Contractual Design and Spatial Organization in Retailing:
Evidence from Brazilian Franchising on Brand Equity Protection Strategy

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Résumé : Dans cet article, nous mettons en évidence l'impact de l'organisation spatiale des réseaux sur les stratégies de protection de la marque et la structure des contrats de franchise. La franchise commerciale repose sur le partage, au sein d'un réseau, d'une marque et d'un concept développés par le franchiseur. En tant qu'actifs immatériels, marques et concepts n'ont pas tous la même valeur. Par ailleurs, dans les contrats de franchise, le taux de redevance et le droit d'entrée sont les principales clauses monétaires définissant le système de paiement entre le franchiseur et le franchisé. Les travaux antérieurs, basés sur la théorie de l'agence, et le cas des pays développés, ont montré que la présence de points de vente distants amène le franchiseur à choisir un mécanisme de paiement conçu pour fournir un maximum d'incitations aux franchisés, soit une faible redevance et un droit d'entrée élevé. A partir de données de panel brésiliennes uniques, nous montrons que la dispersion spatiale du réseau produit le résultat inverse. Ce résultat s'explique par une stratégie de protection de la marque dans le contexte d'un marché émergent.

Abstract: This paper deals with brand equity protection in the case of an emerging franchise system. We address the impact of spatial organization on franchise contracts managed by the parent brand. Business-format franchising is based on having a common brand name and concept within the chain, developed by the franchisor. As intangible assets, the brands and the related business concepts do not all have the same profitability. This idea is captured by the generic concept of "brand equity". In franchise contracts, the royalty rate and the fixed entrance fee are the main monetary clauses defining the payment scheme between the franchisor and the franchisee. Within the traditional agency view, the presence of distant retail outlets leads the franchisor to choose a payment mechanism designed to provide incentives to the franchisee; that is, a low royalty rate associated with a high fixed fee. Based on a unique panel dataset, we provide evidence that spatial dispersion has the opposite impact in Brazil. This result leads to interesting practical and research implications. It is associated with the strategy of brand assets protection, decisive in the context of an emerging market.

Colloque International E.Thil 2019
10 et 11 octobre, ESCP Europe, Paris (France)

Résumé Managérial

Le contrat est un sujet qui est toujours d'actualité de nos jours, en particulier dans le domaine des affaires. Dans le même ordre d'idées, l'importance des contrats a été récemment démontrée lorsque la banque centrale suédoise a choisi d'attribuer le prix 2016 des sciences économiques à la mémoire d'Alfred Nobel à Oliver Hart et Bengt Holmström. La conception des contrats soulève des problèmes d'incitations et de suivi, ainsi que des questions connexes de rémunération et de paiement des indemnités.

Dans les contrats de franchise, le taux de redevance et le droit d'entrée sont les principales clauses monétaires définissant le mécanisme de paiement entre le franchiseur et le franchisé. Du point de vue de la théorie traditionnelle d'agence, qui reste la plus mobilisée pour analyser la franchise, la présence de points de vente distants amène le franchiseur à choisir un mécanisme de paiement conçu pour fournir un maximum d'incitations aux franchisés, c'est-à-dire une faible redevance et un droit d'entrée élevé.

Développant des estimations économétriques sur une base de données de panel brésiliennes unique allant de 2011 à 2016, et comprenant 335 chaînes de franchise, nous montrons que la dispersion spatiale du réseau produit le résultat inverse. Ce résultat s'explique par une stratégie de protection de la marque dans le contexte d'un marché émergent.

Plusieurs implications managériales découlent de ce travail. En effet, nos résultats ont des implications importantes concernant le choix des clauses contractuelles dans la franchise. Nous avons montré, en premier lieu, que le mécanisme de paiement - autrement dit le taux de redevance et le niveau des droits fixes d'entrée – n'a pas seulement des implications bilatérales (franchiseur / franchisé). C'est aussi un facteur déterminant pour la performance au niveau de la chaîne dans sa globalité. Par ailleurs nos résultats suggèrent que les clauses monétaires peuvent faire partie intégrante de la stratégie de gestion des marques. Ces résultats montrent en effet que, dans le contexte spécifique d'un pays émergent, caractérisé par un grand dynamisme de création de chaînes franchisées – c'est le cas du Brésil sur la période étudiée – les mécanismes monétaires jouent un rôle dans la pérennité du capital marque du réseau. Enfin, nos résultats soutiennent l'idée que des performances supérieures sont obtenues par les réseaux lorsque le mécanisme de paiement (modalités de paiement liant le franchiseur et les franchisés) se focalise sur l'incitation des franchisés exploitant la marque commune, parallèlement à l'utilisation d'outils alternatifs, tels que les dispositifs de support (support du franchiseur au franchisé dans les méthodes et l'organisation, support légal, etc.) plus directement liés à la gestion des actifs de la marque.

