

WHY NEW FRANCHISORS SUCCEED

FINAL REPORT

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TABLE OF CONTENTS

Acknowledgments.....	3
Executive Summary.....	4
Introduction.....	6
The 1981-1983 Cohort of Franchisors.....	6
Characteristics of Surviving Versus Non-Surviving Franchise Systems.....	9
Survival Patterns.....	10
Explaining New Franchisor Survival.....	14
Stability of the Successful System Model.....	23
Growth of Successful Systems.....	24
Recommendations to New Franchisors.....	27
Recommendations to Franchisees.....	29
Recommendations for Policy Makers.....	30
Methodological Appendix.....	31

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EXECUTIVE SUMMARY

This study examines why some new franchisors survive and grow, while the vast majority fail. The project, sponsored by the Office of Advocacy of the U.S. Small Business Administration (SBA), investigated a sample of new franchise systems established in the United States between 1981 and 1983 over the period 1984-1995. The study sought to provide a model to explain interrelated decisions that differentiated the survivors from the failures.

The results of this study provide the first normative model to explain the survival of new franchisors. The model indicates that new franchisors need to develop an interrelated system of franchising policies since survival is explained by a set of interrelated choices which may not be manipulated independently by new franchisors. The model can be summarized as follows: new franchisor success depends on system growth. Successful new franchisors grow rapidly to lower the cost of promoting the new system's brand name. By allocating local managerial activity to franchisees, new franchisors can overcome human resource limitations on their growth and establish outlets fast enough to reach minimum efficient scale to promote their brand names competitively with established firms. By signaling the high quality of intangible assets and their intention to act honestly, new franchisors can attract franchisees quickly enough to avoid master franchising, which undermines the high powered incentives of franchising. The study also provides empirical support for this explanation of franchising.

The results of the study also provide several implications for franchisors, franchisees and policy makers. The study confirms the survival patterns of new franchise systems shown in my 1995 report to the Office of Advocacy of the U.S. SBA which was based on a different sample of

new franchisors.¹ On average, an investment in a new franchise system in the year in which it begins to franchise will be an investment in a system that will fail. Over three quarters of the new franchise systems in the study ceased to franchise by the end of the study period.

Although most new franchisors fail, successful franchisors make very different choices from unsuccessful franchisors during their early years of franchising. Potential franchisees should carefully investigate new franchisors before investing in them. To correctly select a new franchise system that is likely to survive over time, a potential franchisee should look for several factors:

- Franchisors that are expanding rapidly through franchising. New franchisors whose rate of system growth greatly exceeds their industry average are more likely to survive.
- Franchise systems that do not promise a great deal of field support. New franchisors that devote their scarce management talent to growing the franchise system rather than providing field support are more likely to survive.
- A lean headquarters operation of a new franchise system. This lean operation enhances the growth of the franchise system and the development of its brand name.
- New franchisors which are successfully establishing their brand names. Successful brand names attract customers and enhance the value of the franchise system.
- Franchisor membership in the International Franchise Association and registration with state authorities, which are positive signals of survival.
- Avoidance of master franchising. While master franchising speeds the growth of new franchise systems, it also increase the likelihood that new franchise systems will fail.

Potential franchisees can use the model described in this study to identify new franchise systems in which to invest. The information used in this model is available from popular franchise guides, such as Bond's *Sourcebook of Franchise Opportunities*.

¹ Shane, S. "Differences between successful and unsuccessful franchisors," Report to the U.S. Small Business Administration, Contract No. SBA-95-0404, October 1, 1995.

INTRODUCTION

Franchising accounts for approximately one third of all retail sales in the United States. Franchisors are displacing independent businesses in many industries, from fast food to auto repair to now the internet. This growth of franchising as a business form has led more and more Americans to purchase franchise outlets as a way to become entrepreneurs.

Each year between 200 and 300 companies seek to meet this demand for franchising by offering franchises for sale for the first time. However, roughly three quarters of these new franchisors cease to franchise within twelve years of beginning to franchise. This high failure rate is troubling to policy makers who regulate franchising, to entrepreneurs who seek to start new franchise systems, and to potential franchisees who are buying new franchised outlets as a way to become entrepreneurs.

The importance of franchising to the U.S. economy combines with this high failure rate to raise the question of why some new franchisors survive and others fail. To answer this question, I examined what happened to 157 companies that first began to franchise in the United States between 1981 and 1983 over the 1984 to 1995 period.

THE 1981-1983 COHORT OF FRANCHISORS

The cohort of new franchisors in this study consisted of 157 firms that began to franchise between 1981 and 1983. They were drawn from 27 different industries. The most common industry was eating and drinking places with 37 new franchisors in the sample. At the other end of the spectrum, only one new franchisor was found in several industries represented in the sample. Table 1 shows the distribution of the sample by industry.

Table 1. The Distribution of New Franchisors by Industry.

Industry	SIC CODE	Number (Pct.) Franchisors - 1996 Study		Number (Pct.) Franchisors - 1995 Study ²	
Eating and drinking places	5812	35	(22)	24	(17)
Computer and computer software stores	5734	11	(7)	7	(5)
Business consulting services	8748	9	(6)	3	(2)
Miscellaneous personal services	7299	9	(6)	0	(0)
Miscellaneous retail	5999	8	(5)	5	(4)
Lumber and other building	5211	7	(4)	9	(6.5)
Beauty shops	7231	7	(4)	1	(1)
Building cleaning and maintenance	7349	5	(3)	3	(2)
Employment agencies	7361	5	(3)	5	(3.5)
Camera and photographic supply stores	5946	4	(2.5)	5	(3.5)
Business brokers	7389	4	(2.5)	0	(0)
Automotive repair shops	7538	4	(2.5)	5	(3.5)
Computer repair and maintenance	7378	4	(2.5)	0	(0)
Courier services	4215	4	(2.5)	0	(0)
Auto and home supply stores	5531	4	(2.5)	1	(1)
Recreation and sports clubs	7997	4	(2.5)	0	(0)
Secretarial and court reporting services	7338	3	(2)	1	(1)
Offices and clinics of doctors of dentistry	8011	3	(2)	2	(1.5)
Record and prerecorded tape stores	5735	3	(2)	4	(3)
Schools	8211	3	(2)	0	(0)
Financial advice	6282	2	(1)	0	(0)
Security system services	7382	2	(1)	3	(2)
Household appliance stores	5722	2	(1)	1	(1)
Grocery stores	5411	2	(1)	4	(3)
Retail bakeries	5461	2	(1)	2	(1.5)
Furniture stores	5712	1	(0.5)	1	(1)
Women's clothing stores	5621	1	(0.5)	2	(1.5)
Miscellaneous publishing	2741	1	(0.5)	3	(2)
Coupon distribution	7319	1	(0.5)	0	(0)
Information retrieval services	7375	1	(0.5)	1	(1)
Outdoor advertising	7312	1	(0.5)	1	(1)
Shoe repair shops	7251	1	(0.5)	2	(1.5)
Hobby, toy and game shops	5945	1	(0.5)	1	(1)
Commercial printing	2759	1	(0.5)	3	(2)
Offices and clinics of doctors of medicine	8011	1	(0.5)	1	(1)
Business associations	8611	1	(0.5)	3	(2)
Data processing schools	8243	0	(0)	4	(3)
Travel agencies	4724	0	(0)	1	(1)
Hardware stores	5251	0	(0)	6	(4)
Miscellaneous apparel and accessories	5699	0	(0)	1	(1)
Drug stores and proprietary stores	5912	0	(0)	2	(1.5)

² Shane. *Ibid.*

Used merchandise stores	5932	0	(0)	1	(1)
Sporting goods stores and bicycle shops	5941	0	(0)	1	(1)
Jewelry stores	5944	0	(0)	1	(1)
Sewing needlework and piece goods stores	5949	0	(0)	2	(1.5)
Catalog and mail order houses	5961	0	(0)	3	(2)
Funeral services and crematories	7261	0	(0)	1	(1)
Credit reporting services	7323	0	(0)	1	(1)
Photocopying and duplicating services	7334	0	(0)	4	(3)
Equipment rental and leasing	7359	0	(0)	1	(1)
Passenger car rental	7514	0	(0)	1	(1)
Top, body, and upholstery repair shops	7532	0	(0)	2	(1.5)
Data processing schools	8243	0	(0)	4	(3)
Accounting, auditing and bookkeeping	8721	0	(0)	2	(1.5)

Summary Statistics

Table 2 provides abbreviated summary information on the sample firms.³ The table shows that the average new franchisor was 7 years old when it began to franchise and had 4.82 company-owned outlets. Its advertising rate was 2 percent of sales and its royalty rate was 5 percent of sales. The mean initial investment in a franchised outlet in the system was \$171,832 and its franchise fee averaged \$18,252. All of these figures, except for royalty and advertising rates, are lower than those that would be found in a cross-section of surviving franchise systems. The average advertising rates, royalty rates, initial investment, and franchise fees of the new franchise systems were 116 percent, 109 percent, 95 percent, and 94 percent of industry averages, respectively.

