Signals that determine internationalisation

ESMERALDA NAA MOMO ARYEE
MASSIEL CAROLINA HENRIQUEZ PARODI

SUPERVISOR
Ilan Alon

University of Agder, [2017]
Faculty of [School of Business and Law]
DECLARATION

We declare that this research is our own work and that, to the best of our knowledge, it does not contain materials that have been previously published by another person neither does it contain materials that have been submitted by any person for the award of any degree to the University of Agder, except where we have made acknowledgement in the text.
ACKNOWLEDGEMENT

The completion of this master thesis would be incomplete without acknowledging the inputs made by some few specials persons who devoted their time, means and intellectual abilities to make our master studies at the University of Agder a success.

At first, we are highly grateful to the Almighty God for His grace, favour, protection and unwavering love towards us throughout the two years of our studies and for seeing us through the writing of this thesis.

Secondly, we would like to express our sincere gratitude to Professor Ilan Alon, whose guidance and immense support helped us broaden our knowledge and understanding, which was vital for the successful completion of this thesis.

Thirdly, we appreciate the help of Michele Boulanger who helped us in the collection and correction of errors in the data.

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FOREWORD

This thesis is written towards the conclusion of our Master of Sciences degree in Business Administration at the University of Agder, specialisation in International Management. The topic of our thesis is “Signals that determine internationalisation”. This thesis relates to the subject matter of our specialisation as we seek to explore and understand the determinants of internationalisation of companies within the franchise industry from a signaling theory perspective. Franchising is one of the most widely used modes of entry within international business and hence, the importance of this study.

At the end of our work we have included reflective notes (of the respective authors of this thesis) that touch on three broader themes of our entire master studies. These themes include: internationalisation, innovation and responsibility. These reflective notes specify how the main theme and findings of this thesis relates to these three broader themes. The reflective notes are enclosed in appendix III.
ABSTRACT

International franchising business model is extensively and increasingly being used by entrepreneurs and firms seeking growth through geographic expansion. Thus, continued research efforts are needed to help entrepreneurs make wise choices when attracting investors into the business. Two popular theories (agency and resource scarcity) have been the basis on which international franchising has been explained. In this research, we expand on existing literature by focusing on signaling theory, answering the question “what are the signals that determine international franchising?” We answer this research question empirically, using cross-sectional data on a sample of 4150 business format franchise systems from 5 industries in the United States in 2016. The findings from this research show that there exists a positive relationship between a firm’s listing status, earning claim (Item 19), and international franchise association membership. Royalty rate and company owned units were not found to be significant with internationalisation. Another striking revelation from the research shows that franchisee in different industry react to signals differently.

Keywords; Franchising, Internationalisation, Signaling
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1. INTRODUCTION

How firms continuously expand, the ways through which they accomplish this task, whether to franchise or not franchise, use wholly owned franchised outlet or franchised outlets are some of the questions that has gained much attention in the franchising literature. In this thesis, we examine the factors that influence the internationalisation decisions of American franchising companies.

As franchise sectors mature and develop in the home market, franchisors seeking to grow must look to international markets as market saturation is ever more becoming the case for franchisors in the US, Canada, Western Europe, and Japan (Alon and McKee, 1999). Franchising is believed to be the most powerful expansion tool for firms that wish to grow under limited managerial resources (Roh, 2002). The franchising concept is of a greater flexibility and adaptability and mostly suited for developing service economies (Connell, 1999) and transitional economies. Thus, franchising is a method that enables business development and growth as it allows rapid penetration into the domestic market of the country in question.

Welsh et al. (2006) probe on the fact that, the fast-growing targets for international franchisors are now the emerging economies like Asia, South America and Africa just to mention to a few. Several surveys conducted by researchers into this area have showed that great number of people are seeking opportunities in these markets. Thus, these markets are receiving huge attention from both the academicians and practitioners. With this in mind we hope our paper will contribute to a better understanding of the internationalisation decision and will become a good source of knowledge for the franchising companies who want to understand the right factors and decide whether to internationalize their business. Most franchising research have been grounded on either resource scarcity or agency theory (Combs and Castrogiovanni, 1994; Alon, 2001) hence whiles we follow this same approach we expand our research by adding signaling theory. Agency theory is concerned with resolving problems that can come about in the agency relationships due to unaligned goals. Agency theory argues that franchising helps to mitigate the agency problem between owners and management. Resource-scarcity theories states that companies typically franchise to extend scarce resources. Thus, firms seek franchising to expand operation to achieve economies of
scale and once the need to expand has been met, the franchisor shifts focus towards maximizing returns. This will lead to the franchisors repurchasing its most profitable franchised outlets as firm ownership is most profitable (Castrogiovanni, Combs and Justis, 2006).

Research conducted in the last decade explained franchising as the need for franchisors to acquire financial capital and thus franchisee served the purpose by providing capital through fees and royalties thereby offering franchisor with relatively inexpensive growth (Alon, 2001; Hunt, 1973; Oxenfeldt and Kelly, 1969). Subsequent research, however expanded this view arguing that firms used franchising because they needed human capital, managerial talents, and local knowledge (Combs and Castrogiovanni, 1994; Oxenfeldt and Kelly, 1969; Norton, 1988). As the world, continuous to evolve trends and patterns that use to govern the way people and businesses behave are changing. Thus, the traditional determinants of internationalisation as discussed by prior authors and researchers seem not to hold in this day and age. As such our work is to explore new factors that are determining internationalisation of franchising through the use of signals. To the best of our knowledge very little literature or research has been undertaken to use other theories to explain the determinants of international franchising hence we add to existing literature.

This paper seeks to expand on the traditional determinants of international franchising by adding signals to the interpretation of extant literature by answering the question: what are the signals that determine international franchising? This study would be of interest to all researchers, practitioners and academicians who are interested in understanding and exploring new approach to internationalisation.

The paper is divided into seven sections inclusive of this introductory section. In the second section, relevant literature is reviewed within the broader context of the international franchising. In section three, we explain and develop the hypotheses for the study. Section four explains the research methodology used for testing the hypotheses and operationalisation of measures. Section five presents the findings and results from the data analysis. In section six we discuss the findings and the final section gives a conclusion.
2. LITERATURE REVIEW

In this section, we elaborate on the relevance and background to the study by presenting the main reason for undertaking it. We will accomplish this by touching on relevant issues on international franchise as well as the economic impact of the franchising sector in the US economy.

2.1 The Franchise Sector and its Impact

Currently the franchise agreement is seen as a “contractual arrangement between two legally independent firms in which one firm, the franchisee, pays the other firm, the franchisor, for the right to sell the franchisor's product, the right to use its trademarks and business format in a certain location for a certain period, or both” (Lafontaine & Blair, 2009). By this definition, we realise that franchising is divided into two sub-divisions; the product/trade-name franchising and the business format franchising. In product franchising the franchisors makes a contract with the franchisee to buy or sell the product or product line (Slater, 2013). The International Franchise Association defines the business format franchising as “a continuing relationship in which the franchisor provides a licensed privilege to do business, plus assistance in organizing, training, merchandising and management, in return for a consideration from the franchisee” (Alon, 2001; U.S. Department of Commerce, 1994, p. ix).

The difference between these two modes of franchising lies in the fact that the business format offers a method of operation or business system that comprises a strategic plan for growth and ongoing guidance (Alon, 2001; Falbe and Dandridge, 1992). Product franchising which is considered as the traditional form of franchising can be seen among the automobile dealerships, the gasoline dealerships, and bottlers of soft drinks such as Coca Cola and Pepsi; thus, the focus on the traditional franchising is on the product of the manufacturer (Dant & Grünhagen, 2014). In the case of the business format franchising the outlet itself is the product (Dicke, 1992). In effect, we can say that selling a “way of doing business” as well as an all-inclusive package of services and an operating manual that stipulates in detail all the activities and skills required to run the business, like standards of quality control and provisions of ongoing training, communication is what is entailed in the business format franchising (Dant & Grünhagen, 2014). Furthermore, it is worth noting that although the
franchisees are identifiable by a common trade, they are in fact true independent contractor who are at liberty to establish business styles that are consistent with the culture of their local market.

According to Michael (2009) the franchise is sold to the franchisee through a sequence of face to face meeting where the franchisor is required to provide a disclosure document that clarifies the terms of the franchise contract and describes the franchise chain to the franchisee. The document provided also stipulates in details the franchisor’s history, size, trademarks, litigation history, royalty, and other payments expected from the franchisee, franchisor’s obligations, and franchisee’s obligations and this is a mandatory document by the US Federal Trade Commission (FTC)

The US franchising sector can be divided into 10 business line which are:

➢ Automotive
➢ Lodging
➢ Commercial & residential Services
➢ Business Services
➢ Retail Food
➢ Real Estate
➢ Quick Service Restaurants
➢ Table/Full Service Restaurants
➢ Personal Services
➢ Retail Products and Services

The next table gives a brief composition of the different business lines in the franchising sector.
Table 2.1. Composition of the different business line in the franchising sector.

<table>
<thead>
<tr>
<th>Type of business line</th>
<th>Composition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automotive</td>
<td>This business line includes tire retailers, parts of motor vehicles and supply stores, automotive equipment rental and leasing as well as automotive maintenance and repair.</td>
</tr>
<tr>
<td>Commercial and Residential Service</td>
<td>This includes developing and general contracting, construction, building support services, waste management.</td>
</tr>
<tr>
<td>Quick Service Restaurants</td>
<td>This business line consists of cafeterias, small service eating places, beverage bars, fast food restaurants, ice cream shops, pizza delivery.</td>
</tr>
<tr>
<td>Table or Full Service Restaurants</td>
<td>All establishment that primarily engage in the business of providing food services to people who order and are served whiles seated.</td>
</tr>
<tr>
<td>Retail Food</td>
<td>This includes all food and beverage stores, bakeries, food service providers, catering services, beer, wine, and liquor stores as well as gas stations with convenience stores.</td>
</tr>
<tr>
<td>Lodging</td>
<td>All business that involve hotels, motels, and all forms of accommodation.</td>
</tr>
<tr>
<td>Real Estates</td>
<td>Includes leasing of buildings, building rental services, self-storage units, property management and other related activities.</td>
</tr>
<tr>
<td>Retail Products and Services</td>
<td>Includes household furnishing stores, electric appliance stores, clothing and general merchandise stores, florists and gift stores, consumer-goods rentals, health and personal-care shops, photographic services, book and music shops.</td>
</tr>
<tr>
<td>Business Service</td>
<td>All establishments that are involved in business transportation, office administrative services, warehousing and storage, data-processing services, insurance agencies, human resources services, security services, tax-preparation and payroll services, and heavy equipment rental.</td>
</tr>
</tbody>
</table>
Personal Service

This business line includes health-care, provision of academic or training services, credit intermediation and related services, entertainment and recreation, personal and laundry services, veterinary services.

Source: Adapted from International Franchise Association; Economic Franchise Business Outlook 2016

Gross Domestic Product (GDP) is a significant indicator of the economic performance of an industry, sector, and business line and of the economy in general. Based on this we present a diagram of the GDP contribution of each franchise business line in the US, which shows the importance of the franchising industry in the general US economy.

