, namely cultural and institutional uncertainty and market uncertainty. One item has been dismissed due to low loadings on both factors ( $< 0.5$ ). Perceived cultural and institutional uncertainty of the franchisor is examined by means of the following questions. Firstly, the franchisor has to evaluate cultural differences between the home and the foreign countries in terms of norms, common values and habits. The second question deals with the different business practices in the franchisor's home and the foreign countries. The

<sup>356</sup> George, Mallery (2002)

third question refers to the franchisor's perception of language barriers between the home and host countries. Responding to the fourth question, the franchisor has to evaluate the statement that the legal protection of intellectual properties, such as patents and trademark, is defective. The fifth question deals with the increased risk of ownership restrictions in foreign countries. Sixthly, the franchisor has to judge the suggested underdeveloped quality of local infrastructure, such as phones, roads and IT, in the host market. Market uncertainty-related questions cover the stated changing customer demand in foreign countries. Another question refers to the proposed and not easy to predict sales forecasts in the foreign countries. Moreover, the franchisor has to evaluate if market shares are unstable in foreign countries. Lastly, one question refers to the higher amount of potential and existing competitors in foreign countries. Whereas there is a good internal consistency among cultural and institutional items, Cronbach's alpha for market uncertainty amounts to 0.589 and, therefore, is classified as poor (see tables 11,12 and 13).<sup>357</sup>

Items	Factor	
	1	2
Cultural and institutional uncertainty: The risk of ownership restrictions is high in foreign countries.	.790	.196
Cultural and institutional uncertainty: The political environment is quite uncertain in the foreign countries.	.786	.182
Cultural and institutional uncertainty: The legal protection of intellectual properties such as patents and trademarks is defective.	.662	.005
Cultural and institutional uncertainty: The business practices in our home and the foreign countries are quite different compared to our home country	.658	.418
Cultural and institutional uncertainty: The quality of local infrastructure, such as phones, roads and IT, is underdeveloped.	.639	.321
Cultural and institutional uncertainty: The language barriers between our home and the foreign countries are high.	.621	-.056
Cultural and institutional uncertainty: Cultural differences between our home and the foreign countries are high in terms of norms, common values and habits.	.607	.460
Market uncertainty: The number of existing and potential competitors is high in foreign countries.	-.143	.857
Market uncertainty: Sales forecasts are not easily predictable in foreign countries.	.165	.675
Market uncertainty: Market shares are pretty unstable in foreign countries.	.352	.551

Extraction method: Principal component analysis.

Rotation method: Varimax with Kaiser normalization.

<sup>357</sup> George, Mallery (2002)

**Table 11: Rotated component matrix: Environmental uncertainty**

Cronbach's Alpha	Number of Items
,848	7

**Table 12 Reliability statistics: Cultural and institutional uncertainty**

Cronbach's Alpha	Number of Items
,589	3

**Table 13: Reliability statistics: Market uncertainty**

Empirical results are supposed to show if values in the independent variables result in a significantly correct prediction of the franchisor's choice to internationalize by SUF or MUF. Thereby, as usually recommended, the 95% confidence interval has been considered in this research. In order to identify and measure possible relationships, correlations between variables have also been investigated. Due to the fact that the dependent variables have two values, a binary logistic regression is applied.<sup>358</sup> Based on the nature of a binary logistic regression, there is no need to check for normal distribution, which is why this research does not entail Kolmogorov-Smirnov tests.<sup>359</sup>

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<sup>358</sup> Garson (2014)

<sup>359</sup> Field (2013)

## 6. Summary of statistics

Table 14 shows the dominant mode choice of the 162 responding international franchisors. Focusing on this paper’s differentiation between SUF and MUF, the first thing is to set up a filter based on the franchisor’s dominant mode choice. In addition, it has to be noted that master franchising and MUF are classified into one category named MUF in the following. As consequence, the investigation was made with a total amount of 144 franchisors comprising of 91 franchisors use MUF and 53 use SUF as their dominant mode. This accords with the proposition of this thesis that there are quantitatively more franchisors favoring MUF (56.2 %) over SUF (32.7 %).