It is interesting to note that new franchisors charge lower up front fees and higher variable fees as a percentage of sales than does the average franchisor. Given the uncertainty about the value of a new franchise system and the trustworthiness of a new franchisor, one would expect this pattern since potential franchisees would be reluctant to make large up-front investments in an unknown franchise system.

³ Table 8 in the methodological appendix shows the full summary statistics.

Table 2. Abbreviated Summary Statistics for the Sample of New Franchisors.

Variable	Mean	Standard Deviation	Minimum	Maximum
Company-owned outlets at start of franchising	4.82	10.63	0.00	85.00
Company-owned outlets at start of franchising (% industry avg.)	44%	92%	0%	667%
Size of system (% industry avg.)	18%	34%	0%	267%
Total number of support services offered to franchisees	5.65	2.25	0.00	9.00
Brand name ranking (in Entrepreneur Magazine)	462.62	101.52	23.00	501.00
Cash Investment (dollars)	\$64,104.09	\$66,394.81	\$500.00	\$500,000.00
Cash Investment (% industry avg.)	93%	82%	1%	458%
Franchise Fee (dollars)	\$18,252.33	\$14,103.99	\$0.00	\$100,000.00
Franchise Fee (% industry avg.)	94%	82%	0%	672%
Total Investment (dollars)	\$171,831.89	\$511,173.54	\$500.00	\$6,000,000
Total Investment (% industry avg.)	95%	110%	1%	645%
Royalty rate (% of sales)	5%	3%	0%	20%
Royalty rate (% industry avg.)	109%	67%	0%	417%
Advertising rate (% of sales)	2%	1%	0%	7%
Advertising rate (% industry avg.)	116%	98%	0%	597%
Efficiency (outlets / employee)	2.66	9.02	0.00	93.43
Average no. employees per outlet	5.99	6.28	1.00	42.50
<u>Variable</u>	<u>Percent that provide or allow</u>			
Master franchising	64%			
Registered with state authorities	72%			
Member of the IFA	26%			
Permit passive ownership	37%			

CHARACTERISTICS OF SURVIVING VERSUS NON-SURVIVING FRANCHISE SYSTEMS

In the sample, the surviving franchise systems differed from the non-surviving franchise systems in several ways. Table 3 summarizes the dimensions upon which there were statistically

significant differences between survivors and non-survivors in 1984.⁴ The surviving franchise systems were larger in terms of number of outlets in their largest state (29.43), number of headquarters staff (42.88), number of states in which they operated (8.62), and system size relative to the industry average (28 percent). Surviving franchise systems had longer term franchise agreements (18.22 years) and were less likely to allow passive ownership. Surviving franchisors were also more likely than non-surviving franchisors to be registered in one or more of the registration states, to have more valuable brand names (*Entrepreneur Magazine* ranking of 391.71), and to have more efficient operations (6.77 outlets per headquarters employee). They were also less likely to provide support services to franchisees (5.05 services), in particular centralized data processing, inventory control and field support. No significant differences were found between surviving and non-surviving franchise systems on initial investment, royalty or advertising rates.

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Table 3. Significant Differences Between Surviving and Non-surviving New Franchisors

Variable	Non-survivors	Survivors
Registered with state authorities	66%	88%
Brand name ranking (in <i>Entrepreneur Magazine</i>)	487.69	391.71
Efficiency (outlets / employee)	1.24	6.77
Number of support services provided to franchisees	5.86	5.05
Number of outlets in largest state	6.95	29.43
Headquarters staff	20.99	42.88
Number of states with outlets	4.26	8.62
Term of original agreement (years)	12.01	18.22
Outlets per state	57.28	134.20
Size at time franchising began (% industry average)	15%	28%

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⁴ Table 9 in the appendix shows the full comparison of survivors and non-survivors across all dimensions.

SURVIVAL PATTERNS

The survival of new franchisors was examined two ways: First, the overall survival of the sample was explored. Second, the survival patterns by industry were investigated.

Overall Survival Patterns

The overall survival pattern for the 157 new franchisors in the sample was not impressive. By the end of their twelfth year, less than one quarter of the initial cohort of franchisors was still franchising. Figure 1 shows these results graphically and compares them to the results shown in 1995 SBA report.⁵

Figure 1. Percent Alive by Year.

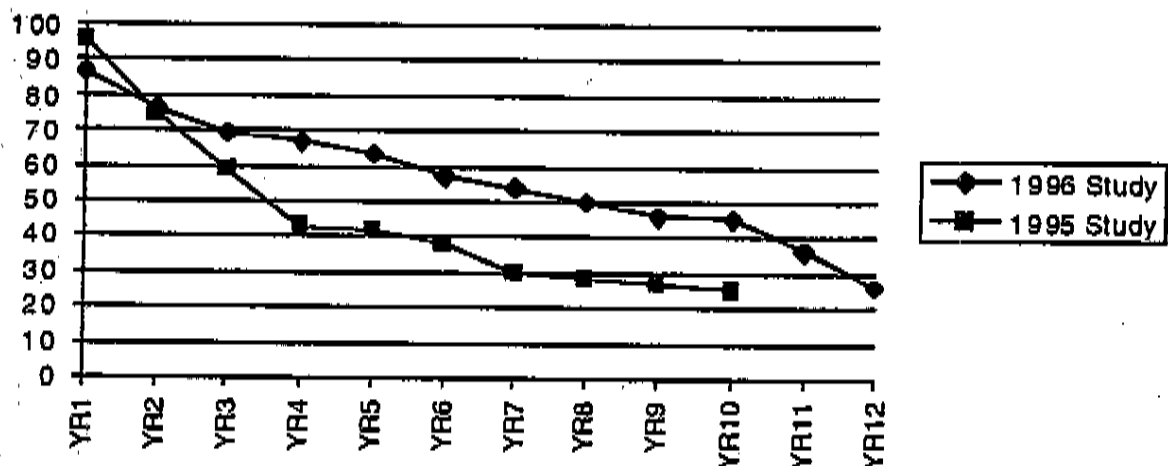


Table 4 shows the number of new franchisors in the sample surviving after each of the first twelve years and the percent of the cohort that died in each year. It also shows a similar death rate to that reported in my 1995 SBA report, although slightly less severe.

⁵ Shane, *Op Cit.*

Table 4. Survival Patterns Over Time, 1984-1995.

	YR1	YR2	YR3	YR4	YR5	YR6	YR7	YR8	YR9	YR10	YR11	YR12
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1996 Study												
Percent Alive	87	77	69	67	64	57	54	50	46	45	35	26
Death Rate ⁶	13	12	10	4	5	10	6	7	8	4	21	25
<hr/>												
1995 Study												
Percent Alive	96	75	59	43	42	38	30	28	27	25	—	—
Death Rate	4	21	15	17	1	4	9	2	1	2	—	—
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The results also show a survival curve of new franchisors somewhat different from that described in my 1995 SBA study. During the first twelve years of the life of a franchise system, there appear to be three distinct phases. Table 4 shows that during the first four years, the death rate of new franchise systems was quite high, with 33 percent dying during this period. During the next six year period, the death rate slowed considerably, with only 22 percent of the original franchise systems dying during this period. In the last two years, the death rate again accelerates, with 19 percent of the franchise systems dying during this two-year interval.