**Figure 2.1: GDP contribution of each industry**

Source: Adapted from the Pwc; The Economic Impact of Franchised Businesses: Volume IV, 2016

From the diagram, we can observe that the quick service restaurant has the highest gross domestic distribution followed by the business service, retail product and service contributes the lowest in terms of gross domestic product. Furthermore, looking at the economic output outlook of the franchising sector from the year 2007 to 2016. The franchise sector is seen as having a steady increase in all aspects. The figures 2.2 and 2.3 located below give a clear picture of this fact. We can observe a clear increase in the productivity levels of the
franchising industry and how franchising has influenced the increase in the general gross domestic product of the overall US economy. For instance, the levels of employment have consistently increased in this industry since 2011, as well as the industry output.

**Figure 2.2 Economic Output from the 2007-2016**

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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Establishments (% Change)</td>
<td>770,835</td>
<td>774,014</td>
<td>746,646</td>
<td>740,098</td>
<td>756,114</td>
<td>747,359</td>
<td>757,857</td>
<td>769,782</td>
<td>782,573</td>
<td>795,932</td>
</tr>
<tr>
<td>Direct Employment (% Change)</td>
<td>7,994,000</td>
<td>8,028,000</td>
<td>7,800,000</td>
<td>7,780,000</td>
<td>7,940,000</td>
<td>8,127,000</td>
<td>8,334,000</td>
<td>8,573,000</td>
<td>8,834,000</td>
<td>9,112,000</td>
</tr>
<tr>
<td>Outputs (% Change)</td>
<td>$675B</td>
<td>$675B</td>
<td>$675B</td>
<td>$699B</td>
<td>$734B</td>
<td>$768B</td>
<td>$804B</td>
<td>$845B</td>
<td>$892B</td>
<td>$944B</td>
</tr>
<tr>
<td>GDP (% Change)</td>
<td>$403B</td>
<td>$410B</td>
<td>$403B</td>
<td>$414B</td>
<td>$434B</td>
<td>$453B</td>
<td>$473B</td>
<td>$495B</td>
<td>$523B</td>
<td>$552B</td>
</tr>
</tbody>
</table>


**Figure 2.3 Graph of the economic output**


The vast majority of franchising owners are small to medium-sized businesses but most people associate franchising to big companies like McDonald’s, Subway, KFC etc. hence franchising is also referred to as a small business (ITA Franchising Top Markets Report 2016). Franchising is and has continued to be an economic driver in the US economy, international trade association (ITA) 2016 franchising report establishes that there are 780,000
franchise businesses that directly employ over 8.8 million people and account for over $890 billion in direct economic output. Based on the franchise business economic outlook 2015 report, the franchising sector will on its six-consecutive occasion outperform the US economy in terms of the overall growth. The report further forecasted 3.1 percent increase in the economic output of the sector, employment in this sector would also grow by 278,000 jobs. In the past five years, the average annual job growth in the franchise sector has been 2.6 percent, nearly 2 percent higher than all businesses economy-wide. The number of franchise establishments was also expected to grow by 13,359, or 1.7 percent, to 795,932.

With numerous franchise organisations in the economy, it is apparent to shed light on the leading franchise organisation in the United States. Based on their sales and location we observe that McDonald's is the leading organisation followed by 7-eleven. A more detailed listed is presented in the table below.

### Table 2.2 Leading Franchise Organisations

<table>
<thead>
<tr>
<th>Company</th>
<th>Industry</th>
<th>Sales</th>
<th>No. of Location</th>
<th>US Location</th>
<th>Total Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>McDonald's</td>
<td>Restaurant</td>
<td>$87.78 B</td>
<td>14,344</td>
<td>36,258</td>
<td></td>
</tr>
<tr>
<td>Oak Brook, IL</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7-Eleven</td>
<td>Retail</td>
<td>$ 84.50 B</td>
<td>7,836</td>
<td>55,801</td>
<td></td>
</tr>
<tr>
<td>Dallas, TX</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>KFC</td>
<td>Restaurant</td>
<td>$ 23.40 B</td>
<td>4,3391</td>
<td>19,420</td>
<td></td>
</tr>
<tr>
<td>Louisville, KY</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subway</td>
<td>Restaurant</td>
<td>$ 18.20 B</td>
<td>26,958</td>
<td>43,154</td>
<td></td>
</tr>
<tr>
<td>Milford, CT</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Burger King</td>
<td>Restaurant</td>
<td>$17.01 B</td>
<td>7,126</td>
<td>14,372</td>
<td></td>
</tr>
<tr>
<td>Oakville, IL</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ace Hardware</td>
<td>Retail</td>
<td>$14.29 B</td>
<td>4,251</td>
<td>4,794</td>
<td></td>
</tr>
<tr>
<td>Oak Brook, IL</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hertz</td>
<td>Automotive</td>
<td>$14.20 B</td>
<td>5,760</td>
<td>11,230</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>
2.2 International Franchising

In this paper, we adopt the definition of international franchising by (Burton & Cross, 1995) as “a foreign market entry mode that involves a relationship between the entrant (the franchisor) and a host country entity, in which the former transfers, under contract, a business package (or format), which it developed and owns, to the latter” (p. 36). Academic interest in international franchising has seen a considerable rise since the early 70’s and thus several studies have been conducted in this area. However, the research on international franchising operation has been concentrated on companies that had built their franchising activities firstly from their domestic market before applying their acquired experiences and franchising system into international arenas (Walker & Etzel, 1973; Hackett, 1976; Walker, 1989; McCosker & Walker, 1992; McIntyre and Huszagh, 1995).

International franchising is a complex process that can be affected by many forces particularly organizational factors and market conditions (Alon et al., 2012). Despite its complexity, Elango (2007) states that international franchising serves as an easier opportunity for growth for franchisors who wish to grow but are faced with saturated markets. Furthermore, international franchising offers an efficient transfer of knowledge and business practices from developed nations to emerging markets. Ayal & Izraeli (1990) probes on the fact that the ability to efficiently transfer knowledge across borders had contributed to firms that were not traditionally franchisors to adopt international franchising.
According to Elango (2007), the literature on international franchising follows three trends. He stated that the first trend focuses on macro differences across countries to determine which countries franchising is spreading and gaining acceptance as an organization format. Such studies have been conducted by (Alon and McKee, 1999; Hoffman and Preble, 2000; Welch, 1989) just to mention a few. Based on their research they reported that franchising was gaining acceptance in countries with high per capita income, having a developed retail-service sector, urbanization, media development, and political and cultural similarity. The second trend of literature focuses on the choice of entry mode used by firms when venturing into international markets. Several findings have been reported as to the factors that influence franchisors choice between company-owned and franchised units such as, increased monitoring complexities and costs due to cultural and other differences, the need for incentives for franchisees, threat of opportunism, and international experience (Erramilli et al., 2002; Burton et al., 2000; Contractor and Kundu, 1998; Fladmoe-Lindquist and Jacque, 1995). The last trend focuses on the factors driving franchisors to international markets. Huszagh and McIntyre (1992) conducted a research where they compared franchisors operating internationally with those with domestic market orientation. Their finding indicated that franchisor’s experience and size of operations were factors driving international operations. They also claimed that, over a period, franchisors acquired competencies in international operations. Kedia et al. (1994), further reported that managers desire to expand and increase profit (rather than firm traits such as size of operations) was also a determining factor for firms to have international operations. Our work focuses on the determining factors of internationalisation hence will be explained further in the proceeding sections.

Welsh (1989) states that the life cycle of franchising primarily starts with an internationalisation into similar markets of the USA like Canada, Australia etc. and further progressing into dissimilar developed markets such as Japan and more so into the emerging economies like China, Brazil etc. that are of diverse culture and less developed economy and the cycle ends with the franchisors from the latter countries entering into the home market of the original franchisors to compete with them. Emerging markets such as Brazil, China, Mexico just to mention a few accounts for 80 and 60 percent of the world’s population and natural resources respectively thus they offer the opportunity for long-term growth to businesses and more specifically to franchising (Alon, 2006). Furthermore, the US Department of Commerce projected that over 75 percent of the expected world trade growth will in the next two decades be obtained from emerging economies as they account for half
the world’s population and 25 percent in gross domestic product (Alon, 2006). Baena (2009) argued in her paper that geographical and cultural distance between the host and home country, uncertainty avoidance, individualism, political stability, and corruption are some of the factors that affect international franchising expansion into emerging markets.

There are several articles that address the internationalisation process and these researches and models of internationalisation have long existed since the early days of international business. Uppsala model is one of the well-known model used to explain the internationalisation process of organizations. This model suggests that companies tend to internationalize in small, incremental steps to enable risk-averse managers to identify and seize expansion opportunities that are available in the local foreign environment. According to Johanson and Wiedersheim-Paul (1975) and Johanson and Mattson (1985), this model was inspired in the early 1970’s due to companies entering their neighboring countries firstly through sales agents and then advancing to direct investments. However, Barkema and Drogendijk (2007) stated that aside from companies entering foreign markets incrementally as suggested by various theories, sequential internationalisation strategies still do matter and that companies are faced with the task of balancing both the exploitation and exploration in internationalisation

Based on McIntyre and Huszagh (1995); Cavusgil and Nevin (1980) works on international franchise they developed a conceptual model to explain the internationalisation process of firms. They defined this process according to these four stages; domestic marketing, experimental involvement, active involvement, and committed involvement. They further noted in their work that different firms can be found at different stages in the internationalisation process, at any point in time and firms will progress through the stages at different pace. Below is a conceptual model of the different stages of international franchising.
In addition, Ni & Alon (2010) stated that during the initial stages of the franchising development, franchisors tend to focus their attention on building their system, and they accomplish this through domestic franchising. Thus, it is worth noting that at this stage, resource scarcity considerations dominate. However, over time as the franchisors mature, other factors become more relevant such as agency factors. They argued that as the franchisor reaches a certain age, it mostly likely starts seeking for internationalisation through international franchisees in foreign markets.

2.3 Core Theories

In this section, we present the core theories for this research. The core theories: agency theory, resource scarcity and signaling theory are discussed below.

2.3.1 Agency theory

Doherty & Barry (1999), and Jensen & Meckling (1976) in their article on international retail franchising stated that agency theory is based on the principal-agent relationship. In this relationship, the principal is in control of a set of economic functions or assets in some form of ownership or property rights whiles the daily control of these functions or assets have been delegated, by the principals, to agents, who operate them on their behalf.

Thus, an agency relationship is established whenever one party (the principal) relies on another party (the agent) to perform certain actions on the principal’s behalf (Alon, 2001; Bergen, Dutta, & Walker 1992, p. 1). Based on this fact the franchisor is the principal and the
franchisee the agent in the agency relationship. Each party in the agency relationship is assumed to be self-interested and have independent goals they wish to accomplish hence the principals must use its resources to ensure that agent acts in their best interest (Jensen & Meckling, 1976). Due to this the principals adopts two basic tools to ensure that the agent cooperate. These tools are; direct observation of agent behavior also known as monitoring and incentives linked to agent outputs (Castrogiovanni et al., 2006; Eisenhardt, 1989). Baker & Dant (2008) noted that the agency theory is the main paradigm used to explain franchising typically in the United States. Since both parties have divergent goals this gives rise to agency cost along with the opportunism risk. The principal can reduce this cost and risk through direct observation and monitoring or better still through a system of aligned incentives. (Alon, 2012; Eisenhardt, 1989; Jensen & Meckling, 1976).