		Frequency	Percentage	Valid percentage	Cumulative percentage
Valid	Master franchising	56	34.6	34.6	34.6
	Multi-unit franchising	35	21.6	21.6	56.2
	Single-unit franchising	53	32.7	32.7	88.9
	Joint Venture franchising	5	3.1	3.1	92.0
	Wholly-owned subsidiary	13	8.0	8.0	100.0
	Total	162	100.0	100.0	

**Table 14: Dominant mode choice**

Table 15 shows the amount of received responses, mean values, standard deviations as well as average minimum and maximum values based on respondents assigning MUF or SUF as their dominant mode. The table demonstrates that all values are quite identical with two exceptions. First, it should be noted that the valid number of responses is almost twice the number in MUF compared to SUF. Furthermore, the biggest difference in mean values between SUF and MUF can be seen in the factor partner-transaction specific investments.

Dominant mode		General Trust	Knowledge-based trust	Partner transaction-specific investments	Behavioral uncertainty	Cultural and institutional uncertainty	Market uncertainty
MUF	N	59	61	69	76	77	77
	Mean	3.6737	5.5519	4.7874	3.9408	3.7978	3.7056

	Min	1.00	2.67	1.00	1.00	1.29	1.33
	Max	6.00	7.00	7.00	7.00	6.57	6.67
	Standard deviation	.98835	.93072	1.37195	1.43112	1.17286	1.20303
SUF	N	32	33	35	36	37	38
	Mean	3.9063	5.4242	3.6857	4.0833	3.4788	3.8684
	Min	1.50	1.00	1.00	1.00	1.29	1.67
	Max	7.00	7.00	6.33	7.00	6.29	6.00
	Standard deviation	1.05063	1.38512	1.60665	1.40026	1.34148	1.10293
Total	N	91	94	104	112	114	115
	Mean	3.7555	5.5071	4.4167	3.9866	3.6942	3.7594
	Min	1.00	1.00	1.00	1.00	1.29	1.33
	Max	7.00	7.00	7.00	7.00	6.57	6.67
	Standard deviation	1.01103	1.10579	1.53896	1.41654	1.23329	1.16858

**Table 15: Basic statistics: MUF vs. SUF**

Tables 16 and 17 show correlations between the independent variables. Pearson's correlation coefficients range from -1 having a negative effect on the other variable, over 0 with no effect at all, to value +1 implying a positive effect toward the other variable. This research does not consider correlations with an r-value < 0.3.<sup>360</sup> Respondents choosing MUF as their dominant franchise mode show correlations between general trust and partner transaction-specific investments (r-value: -0.354) and general trust and behavioral uncertainty with an r-value of -0.329. A positive correlation was found between behavioral uncertainty and cultural and institutional uncertainty (r-value: 0.407), behavioral uncertainty and market uncertainty (r-value: 0.484) and between cultural and institutional uncertainty and market uncertainty (r-value: 0.383). SUF respondents provide correlations between general trust and behavioral uncertainty (r-value: -0.371) and general trust and cultural and institutional uncertainty (r-value: -.462). The highest degree of correlation could be found between behavioral uncertainty and cultural and institutional uncertainty (r-value: 0.526). Furthermore, market uncertainty correlates with knowledge-based trust (r-value: 0.359), behavioral uncertainty (r-value: 0.341) and cultural and institutional uncertainty (r-value: 0.338).