I. Introduction

This paper deals with brand equity protection in the case of an emerging franchise system. We address the impact of spatial organization on franchise contracts managed by the parent brand. Business-format franchising is based on having a common brand name and concept within the chain, developed by the franchisor. The very close relationship between branding and franchising is for example underlined by Merrilees and Frazer (2013), and by Nyadzayo et al. (2015). As intangible assets, the brands and the related business concepts do not all have the same profitability. This idea is captured by the generic concept of “brand equity”, defined by the following elements: perceived quality, brand name, brand image, brand associations, brand reputation, and brand assets including patents, trademarks, goodwill, franchises, etc. (Keller, 1993; Simon and Sullivan, 1993; Yoo, Donthu, and Lee, 2000).

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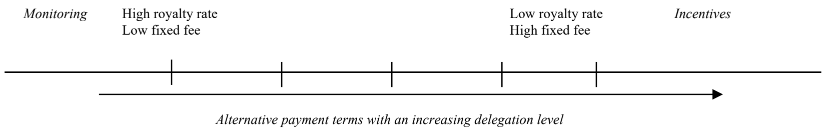
The rest of our article is organized as follows. Section II presents the related literature and develops the testable predictions. Section III describes the data and the study variables. The estimation strategy and the results are contained in section IV. Section V offers a concluding discussion.

II. Related literature, Brazilian context, and hypotheses

Traditional dilemma between incentives versus monitoring and the impact of geography

Based on previous literature in the agency framework and related evidence (e.g. Lanchimba et al., 2018), Figure 1 presents the different options for payment mechanisms in franchise contracts.

Figure 1 - Payment terms and franchisor’s dilemma between monitoring and incentives.



Assuming that the geographical dispersion of the chain increases the monitoring cost, the franchisor chooses payment terms oriented towards incentives, i.e. a low royalty rate. In this case, the franchisor’s payment is mainly based on the fixed fee. The related predictions are as follows:

H1. The royalty rate decreases with the chain geographic dispersion.

H2. The fixed fee increases with the chain geographic dispersion.

Alternative view and competing hypotheses within the spatial development of an emerging franchise system

The specific context of emerging markets justifies hypotheses competing the traditional view. Extant literature acknowledges that emerging market firms want first to accumulate brand equity assets (Contractor et al., 2007; Thite et al., 2012; Yeung, 1999). For this reason, the geographical expansion of a franchise chain in a continent-sized emerging market like Brazil is associated with the need to set efficient mechanisms enabling the enforcement of quality standards for the brand and business concept throughout the chain[1]. In this context, franchisors might choose a payment mechanism allowing more control of the franchisees, i.e. a lower delegation level (see Figure 1). The following counter-propositions express this alternative view:

[1] In this case, the contractual design with a high royalty rate and a low fixed fee is a proxy for a strategy of brand equity protection.

H3. The royalty rate increases with the chain geographic dispersion.

H4. The fixed fee decreases with the chain geographic dispersion.

Support devices as an alternative to monetary provisions in maintaining the common brand reputation

In addition to the preceding reasoning, we here develop the idea that support devices can be an alternative to monetary provisions in maintaining a common brand reputation. In the context of an emerging franchise sector, with chain reputations yet to be settled, the franchisor can use non-monetary contractual terms to maintain a close relationship with the franchisees, and then to keep control over the operating of the brand. These support devices may act as substitutes for the monetary clauses (royalty rate, fixed fee). Consistent with this idea, empirical evidence on the links between the parent and owned company in emerging markets emphasizes that the latter benefits from the support of the parent brand (e.g. Luo, 2003; Chiao et al. 2010). This discussion leads to the following prediction:

H5. The higher the support devices in the franchise relationship, the lower the royalty rate.