The agency problem can be explained in two parts, firstly the **vertical agency problem**; this problem arises due to the conflict between the firm and its outlets manager. Rubin (1978) therefore noted that franchising is the solution to this problem as all profits after expenses (also known as residual claims) are given to the franchise manager. This will in turn, cause the franchisee not to reduce his/her efforts as their income is tied to it. But that of the employee manager will reduce as they do not have any ownership incentive. To resolve this agency problem, a trade-off between monitoring and incentives is required as the behaviour of employee must be closely monitored which is costly (Bradach, 1997). Thus, franchising is only used when the cost of monitoring is high (Combs et al., 2004).

**Horizontal agency problem** is another form of agency issue. This problem also arises due to the potential for franchisees to free ride on other outlets. This situation occurs because all the outlets tend to operate under a shared brand name or image hence customers transfer goodwill from one outlet to the other. (Gal-Or, 1995; Brickley & Dark, 1987; Caves & Murphy, 1976). Since these benefits are shared, franchisees prefer to free ride on others rather than investing in their own outlets and this decision overall leads to a wider chain under investment. Rubin (1978) again stated that one of the best solution to this, is monitoring from the franchisor. But monitoring the franchisee is a main disadvantage to franchising because of the costs and managerial time involved in the process.

Furthermore, the agency theory presumes that organizations desire to minimize the monitoring costs. In order to do so they reward franchisees’ efficiency with profits as the
franchisee plays the role of both a sole proprietor and a single-unit manager in the chain (Alon, 2001). By doing this, franchisees are highly motivated to maximize the performance of their outlets. These franchisees are the residual claimants of their outlets profits which reduces the monitoring costs that the franchisors must incur (Castrogiovanni et al., 2006; Bradach, 1997; Norton, 1988; Rubin, 1978). In addition, the substantial part of the investment into franchised outlet is bear by the franchisee thus the anticipated profit from the investment is dependent on the best efforts of the franchisee (Castrogiovanni et al., 2006; Klein, 1995). Researchers have also highlighted that the main cause of the agency problem is information asymmetry and moral hazard. Information asymmetry is a problem in the agency relationship when the agents have more detailed knowledge of the operation and can easily interpret information due to their day to day running of the organization than the principal. Moral hazard is explained as the possibility of agents operating in their own self-interests without factoring in the objectives of the principals (Doherty & Quinn, 1999). Thus, the combination of both concepts puts the principal in a bad position so it is important to align the goals of both parties involved.

2.3.2 Resource scarcity theory

Resource scarcity theory analyses the competitive advantage of firms according to their geographical location, resources, and internal capabilities as organization (Peteraf, 1993). Andrews (1971) stated that the main strengths of a company comes from its organizational competencies and resources, when these are different or superior to those of its competitors, it becomes the base of its main advantage over other companies, if used appropriately within the environment.

One of the main tenets of the resource scarcity theory is that the resources are heterogeneous among firms, which means that resources vary among organizations. This theory supports the fact that companies offer the possibility of franchising at a greater degree in their early years because of their managerial expertise and their lack of sufficient capital to open more outlets by themselves (Castrogiovanni et al., 2006). The managerial expertise is an intangible resource that is gained by the company when its managers acquire market experience by operating through time. Castrogiovanni et al. (2006) stated that according to the resource scarcity theory firms decide to turn towards the franchising mode of entry when they want to achieve economies of scale. This puts pressure on them to expand beyond their financial
capacity, so their own resources are not enough for this purpose. Oxenfeld and Kelly (1969) affirmed that, companies franchise when they do not have the necessary capital to own their own subsidiaries. The availability of essential resources constitutes one of the main reasons of franchising. The scarcity of capital decreases as the franchise becomes more successful over time and as the franchisor is able to self-finance his own operations. Additionally, the availability of a supply of managerial talent to substitute existing franchisees or administer new subsidiaries.

Oxenfeldt and Kelly (1969), based on this theory explains that young and upcoming firms use franchising to expand until they have achieved a sufficient level of economies of scale and once such economies have been achieved they no longer seek rapid expansion but rather start focusing on maximizing returns from each outlet. Due to this, new franchising will cease and the franchisor will try to enhance profits by repurchasing the most profitable franchised outlets a phenomenon known as ownership redirection (Combs et al., 2011). Thus, a successful matured franchisor firm will primarily be firm owned and not franchised owned (Castrogiovanni et al., 2006).

Overall, agency theory and resource scarcity theory remains a very important tool for understanding the backgrounds to franchising and new results and evidence continue to support their basic predictions and assumption. Nevertheless, there is a great deal about international franchising that remains unexplained. Which bring us to the signaling theory to help fill the gap in the franchising literature.

2.3.3 Signaling theory

Signaling theory is of the view that information is sent in a direct or indirect way from the companies that communicate a specific message to those who see it or observe it. One of the goals of signaling is to reduce information asymmetry. Its focus is to communicate positive aspects of the organization, in a deliberate way. The definition of signaling theory can be better explained and understood through the construct of a model that illustrates the mechanics of the theory, as follows:
In this illustrated timeline shown in figure 2.5, it is possible to observe the dynamics and different elements involved in signaling theory. It is essentially made up of a signaler, a signal, a receiver, and a feedback. The signaling process starts with a signaler (a person or firm), who sends a specific signal, deliberately or not, and a receiver who observes and interprets the signal. After the receiver has received the signal, there is a feedback that is produced, giving the possibility to the signaler to notice the effect of his actions.

According to Connelly et al., (2011) there are two main characteristics of effective signaling. The first being signal observability, or how easy it is for the outsiders (those receiving or observing the signal) to notice the signal that has been sent. Not all actions made by the organizations are observable. The second important aspect of effective signaling is the signal cost. Some firms have a better financial capacity to bear the cost that involves signaling. Connelly et al., presents a good example of this: when manufacturing companies decide to get the ISO 9000 certification. A high quality manufacturer may be in a better financial situation to afford all what the certification process involves while a low quality manufacturer might
not prefer to incur the costs involved with the improvements that may come into place when deciding to certify the company. Thus, a signaler who does not have the underlying quality associated with this signal might attempt to engage in false signaling when they perceive the benefits of sending the signals outweighs the cost of producing the signal. As such the cost of a signal must be structured in such a way that dishonest signals do not pay.

One of the most important models of signaling is the message of quality, as the “underlying, unobservable ability of the signaler to fulfill the needs or demands of an outsider observing the signal” (Connelly et al., p. 43). The sense of quality is highly related with reputation (Kreps and Willson, 1982) and prestige (Certo, 2003). Moreover, corporate reputation is one of the aspects that has been the focus of attention among business executives, knowing that organizational actions and communications have an impact on it. As stated by Carter (2006), top management groups and reputation management activities in which the firm is involved has an influence in the perception that outsiders have on the innovativeness and financial soundness of the firm, as well as the selection and retention of good employees. It also influences the capacity of charging premium prices, attracting investors, and building a competitive advantage. This shows how the different corporate activities signal different characteristics of the firm to the outsiders and different stakeholders of the company.

Michael (2009) noted that how entrepreneurs try to attract resources is of utmost importance in entrepreneurship. To attract resources entrepreneurs must provide information, which is referred to as signaling to convince resource providers. For entrepreneurs in the service sector, franchising is an important and significant method for attracting resources (Combs et al., 2004). Signaling theory proposes that the cost, quality, and competition are factors that can affect the willingness of entrepreneurial firms to signal. Since franchisors compete for resources in a market for franchisees, franchising offers a unique insight into the nature of competition and the use of signals. From the franchising perspective, researchers have tried to assess the extent to which profits serve as a good signal to attract franchisees, such works were carried out by Gallini and Lutz (1992) and Lafontaine (1993).

Signaling theory although not widely published in franchised literature, can be traced to having its foundation stem from the economic contract theory and has been used by several researchers to study franchise use and strategy (Gallini and Lutz, 1992; Vincent and Kaufmann, 1996; Dant and Kaufmann, 2003; Alon et al., 2011). This theory tries to explain
organizational choice through externalities of market imperfection and knowledge asymmetries. In practice, it is often seen that entrepreneurs or franchisors who seek incentive advantage in the franchising industry face the problem of information asymmetry (Dant and Kaufmann, 2003). In an attempt to counter the effect of information asymmetry, firms adopt a variety of signaling devices such as pricing, advertising, and promotion etc. to signal the quality of their product. It can also be argued that there is a link between agency theory and signaling theory as both theories propose a preference towards franchised units. Signaling theory suggests that in the initial stage of the franchise, company owned units are used to get the system over a credibility hurdle until it can grow with preferred franchised units. It also posits that franchised outlets are superior to company-owned unit’s due to hard-working franchisees (Alon et al., 2011).

According to Gillis and Castrogiovanni (2010), signaling theory explains the mix in company owned units and franchised outlets as an indication of the franchisor’s business quality. It assumes that franchisors have a superior business model which they try to convey to franchisee through the opening of company owned units and high royalty rates (Gallini and Lutz 1992). It is also found in literature that franchised outlets are more profitable than company owned outlets as such franchisors/ firms only operate company units in order to signal high quality operation to potential franchisees. Therefore, firms charge high royalty rate as a signal to potential franchisees that they provide a high-quality system that should demand a premium price (Alon et al., 2011). Signal theory posits that as franchising firms age so would their brand image improve hence franchising more and opening less company owned units (Gallini and Lutz, 1992) and thus unless these firms can signal a high quality of service through its reputation and high royalty rate it would be required to operate some percentage of company owned units. Signaling theory has received a lot of mixed empirical supports (Gillis and Castrogiovanni 2010). Scott (1995) found out that firm age was positively related to the percent of franchised outlets indicating that as firms grow and franchised outlets increase, companies were able to signal better quality. This finding was however opposite to that of Dant and Kaufmann (2003) who found that aging firms moved towards more company owned outlets. Lafontaine (1993) found no evidence for signaling theory in her work. She found out that firms with good brand image did not use royalty rate, franchise fee or proportion of company owned units to send a signal to prospective franchisee about the quality of the franchise system.
### 2.3.4 Theoretical Summary

<table>
<thead>
<tr>
<th>Theories</th>
<th>Summary</th>
<th>Variables</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agency Theory</td>
<td>This theory predicts that there exist an agency problem/cost between the principal and the agent due to divergent goals of both parties. There are two types of agency problem; vertical and horizontal agency problem. The franchisor (principal) can reduce the agency cost through monitoring/direct observation or through a system of aligned incentives. It further argues that firms franchise due to their inability to monitor managers efficiently.</td>
<td>Number of franchised units, Number of company owned units, Royalty fees, Geographical scope, Investment</td>
</tr>
<tr>
<td>Resource Scarcity Theory</td>
<td>Resource scarcity theory analyses the competitive advantage of firms according to their geographical location, resources, and internal capabilities. Firms are said to franchise because they lack the necessary capital, but as they expand they can finance their operation. Thus, according to this theory in the early stages of a franchise there are a lot of franchised units but as the franchisors matures it buys out the franchised units and convert them to company owned units.</td>
<td>Number of franchised units, Royalty fees, Number of company owned units, Age, Total Units, Franchise experience</td>
</tr>
<tr>
<td>Signaling Theory</td>
<td>Signaling theory is of the view that information is sent in a direct or indirect way to people. This is due to information asymmetry. Signaling theory proposes that the cost, quality, and competition are factors that can affect the willingness of entrepreneurial firms to signal. Also, franchisors signal in order to attract resources. It posits that franchise system will move to a greater reliance on franchised outlets as they mature.</td>
<td>Initial Support, Earning Claims, Franchise experience, Total unit growth, company owned units, Chain size</td>
</tr>
</tbody>
</table>
2.4. Determinants of International Franchising

Franchising is one of the entry modes that companies use when they desire to enter to other markets and it is defined according to the level of risk and control that the firms can or want to have on their operations. Welch, (1990) identifies “direct stimuli”, which he defines as when third parties, such as local companies from the hosts markets make contact with the potential franchisor firm. Another direct stimulus is market saturation: after the local markets become saturated with the domestic firms, companies decide to internationalise, in order to improve their levels of financial performance. Abell’s (1991) also identifies, after his study on expansion of franchise companies in Europe, that the majority of franchisors enter foreign markets as a consequence of a third party approaching them than it being a planned move to the foreign markets. It was also a confirmation of Welch (1989) work where (s)he identified that in the case of Australian franchisors, their decision to enter to international markets was mostly driven by the approach by interested foreign firms who showed interest in their business model and brand. Welch, (1989) found that in the case of Australian franchisors, the approach by an interested foreign party was the most important catalyst mentioned in starting the move to international operations.