<sup>360</sup> Field (2013)

		General trust	Knowledge-based trust	Partner transaction-specific investments	Behavioral uncertainty	Cultural and institutional uncertainty	Market uncertainty
General trust	Pearson Correlation	1	.189	-.354**	-.329*	.085	-.218
	Sig. (2-tailed)		.155	.007	.012	.531	.103
	N	59	58	57	58	57	57
Knowledge-based trust	Pearson Correlation	.189	1	.160	.022	.012	-.006
	Sig. (2-tailed)	.155		.227	.865	.926	.966
	N	58	61	59	60	59	59
Partner transaction-specific investments	Pearson Correlation	-.354**	.160	1	.112	.000	-.026
	Sig. (2-tailed)	.007	.227		.364	.998	.832
	N	57	59	69	68	67	68
Behavioral uncertainty	Pearson Correlation	-.329*	.022	.112	1	.407**	.484**
	Sig. (2-tailed)	.012	.865	.364		.000	.000
	N	58	60	68	76	73	74
Cultural and institutional uncertainty	Pearson Correlation	.085	.012	.000	.407**	1	.383**
	Sig. (2-tailed)	.531	.926	.998	.000		.001
	N	57	59	67	73	77	74
Market uncertainty	Pearson Correlation	-.218	-.006	-.026	.484**	.383**	1
	Sig. (2-tailed)	.103	.966	.832	.000	.001	
	N	57	59	68	74	74	77

\*. Correlation is significant at the 0.05 level (2-tailed).

\*\* . Correlation is significant at the 0.01 level (2-tailed).

**Table 16: Correlations MUF**



		General trust	Knowledge-based trust	Partner transaction-specific investments	Behavioral uncertainty	Cultural and institutional uncertainty	Market uncertainty
General trust	Pearson Correlation	1	.095	-.015	-.371*	-.462**	-.193
	Sig. (2-tailed)		.604	.935	.040	.009	.290
	N	32	32	31	31	31	32
Knowledge-based trust	Pearson Correlation	.095	1	.081	.096	.242	.359*
	Sig. (2-tailed)	.604		.658	.601	.181	.040
	N	32	33	32	32	32	33
Partner transaction-specific investments	Pearson Correlation	-.015	.081	1	.002	.140	.028
	Sig. (2-tailed)	.935	.658		.990	.429	.874
	N	31	32	35	34	34	35
Behavioral uncertainty	Pearson Correlation	-.371*	.096	.002	1	.526**	.341*
	Sig. (2-tailed)	.040	.601	.990		.001	.042
	N	31	32	34	36	36	36
Cultural and institutional uncertainty	Pearson Correlation	-.462**	.242	.140	.526**	1	.338*
	Sig. (2-tailed)	.009	.181	.429	.001		.040
	N	31	32	34	36	37	37
Market uncertainty	Pearson Correlation	-.193	.359*	.028	.341*	.338*	1
	Sig. (2-tailed)	.290	.040	.874	.042	.040	
	N	32	33	35	36	37	38

\*. Correlation is significant at the 0.05 level (2-tailed).

\*\* . Correlation is significant at the 0.01 level (2-tailed).

**Table 17: Correlations SUF**

The main part of the empirical research is the logistic regression. It is a type of multiple regression with a categorical outcome variable and continuous independent variables that are both prevalent in this particular research.<sup>361</sup> Furthermore, the regression helps “[...] to determine the effect size of the independent variables on the dependent variable; to rank the relative importance of the independent variables; to assess interaction effects [...]”<sup>362</sup> What is more, odds ratios (Exp (B)) can explain the

<sup>361</sup> Field (2013)

<sup>362</sup> Garson (2014), p.12

influence of predictor variables<sup>363</sup> and represent “[...] an indicator of the change in odds resulting from a unit change in the predictor.”<sup>364</sup>

Due to missing values in the dataset, only 82 out of 144 filtered cases can be included in the regression model (see table 18). This results from questions left blank by the respondents. The research can only include datasets with all questions being answered considering the respective factors. Going ahead with 82 cases, the model chi statistic shows the differences of the prevailing model compared to the constant model. The initial model includes the constant only (see table 20 and 21) and states that 52 of the respondents did chose MUF and 30 chose SUF as their dominant mode. As a result, if the SPSS program would predict every respondent choosing MUF as its dominant mode, the prediction would be correct by 63.4% of the cases (see table 19).