Survival Patterns by Industry

The survival patterns differed significantly across industries. Although the small sample size necessitated the rough categorization of the new franchisors into three broad categories -- food, other retail, and services -- different survival patterns emerged across these three groups. Table 5 shows the percent of franchisors surviving in each group across the 12 year period.

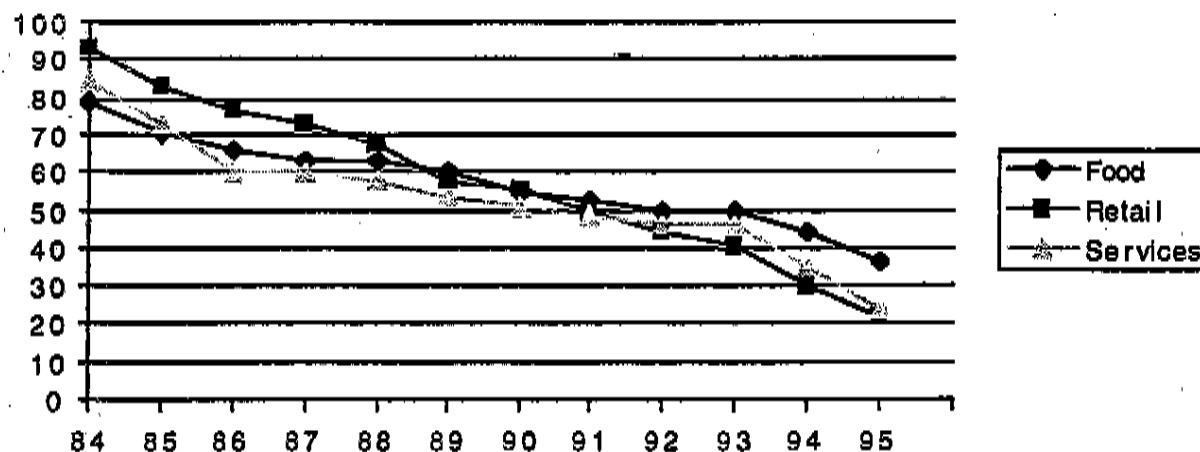
⁶ The death rate is the percent of the new franchisors still alive in a given year that died during that year.

Table 5. Percent Alive by Industry and Year.

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Food	78.9	71.0	65.8	63.2	63.2	60.1	55.2	52.6	50.0	50.0	44.7	36.8
Retail	93.2	82.4	77.0	73.0	67.6	58.1	55.4	50.0	44.6	40.5	29.7	21.6
Services	84.4	73.3	60.0	60.0	57.8	53.3	51.1	48.9	46.7	46.7	35.6	24.4

Figure 2 shows this information graphically. New food franchisors have a more severe failure rate in their early years than do retail or service franchisors, but this failure rate slows more quickly than for the other two groups. Twelve year survival rates are also higher for food franchisors than for service or retail franchisors. Service franchisors have nearly as slow failure rates in early years as food franchisors, but continue to fail at a faster rate than food franchisors after their seventh year. Retail franchisors appear to have a lower failure rate than service or food franchisors in their early years. However, they display little decline in the pace of that failure rate as they age.

Figure 2. Percent Alive by Industry.



The high death rate of new franchise systems found in my two SBA studies suggests that franchising is not an easy business in which to succeed, and demonstrates the importance of creating a model to explain the survival of new franchise systems. This model is important to policy makers who seek to minimize problems that result from new franchisor failure; franchisees seeking to pick the best franchise systems to buy into and new franchisors wanting to be successful. Fortunately, the data do reveal a consistent model of new franchisor success which holds up when subjected to rigorous scientific methodologies. In the pages below, I describe the model that the data reveal.

EXPLAINING NEW FRANCHISOR SURVIVAL

The story begins with the vision of an entrepreneur. Through the operation of a non-franchised business or through other experiences, the entrepreneur develops an idea of how to operate a company that he or she believes is superior to the operation of existing franchise chains. The entrepreneur believes that he or she can profit from the implementation of that idea by establishing a franchise chain. Unfortunately for the entrepreneur, the operational ideas themselves

do not provide the entrepreneur with a competitive advantage. Since these ideas are neither trade secrets nor patentable technologies, they can be copied once they have been made public.

Development of the Brand Name

To create a competitive advantage for the new chain, the entrepreneur seeks to build a valuable brand name for it. This brand name protects the chain from imitation. While a competitor can copy the outlet's operations, it cannot copy the brand name. So outlets bearing the brand name cannot be imitated completely by other firms.

An entrepreneur who has an idea for a new franchise system will need to develop a brand name quickly. Economies of scale in advertising allow retailers to lower the per unit cost of advertising to promote their brand names as they grow larger.⁷ This means that it is more costly for the new franchisor to promote its brand name than it is for an established competitor to do so until the new franchisor reaches minimum efficient scale. Until the new franchisor reaches that point, the greater cost the new franchisor incurs to promote its brand name threatens its survival.⁸

The development of the new system's operating routines may be costly for the entrepreneur, but once they have been developed, they can be replicated in multiple locations at very low additional cost. Economies of scale in advertising provide the franchisor with an incentive to establish outlets as quickly as possible. These scale economies allow companies to lower the per unit cost of advertising to promote their brand names.

At the time it began to franchise, the average surviving new franchisor in this study had only seven company-owned outlets and was less than 30 percent the size of the average franchise system in its industry. This means that when the average successful new franchisor in the study began to franchise, its per outlet cost of brand name promotion was higher than that of established competitors. Far too small to have economies of scale in advertising to promote the new system's

⁷ Norton, S. "An empirical look at franchising as an organizational form," *Journal of Business*, 61, 1988, p. 197-218.

⁸ Shane, S. "Hybrid organizational arrangements and their implications for firm growth and survival: A study of new franchisors." *Academy of Management Journal*, 39(1), 1996, p. 216-234.

brand name and attract consumers, the ultimately surviving new franchisors faced a fundamental choice -- find a way to grow or cease to franchise.

The faster the new franchisor can create retail outlets, the greater the chance that it will reach a scale to promote its brand name competitively before competitors can copy its outlet operations.⁹ Since retail outlets draw customers only from a constrained geographic area, the creation of a large number of outlets puts pressure on the entrepreneur to expand the system geographically. Consequently, the average surviving new franchisor sought franchisees in 41 states at the time it began to franchise, but did not seek foreign franchisees.

Delegation of Tasks to Franchisees

The entrepreneurs who start new-franchise systems have only limited time. Therefore, firm growth imposes great pressure on them to explore new products and markets and to manage existing operations simultaneously. The entrepreneurs can try to delegate these activities to others, but some activities are best accomplished by the entrepreneur. The entrepreneur has a greater incentive than others to explore new products and markets because he or she receives the benefit from their exploitation. Entrepreneurs also manage existing operations efficiently because they earn profits from their activities and have an incentive to work hard.

The entrepreneur can overcome time constraints and expedite growth by delegating many local entrepreneurial tasks to franchisees.¹⁰ As the franchisor spreads into different geographical markets, he or she will need to adapt the product or service to local real estate, labor markets, and customer tastes. The franchisor will find it expensive to gather this information directly since it will require the investment in employees in these different local markets. The cost of undertaking activities such as selecting sites for outlets, negotiating leases on property, opening outlets, and

⁹ Martin, R., and Justis, R. "Franchising, liquidity constraints, and entry. *Applied Economics*, 25, 1993, p. 1269-1277. Although one might expect a curvilinear relationship between growth rate of the system and survival, the results of this study do not provide any evidence of new franchisors that grew too rapidly to survive. However, the small sample size of the study makes it difficult to rule out the possibility that there is an optimal rate of growth for new franchisors beyond which the probability of firm survival is reduced.