One of the most significant factors influencing the desire to internationalise is the interest of exploiting potential markets as stated by Hackett’s (1976) study on internationalisation of US-based franchisors. His findings were subsequently confirmed by Tankheim, (1979) research on franchise internationalisation. He found that the most important reasons of entering foreign markets was market expansion, desire to be more known internationally and the improvement of profits and sales. Organisational and environmental factors are also determinants of international franchising. Doherty, (2009) in her research about the factors influencing retail companies to choose franchise as a market entry strategy, defined in her findings organisational and environmental factors. Among the organisational factors found were international retail experience: in the mid 1980’s companies decided to convert their general wholesale exporting business to a franchise. Also, companies who were franchising had previously passed through acquisitions, joint ventures, and organic growth.

Another organisational factor is the availability of financial resources. Retailers feel motivated to use franchise as their entry mode in foreign markets because it gives them the possibility of growing internationally with relatively small financial commitment and risk.
The presence of brands that can be franchisable is another important factor that motivates retailers to franchise internationally. Brands that are more widely known produce a higher interest in potential franchise partners because the brands are easier to replicate. Past research is consistent with the general view that multinationals tend to franchise more than local or national franchisors (Combs and Ketchen 1999; Huszagh, Huszagh, and McIntyre 1992).

The tendency to franchise internationally according to Fladmoe-Lindquist and Jacque, (1995) is also related to both geographic and cultural distance. Researches also indicated that another factor of internationalisation is due to an increase in firm size. The resource scarcity theory is mostly used to explain firm size relationship with internationalisation. Researchers have argued that international expansion requires a great deal of resources from the expanding firm. Thus, the larger the firm became the greater its ability to effectively engage in exporting activities and the larger the firm appeared to be better equipped to handle the risk of internationalisation (Javalgi et al., 2003; Aaby and Slater, 1989). It is also noted by researchers that a firm’s perceived competitive advantage does directly influence management attitudes towards internationalisation. They propose that when an organisation becomes aware of its unique assets and resources it possess, they are more likely to search for wider exploitation which leads to internationalisation (Katsikeas, 1994; Edvardsson et at., 1993). Another determinant of internationalisation is location specific market characteristics such as host government regulation, restraints on market entry, local content requirement, financial and fiscal controls. Extant literature exists on how these factors have an impact on internationalisation. When organisations perceive lower trade barriers to internationalisation they often tend develop positive attitudes towards expanding their activities internationally (Javalgi et al., 2003).

Furthermore, management attitude is another factor that can determine a company’s level of internationalisation. Axinn, (1988) states that the relationship between management attitude towards internationalisation should not be undervalued. In her research, she found out that the single most important indicator of firm expansion performance was due to the manager’s attitude towards international operations. Zhu et al., (2011) expressed in their work that international franchising system life cycle is another determinant and the life cycle was divided into penetration, expansion, maturity, and late maturity. They stated that once the franchise system in the home country reaches a maturity state franchisors start to exploit international markets. Also, the international business experience is an important factor that
affect international franchising with the greater the experience the greater the level of internationalisation. Elango (2007) research on internationalisation also pointed to the fact that the monitoring experience of the franchisor also contributed to the franchisor's ability to operate internationally. Zhu et al., (2011) argued that the country risk, location familiarity which consist of physical and cultural distance also determine international franchising.

According to Altinay (2006) the various determinants of franchise internationalisation can be summarised in a simple conceptual model which is presented in figure 2.6 below.

Figure 2.6 Determinants of International Franchise

<table>
<thead>
<tr>
<th>Organizational</th>
<th>Perceived benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm Size</td>
<td>Importance of benefits</td>
</tr>
<tr>
<td>Operation experience</td>
<td>Probability of benefit</td>
</tr>
<tr>
<td>Top management international orientation</td>
<td>Perceived Risk</td>
</tr>
<tr>
<td>Top management tolerance to risk</td>
<td>Importance of cost</td>
</tr>
<tr>
<td>Top management perception of the firm’s competitive advantage</td>
<td>Probability of cost</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Environmental</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic competitive pressures</td>
</tr>
<tr>
<td>External change agent influence</td>
</tr>
<tr>
<td>Perceived favourability of external environment</td>
</tr>
</tbody>
</table>

Source; Adapted from Altinay (2006) Selecting Partners in an international franchise organization.
3. HYPOTHESIS DEVELOPMENT

3.1 Firms listing and internationalisation

There are currently a small number of franchisors listed on the United States’ stock market, but this is likely to change over the next couple of years as the franchise business model continues to mature and expand, and the owners decide to extract value. According to Hodson (2012) the Australian franchising market has been growing rapidly over the last five years, and as such many of the businesses are rapidly nearing, or have already reached the critical mass that is arguably necessary for a stock exchange listing. Even though, franchisors are very skeptical about listing on the stock market, listing has numerous benefits for firms such as an aggressive growth paths ranging from access to equity capital to fund expansion and acquisition, to extracting a percentage of value from the years invested in building the business, whilst still retaining in control. Furthermore, Hodson (2012) stated that there is a powerful and often underestimated benefit of listing which is the ability for the franchisors to retain franchisees and employee’s due to higher public profile as well as the ability to offer unique remuneration structures whiles using the listed company’s shares.

Terry (2010) also argued that franchisees that find themselves to be part of a public company franchise may be in a more advantageous position that franchisees found in a smaller private company and stated such instances could be found from the Australian franchising sector. In addition, public companies or franchisors would not only be limited to access to public funds for development and expansion but can also attract specialist management and directors who can add real value to their business. Public/ Listed companies tend to be subjected to higher levels of financial disclosures unlike small private companies which are largely exempted from audit and reporting requirement. Thus, for listed companies the rules and regulation sets out higher standards that must be followed to maintain listing status. Taking this into consideration for a prospective franchisee this level of disclosure sends a good signal and enables more effective due diligence.

Lopes et al., (2007) noted that the relationship that exist between a company listing status and disclosure practices is primarily based on agency cost and signaling argument. Companies therefore expect that their compliance with international accounting standards and high disclosure levels would be interpreted as good signals by the market, therefore becoming a
means of obtaining cheaper capital from potential investors. Cooke, (1989) argued that a firm that is listed on an exchange turn to disclose more information since it needs to observe the rules and regulations, which attract more attention and send good signals.

With the domestic franchise market, swiftly approaching saturation point and the competition for quality franchisees stronger than ever, it will take strong signals and effectiveness on the part of franchisors that makes the difference between sustained growth and stagnation. Based on this we hypothesise:

\[ H1: \text{There is a positive relationship between firms listed on the stock exchange and the level of internationalisation.} \]

3.2 Earnings Disclosure (Item 19) and Internationalisation

Do all firms disclose their earnings? is a question we find ourselves asking when it comes to international franchising. Thus, earning disclosure is a signal that franchisors use to attract resources. In previous studies made about signaling theory and its relationship with franchising, there was empirical evidence suggesting that earnings claims are a signal with which the franchisor attracts new investors and potential franchisees. Grossman and Milgrom (1981) propose that all franchisors will publish their earnings, in case a franchisor does not publish their earnings; skeptical franchisees might request them to publish it. If a franchisor refuses to publish his earnings, the theory suggest that the lack of transparency is due to the costs related to making earning claims, the quality of its products or services and mirroring the competition when the industry rivals do not disclose financial information either.

As Michael (2009) noted, franchisors that are more likely to disclose earnings are those whose industry competitors disclose as well. Lucia-Palacios et al., (2014) argued in their research that earning claims are estimates or historical figures detailing the levels of sales, expenses, and income that the prospective franchisee can expect to gain from the franchise. This form of disclosure can serve as a selling tool for successful franchising. According to signaling perspective, only firms with a good market position, high-quality financial returns, and low business risks provide earnings disclosures (Michael, 2009). Thus, a franchisor who does not disclose its earnings might be signaling to its potential investors that the brand is not very valuable (Weaven and Frazer, 2006).
The franchising mode of entry has some legal and contractual arrangements that make the franchisor-franchisee relationship interdependent to some extent (Kuratko and Hodgetts, 1995). The disclosure of potential earnings from the franchisor to potential franchisees can be seen as a form of financial cooperation (Clarkin and Rosa, 2005). In the United States, other forms of disclosure are mandatory to all franchises, but in the year 2000 the US Federal Trade commission estimated that 20% of franchisors make a voluntary earning disclosure. These group of firms who voluntarily decide to disclosure their earnings make it easier for potential franchisees to have knowledge about their potential sales, costs, income, or profit. Price (2000) studied the relationship between earning disclosure and investment risk: she found out that firms that disclose earning information face greater investment risk, and therefore must find a way to decrease this risk with higher fees from franchisees. The company is able to have higher fees at some extent because of the value perceived through the increased sense of trustworthiness, transparency and security they signal with the disclosure of earnings (Lucia-Palacios et al., 2014).

Clarkin and Rosa (2005) stated that the franchise systems that disclose earnings voluntarily have an advantage when attracting potential franchisees over those who do not disclose their earnings. Franchisors with a performance or sales above average have a higher probability of disclosing their earnings compared with those that have a below average performance. Additionally, they noted that these firms have a higher likelihood to have a system with more favorable wealth-creation potential at a franchise level. According to the study made by Clarkin and Rosa (2005) the disclosure of earning clams is also of high importance in the systems with higher dependence on franchising as a growth strategy: the firms that disclose their earnings have more units in operation than those firms that do not disclose their earnings. We therefore hypothesise that:

\[ H2: \text{There is a positive relationship between disclosure of earnings and level of internationalisation} \]

### 3.3 Organisational format and Internationalisation

Fadairo and Lachimba, (2016) stated that, the ownership structure of the franchised networks works as signaling device to show the value of a business. New franchisors have some challenges at communicating the right message when enlisting new franchisees, nevertheless,
the franchisor can solve part of the information asymmetry problem, by stating that its operations are also part of the profitability (Gallini & Lutz, 1992), either via company owned-units, where the company directly receives the revenue or from franchise royalties, where the company receives a part of the revenue of franchisees. As Gallini and Lutz, (1992) affirmed, only profitable franchisors would be able to take its compensation in this way, though dual distribution: only good franchisors, who own at least two units, are able to show that the business is so good and profitable that they decide to have company-owned units and participation in the continuity of the franchise network rather than its role being solely selling its business units to potential franchisees.