Table 22 shows that the new model including independent variables is better able to significantly predict whether the respondents operate with SUF or MUF systems compared to the null model consisting of constants only. The chi square provides the difference between new and the constant model. The chi square amounts 17.643, which is significant at  $p < 0.05$ . Furthermore, the Nagelkerke’s R-Square value demonstrates that the error rate can be reduced by 26.5% through the independent variables (see table 23). The classification table indicates that the model correctly classifies 47 franchise systems as MUF and 18 as SUF. As a result, the accuracy of correctly predicting a MUF is 90.4% and correctly predicting a SUF amounts 60.0%. The overall accuracy of the model is calculated by the weighted average and, therefore, amounts to 79.3%. As a result, the inclusion of the independent variables as a predictor increases the overall accuracy by 15.9% compared to the previous model up to 79.3% (see table 24).<sup>365</sup>

Unweighted cases		N	Percentage
Selected cases	Included in analysis	82	56.9
	Missing cases	62	43.1

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<sup>363</sup> Garson (2014)  
<sup>364</sup> Field (2013), p. 271  
<sup>365</sup> Field (2013)

Total	144	100.0
Unselected cases	0	.0
Total	144	100.0

**Table 18: Case processing summary**

Observed	Dominant mode choice	Predicted		Percentage correct
		Dominant mode choice		
		MUF	SUF	
Step 0	MUF	52	0	100.0
	SUF	30	0	.0
Overall percentage				63.4

**Table 19: Classification table step 0**

Step 0	Constant	-.550	.229	5.756	1	.016	.577
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**Table 20: Variables in the equation**

Step 0	Variables	Score	df	Sig.
	General trust	.914	1	.339
	Knowledge-based trust	.093	1	.761
	Partner transaction-specific investments	15.856	1	.000
	Behavioral uncertainty	.163	1	.686
	Cultural and institutional uncertainty	.334	1	.564
	Market uncertainty	.641	1	.423
Overall statistics		16.693	7	.010

**Table 21: Variables not in the equation**

Step 1		Chi-square	df	Sig.
	Step	17.643	6	.007
	Block	17.643	6	.007
	Model	17.643	6	.007

**Table 22: Omnibus tests of model coefficients**

Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
1	90.058	.194	.265

**Table 23: Model summary**

Observed		Predicted			
		Dominant mode choice		Percentage correct	
		MUF	SUF		
Step 1	Dominant mode choice	MUF	47	5	90.4
		SUF	12	18	60.0
Overall percentage					79.3

**Table 24: Classification table**

		B	Standard deviation	Wald	df	Sig.	Exp(B)	95% Confidence interval (lower bound)	95% Confidence interval (upper bound)
Step 1	General trust	.100	.290	.118	1	.732	1.105	.625	1.952
	Knowledge-based trust	.034	.270	.016	1	.899	1.035	.609	1.757
	Partner transaction-specific investments	-.653	.186	12.275	1	.000	.521	.361	.750
	Behavioral uncertainty	.091	.218	.174	1	.677	1.095	.714	1.679
	Cultural and institutional uncertainty	-.152	.231	.434	1	.510	.859	.546	1.351
	Market uncertainty	.174	.263	.434	1	.510	1.190	.710	1.994
	Constant	1.859	1.298	2.059	1	.152	6.414		

**Table 25: Variables in the equation**

Having a look at the factors of the equation in table 25, it can be seen that the only significant variable is partner transaction-specific investments. All other variables could be excluded from the model due to the fact they do not provide a significant contribution. The negative regressions coefficients with increasing X-values lead to a lower propensity for the characteristic  $y=1$  which would be SUF. As predicted in this thesis, the regression coefficient B shows that the factor partner transaction-specific investments lead to higher propensity to predict MUF systems. Exp (B) states the de-logarithmed coefficients as an odds ratio. Related to this study, it implies that the

probability to predict a SUF decreases by the factor 0.521 when the value of the factor partner transaction-specific investments changes by one scale unit.<sup>366</sup>