¹⁰ Norton, *Op.Cit.*

adapting operations to local labor and demand conditions can be reduced assigning them to franchisees who already have this knowledge.¹¹

The surviving new franchisors in this study provided significantly fewer support services to franchisees than did non-surviving new franchisors. Moreover, much of the difference between surviving and non-surviving new franchisors on these support services was in the area of field support activity.

Efficiency

The assignment of local market activities to franchisees enhances the franchisor's efficiency in growing the franchise system.¹² Since the franchisor's employees do not have to be devoted to gathering information about local markets, the franchisor can concentrate on selling outlets and selecting and training franchisees. This increases the new franchisor's efficiency. The efficiency of the average surviving franchise system in this study was seven outlets per member of headquarters staff, in contrast to an average of only one outlet per headquarters staff for each non-surviving franchise system.

This efficiency speeds up the system's growth rate, and enables it to grow rapidly within in a short period of time. As the franchise system grows, its cost of competing with established franchisors to promote the system's brand name, decreases. Therefore, as the size of the new franchise system increases, brand name development is enhanced.¹³ The increase in the value of the brand name makes the new franchisor more likely to survive by making it possible to attract customers in ways that competitors cannot easily copy. Consequently, the surviving new franchisors in this study had significantly higher brand name rankings in *Entrepreneur Magazine* than did the non surviving franchise systems.

¹¹ Minkler, A. "Why firms franchise: A search cost theory," *Journal of Institutional and Theoretical Economics*, 148, 1992, p. 240-259.

¹² Norton, *Op Cit.*

¹³ Lafontaine, F. "Agency theory and franchising: Some empirical results," *Rand Journal of Economics*, 23(2), 1992, p. 203-283.

Signaling Quality

The growth of the franchise system and the reliance on franchisees to provide local market entrepreneurship requires the new franchisor to attract franchisees. This is a difficult undertaking. Franchisees find it difficult to evaluate the quality of a franchise system before investing in it.¹⁴ Moreover, the quality of new franchise systems is very uncertain since outlets in new franchise systems often do not generate the projected level of sales, and since a large number of new franchise systems and outlets fail.¹⁵

To reduce the risk of investing in new franchise systems, potential franchisees like to gather as much information as they can about franchisor quality before they invest. Successful franchise systems reduce franchisee risk by signaling their quality. One way that they do this appears to be by subjecting their systems to the scrutiny of the International Franchise Association. By joining the franchise trade association, the new franchisor demonstrates that his or her franchise system adheres to the trade association's standards, which are higher than those in the general franchising market.¹⁶

To become a member of the International Franchise Association, a franchisor must certify that he or she has never been "convicted of a felony or been held liable in a civil action involving fraud, fraudulent conversion or misappropriation of property."¹⁷ The franchisor cannot be "subject to any order of the Securities and Exchange Commission or the securities administrator of any state denying, revoking or suspending the registration or sale of any securities property ... subject to

¹⁴ Gallini, N., and Lutz, N. "Dual distribution and royalty fees in franchising," *Journal of Law, Economics, and Organization* 8(3), 1992, p. 471-501.

¹⁵ Desai, P., and Srinivasan, K., "Demand signaling under unobservable effort in franchising: Linear and non-linear price contracts," *Management Science*, 41(10), 1995, p. 1608-1623.

¹⁶ Sen, K., "The use of initial fees and royalties in business format franchising," *Managerial and Decision Economics*, 14, 1993, p. 175-190. Membership in the International Franchise Association is unlikely to cause survival. In addition to the signal of adherence to quality standards that membership in the International Franchise Association may provide, it might also serve as a proxy for greater capitalization, or the presence of a large corporate parent which actually causes survival. Therefore, new franchisors should not see this finding as an indication that they can enhance their survival chances by joining the International Franchise Association. But potential new franchisees can view this finding as providing evidence that new franchisors who are members of the International Franchise Association have a greater probability of surviving over time.

any order or ruling of the Federal Trade Commission property ... [or] subject to an injunctive or restrictive order relating to business activity as a result of any action brought by any public agency or department property..... [Nor can the franchisor be] subject to any order issued under any federal or state law regulating the sale of franchises or distributorships which denies, revokes or suspends the registration or sale of franchises or distributorships within any jurisdiction or requires the posting of a bond, the escrow of monies to be paid by franchisees or distributorships or any similar action as a pre-condition of the registration or sale of franchises or distributorships property.¹⁸ The franchisor must provide the International Franchise Association with a copy of their Uniform Franchise Offering Circular, including a financial statement. Finally, the franchisor must certify that they have read, understand and will comply with the International Franchise Association's code of conduct. This code of conduct includes a commitment to conduct business with franchisees accurately and fairly and in good faith, adhere to all applicable laws and regulations, establish franchise relationships subsequent to the delivery of "a clear and complete" written disclosure document, foster communication and open dialogue with franchisees, terminate relationships only for good cause and subject to certain guidelines, and adhere to specified conditions for transfer of franchises, system expansion, supplying raw materials, and resolving disputes.¹⁹ Since the franchisor must pay to become a member of the franchise association, this commitment can be seen as credible by potential franchisees.

Surviving franchise systems were eleven percent more likely to have joined the International Franchise Association than were unsuccessful new franchisors. And in the critical early years of the franchise system, when the new franchise system did not have a reputation, new franchisors were as much as twenty-six percent more likely to join the International Franchise Association than were unsuccessful new franchisors.

¹⁷ International Franchise Association, "Membership application," International Franchise Association: Washington, D.C. 1994, p. 2.

¹⁸ *Ibid.*, p. 2.

¹⁹ *Ibid.*, p. 2.

Moreover, membership in the International Franchise Association requires franchisors to adhere to state and federal franchise regulations as a condition of membership. Barkoff has explained that "there is concern among franchisor's counsel that in litigation the [IFA] Code will be introduced as evidence of a standard which, if not complied with, may result in liability to the franchisor for, among other reason, breach of an implied covenant of good faith and fair dealing."²⁰ Consequently, membership in the International Franchise Association leads franchisors to register their franchise documents with the appropriate state authorities in the registration states to ensure adherence to state standards. Since registration states have a higher standard for new franchisors than do non-registration states, registration provides a signal of quality which enhances the new franchisor's chance of survival.

In this study, surviving new franchisors were twenty-two percent more likely to register their franchise systems with state authorities than were non-surviving new franchisors. Moreover, successful new franchisors expanded into additional registration states as they aged, increasing the number of registration states in which they operated from five in 1985 to seven by 1989 and maintained this level at seven through 1995.

The larger the retail outlet which the franchisee is buying, the greater the size of its investment in the franchise system. The higher the outlet cost, the greater the franchisee's downside risk. The greater this downside risk, the more franchisees are concerned with obtaining information about the quality of new franchise system.²¹ Therefore, franchisors are more likely to signal the quality of more costly systems.

Overcoming Risk of Opportunism

Another problem that the new franchisor faces is convincing potential franchisees that it will not seek to take advantage of them. Franchisees are required to invest in franchisor assets,

²⁰ Barkoff, R., "Government regulation of the franchise relationship in the United States", *Paper Presented to the Committee on International Franchising (Committee X) Section on Business Law, International Bar Association Annual Meeting, New Orleans, LA: October 10-15, 1993*, p. 8.

²¹ Lafontaine, F. "Contractual arrangements as signaling devices: Evidence from franchising," *Journal of Law, Economics, and Organization*, 9(2), 1993, p. 256-289.

like signs, uniforms, and other materials that cannot be used except within the franchise system. Since most franchise contracts give franchisors the right of termination, franchisees are often afraid that franchisors will use termination as a way to take back high performing outlets before their investment in these assets has been paid off. This problem is particularly great with new franchisors since they have not yet established a reputation for trustworthy behavior.²² One way to reduce this problem is to establish longer term contracts. With longer term contracts, the franchisee investment in the franchisor system will be more likely to be paid off before the franchisor has a chance to terminate the franchisee to gain control of the outlet. In this study, surviving new franchisors provided franchisees with a franchise contract that was, on average, six years longer than that of unsuccessful new franchisors.