Existing research has explained the reasons why firms decide to opt for the franchising mode of business, which signals different lacks and managerial necessities from the company. Oxenfeldt and Kelly, (1989) and Hunt, (1973) mentioned that companies franchise for their need of financial capital. When a franchisee starts operating, he provides the company with an injection of resources through franchising fees and royalties which means the easiest form of growth for the company. Later on, there are other factors that signal a different necessity of the company: It was not just financial resources but also human capital and managerial talent as stated by Norton (1988), Oxenfeld and Kelly (1969) and Combs and Castrogiovanni (1994).

Local knowledge (Combs and Castrogiovanni, 1994) is also one of the lacks that companies had when they decided to use the franchise mode of entry: it was an alternative to enter to a new market where the market knowledge of the franchisor was more incipient and the cultural distance from the firm’s home country was greater. There is a believe that as a franchise system matures and accumulates resources and knowledge, the urge for franchising would decrease and companies would shift their ownership setting, passing from franchisee owned to company owned outlets for expansion (Alon, 2001). When this occurs, the firm signals a more stable financial situation, therefore, a higher profitability of their operations. Hunt, (1973) documented this trend in the US fast food franchising. He demonstrated through his research that the sector was moving towards company-owned units and it was because the firm did not have to depend on the franchisees anymore to obtain resources. There has been evidence from his research that signal that the need of financial resources and capital is the most important motivation to use franchising: larger fast food franchises had more company operated units and older franchising systems had higher percentages of company-owned units.
Additionally, Combs and Castrogiovanni, (1994) stated that as the company matured they were able to buy back profitable franchised units in order to attain more rents. LaFontaine and Kaufmann, (1994) also affirmed that companies start with franchising to raise capital and end with “buy-outs” as they mature, which signals different stages of the firm life cycle. With this we can affirm that the company signals better profitability when they are able to buy units back and incorporate the franchised units to their operation. A study of 91 publicly-traded restaurant chains revealed that capital-restrained companies were more likely to use franchising for expansion (Combs and Ketchen, 1999). Dant and Kaufmann, (2003) further argued that one major signal to prospective franchisee is the level of ownership within the chain by the franchisor. This is due to the fact that franchisors would most likely own more units when the chain is profitable hence the percentage of units owned by the franchisors could send a signal of the quality of opportunity to franchisees. We therefore hypothesise that:

\[ H3: \text{There is a positive relationship in the number of company owned units and internationalisation.} \]

3.4 Royalty fees and Internationalisation

In franchising, specifically business format franchising, the franchise contract typically involves payment from the franchisee to the franchisor. This payment is a proportion of the franchisee’s sales which is normally referred to as royalties and this proportion is constant on the overall sales levels. According to Roh, (2002) the purpose of royalty is to ensure that the franchisors gets to share in the success of the franchised outlets. Also since the minimum value of sales is always positive, this sharing arrangement has the benefit of reducing the business risk factor of the franchisor. Michael, (1999) found a positive relationship between the royalty rate and franchisee income in the restaurant industry. He explained this finding that, royalty rate represented an amount spent on product differentiation by the franchisee, and as such product differentiation was profitable. Therefore, royalty rate served as a measure for profit. However, his further studies into franchising using earning claims as a form of signal found no significant relationship between royalty rates and the profitability of claiming. Thus, there was no support for his hypothesis that franchisors offering higher profitability as measured by royalty rate are more likely to claim than franchisors offering lower profitability. In addition, Combs and Castrogiovanni, (1994) also found a positive relationship between the number of units franchised by a franchisor and the amount of royalty rate charged by the
franchisor. Agrawal and Lai, (1995) as well found that franchisors that charged higher royalties also tend to invest heavily in their franchise system.

Gallini and Wright, (1990) as well as Beggs, (1992) also expressed in their works that the use of royalties on the sale of licensing agreements can be explained as the need for licensor (franchisor) to signal the value of the offered technology or product. Thus, royalties could be used by franchisors to signal to potential franchisees about their profitability. Backing this argument Lafontaine, (1993) noted that firms with a high-value trade name who had not yet established their reputation can send signal to potential franchisee by offering a contract that makes their revenues highly dependent upon the performance of the outlet. Thus, the contract of the high value franchisor should offer to differentiate itself from low type franchisor through higher royalty rate and lower franchise fee to the point where it would be difficult and unprofitable for the low value franchisor to imitate.

Furthermore, Calderon-Monge & Huerta-Zavala, (2015) probed on the fact that royalties serve as a signaling tool that the franchisors use to send the quality of their franchise to the market. High royalties were seen as a signal of business superiority. They further stated that the size of the royalty rate served as a credible signal of the quality of the franchise to franchisee as this rate indicated that franchisor provided a good number of services with value. Thus, franchisees saw small royalty rates as signal of smaller number of services offered and these services provided little value (Shane et al., 2006). Signaling theory also implies that royalty rates are primarily a signal of brand equity for the chain that have been in operation for a period and also provides an intuition into expansion process of franchises that have just been in operating in the market (Penard et al., 2003).

As such royalties constitutes an important signal for potential franchisees looking for a franchise chain to invest in. We hypothesise that;

\[ H4: \text{There is a positive relationship between royalty fee and the level of internationalisation.} \]

3.5 International franchise association (IFA) membership and Internationalisation

International franchise association since its inception in 1960 has represented numerous industry leaders that use franchising as a method of distribution. Members of this association
cut across all industries such as the automotive, fast food, retailing etc. In addition, the mission of this association is to protect, enhance and promote franchising. Members of this association were deemed by franchising experts as the leaders and quality companies within the franchising community. This therefore goes to show the level of credibility linked with franchisors and firms in this association (International Franchise Association).

According to Adler (2009) franchising involves not only legal obligation but also ethical obligation. Currently franchise association all over the world have developed ethics designed to codify certain ethical values. As such membership in these associations (example international franchise association) is contingent upon accepting and applying these codes of ethics. To maintain a good reputation and credibility with franchisees and with the franchise community, it is necessary for franchisors to have an ethical framework that govern the way they operate (Franchise Direct). These codes serve as a guide for franchisors to self-regulate themselves and give franchisees some level of ease that they are dealing with trustworthy firms. Thus, potential franchisees can interpret this as a form of signal that firms found in this association are of good repute seeking to promote and enhance their business.

Another important aspect of being part of this association comes with honesty and trust. Franchising is a partnership between franchisors and franchisees, and just like any other relationship, transparency is of utmost importance and this is embedded in the membership. A loss of a membership in a franchise association due to failure to abide by the code of ethics can seriously undermine the integrity of the franchisor’s brand hence sending a bad signal to potential franchisees. Furthermore, since this association consists of all the best franchise firms in the industry it creates an atmosphere of competition between the members who want to both attract and send good signals about the quality of their service. Thus, they seek to be honest, trustworthy, and transparent to their franchisees. This, in a longer run, communicates a good signal to potential franchisees about how reliable and efficient these franchisors are in their business. We therefore hypothesise that:

\[ H5: \text{There is a positive relationship between membership to the International Franchise Association and internationalisation.} \]
3.6 Conceptual Framework

We propose a conceptual framework where we identify the determinants of international franchising. Although several variables can potentially influence the level of internationalisation through signaling, we focus on these determinants to franchisors and treats other determinants as control variables.

**Figure 3.1 Conceptual Framework**

- **Signaling Theory**
  1. Stock Exchange
  2. Item 19
  3. Company Owned Units
  4. Royalty rate
  5. IFA membership

- **Agency theory**
  1. Franchised fee
  2. Total Investment

- **Resource scarcity Theory**
  1. Total Units
  2. Age
  3. Industry

Source: Author’s own construct
4. METHODOLOGY

In this section, we present the research methodology. Here we will be documenting the various techniques, methods, and procedures we employed in analyzing the data by discussing the data, the operationalization of focal and control variables, the empirical model, and its estimation.

4.1 Data

According to Sekaran and Bougie, (2013, p. 112-113), there are three main methods of collecting data when conducting a survey research, which are interview, observing people and administering questionnaires. Primary and secondary data source is defined respectively as “information obtained first hand by the researcher on the variable of interest for the specific purpose of the study while information gathered from sources that already exist is referred to as secondary data”.

Sekaran and Bougie, (2013, p. 112-113) further explained that the source of information and the manner in which data is collected could show the difference in the effectiveness of a research work. Thus, the data used to carry out this research is secondary in nature. This is a cross sectional data obtained from the world franchising network in the year 2016 through the use of questionnaire. World franchising network is a preeminent provider of reliable, up to date and easy to use information on franchising. Thus, we deem the data as reliable and of high quality.

The dataset employed is subdivided into forty- three (43) different sections some of which are listed as; Legal/ Incorporation name, Division of Parent, Franchised Units, Company owned Units, Total units, Global Sales, Franchise Fee, Royalty Rate, International Units, Total Investment. Based on our dataset we have 4,150 franchisors from the United States which are categorised under five (5) primary industry sector.
Table 4.1: Distribution by primary industry

<table>
<thead>
<tr>
<th>Primary Industry</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conglomerate</td>
<td>45</td>
</tr>
<tr>
<td>Food-service</td>
<td>1411</td>
</tr>
<tr>
<td>Lodging</td>
<td>270</td>
</tr>
<tr>
<td>Retail</td>
<td>289</td>
</tr>
<tr>
<td>Service-based</td>
<td>2129</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>4149</strong></td>
</tr>
</tbody>
</table>

*There are 4 cases without industry specification.

4.2 Operationalisation and measure of concept

Operationalization is defined by Shuttleworth (2008) as “the process of strictly defining variables into measurable factors. This process helps to defines concepts and allows them to be measured, empirically and quantitatively”. Thus, operationalization sets down the exact definitions of each variable, which increases the quality of the results and improves the robustness of the design.

Sekaran and Bougie, (2013, p. 200) also explained operationalization as “looking at the behavioural dimensions, facets, or properties denoted by the concepts. These are then translated into observable and measurable elements so as to develop an index of measurement of concept”. It is worth noting that though operationalization is important this process does not describe the correlates of the concept. The concepts in this paper are operationalized with the aid of variables that are empirically supported.