Independent variable	Predicted influence on SUF vs MUF	Empirical results	Significant (yes/ no)
Knowledge-based trust	MUF (-)	SUF (+)	no
General trust	SUF (+)	SUF (+)	no
Partner transaction-specific investments	SUF (+)	MUF (-)	yes
Behavioral uncertainty	MUF (-)	SUF (+)	no
Cultural and institutional uncertainty	SUF (+)	MUF (-)	no
Market uncertainty	SUF (+)	SUF (+)	no

**Table 26: Hypotheses vs. empirical outcomes**

Table 26 summarizes all empirical results and this paper's expectations made before the empirical analysis. Based on the dependent variable coding (MUF = 0; SUF = 1) the influence on mode choice is marked with (-) for MUF and (+) for SUF. It can be seen that general trust and market uncertainty influence on SUF was correct, however, not significant. The only significant independent variable is partner transaction-specific investments with identical expectation and outcome of influence.

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<sup>366</sup> Field (2013)

## 7. Empirical findings

This study examined 144 franchise companies stating whether their dominant mode of entry choice is SUF or MUF. Responses of executives in charge of franchising related to knowledge-based trust, general trust, partner transaction-specific investments, behavioral uncertainty as well as cultural and institutional and market uncertainty were evaluated. Frequency tables already signaled that there is a considerable difference in evaluation of partner transaction-specific investments between SUF and MUF. Based on Windsperger's and Williamson's definition of a higher degree of control in MUF compared to SUF, higher transaction-specific investments are connected to higher control modes in this study.<sup>367</sup> This is in accordance with the expectations in this research predicting MUF. More precisely, it turns out that MUF respondents perceive their partners' commitment in terms of time, money and investments in equipment and procedures, higher than single-unit franchisors do. What is more, multi-unit franchisors claim that their partners would lose a lot if the cooperation would be terminated by the franchisee, whereas SUF respondents did expect not that much harm. Thus, opposed to single-unit franchisors, multi-unit franchisors rather believe there is a sort of dependence based on potential losses a termination of contract might cause to their partner. High partner transaction-specific investments lead to a bonding effect, enhancing the franchise contract importance and consequently, the propensity to not acting opportunistically on the franchisee side. As a consequence, in accordance with this paper's expectation, higher transaction-specific investments leads to the franchisor's decision to choose MUF.

The regression model including independent variables predicts the outcome, whether SUF or MUF, 15.9% better than the constant model leading to an overall accuracy of 79.3%. Considering the factors in the logistic, regression delivers partner transaction-specific investments as the only significant factor. Focusing on partner transaction-specific investment and increasing it by one scale unit, the probability to predict an SUF system decreases by the factor 0.521. This implies that franchisees with high franchise-related commitment leads to the franchisor perception that those franchisees need to be monitored more than those with fewer commitments.

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<sup>367</sup> Williamson (1975); Hussain, Windsperger (2015)

Furthermore, higher partner-specific investments lead to the franchisor's perception that the partner would also invest into other outlets and, therefore, giving those franchisees more than one outlet. MUFees might be further encouraged as they get more responsibilities by running several units. SUFees are less likely to be able to fund and make substantial investments targeted on the host market compared to MUFees. The latter could also benefit from synergies of high investments in several units by generating economies of scale and scope and increased sales. This enhances the success of the whole franchise system. In order to remain successful, the franchisor might operate with MUF due the fact MUFees are more likely to take care and protect the brand name since they would suffer higher damage due to the higher amount of outlets compared to SUFees.<sup>368</sup> As a result, a MUFee with high responsibility in a territory needs to be controlled more strongly by the franchisor since this partner account for a high share of sales and its existence is crucial for persistent corporate success.

Furthermore, considering MUF respondents only, the study detected a negative correlation between general trust and partner transaction-specific investments with an r-value of -0.354. As a consequence, a high level of general trust reduces the need for partner transaction-specific investments because the franchisor trusts their partners anyway. Admittedly, it has to be noted that the correlation is weak. At least, there is a reduced degree to that the franchise partner has to show its commitment with relationship specific investments when the franchisor's general trust is high.