If the franchisor cannot write long term contracts to minimize this opportunism problem, it can signal its willingness to forgo this termination strategy by registering in registration states. Since most registration states have laws restricting termination by the franchisor to good cause, have procedural requirements for termination, and place the burden of proof on the franchisor to deny renewals, registration raises the cost of termination and provides evidence that the franchisor is less likely than the average unregistered franchisor to use a termination strategy.²³

Master Franchising

The value of growth to new franchisors leads those new franchisors which have not yet reached minimum efficient scale to adopt the tactic of master franchising to boost the rate of growth of the franchise system. Master franchising speeds system growth by providing the new franchisor with someone else to perform the functions of recruiting, supporting and training franchisees for

²² Dant, R., Kaufmann, P., and Paswan, A. "Ownership redirection in franchised channels," *Journal of Public Policy and Marketing*, 11(1), 1992, p. 33-44.

²³ Beals, J., and Muris, T. The foundations of franchise regulation: Issues and evidence. *Journal of Corporate Finance*, 2, 1995, p. 157-197.

them. The allocation of these tasks to master franchisees allows the new franchisor to grow at several times the rate at which it can grow without master franchising.²⁴

However, master franchising is not without its costs. In return for enhancing system growth, master franchising demands passive ownership. Passive ownership undermines the entrepreneurial incentives that come from outlet ownership.²⁵ Therefore, the need to grow quickly through master franchising increases the probability of system failure. Because of their rapid growth and reluctance to use master franchising, successful new franchisors were seventeen percent less likely than unsuccessful new franchisors to allow passive ownership. Moreover, as these successful systems aged, they became less and less likely to permit passive ownership.

New Franchisor Path Model

Table 6 shows the model just described. This model can be used by potential franchisees to identify new franchise systems in which to invest. The information used in this model is available from popular franchise guides, such as Bond's *Sourcebook of Franchise Opportunities*.

²⁴ Kauffman, P., and Kim, S., "Master franchising and system growth rates," *Journal of Marketing Channels*, 4(1/2), 1995, p. 49-64.

²⁵ Brickley, J., and Dark, F., "The choice of organizational form: The case of franchising," *Journal of Financial Economics*, 18, 1987, p. 401-420.

changed very few of their basic policies during the twelve years that I studied them. For example, the average royalty rates and advertising fees remained five percent and two percent of sales respectively across the time period of the study. The average franchise fees fluctuated between \$19,488 and \$28,385, but showed no apparent trend up or down. Similarly, the amount of training provided to franchisees, the size of the initial investment, and the amount of the cash investment varied, but without a trend. The term of the franchise agreement and the length of the renewal period also remained relatively constant during the period. Virtually no change was found in the support services that successful new franchisors offered to their franchisees.

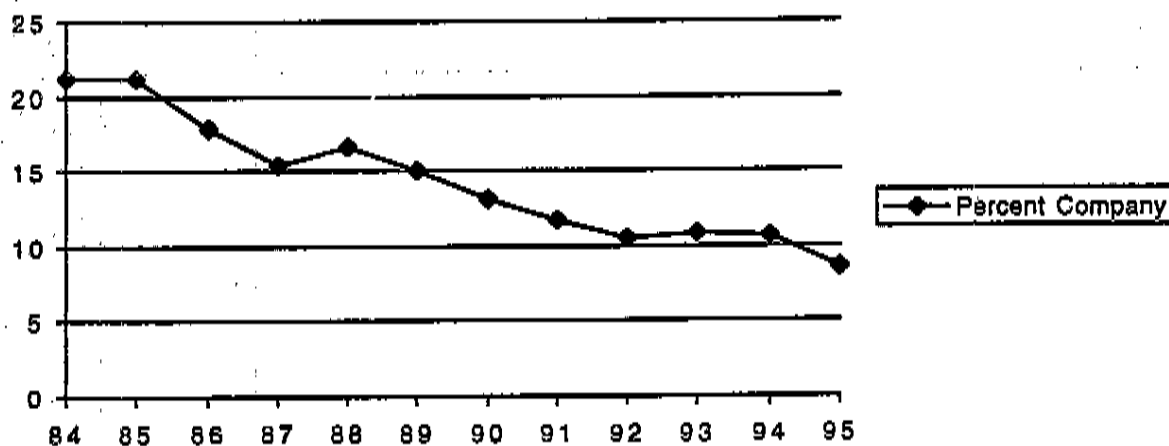
This stability of policies meant that if the new franchisors initially established franchise systems in line with the success model, the franchisors were able to maintain the positive web of policies and increase their likelihood of survival over time. Franchising requires a contractual agreement between the franchisor and franchisee. This contract lasts a relatively long time and is subject to some regulatory scrutiny. A contract makes it difficult for the franchisor to change policies and fees. A new franchisor, for example, that discovered that it provides too many services cannot easily change the contractual provisions regarding support services provided to franchisees. It is difficult to treat new franchisees differently from existing franchisees by establishing new provisions for them. This kind of action invites franchisee lawsuits from either the new or the old franchisees, depending on who is hurt by the changes. Consequently, if the new franchisor does not get the system model right initially, it is not likely to adapt to a successful system over time.

GROWTH OF SUCCESSFUL SYSTEMS

On several dimensions, the successful franchise systems in the study did change over time. However, these changes are largely related to the size and distribution of the franchise system, not franchisor policies. The average surviving franchise system in the study grew very rapidly, increasing the number of outlets in the system by an average of 330 percent per year. By the end of 1995, the average surviving franchisor had established 305 outlets.

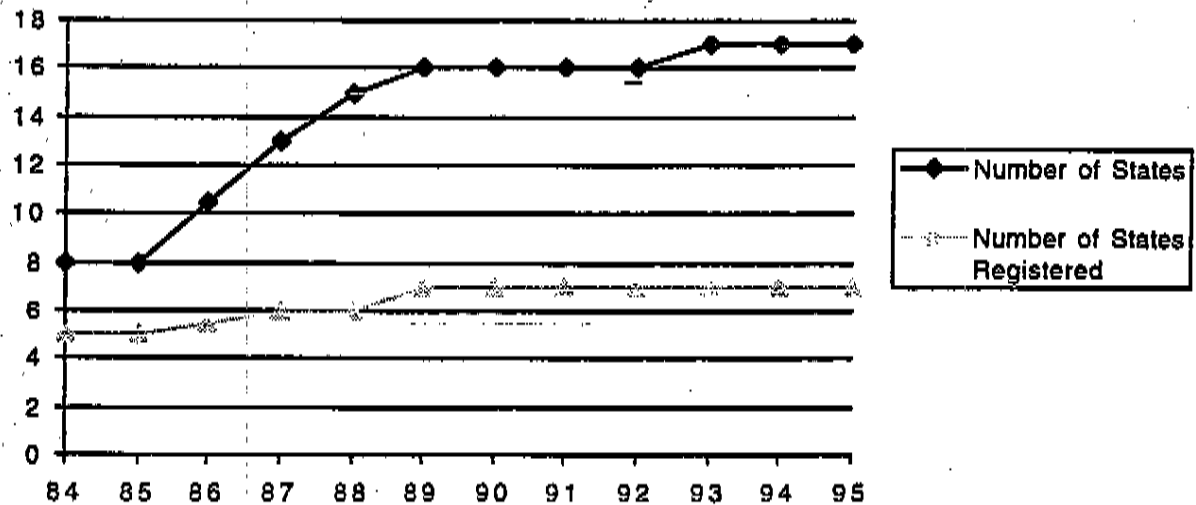
While surviving franchise systems grew significantly during the 1984-1995 period, this growth occurred primarily through the establishment of additional franchised outlets. Survivors maintained a relatively stable number of company owned outlets. The average surviving franchisor had only 26 company-owned outlets in 1995. Consequently, as Figure 5 shows, the percentage of company-owned outlets in the systems declined significantly throughout the period of the study.