4.2.1 Independent and dependent variables

The operationalization of variables are shown in table 4.2. The dependent variable in this study is internationalisation (whether or not firms sought international expansion). This is a binary variable where a given firm is coded “1” if it looked to expand and had international units and “0” otherwise.
Table 4.2: Operationalization of variables

<table>
<thead>
<tr>
<th>Hypotheses</th>
<th>Variable Proxies</th>
<th>Prior Research</th>
<th>Expected Relationship</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1=Yes 0= No</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Earning Claim</td>
<td>1 Dummy Variable</td>
<td>Michael, 2009</td>
<td>Positive association with internationalisation</td>
</tr>
<tr>
<td></td>
<td>1= Yes 0=No</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Royalty rate</td>
<td>Average percentage of sales that franchisees paid to the franchisor on an ongoing basis</td>
<td>Shane, 2009; Lafontaine 1992, 1993, Shane et al, 2006</td>
<td>Positive association with internationalisation</td>
</tr>
<tr>
<td>4. Company Owned Units</td>
<td>Ratio of company-owned outlets to the total number of outlets in the system</td>
<td>Shane, 2009; Shane et al, 2006</td>
<td>Positive association with internationalisation</td>
</tr>
<tr>
<td>5. IFA Membership</td>
<td>1 Dummy Variable</td>
<td>Author’s own construct</td>
<td>Positive association with internationalisation</td>
</tr>
<tr>
<td></td>
<td>1= Yes 0=No</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

4.2.2 Control Variables

In analyzing our model, it seemed of utmost importance to control for certain variables which are of no theoretical interest to the research. This will enable us to rule out any rival explanations for our results and look for boundaries of hypothesized effects.

We control for total investment, franchise fee, number of total units, age, and industry. Total investment which is a measure of the start-up cost. The franchise fee is measured as the average amount that a potential franchisee must pay as a single initial payment to the franchisor in the year t. (Kaufmann & Dant, 2001). We control for all these variables because we believe they could have an effect on the dependent variable in question. In Table 4.3 we explain the measures for the control variables.

Table 4.3: Control Variables

<table>
<thead>
<tr>
<th>Variable</th>
<th>Variable Proxies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Investment</td>
<td>Mean start-up cost</td>
</tr>
</tbody>
</table>
Franchised Fee

Average amount paid by the franchisee to the franchisor as up-front fee to open an outlet

Number of Total Units

Total units- Overall Chain size

Industry

Categorized based on the primary industry

Age

Number of years from the inception of the franchisor until the year of observation

4.3 Data analysis technique

As raw data is hard to visualize, we will begin our analysis with descriptive statistics to enable us present data in a more meaningful way which allows a simpler interpretation of the data. Descriptive statistics is a term given to the analysis of data that helps describe or summarize data in meaningful way such that, for example, patterns might emerge from data.

Furthermore, to answer our research question we ran a binomial logistic regression. A binomial logistic regression as explained by Sekaran and Bougie (2013), is used when a dependent variable is non-metric. We chose this form of regression because it allows us to predict a discrete outcome from a set of variables that may be continuous, discrete, or dichotomous and binomial logistic regression allow us to test our dependent variable with two categories. It also does not face the strict assumptions that discriminant analysis faces and because it is very similar to regression analysis. This model is also used to ascertain the probability of a binary response based on one or more independent variables.

**Binomial logistic equation**

The general form of a logistic regression model is given as;

\[ P_i = \frac{e^t}{e^t + 1} = \frac{1}{1+e^{-t}} \text{ where } t = \beta_0 + \beta_1 x \]

\[ P_i = \frac{1}{1+e^{-(\beta_0 + \beta_1 x)}} \]
Where $P$ is the probability of seeking internationalisation; $x$ is the vector of the variables of the logistic regression and $B$ is vector of the coefficients of the variables in the logistics regression. To explain the support that our regression gives to the hypotheses, we used the above equation to find the marginal impact that the five independent variables (listing status, Item 19, royalty rate, company owned units, IFA membership) have on the probability of seeking internationalisation.

### 4.3.1 Assumptions of regression

**Dichotomous dependent variable**: According to the logistic regression the dependent variable used in the analysis must be dichotomous (Binomial logistic regression using SPSS statistics, 2013). A dichotomous data is a data defined in two categories. For example, gender can be categorised as male or female. In our work, the dependent variable “Internationalisation or International Units” is defined as yes or no in the companies being studied. In the statistical analysis, we assigned the value yes (1) to the companies with international units and no (0) to the companies without.

**One or more independent variable continuous or categorical**: From this assumption, our data set has both categorical and continuous variables. The primary industry variables have been categorised into five subsets (conglomerates, food service, retail, lodging and service based) also are independent variables item 19 and listing status are also categorised. Age, royalty rate, franchise fee, total units just to mention a few of our variables are also continuous variables.

**Mutually Exclusive**: The observations should be independent and the dependent variable should be mutually exclusive and exhaustive categories. For a variable to be mutually exclusive it means that they cannot occur simultaneously. This means that each one of the observations used to make the analysis should be independent from each other and the probability of the variables having the same outcome is low, which are dataset meets.

**Multicollinearity**: This assumption prohibits the existence of a perfect linear relationship among the predictor variables. Sarstedt and Mooi (2014 p. 198-199) states that collinearity is a data issue that arises when two independent variables are highly correlated and
multicollinearity occurs whenever two or more independent variables are highly correlated. Collinearity is detected by calculating the tolerance or VIF (Variance Inflation Factor). A tolerance of below 0.8 indicates that multicollinearity is not a problem. The VIF is just the reciprocal value of the tolerance. Thus, VIF values above ten indicate collinearity issues. To test for this assumption, we generate a correlation matrix for the predictor (independent) variables. The correlation matrix is presented in table 4.4 below and the corresponding Variance Inflation Factors (VIFs) for the independent variables are presented in appendix I

**Table 4.4 Correlation Matrix**

<table>
<thead>
<tr>
<th></th>
<th>Item 19</th>
<th>Listing Status</th>
<th>Royalty Rate</th>
<th>Company Units</th>
<th>Age</th>
<th>Total Investment</th>
<th>Total Units</th>
<th>Franchise Fee</th>
<th>Primary Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Item 19</td>
<td>1.000</td>
<td>0.222</td>
<td>0.351</td>
<td>-0.30</td>
<td>0.237</td>
<td>0.025</td>
<td>0.337</td>
<td>0.140</td>
<td>-0.04</td>
</tr>
<tr>
<td>Listing Status</td>
<td>0.222</td>
<td>1.000</td>
<td>-0.034</td>
<td>-0.043</td>
<td>0.356</td>
<td>-0.103</td>
<td>0.479</td>
<td>0.076</td>
<td>0.155</td>
</tr>
<tr>
<td>Royalty Rate</td>
<td>0.351</td>
<td>-0.034</td>
<td>1.000</td>
<td>-0.221</td>
<td>-0.110</td>
<td>-0.103</td>
<td>0.034</td>
<td>0.089</td>
<td>0.155</td>
</tr>
<tr>
<td>Company Units</td>
<td>-0.30</td>
<td>-0.043</td>
<td>-0.221</td>
<td>1.000</td>
<td>0.232</td>
<td>0.201</td>
<td>-0.505</td>
<td>-0.049</td>
<td>-0.120</td>
</tr>
<tr>
<td>Age</td>
<td>0.237</td>
<td>0.356</td>
<td>-0.110</td>
<td>-0.232</td>
<td>1.000</td>
<td>0.125</td>
<td>0.565</td>
<td>0.091</td>
<td>-0.152</td>
</tr>
<tr>
<td>Total Investment</td>
<td>0.025</td>
<td>0.291</td>
<td>-0.103</td>
<td>0.201</td>
<td>0.125</td>
<td>1.000</td>
<td>-0.565</td>
<td>0.038</td>
<td>-0.457</td>
</tr>
<tr>
<td>Total Units</td>
<td>0.337</td>
<td>0.479</td>
<td>0.034</td>
<td>-0.505</td>
<td>0.565</td>
<td>0.240</td>
<td>0.091</td>
<td>0.028</td>
<td>-0.058</td>
</tr>
<tr>
<td>Franchise Fee</td>
<td>0.140</td>
<td>0.076</td>
<td>0.089</td>
<td>-0.049</td>
<td>-0.013</td>
<td>0.038</td>
<td>0.091</td>
<td>1.000</td>
<td></td>
</tr>
<tr>
<td>Primary Industry</td>
<td>-0.04</td>
<td>-0.225</td>
<td>0.155</td>
<td>-0.120</td>
<td>-0.152</td>
<td>-0.457</td>
<td>-0.152</td>
<td>0.028</td>
<td>1.000</td>
</tr>
</tbody>
</table>

From this table, we can observe that the highest correlation coefficient was from total units with 0.56 which meet the tolerance level of below 0.8 hence there is no presence of multicollinearity within our variables. Also looking at the VIF all the variables are less than 10.0 indicating the absence of collinearity in the analysis.

**4.4 Robustness check**

Robustness is a characteristic used in describing a model’s test, or system’s ability to effectively perform whiles its variables or assumptions are altered. Thus, for the purpose of
ensuring that our results are robust we perform further analysis. We perform this by substituting and including other variables in the logistic regression.

4.5 Statistical package

We carried out all tests and analysis of the data using IBM SPSS software. This is a predictive software that provides statistical analysis and reporting that helps you to gain deep and accurate insights from your data and drive better decision making.
5. PRESENTATION OF FINDINGS

In this section, we present the results of the statistical techniques that have been applied to analyse the data. In order to answer the research question, we applied binomial logistic regression and the results and findings are presented below.

5.1 Descriptive Statistics

We begin the presentation of our findings by presenting the descriptive statistics, the goal is to show the general characteristics of the variables in the data set. This is shown in table 5.1.

<table>
<thead>
<tr>
<th>Table 5.1: Descriptive statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>N=4150</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>International units</td>
<td>0</td>
<td>1</td>
<td>0.14</td>
<td>0.35</td>
</tr>
<tr>
<td>Primary Industry</td>
<td>0</td>
<td>5</td>
<td>3.73</td>
<td>1.41</td>
</tr>
<tr>
<td>Total Units</td>
<td>0</td>
<td>56439</td>
<td>1243.61</td>
<td>6328.55</td>
</tr>
<tr>
<td>Company Units</td>
<td>0</td>
<td>1</td>
<td>0.19</td>
<td>0.30</td>
</tr>
<tr>
<td>Total Investment</td>
<td>0</td>
<td>63624250</td>
<td>1341326.74</td>
<td>6699122.16</td>
</tr>
<tr>
<td>Franchise Fees</td>
<td>0</td>
<td>650000</td>
<td>38835.80</td>
<td>63260.59</td>
</tr>
<tr>
<td>Royalty Rates</td>
<td>0.00</td>
<td>0.45</td>
<td>0.04</td>
<td>0.05</td>
</tr>
<tr>
<td>Item 19</td>
<td>0</td>
<td>1</td>
<td>0.48</td>
<td>0.50</td>
</tr>
<tr>
<td>Listing Status</td>
<td>0</td>
<td>1</td>
<td>0.13</td>
<td>0.33</td>
</tr>
<tr>
<td>Age</td>
<td>0</td>
<td>146</td>
<td>26.10</td>
<td>22.61</td>
</tr>
</tbody>
</table>

From the table above, fourteen (14) percent of the firms in the dataset had international units, in addition only nineteen (19) percent of the firms had company owned units and an average of 1244 total units. Additionally, forty-eight (48) percent of the firm’s disclosed their earning claim which to us is a good indication as firm typically do not wish to disclose their earning to franchisees. This goes to support the argument that trends are changing and in order for franchisors to be more competitive and attract potential franchisee they have to go out of their ways to send out certain signals or information leading to more earning disclosures. However, only thirteen (13) percent of the firms were listed on the stock exchange. This we believe could be due to the perception of franchisors that public equity was not the fastest and easiest way to acquire financial resources. The average total investment and franchise fee by these firms were $1,341,327 and $38,835 respectively whiles the average age of the firms was approximately 26 years. The average royalty rate charged by franchisors was also four (4) percent.
5.2 Logistics Regression

We perform the analysis in two stages. First, we performed the regression without any control variables and later with age, industry, total investment, total units, and franchise fee as controls. We performed a logistic regression analysis with the international unit variable being the dependent variable while the other five tested variables were the independent ones. A positive coefficient indicates that an increase in the independent variable is associated with an increase in the predicted probability, hence increasing the likelihood that a franchise firm would internationalise, while a negative coefficient indicates a decrease in the likelihood of the predicted probability of the internationalisation of franchise firms.