The study claims that a high level of general trust leads to a lower degree of behavioral uncertainty considering MUF respondents alone. As a result, the franchisors believe the partner's goodwill reduces the extent of uncertainty about the partner's behavior. More precisely, it reduces difficulties in assessing, monitoring and evaluating franchisee behavior.<sup>369</sup> Empirical findings also suggest that a high level of general trust implies low relational risk.<sup>370</sup> This is in accordance with our expectations that there is a negative correlation between general trust and MUF as a control item. What is more, MUF have a higher control efficiency and, therefore, behavioral

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<sup>368</sup> Garg, Rasheed (2003)

<sup>369</sup> Weaven, Frazer (2003)

<sup>370</sup> Griessmair et al. (2014)

uncertainty can be reduced.<sup>371</sup> That supports the thesis's theoretical explanations since multi-unit franchisor's trust in people the person does not know or did not have business interactions with, is connected to a low perception of new business relationships could be dangerous due to opportunistic behavior of their counterparts. As a consequence, franchisors prefer MUF over SUF. Quite surprising and against this thesis's predictions, an even higher negative correlation could be discovered between general trust and behavioral uncertainty among SUF respondents as for MUF ones.

Additionally, there is a positive correlation between behavioral uncertainty and cultural and institutional uncertainty. Thus, a high uncertainty level due to difficulties in assessing, monitoring and evaluating the counterpart also raises concerns about the cultural, political and institutional prevalent situation in the host country the partners are operating in. The study predicted a negative connection between both factors since a high level of behavioral uncertainty is supposed to lead to MUF usage due to franchisees' self-responsibility over profits and their outlets. A high level of cultural and institutional uncertainty was predicted to be associated to SUF systems since the inherent problems are solved by the characteristic of SUF.<sup>372</sup> SUFees are supposed to act more entrepreneurial and superiorly get along with changing conditions ensuring fast and effective reactions to changing conditions compared to MUFees.<sup>373</sup> The same can be said about the correlation between behavioral uncertainty and market uncertainty. Thereby, changes in demand and forecasts and the prevailing competitor structure are more effectively encountered by SUFees since changes affect their profits inevitably compared to MUFees distributing risk among several outlets.<sup>374</sup> Cultural and institutional uncertainty and market uncertainty are positively correlated. This was expected since both variables deal with changes in the environment of host countries. Against the expectations in this paper, there is almost no difference in correlations between SUF and MUF respondents. What is more, nearly the same r-values could be detected for the correlation between cultural and institutional uncertainty and market uncertainty as well as between behavioral uncertainty and cultural and institutional uncertainty and market uncertainty among

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<sup>371</sup> Weaven, Frazer (2003); Hussain, Windsperger (2015)

<sup>372</sup> Garg et al. (2005)

<sup>373</sup> Chapter 4.5.

<sup>374</sup> Rubin (1978); Garg et al. (2005)



SUF respondents. Respondents of both groups assigned a similar positive sized correlation between environmental and behavioral uncertainty. Obviously, there is no difference between SUF and MUF regarding the fact that uncertainty about harmful effects caused by partners is correlated to uncertainty of environmental influences like culture, political risk and unforeseen economic changes in the host country. Vice versa, culturally different and politically unstable countries also lead to a high perception of opportunistic behavior of foreign franchise partners.

There is a negative relationship between general trust and cultural and institutional uncertainty among SUF respondents, which can be refer to the franchisor's goodwill in people, in general. This results in a low perception of cultural and institutional uncertainty harming the franchise system. This is in accordance with this paper's explanations that a franchisor with high general trust is willing to reduce control, monitoring and agency costs by choosing SUF.<sup>375</sup>

The paper expected a mitigating effect of knowledge-based and general trust toward environmental uncertainty variables for both SUF and MUF, which could not be confirmed by the empirical research.<sup>376</sup> What is more, knowledge-based trust led to an even higher amount of market uncertainty among SUF respondents.