Performance outcome

While the literature on franchise data often addresses the performance outcome of organizational choices (e.g Madanoglu et al., 2011; Fadairo and Lanchimba, 2014), few empirical studies deal with the impact of contractual terms, and more precisely of the royalty rate, on chain performance.

These studies (Shane et al., 2006; Kosová and Lafontaine, 2010; El Akremi et al., 2015; Lanchimba et al., 2018) highlight contrasting results, from which we formulate the following prediction:

H6. The payment mechanism has a significant impact on the chain performance.

III. Data and measurement

We use recent panel data for the period 2011–2016, regarding 335 franchise chains implanted in the Brazilian market. Our unique dataset compiles information from three main sources: 1) ABF[2]’s Official Franchise Guides, 2) websites of franchise chains, and 3) Brazilian Institute of Geography and Statistics (IBGE). The study variables are as follows.

Three dependent variables are distinguished. The *Royalty Rate* is defined as the percentage of the downstream sales accruing to the franchisor. The *Fixed Fee* is defined as the upfront fixed amount paid by the franchisee when entering the chain. As *Chain Performance* variable, we use the market share, measured as the franchisor’s turnover divided by the sector turnover. The *Chain Geographic Dispersion* is our first independent variable of interest. To construct this variable, we use Google Maps to geo-reference the addresses of the franchised units entered in the dataset. Our second variable of interest is the *Support Devices*[3] provided by the franchisor to the franchisees, representing the level of control *versus* delegation in the vertical relationship regarding the exploitation of the franchisor’s brand name. Finally, we add a set of *control variables.*

IV. Estimations

Step one: determinants of the monetary choice

To test H1–H5, we estimate the following linear model:

[2] Associação Brasileira de Franchising.

[3] We construct this variable based on the ABF indications. Thirteen types of supports are indicated in the guide, like “plant and equipment selection”, or “training”. For each support device, the information is available as a dummy variable. Summing these categorical variables for each chain, we create the *Support Devices* variable as an ordered multinomial variable.

$$MC_{it} = \mu + \pi_1 D_{it} + \pi_2 S_{it} + \pi_3 \rho X_{it} + u_i + \epsilon_{it} \quad (1)$$

i = 1, …, 2010 t = 2011, …, 2016

where MC is the monetary clause, μ the constant term, D the chain geographic dispersion, S the support devices, X the matrix of control variables, u_i the random disturbance that characterizes the ith observation (constant over time) and ϵ_{it} the error term. We control for endogeneity and heteroskedasticity. The estimation results are presented in Table 1.

Table 1 - Results for the monetary clauses

	(1) Royalty rate	(2) Royalty rate	(3) Royalty rate	(4) Fixed fee	(5) Fixed fee	(6) Fixed fee
Chain Geo. dispersion	1.31e-05*** (1.20e-06)	1.29e-05*** (1.45e-06)	1.11e-05*** (1.87e-06)	-6.49e-03*** (8.9e-04)	-5.48e-03*** (7.64e-04)	-5.25e-03*** (7.22e-04)
Support devices	-2.31e-04*** (2.72e-05)	-3.16e-04*** (2.74e-05)	-1.67e-04*** (0.3e-04)	-0.150* (0.0626)	-0.0786* (0.00750)	-0.262*** (0.0770)
P. of franchised units		-2.88e-05 (8.04e-05)	-2.97e-04 (3.32e-04)		-14.72*** (0.538)	-15.27*** (0.685)
Age of the chain		-3.08e-04*** (2.86e-06)	-2.79e-04*** (9.77e-06)		0.0461*** (0.0109)	0.0241** (0.00778)
Contract length		5.08e-06 (3.6e-06)	2.99e-06 (3.95e-06)		0.170*** (0.00999)	0.166*** (0.0113)
Year dummies	no	no	yes	no	yes	yes
_cons	0.0576*** (0.000365)	0.0657*** (0.000346)	0.0629*** (0.000544)	39.64*** (0.662)	39.25*** (0.729)	33.11*** (1.143)
N	2010	2010	2010	2010	2010	2010
Wald Chi2	190.18	11805.90	903.42	59.15	1244.69	825.94

Standard errors are in brackets - * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Step two: performance outcome

To test H6, we estimate the following linear model:

$$P_{it} = \varphi + \beta_1 MC_{it} + \beta_2 Z_{it} + v_i + \psi_{it} \quad (2)$$

i = 1, …, 2010 t = 2011, …, 2016

where P, the *performance* variable, is the market share, φ is a constant term, MC is the monetary clause (royalty rate *versus* fixed fee), Z is a matrix of control variables, v_i is a random disturbance that characterizes the ith observation (constant over time), and ψ_{it} is the error term. We deal with a revealed endogeneity problem by using the two-step methodology developed by Murphy and Topel (1985). The estimation results are presented in Table 2.