The result of the logit regression without control variables is shown in table 5.2 below. From this table, we observe that Item 19, listing status, and royalty rate were significant whiles company units and international franchise association membership (IFA) were non-significant. In addition, we observe a negative relationship between company units, royalty rate and IFA membership, item 19 and listing status had a positive relationship. The $R^2$ from this regression was also fifty-five (55) percent.

<table>
<thead>
<tr>
<th>Variables</th>
<th>B</th>
<th>S.E</th>
<th>Wald</th>
<th>df</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company Units</td>
<td>-0.33</td>
<td>0.27</td>
<td>1.44</td>
<td>1</td>
<td>0.23</td>
</tr>
<tr>
<td>Item 19</td>
<td>3.69</td>
<td>0.4</td>
<td>238.29</td>
<td>1</td>
<td>0.00</td>
</tr>
<tr>
<td>Listing Status</td>
<td>3.30</td>
<td>0.15</td>
<td>518.64</td>
<td>1</td>
<td>0.00</td>
</tr>
<tr>
<td>Royalty Rate</td>
<td>-3.21</td>
<td>1.55</td>
<td>1.44</td>
<td>1</td>
<td>0.04</td>
</tr>
<tr>
<td>IFA-CFA Member</td>
<td>-0.46</td>
<td>0.12</td>
<td>0.14</td>
<td>1</td>
<td>0.70</td>
</tr>
<tr>
<td>Constant</td>
<td>-5.02</td>
<td>0.25</td>
<td>433.43</td>
<td>1</td>
<td>0.00</td>
</tr>
<tr>
<td>Chi square</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>59.10</td>
</tr>
<tr>
<td>-2Log likelihood</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1855.08</td>
</tr>
<tr>
<td>Nagelkerke $R^2$</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.55</td>
</tr>
</tbody>
</table>

As it can be observed from table 5.3 that three of our variables had a positive coefficient and were significant. The beta coefficient of listing status is 2.46, which indicates that for every
unit increase in this variable the logit or log odds of internationalisation would increase by 2.46. Item 19 or earnings claims, as shown in the table has a coefficient of 5.83 which also indicates that the increase of one unit in earning claims would increase the log odds of internationalising by 5.83. In the case of royalty rates and company owned units we can observe that they represent a negative relationship with internationalisation. Indicating that for a unit increase in company units the log odds of internationalisation would decrease by 0.73 as well for royalty rate every unit increase in this variable the logit estimate would decrease by 0.36. Membership in the IFA association also had a beta coefficient of 0.68 explaining the increase in this variable will increase the log odds of internationalisation by 0.68. From all our variables disclosing earning claims has the highest influence in determining the level of internationalisation for these firms which is followed by their listing status and lastly their IFA membership.

Table 5.3: Logistic regression results

<table>
<thead>
<tr>
<th>Variable</th>
<th>B</th>
<th>S.E.</th>
<th>Wald</th>
<th>df</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Listing Status</td>
<td>2.46</td>
<td>0.23</td>
<td>119.88</td>
<td>1</td>
<td>0.00</td>
</tr>
<tr>
<td>Company owned Units</td>
<td>-0.73</td>
<td>0.45</td>
<td>2.42</td>
<td>1</td>
<td>0.48</td>
</tr>
<tr>
<td>Royalty Rate</td>
<td>-0.36</td>
<td>2.132</td>
<td>0.03</td>
<td>1</td>
<td>0.87</td>
</tr>
<tr>
<td>Item 19</td>
<td>5.83</td>
<td>0.46</td>
<td>162.81</td>
<td>1</td>
<td>0.00</td>
</tr>
<tr>
<td>IFA-CFA</td>
<td>0.68</td>
<td>0.18</td>
<td>14.22</td>
<td>1</td>
<td>0.00</td>
</tr>
<tr>
<td>Primary Industry</td>
<td></td>
<td></td>
<td>4.16</td>
<td>3</td>
<td>0.24</td>
</tr>
<tr>
<td>Conglomerates</td>
<td>-0.17</td>
<td>1.02</td>
<td>0.03</td>
<td>1</td>
<td>0.90</td>
</tr>
<tr>
<td>Food Service</td>
<td>0.12</td>
<td>0.33</td>
<td>0.14</td>
<td>1</td>
<td>0.70</td>
</tr>
<tr>
<td>Lodging</td>
<td>-1.58</td>
<td>0.41</td>
<td>14.86</td>
<td>1</td>
<td>0.00</td>
</tr>
<tr>
<td>Retail</td>
<td>0.92</td>
<td>0.49</td>
<td>3.49</td>
<td>1</td>
<td>0.06</td>
</tr>
<tr>
<td>Age</td>
<td>1.93</td>
<td>0.38</td>
<td>25.05</td>
<td>1</td>
<td>0.00</td>
</tr>
<tr>
<td>Total Investment</td>
<td>0.48</td>
<td>0.30</td>
<td>2.60</td>
<td>1</td>
<td>0.11</td>
</tr>
<tr>
<td>Total Units</td>
<td>3.11</td>
<td>0.29</td>
<td>114.54</td>
<td>1</td>
<td>0.00</td>
</tr>
<tr>
<td>Franchise Fee</td>
<td>0.12</td>
<td>0.49</td>
<td>0.06</td>
<td>1</td>
<td>0.81</td>
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<tr>
<td>Constant</td>
<td>-25.69</td>
<td>6.131</td>
<td>17.56</td>
<td>1</td>
<td>0.00</td>
</tr>
<tr>
<td>Chi-square</td>
<td></td>
<td></td>
<td>1516.28</td>
<td></td>
<td></td>
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</table>
From our test, it can further be observed that not all the variables significantly support the model. The company owned units did not add significantly to the model (significance of 0.48), as well as royalty rate (0.87). On the other hand, three of our variables were supported by the model and provide evidence for the internationalisation of franchise firms: Item 19, listing status and membership to the International Franchise Association do communicate positive signals towards potential franchisees, confirming so with significance levels of 0.00 each. Also, the coefficient of the independent variables (Item 19, listing status and IFA-CFA membership) used in the data analysis were positive indicating a positive relationship between the signals and internationalisation as stated in the hypothesis.

These findings show that firms that intend to expand through internationalisation need to send such signals to potential franchisee as it has positive impact. Since the Nagelkerke $R^2$ tests is a modification of the Cox and Snell $R^2$ we have decided to maintain the Nagelkerke $R^2$ tests to confirm the goodness of fit of the model as ninety (90) percent of the variance is accounted for by the model. Regarding the control variables, age, total units, and lodging have a significant relationship with the dependent variable. Furthermore, in terms of the industry only lodging had a significant level with internationalisation this goes to show that potential franchisees in this industry tend to play close attention to signals as compared to the other industry. This situation can be attributed to the fact that, the lodging industry is capital intensive thus franchisees in this industry would like to observe certain quality of the franchise system (such as earning claim, membership, and listing status) before they engage in any contractual relationship with the franchisor.

The running of the test with and without the controls was to assess the behavior of the pseudo $R^2$ and the significance levels of our variables. By performing this, we observe that the goodness of fit increased from fifty-five (55) to ninety (90) when running the test with the control variables, which indicates that it is appropriate to include the control variables in the logistic regression analysis. As such among the hypothesized drivers of internationalisation, listing status, earning claim and IFA membership are the important determinants.
The table 5.4 shows the summary of results of the binomial logistic regression with the description of the statistical support for each of the hypothesis.

**Table 5.4 Summary of Results**

<table>
<thead>
<tr>
<th>Hypothesis</th>
<th>Hypothesized Relationship</th>
<th>Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Listing status and internationalisation are positively related.</td>
<td>Supported</td>
</tr>
<tr>
<td>2</td>
<td>Earnings disclosure is positively related to internationalisation.</td>
<td>Supported</td>
</tr>
<tr>
<td>3</td>
<td>Company owned units are positively related to internationalisation</td>
<td>Not Supported</td>
</tr>
<tr>
<td>4</td>
<td>Royalty rates has a positive relationship with internationalisation.</td>
<td>Not Supported</td>
</tr>
<tr>
<td>5</td>
<td>IFA membership and internationalisation are positively related</td>
<td>Supported</td>
</tr>
</tbody>
</table>

### 5.3 Robustness Check Results

We conducted additional test to confirm the robustness of our results. We substituted the variable total units with franchised units and additionally introduced a new variable: verified 2016, into the logistic regression. Franchised units were measured as the ratio franchised units to the total number of outlets in the system and verified is the authentication of the company information by Franchise World.

The results from this model found in appendix II was substantively the same as those from the proposed model for all but one of the hypotheses. Only the effect of company units with internationalisation changed in this alternative model.
6. DISCUSSION

In this section, we discuss the findings presented in the prior section, making reference to core theories and previous empirical findings. Whereas some of our results are consistent with previous research, our findings extend on prior research and offer some counterintuitive insights. The major observation about our findings collectively is that they are consistent with signaling theory. Among the hypothesis we formulated, we found statistical support for three (3) of them: Listing status, item 19 and membership to IFA or CFA. On the other hand, we found no statistical support for the other two (2) hypothesis: Company units and royalty rate.

6.1 Listing on the stock exchange

The results from the logistic regression shows that firms that are listed in the stock exchange send a positive signal to potential franchisees thus increasing their level of internationalisation, hence listing status is a good signal. From Hodson (2012) he started that businesses are rapidly nearing or reaching their critical mass as such it was necessary for them to be listed on the stock exchange. His argument can evidently be found in the descriptive statistics as forty-eight (48) percent of the firms were found to be listed on the stock exchange. This shows that franchisors are now coming to the realisation of how important it is to be listed on the stock exchange and how signals of good quality can be sent to potential franchisees.

According to signaling theory the observability of a signal is an important aspect of sending a quality signal. Thus, we believe that being listed on the stock exchange is one of the effective means of ensuring that potential franchisee can see the quality of the service. Through our analysis we were able to find a significant relationship between listing and internationalisation. This helps us to confirm our hypotheses that there actually is a relationship between sending signals through the listing status and a firm’s levels of internationalisation. Much research in franchising have argued that big publicly traded franchises outperform their non-franchise counterparts. Greenfield and Levine (2014) make reference to this fact that in 2014 a number of franchise companies found solid traction in initial public offerings markets. Some of these franchise companies include Hilton worldwide holding, La Quínta inn, Potbelly corporation just to mention a few as well as successfully traded public companies like Dunkin’ Brands Group, McDonald’s Corporation, Wendy’s,
Yum! Brands, Marriott International etc. This further goes to support the signaling proposition that the competition in the industry can also determine the effectiveness of an organization engaging in signaling. According to our analysis, for firms to expand through internationalisation it is highly recommended that they engage in these kinds of signals.