Surprisingly, whereas there is a negative correlation between behavioral uncertainty and general trust among MUF respondents, SUF outcomes also showed a negative correlation between both factors. Furthermore, there is a positive connection between market uncertainty and knowledge-based trust among SUF respondents. This paper would have rather expected a negative relationship since trust based on past interaction is supposed to increase communication exchange about the prevalent market and competitor situation and, therefore, rather diminish market uncertainty.

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<sup>375</sup> Griessmair et al. (2014)

<sup>376</sup> Mumdziev, Windsperger (2013)

## 8. Limitations

The study has focused on multi-unit, master and single-unit franchising only. In the theoretical part, master franchising as a special type of MUF was described. However, there is no distinction made between MUF and master franchising in the study. Bodey et al.,<sup>377</sup> Garg and Rasheed,<sup>378</sup> Weaven and Frazer,<sup>379</sup> Kaufmann and Dant<sup>380</sup> and Moritz<sup>381</sup> argue the same way; however, it might have influenced the outcomes since there are slightly different characteristics between MUF and master franchising.

Due to the poor response rate, it did not make sense to differentiate results among the franchisor's location of headquarters because the number among the countries ranges between 8 and 41, which makes it impossible to make sound comparisons (see table 27). More precisely, it was not possible to make a sound country comparison to show differences for European countries in comparison to the USA, for instance. Without a specific distinction, the outcomes of the study are valid for Italy, Spain, Austria, France, Germany, UK, USA and the Netherlands only and cannot be generalized for other countries. Future research needs to make a worldwide study in order to show universal results.

Additionally, it has to be noted that empirical investigations in this study did not make any distinctions according to the industry the responding companies belong to. Categorizing franchisors according to their business industry might lead to different results.

	Frequency	Percentage	Valid percentage	Cumulative percentage
Valid USA	24	14.8	14.8	14.8
UK	8	4.9	4.9	19.8
Germany	41	25.3	25.3	45.1
Austria	16	9.9	9.9	54.9

<sup>377</sup> Bodey et al. (2011)

<sup>378</sup> Garg, Rasheed (2006)

<sup>379</sup> Weaven, Frazer (2003)

<sup>380</sup> Kaufmann, Dant (1996)

<sup>381</sup> Moritz (2011)

The Netherlands	10	6.2	6.2	61.1
Italy	18	11.1	11.1	72.2
France	22	13.6	13.6	85.8
Spain	23	14.2	14.2	100.0
Total	162	100.0	100.0	

**Table 27: Franchisor's location of headquarters**

In general, the poor response rate might be reduced to the time frame when the survey was conducted. Before and after Christmas 2014 contact persons in charge probably had no time to fill out the questionnaire. Therefore, the survey was send out again in March/ April and, what is more, companies were also contacted directly via telephone. Nevertheless, the response rate did not increase considerably. Another reason might have been the discouraging effect of the processing time of the questionnaire with about 20 minutes.

Further research also needs to investigate this paper's outcomes and whether find evidence for them or reject them.

## 9. Conclusion

This thesis aimed to ascertain the significant differences between the usage of SUF or MUF in international markets by considering trust, transaction cost and agency theoretical issues. The fact that all but one independent variables do not show a significant difference between SUF and MUF in the logistic regression model is hard to explain. The only variable both SUF and MUF outcomes are significantly different for is partner transaction-specific investments. All other null hypotheses cannot be rejected because evaluation figures are nearly the same in SUF and MUF. Despite enormous effort, it also has to be noted that the response rate was relatively low which might also be a reason for the low level of statistical significant outcomes.

The developed regression model including all factors increased the overall accuracy by almost 16% compared to the model including the constant only; however, the percentage of correctly predicted SUF amounts to 60.0%, which is low. Based on the empirical research, it can be concluded that only H3 is significant with an influence on the choice between SUF and MUF. As proposed in this study, empirical findings indicate that high partner transaction-specific investments lead to the franchisor's choice to operate with MUF.