Figure 5. Percentage of Company Owned Outlets in System Over Time.



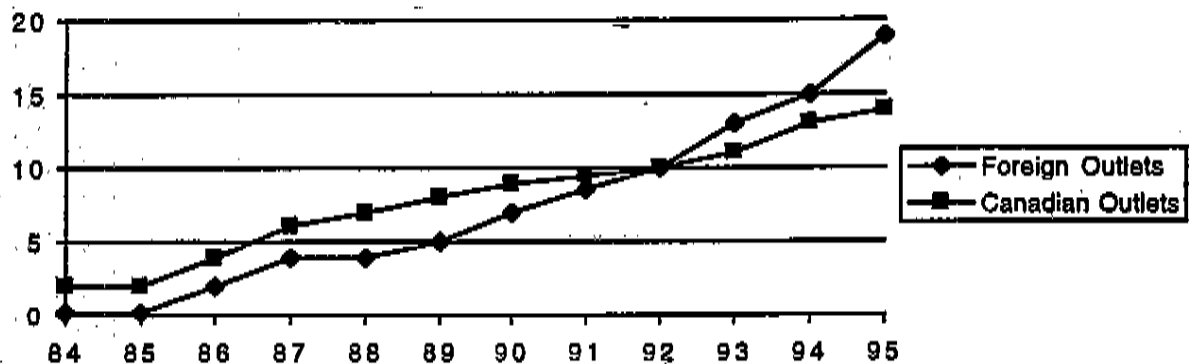
Over time, the surviving new franchise system also expanded geographically. Over the 1984-1995 period, the survivors showed significant domestic geographic expansion, registering in new states, establishing outlets in new states and by increasing the number of outlets in the states in which they operated (see Figure 3). By 1995, the average surviving franchisor had outlets in seventeen states, of which seven were registration states.

Figure 3. Surviving New Franchisors' Geographic Expansion.



In addition, successful new franchisors expanded overseas. The percentage of successful new franchise systems indicating that they were looking for franchisees overseas, increased from thirty-nine to fifty-nine percent during the period of the study. By 1995, the surviving new franchise systems had established a significant presence in both Canada and other foreign countries (see Figure 4). The average surviving franchisor had 14 outlets in Canada and 19 in other foreign countries in 1995.

Figure 4. Surviving New Franchisors' International Expansion.



Of course, the surviving new franchisors made some changes to their operations and to the terms of their contracts over time. However, their initial choices in pricing, services and operations had powerful consequences for the growth and overall success of their new franchise systems. These early decisions about contracts influence operations today -- the surviving new franchisors' contracts with franchisees established in the early 1980s are still in force. Their correct choices in 1984 are a big reason that they are still franchising today.

RECOMMENDATIONS TO NEW FRANCHISORS

New franchisors should treat the development of a franchise system as a process of creating an interrelated web of policies that lead to more effective franchising. This means that they should not treat the recommendations here as an independent list of suggestions from which they can pick and choose, but rather should view them as a comprehensive set of policies to be implemented jointly.

Once the entrepreneur has decided to develop a new franchise system, he or she should expand rapidly. Rapid expansion allows the franchise system to reach a size at which the new

franchisor can promote its brand name at a cost competitive with existing franchise chains. Achievement of this rapid growth is easier if the new franchisor delegates local market activities like lease negotiation, site selection, store opening activity and field training to franchisees. In particular, survival is enhanced if the franchisor does not provide field operations assistance, and to a lesser extent, field training and lease negotiation assistance. This delegation of local market activity allows the franchisor to achieve a higher ratio of outlets to head quarters employees and so allows the new franchisor to grow a large system relative to its employee base. The provision of data processing and inventory management assistance also reduce the new franchisor's likelihood of survival, perhaps because they also place demands on the new franchisor's stock of human resources. The results of this study indicate that relinquishing of control over these services enhances new franchisor survival even though this delegation might interfere with quality control if the franchisor does not specify adequately the requirements for such decisions as facilities selection, employee training or inventory management.

Failure to grow rapidly to a size at which the new franchisor can promote its brand name in a cost competitive manner encourages the new franchisor to adopt master franchising as a technique to speed growth. This alternative is clearly second best to the form of growth described above because it necessitates the use of passive ownership of retail outlets. Passive ownership undermines the ownership incentives that make franchising so effective in the first place. Consequently, it leads to a higher rate of new franchisor failure.

New franchisors also need to take actions to show their trustworthy nature and high quality to potential franchisees. One of these actions is to register the system in one of the registration states. Registration shows that the franchisor will adhere to the higher standards for franchising of the government authorities in registration states.

Franchisors which have short term contracts with franchisees or which have larger outlets also need to register because of the greater risks that these systems impose on potential franchisees. Short term contracts increase the potential franchisee's risk of loss from termination. Larger outlets raise the cost of franchisee entry and so raise the potential downside risk to franchisees.

Franchise systems with these characteristics can mitigate greater franchisee reluctance to buy into the system that results from these risks by registering with state authorities and demonstrating their willingness to adhere to more rigorous standards for franchisor behavior.

RECOMMENDATIONS TO FRANCHISEES

Potential franchisees should carefully investigate new franchisors before investing in them. On average, an investment in a new franchise system in the year in which it begins to franchise will be an investment in a system that will fail. To correctly select a new franchise system that is likely to survive over time, a potential franchisee should look for several factors.

First, franchisees should seek franchisors that are expanding rapidly through franchising. Examples of firms from this study that grew rapidly through franchising during the period of this study are: Lagenwalter Carpet Dyeing, Mail Boxes, Etc., Coverall and Software City. System growth is important to the establishment of the new franchisors brand name, and slow growth franchise systems may not be able to promote their brand names in a cost competitive manner. Franchisees should note that the rate of system growth is something that should be measured relative to the industry average. By dividing a target system growth rate by the average system growth rate in a particular industry, a potential franchisee can identify the fast growth systems.

Second, the potential franchisee should not seek a franchise system that promises a great deal of field support. Field support, such as lease negotiation and site selection assistance, initial store opening assistance, field training and field operations assistance are very costly for new franchisors because they are manpower intensive. New franchisors do better if they devote their scarce management talent to growing the franchise system rather than providing this field support. By selecting new franchisors that provide extensive field support, potential franchisees are incorrectly choosing the franchise systems that are least likely to survive.

Third, the potential franchisee should not be dismayed by a lean headquarters operation of a new franchise system. This lean operation enhances the growth of the franchise system and the

development of its brand name. In fact, potential franchisees should favor new franchise systems with a high outlet to headquarters staff ratio.

Fourth, franchisees should seek new franchisors that are developing strong brand names. Systems that have reached a relatively large number of outlets relative to their industry average are more likely to develop strong brand names. Therefore, potential franchisees should use system size as a positive indicator when deciding whether or not to invest in a system. Another indication of this brand name value is the ranking of the system in *Entrepreneur Magazine*. Potential franchisees should view this ranking as a positive signal of future new franchisor survival.

Fifth, membership in the International Franchise Association and registration with state authorities should be seen by potential franchisees as positive signals for new franchisors. Registration with state authorities both provides a quality check on the system and reduces the likelihood that the franchisor will act in an untrustworthy manner toward franchisees. Membership in the IFA may also provide a quality check on the franchise system by increasing the standards for the system above that in the general franchising market. Alternatively, it may provide a signal that the franchisor has better capitalization or a corporate parent and is more likely to survive because of the possession of these attributes.

Sixth, potential franchisees should be wary of new franchisors which offer master franchising. While master franchising speeds the growth of new franchise systems, it also increases the likelihood that the new franchise system will fail.

RECOMMENDATIONS TO POLICY MAKERS

The government should require franchisors to register their franchise systems. Registration with state authorities increases the likelihood that new franchise systems will survive. This effect is particularly important for franchise systems with contracts of short duration.