Table 2 - Performance outcome of the monetary choice

	(7) Performance	(8) Performance	(9) Performance	(10) Performance	(11) Performance	(12) Performance
Royalty rate	-0.349*** (0.0479)		-0.539*** (0.0547)		-0.437*** (0.0269)	
Fixed fee		8.00 e-4*** (0.0000434)		1.08 e-4*** (0.0000624)		7.00 e-5*** (0.0000280)
Population			2.59e-10*** (1.46e-11)	2.59e-10*** (1.36e-11)	8.65e-11*** (5.19e-12)	1.14e-10*** (5.09e-12)
Localized			0.126***	0.109***	0.132***	0.127***
HDI			(0.0124)	(0.0123)	(0.00607)	(0.00594)
Sector dummies	no	no	no	no	yes	yes
_cons	0.0460*** (0.00274)	-0.00238 (0.00158)	-0.0506*** (0.00991)	-0.107*** (0.00943)	0.0378*** (0.00578)	-0.00929 (0.00595)
N	2010	2010	2010	2010	2010	2010
Wald chi2	53.11***	339.34***	193.82***	443.10***	6024.62***	6063.84***

Standard errors are in brackets * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$ The performance criterion is the market share

V. Concluding discussion

Main findings and contribution - This study presents the first empirical evidence that spatial organization of franchised chains impacts the contractual design. We focus on the payment terms and show that, in the Brazilian case, their setting is closely related to the protection of the franchisor's brand within a context of chain spatial expansion. Yet, our estimations of the performance outcome suggest that it would be more efficient that the franchisors use the monetary provisions to motivate the franchisees rather than for brand protection. Fruitful implications and directions for further research can be highlighted.

Implications for practice - Our results have important practical implications for contractual choices in franchising. We show, first, that the monetary choice in the design of franchise contracts, i.e. the royalty rate and the fixed fee level, is not only a bilateral issue i.e. a coordination means between the franchisor and the franchisee. It is also an important determinant of the chain performance. Secondly, our estimations suggest that the payment terms can be part of the brand-name management strategy. Our empirical results suggest that monetary provisions play an important role in maintaining the common brand equity in the context of an emerging economy. Finally, our results support the idea that the payment mechanism (payment terms linking the franchisor and the franchisees) should be focused on the provision of incentives for the franchisees operating the common brand name, while alternative tools, like the "support devices" are more appropriate for the management of brand-name assets.

Implications for research - This article has also interesting implications for research. We build on the extant literature linking organizational choices in franchising with geographical features (e.g. Perryman and Combs, 2012). We here provide clear and robust evidence that the geographical features (spatial organization of the chain) impact the contractual design. To the best of our knowledge this is a new academic result. Secondly, our results support the idea of a negative relationship between the two monetary provisions. However, we find evidence for an alternative view, contrasting with the standard-agency framework. Indeed, we show that, in the studied case, geographical dispersion of the chain leads the franchisors to choose a payment mechanism allowing more control of the franchisees, with a high royalty rate and a low fixed fee. These results suggest that the monetary clauses can be part of the brand-name management strategy in the specific context of an emerging market. Finally, our paper shows that, in addition to the debate on the sign of the correlation between the fees, another discussion occurs when the fees are substitute: substitute payment terms oriented towards incentive provisions in the context of spatial dispersion of the chain outlets, *versus* substitute payment terms oriented towards brand-name assets protection. While previous research based on franchise data from developed countries have provided evidence on the link between spatial dispersion and incentive organizational design, we show that, in the Brazilian case, brand equity protection is a dominant rationale behind the setting of the payment clauses.

Limitations and future research directions - This study is not without limitations. First, it would be worth to extend the geographical focus and address the same issue in different empirical contexts, more precisely other continent-sized emerging countries, like China. Second, we dealt with a six-year panel dataset. A longer panel may provide complementary results. While we here focus on the monetary clauses in franchise contracts, it would also be interesting to take into account other contractual provisions.

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