MUFees assign more efforts to the franchise system compared to SUFees based on the judgement of franchisors. In order to keep the success of a franchise system, the franchisors operate with MUF systems because MUFees have fewer incentives to act opportunistically. Moreover, brand name capital is stated to be more secure under MUF. What is more, multi-outlet owners have more assets at stake and, therefore, would suffer higher damages by cheating on the franchise system due to their higher amount of outlets compared to SUFees.<sup>382</sup> As a result, an MUFee with high a responsibility in a territory needs to be controlled more strongly by the franchisor since this partner account for a high share of sales and its existence is crucial for abiding corporate success. By owning several franchise outlets, control does not become weaker. In fact, it becomes stronger due to the increased need for control of the MUFee incurring more responsibility and market power. The more market power

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<sup>382</sup> Garg, Rasheed (2003)

and territory responsibility, the higher the dependence of the franchisor toward the franchisee. As a result, MUFees have a high influence on overall sales and, therefore, need to be more closely monitored by the franchisor as when partner transaction-specific investments would be low.

MUFees are supposed to have more financial funds and opportunities to make partner transaction-specific investments compared to SUFees. This might lead to the franchisor's perception of the former making higher transaction-specific investments opposed to SUFees. MUFees' investments lead the franchisor to believe that their counterpart might also invest in further outlets. As a result, the franchisor is not looking for new franchisees and rather expands by granting multi-unit contracts to established partnerships. This effect is strengthened in case the franchisor itself lacks financial funds to internationalize into foreign markets.<sup>383</sup>

A similar approach would be that franchisors reward franchisees investing in the relationship by issuing multi-unit contracts. MUFees are encouraged as they receive more responsibilities by running several units and, thus, having more sources of generating turnover. MUFees could also benefit from synergies of investments in multiple units by exploiting economies of scale and scope. In turn, this might increase the success of the whole franchise system and end up with a win-win situation for both parties.

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<sup>383</sup> Hussain, Windsperger (2015)

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## Appendix: Abstract (German)

Franchising ist ein weitverbreitetes Mittel, um in internationale Märkte einzutreten. Aufgrund der Vielzahl an Franchise-Formen ist es interessant, Gründe für den Gebrauch des jeweiligen Modus zu untersuchen. Diese Arbeit zielt darauf ab, internationales Franchising vor dem theoretischen Hintergrund der Vertrauens-, Transaktionskosten- sowie der Agency Theorie zu durchleuchten. Es wird der Einfluss von ‚knowledge-based‘ und ‚general trust‘, transaktionsspezifischen Investitionen, umweltbezogenen Unsicherheiten und Verhaltensunsicherheiten auf die Wahl des Franchisegebers zwischen SUF und MUF untersucht. Franchisegeber, die mittels MUF internationale Märkte penetrieren, haben ein vergleichsweise höheres Maß an Kontrolle über deren Franchisenehmer. Basierend auf der literarischen Analyse des Themengebiets wurde eine empirische Analyse mit 162 Franchisegebern durchgeführt. Die empirischen Ergebnisse zeigen einen signifikanten Unterschied zwischen MUF und SUF in Bezug auf der Einschätzung des Franchisegebers zu transaktionsspezifischen Investitionen der Franchisenehmer. In Übereinstimmung mit den theoretischen Ausführungen dieser Arbeit, liefert die empirische Untersuchung die Erkenntnis, dass Franchisegeber bei hohen transaktionsspezifischen Investitionen der Partner, MUF präferieren. Eine mögliche Erklärung liegt in der Notwendigkeit eines höheren Ausmaßes an Kontrolle von Multi-Unit-Franchisenehmern, aufgrund der größeren Verantwortung und Marktmacht, die das Führen von mehreren Franchisebetrieben, im Vergleich zur Verwaltung eines einzelnen Standortes, mit sich bringt. Darüber hinaus konnte kein signifikanter Zusammenhang zwischen ‚general‘ und ‚knowledge-based trust‘ und der Wahl der Franchisegeber zwischen SUF und MUF, festgestellt werden.

**Keywords:** Internationales Franchising, SUF, MUF, Vertrauen, Transaktionskostentheorie, Agency-Theorie, Transaktionsspezifische Investitionen Umweltunsicherheit, Verhaltensunsicherheit.