Policy makers should also consider the adverse effects of master franchising on the institution of franchising. While master franchising increases the growth rate of franchisors, it also increases the likelihood that they will fail. Consequently, liberal policies toward master franchising

may be putting more franchisees at risk than would be the case if more restrictive policies were adopted.

Policy makers should also realize that new franchise systems are not made more successful by making them provide more services to potential franchisees. Although many potential franchisees see support services as a reason to buy into franchise systems, franchisees in new franchise systems, on average, will be hurt by government policies to enhance the provision of these services to franchisees.

METHODOLOGICAL APPENDIX

The sample consists of 157 new franchise systems that were established in the United States between 1981 and 1983. The list was obtained from Bond and Bond's *Sourcebook of Franchise Opportunities*. Data were gathered for each firm from its entry into franchising forward in time and were compiled from the *Sourcebook* and supplemented with data from *Franchise Annual*, *IFA's Franchise Opportunities Guide*, and *Entrepreneur Magazine's Franchise 500*.

Test of Representativeness

Since the *Sourcebook of Franchise Opportunities* did not contain data on all new franchisors started between 1981 and 1983, the sample was compared to a larger list of new franchisors started between 1981-1983 constructed from *Franchise Annual*, *IFA's Franchise Opportunities Guide*, and *Entrepreneur Magazine's Franchise 500* for which partial data could be obtained. This comparison is shown in Table 7. It reveals that there are no significant differences between the sample and firms for which data could not be obtained.

Table 7. Representativeness of the Sample.

	Sample	Non-Sample	t-value
Number	157	479	-
Year started	1975.4 (12.57)	1976.8 (11.60)	1.27
Year first franchised	1981.9 (0.76)	1981.9 (0.77)	-0.60
Company-owned outlets at time franchising began	4.85 (10.66)	5.05 (10.39)	0.21
Franchised outlets in 1984	24.26 (69.55)	15.28 (65.71)	-1.42
Total investment (dollars)	\$171,832 (511,174)	\$114,127 (187,474)	-1.38
Royalty rate (% of sales)	0.05 (0.03)	0.05 (0.03)	0.19

Summary Statistics

Table 8 shows full summary statistics for the sample. It demonstrates that the surviving franchise systems were different from the non-surviving franchise systems across several dimensions -- such as likelihood of registration with state authorities, brand name ranking in *Entrepreneur Magazine*, outlets per employee, number of support services provided to franchisees, number of outlets in their largest state, headquarters staff, number of states with outlets, term of original agreement, outlets per state, and size at the time franchising began -- but that the survivors and non-survivors were more similar than different.

Table 8. Summary statistics for the sample of new franchisors.

Frequencies	Percent that Provide or Allow			
Initial store opening assistance	75%			
Site selection assistance	80%			
Field training	83%			
Lease negotiations	64%			
Field operations assistance	89%			
Hotline	63%			
Newsletter	73%			
Data processing assistance	20%			
Centralized purchasing	52%			
Annual conference	57%			
Cooperative advertising	64%			
Master franchising	64%			
Registered with state authorities	72%			
Member of the IFA	26%			
Franchisee experience required	11%			
Direct financing provided	15%			
Indirect financing provided	29%			
Permit expansion in territory	36%			
Permit passive ownership	37%			
Looking for foreign franchisees	76%			
Expanding overseas	76%			
Descriptive Statistics	Mean	Standard Deviation	Minimum	Maximum
Size of system (% of industry average)	18%	34%	0%	267%
Number of states in which seeking franchisees	41.64	14.67	12.50	50.00
Hours of training provided	119.41	138.89	4.00	1440.0
Brand name ranking in Entrepreneur Magazine	462.62	101.52	23.00	501.00
Cash Investment (dollars)	\$64,104.09	\$66,394.81	\$500.00	\$500,000.00
Cash Investment (% industry avg.)	93%	82%	1%	426%
Franchise Fee (dollars)	\$18,252.33	\$14,103.99	\$0.00	\$100,000.00
Franchise Fee (% industry avg.)	94%	82%	0%	672%
Total Investment (dollars)	\$171,831.89	\$511,173.54	\$500.00	\$6,000,000
Total Investment (% industry avg.)	95%	110%	1%	645%
Royalty rate (% of sales)	5%	3%	0%	20%
Royalty rate (% of industry avg.)	109%	67%	0%	417%
Advertising rate (% of sales)	2%	1%	0%	7%
Advertising rate (% of industry avg.)	116%	98%	0%	597%
Outlets in Canada	2.01	13.40	0.00	120.00
Outlets outside U.S. and Canada	0.25	1.51	0.00	15.00
Efficiency (outlets/ employee)	2.66	9.02	0.00	93.43
Number of states registered	3.78	4.89	0.00	16.00
Company-owned outlets at start of franchising	4.82	10.63	0.00	85.00

Company-owned outlets (% industry avg.)	44%	92%	0%	667%
Number of states with outlets	5.40	7.12	1.00	45.00
Number of states with outlets (% of industry average)	49%	73%	4%	500%
Total number of support services offered to franchisees	5.65	2.25	0.00	9.00
Average no. employees per outlet	5.99	6.28	1.00	42.50
Initial contract term (yrs.)	13.63	15.00	1.00	99.00
Length of first renewal (yrs.)	8.90	4.78	1.00	25.00
Length of contract term (yrs.)	22.53	16.78	2.00	108.00
Number of outlets in largest state	12.82	35.37	0.00	398.00
Number of headquarters staff	26.71	52.04	1.00	450.00

Table 9 shows the comparisons of surviving and non-surviving franchise systems across these dimensions.

Table 9. Significance of differences between surviving and non-surviving new franchisors.

Percent that Permit or Allow	Non-survivor	Survivor	t-value
Registered in a registration state	66%	88%	-2.67*
Passive ownership permitted	41%	24%	1.95†
Lease negotiations assistance	67%	54%	1.56
Site selection assistance	82%	76%	0.87
Field operations assistance	92%	80%	2.10*
Field training	86%	76%	1.57
Hotline	63%	63%	-0.05
Central purchasing	55%	41%	1.51
Conference	58%	56%	0.18
Data processing	24%	7%	2.35*
Inventory assistance	57%	39%	2.08*
Newsletter	72%	73%	-0.09
Master franchising	67%	56%	1.28
Indirect financing	30%	24%	0.70
Direct financing	15%	12%	0.51
IFA member	23%	34%	-1.98*
Expanding overseas	75%	78%	-0.39
Expansion in territory	34%	39%	-0.52
Franchisee experience required	10%	12%	-0.33
Cooperative advertising	62%	71%	-0.99

Mean	Non-survivor	Survivor	t-value
Number of outlets in largest state	6.95	29.43	-3.63*
Number of headquarters staff	20.99	42.88	-2.35*
Number states registered	3.53	4.51	-1.11
Brand name ranking in Entrepreneur Magazine	487.69	391.71	5.71*
Efficiency (outlets/employee)	1.24	6.77	-3.52*
Number of support services provided to franchisees	5.86	5.05	2.01*
Number of states with outlets	4.26	8.62	-3.49*
Number of states (% industry avg.)	40%	74%	-2.70*
Length of contract (yrs.)	21.28	26.04	-1.57
Term of original agreement (yrs.)	12.01	18.22	-2.31
Term of first renewal (yrs.)	9.27	7.82	1.68†
Outlets per state	57.28	134.20	-3.28*
Size (% industry average)	0.15	0.28	-2.23*
Outlets outside U.S. and Canada	0.30	0.10	0.74
Number of outlets in Canada	1.97	2.15	-0.07
Number of states in which seeking franchisees	41.81	41.16	0.24
Franchise fee (dollars)	\$17,816	\$19,488	-0.65
Franchise fee (% industry avg.)	0.94	0.95	-0.07
Total investment (dollars)	\$169,956	\$177,140	-0.08
Total investment (% industry avg.)	98%	86%	0.61
Cash investment (dollars)	\$65,082	\$61,337	0.31
Cash investment (% industry avg.)	96%	83%	0.85
Royalty rate (% of sales)	5%	5%	-0.61
Royalty rate (% industry avg.)	110%	108%	0.19
Advertising rate (% of sales)	2%	2%	-1.24
Advertising rate (% industry avg.)	112%	128%	-0.90
Employees per outlet	5.71	6.79	-0.95
Company-owned outlets at start of franchising	3.99	7.15	-1.64
Company-owned outlets (% industry average)	45%	41%	0.22
Hours of training provided	115.70	129.91	-0.56

† $p < .10$, two-tailed test

* $p < .05$, two-tailed test

Path Model

Most of the research on franchising has assumed that the independent variables of interest can be manipulated independently by franchisors. I argue, in contrast, that a new franchise system is a set of interrelated factors that are partially determined by franchisor manipulation and partially determined by other factors in the franchise system. Given this argument, a theory of

new franchisor survival must be consistent with the empirical relationship between these independent variables as well as with the relationship between these variables and system survival. To show that the explanation meets both conditions, I conducted path analysis to identify the causal paths between the independent variables and event history analysis²⁶ to show the relationship between the proximal causes of survival and system survival. By jointly conducting path and event history analysis, I obtain estimates of the time varying proximal causes of survival as well as the causal paths leading to these proximal causes. This approach imposes a more rigorous test of the acceptance of our theoretical explanation than is the case with event history or path analysis alone.

The following variables were used in the path and event history analysis: Survival, passive ownership, efficiency, master franchise agreement, contract length, cost, expansion, services left to franchisees, brand name, system size, International Franchise Association, registration, and outlet size. The operationalization of these variables is described below.

Survival. In our event history analysis, the outcome of interest is the continuation of franchising. Survival was operationalized as the existence of the franchise system in a given year. This condition was demonstrated if the franchisor was listed in *Sourcebook of Franchise Opportunities*, *Franchise Annual*, *IFA's Franchise Opportunities Guide*, or *Entrepreneur Magazine's Franchise 500* for the year under investigation.

I examined the hazard of survival using a logistic regression survival model in which the probability that an organization would cease to franchise is a function of time varying covariates. In order to consider time-variation in the covariates, we divide each organization's participation in franchising into yearly spells and measured the covariates for each of these years.

Passive Ownership. Passive ownership is the ownership of the retail outlet by someone other than an owner-operator. Passive ownership is measured by a dummy variable in which one indicates that the franchisor allows passive ownership.

²⁶ Event history analysis is a statistical technique that estimates the effects of independent variables on the probability of a event occurring -- in this case the cessation of franchising.

Efficiency. Efficiency is measured as the ratio of the number of outlets in the franchise system to franchisor staff. In this ratio, a part-time staff member is counted as one half of a full-time staff member. To control for industry differences, this variable is calculated relative to the industry average.

Master Franchise Agreement. Master franchise agreements are agreements to allow an organization to sell individual franchises in a particular location. The use of master franchise agreements is measured by a dummy variable in which one indicates that the franchisor uses master franchise agreements.

Contract length. Contract length is the number of years for which the franchise agreement is operative. It is measured in years as the sum of the length of the initial franchise agreements and the length of renewal periods.

Cost. Cost was measured as a varimax factor of three variables: cash investment, initial investment and franchise fee. All three of these variables were calculated relative to the industry average before factor analysis. The resulting three item scale had a Cronbach's alpha of 0.7256.

Expansion. Expansion was measured as the number of states into which the franchisor intends to expand during the year. To control for industry differences this variable is calculated relative to the industry average.

Services Left to Franchisees. Services left to franchisees was measured as a varimax factor of five variables: lease negotiation, site selection assistance, initial store opening assistance, field operations assistance and field training. The five variables making up the factor were measured as dummy variables equal to one if the support service was provided. The resulting five item scale had a Cronbach's alpha of 0.7493.

Brand Name Ranking. Brand name ranking was measured as *Entrepreneur Magazine's* ranking of the quality of the franchise system. The highest brand name in *Entrepreneur Magazine* received a score of 1. The lowest brand name received a score of 500. Franchise systems not ranked by *Entrepreneur Magazine* were assigned a brand name score of 501.

System Size. System size is measured as the ratio of the number of outlets in the franchise system to the average system size in the industry.

International Franchise Association. International Franchise Association was measured as a dummy variable of one if the franchisor was a member of the franchising trade association.

Registration. Registration was measured as a dummy variable of one if the franchisor registered in one or more of the registration states.

Outlet size. The size of the retail outlets was measured by the average number of employees working in each outlet. To calculate number of employees, part-time employees were counted as one-half of a full-time employee. To control for industry differences this variable is calculated relative to the industry average.

Our explanation for new franchisor survival hypothesizes a specific path model for the relationship between different dimensions of new franchise systems. We used LISREL 8 to test all hypotheses with path analysis. This approach allows us to test how well the overall model fits the data as well as the significance of specific paths hypothesized. Table 10 shows this model. Overall the model fit the data well. The goodness of fit index shows a value of 0.9, with values greater than 0.9 indicating a good fit of the measured and hypothesized covariances. The chi-square goodness of fit index with 55 degrees of freedom is 133.15 shows a p-value of 0.199, with a p-value $>.10$ indicating that the observed model is, as desired, not significantly different from the theoretical model. Moreover, the model had a standardized root mean square residual of 0.09, indicating good fit. Finally, the model is significantly different from the null model (Δ chi-square = 338.7 with 23 degrees of freedom, $p < .0001$). However, the normed fit index showed a value of 0.72, slightly below the appropriate fit level of 0.80, indicating that a more parsimonious model might better fit the data.

Table 10. Results of the Path Model Tests.

Path	Coefficient (Standard error)	t-Value
Expansion to Services left to franchisees	-0.37 (0.08)	-4.98*
Services left to franchisees to Efficiency	-0.25 (0.08)	-3.18*
Efficiency to Size	0.41 (0.07)	5.51*
Efficiency to Brand name ranking	0.42 (0.07)	6.20*
System Size to Brand name ranking	0.25 (0.07)	3.69*
System Size to Master franchising	-0.19 (0.08)	-2.39*
Master to Passive ownership	0.32 (0.08)	4.16*
IFA to Brand name ranking	0.22 (0.06)	3.54*
IFA to Registration	0.42 (0.07)	6.31*
Length to Registration	-0.18 (0.07)	-2.76*
Outlet size to Cost	0.25 (0.08)	3.23*
Cost to Registration	0.18 (0.07)	2.75*
Registration to Survival	0.20 (0.07)	3.00*
Passive ownership to Survival	-0.36 (0.06)	-5.23*
Brand name ranking to Survival	0.39 (0.07)	5.86*
GFI	0.90	
NFI	0.72	
Chi-Square	133.15	p<.199
Δ Chi-square from null model	338.7, 23	p<.0001
df	55	

† p<.10, two-tailed test

* p<.05, two-tailed test

An examination of the specific paths shows strong support for the overall model as well as the significance of the hypothesized paths. Each of the fifteen hypothesized paths is significant at the p<.05 level with the hypothesized sign and in the hypothesized direction.

Survival Model

Table 11 shows the results of the maximum-likelihood estimates of a multiple spell logistic regression model with time varying independent variables to examine the relationship between the proximal causes of survival on the hazard of new franchise system survival during the 1984-1995 period. The model is significantly different from zero (Chi-squared = 20.25, p<.0002), indicating...

that it does predict the hazard of survival better than chance. All three parameter estimates are in the direction hypothesized and predict the hazard of survival at the $p < .05$ level or better. This finding provides strong support that the relationship between the proximal causes of new franchisor survival -- strong brand name, registration and lack of passive ownership -- and the probability of survival in each year.

Table 11. Event History Analysis To Predict Survival of the Proximal Causes in the LISREL Model With Time Varying Independent Variables.

	Parameter Estimate	P-value
Passive Ownership	-0.63 (0.22)	0.0043
Registration	0.48 (0.23)	0.0401
Brand Name	0.01 (0.004)	0.0090
-2 Log Likelihood	701.778	0.0001
Model Chi-square	20.25	0.0002