Another factor we believe is contributing to this positive relationship between listing status and internationalisation is the cost involved in sending this signal. Signal involves a costly action, which because of its cost is not likely to be done in settings where there is low-quality entrepreneurial venture (Spence, 1973). Thus, the perceived benefit in sending a false signal should be lower than the cost. The cost involved in getting listed on a stock exchange is high indicating that only successful and quality franchise firms are found to be listed on the stock exchange as the perceived benefit from getting listed far outweighs the cost involved. This situation therefore communicates the quality and profitable of the firms which can attract potential franchisee hence increasing their level of internationalisation.

6.2 Earning Claims or Item 19

We hypothesised that from the signaling perspective, the disclosure of earnings is a feature of the company that communicates a positive signal to potential franchisees and that franchisors use to attract resources. According to Michael (2009) earning disclosures is a signal of good market position, good financial returns, and relatively low risks.

After we analysed our data, we found out that indeed there is a positive relationship between earning claims and internationalisation. If we think about it, when a potential franchisee is interested in investing in a business idea, they need to know with as much certainty as possible what is the return of their investment at the short, mid, and long term: the earning claims are a good mean to know the risk, estimate level of expenses, return of your investment and potential earnings and profits. Item 19 is an important element of the franchise disclosure document which is widely utilised when making contractual transactions with a franchisor, and it can serve to facilitate the flow of the due diligence when making transactions. As such franchisors disclosing these documents communicate a good signal to potential franchisee about the quality of the franchise business they wish to engage in. This in a long run attract franchisees from all walks of life and hence increasing their level of internationalisation.
6.3 Company owned units

In our study, only nineteen (19) percent of the firms had company owned units. This variable, after running the binomial logistic regression, had a significance level of 0.48, which indicates that there is no evidence that company ownership is a positive signal towards the internationalisation of franchise firms. Oxenfeld and Kelly (1968) in their study, affirmed that franchisors use franchising as a strategy to penetrate the market when they are starting their corporate trajectory and lack the profitability and managerial capacity required for the opening of a new outlet. There are other studies that try to support the statements of Oxenfeld and Kelly (1968). For instance, Combs and Castrogiovanni, (1994) stated that as the company matures it is able to buy out profitable franchising in order to have better profitability and financial performance. Other authors that made reference to company owned units were Lafortaine and Lakaufmann (1994): in their work, they affirmed that companies start their expansion activity through franchising in order to raise capital and financial resources and would end up buying out the franchised units in order to get a greater company ownership as they mature and that it would signal different stages of the firm life cycle.

This studies and arguments on company ownership are based mostly on the financial capacity and performance of the company owned units versus the franchised units. Some studies went towards a different direction: Wattle (1968) and Rubin (1978) noted that because of the different incentives that the owner had compared to the franchisee, the financial performance would be different: the franchisees would be more sensitive to the daily use of resources, cost distribution and market conditions that affect unit performance. This was found to be true in a study of restaurants performed by Shelton (1967, p.1258) where he found that the franchisee owners’ performance was greater than the company managers’ performance, which relates to the findings of our study, in the way that we did not find evidence that company owned units was a signal of higher profitability or financial performance that would influence internationalisation.

Anderson (1884) performed a study on company ownership and relative performance of company owned establishments in a time lapse of ten (10) years, from 1969 to 1980, using aggregate time series data from seventeen (17) different business areas, where in the first set of hypothesis of his work which was related to the increase in the percentage of company owned units through time, he found out that companies expanded their ownership shares in
nine (9) out of seventeen (17) commercial areas. Even if in some business areas this occurred, he was unable to reject the null hypothesis that the ownership shares would stay the same through time. In one half of the business areas studied, he found that different business areas in franchising presented different behaviour and develop differently throughout time, which made him not support the conclusion of earlier works. In our study, we neither found support of our null hypothesis of company-owned units being a positive signal towards the internationalisation of franchise firms. Lafontaine (1993) also stated in her research that no evidence could be found to support the argument that franchisors used their capacity to operate outlets directly in order to communicate to potential franchisees about the value of the franchise, which also equals our findings.

6.4 Royalty rate

There has been numerous research on the effect of royalty rate in the franchising industry. Whereas some are able to find support for their hypotheses others are not able to find any evidence. After testing our hypotheses no evidence was found to support $H4$ that is we found no positive relationship when royalties were used as a signal to determine internationalisation. Calderon-Monge and Huerta-Zavala (2015) also found out that only brand equity, franchisee fee and initial investment were signals that was taking into consideration by franchisees and not royalty fee. This finding is explained in the sense that franchisee fee and initial investment affected the franchisee in the short term, whiles royalties only came to play once the franchisee had entered into a contractual agreement with the prospective franchisor hence greater focus is given to these factors than royalty. Michael (2009) also stated in his research that royalty served as a measure of a firm’s profitability. Hence franchisors who were more profitable measured in terms of royalty who send a signal to engage in earning disclosure. But no evidence was also found to support this claim.

Furthermore, Lafontaine (1993) research on signaling also found no support for the notion that franchisors use their terms of contract (royalty rate and franchisee fee) to communicate to potential franchisees about the value of their franchise. We obtained similar findings from our analysis: that using royalty as not a good signal to increase internationalization. Our study did not support the use of royalty rate as a signaling device to communicate about the quality of the franchise, hence limiting the ability to attract potential franchisees. An explanation for this situation is that sending a signal through royalties implied inefficiencies and a lack of
flexibility (Lafontaine, 1993). Thus, Lafontaine (1993) states that there exist more efficient ways through which franchisors can communicate their quality levels such as membership in the international franchise association.

6.5 International franchise association (IFA) membership

Lafontaine (1993) statements brings us to our final hypotheses that, using the international franchise membership to signal the quality of franchise which in our case can increase internationalisation. A significant positive relationship was established between using IFA membership and internationalisation. This goes to show that belonging to this association is seen by franchisees as a credible way to convey the quality of your franchise. Thus, being a member of this association increases the firm’s exposure to franchisees which in turn can increase the level of international through attracting more franchisee. Furthermore, we believe this positive relationship between IFA membership and internationalisation is due to the credibility and trust given to members of this association by all stakeholders in the industry. Thus, this finding shows that franchisor’s that engage in these kinds of signal send a positive information about their franchise system as such they attract potential franchisee which in the long run increases their level of internationalisation.
7. CONCLUSION

Given the prominent role of franchising in the United States and today’s economy as a whole, the current aim of this study is to analyse the determinants of internationalisation through signals. Despite franchising being an inherently low risk business model, firms still find it challenging to increase their level of internationalisation. With this in mind, we conceptually and empirically investigated the relationship between signals and internationalisation and our findings showed that signals in fact, can influence the way franchisors attract franchisees. Our findings not only corroborate previous studies but also add more insights to how signals influence international franchising. This is an important contribution to the existing international franchising literature which indicates that a firm’s listing status, earning claims or item 19 as well as international franchise association membership has a positive relationship with internationalisation whiles it could not be confirmed that royalty rate and number of company units have a positive relationship with a firm’s level of internationalisation. We hope that our findings will spur future researchers to analyse the effect of signaling in the franchising industry.

7.1 Implications

Our findings have both important and practical implications for researchers and firms in the franchise industry. Firstly, our research help franchisors in their decision-making process to minimise the level of risk. It creates an awareness of how important signals are, in revealing the quality of the franchise system. It also enables franchisors to gain an understanding and knowledge of the signals that are important to franchisees and the signals that they ignore. This knowledge allows franchisors to better manage the content of their information efficiently and effectively in order to send pertinent signals to future franchisees. Finally, this study provides useful addition to the growing literature in franchising by highlighting the significance of signaling theory.

7.2 Limitations and further research

This study has limitations that we acknowledge. The data used in the analysis is cross-sectional in nature and as such, it is limited to just a specific period of time. Additionally, we
only examined five signals thereby excluding many other signals that may be of greater professional interest such as the brand, the cost of the signal and the quality of the signal sent.

Despite these limitations, further research should include other traits. For instance, it would be also enlightening to include qualitative elements such as website content and social networking as a form of signal. We also suggest that researchers examine not only the franchisor-related signals but also the franchisee-related signals that determine international franchising. A recommendation to future researchers would be to use panel data for their study, since this could provide a broader and better scope of how signaling can determine international franchising, and the evolution of it through time. Additionally, it would be of high interest to study the dynamics of signaling towards internationalisation among and within industries. Finally, researchers can expand this research by comparing results of this research to those of other countries.
REFERENCES


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### APPENDICES

#### APPENDIX I

#### Variance Inflation Factor

<table>
<thead>
<tr>
<th>Variable</th>
<th>VIF</th>
<th>1/VIF</th>
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<td>Total Units</td>
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<td>Mean VIF</td>
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## APPENDIX II

### Robustness check

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<thead>
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<th>df</th>
<th>Sig.</th>
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<td>0.00</td>
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<td>Franchised units Total</td>
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<td>Primary Industry Constant</td>
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APPENDIX III

REFLECTION NOTES

1.0 Introduction

In these reflection notes, the findings from our research are presented, we then further proceed to touch on three (3) issues relating to internationalisation, innovation and responsibility related with our master thesis.

2.0 Summary of findings

The goal of this thesis was to assess the determinants of internationalisation through signals by testing the following signals (listing status, earning claims, company owned units, royalty rate and international franchise association membership). After subjecting our data to binomial logistic regression, we found out that there actually exists a positive relationship between a firm’s listing status, earning claim also known as Item 19 and their international franchise association membership to the level of internationalisation while no support was found for company owned units and royalty rate. Another, findings worth noting was the significant level of the lodging industry to internationalisation. Indicating that signals behave differently in the respective industries. Our findings show that franchisors that engage in these forms of signal send a positive information about the quality of their franchise system. As such they attract potential franchisee which in the long run increase their level of internationalisation.

3.0 Reflection note by Esmeralda Naa Momo Aryee

Internationalisation

Internationalisation is a prerequisite for firm growth and competitiveness today (Madanoglu et al., 2017; Ronkainen, 2013). In order to expand firm sort out different modes of entry to accomplished this task. Among the various channels of internationalisation franchising is seen to have gained the most popularity due to its lower embedded risk and high level of
contractual control. As a result, this business concept has become a dominant strategy among internationalising firms across the various industries.

International franchising accelerated in America as far back as the early 1990s due to both the push and pull factors such as domestic market saturation, competition and economic opportunities. Furthermore, other factors that contribute to the internationalisation goals of an organisation are categorised under two broad concepts that are: organisational and environmental factors. Organisational factors as the name stands, are influences that originate from the firm/organisations perceived skills and competences whiles environmental factors originate from forces outside the organisation. Factors both organisational and environmental are; firm size, firm’s operational experience, competitive advantage, competitive pressures, and adaptability to change. All these factors when effectively and efficiently managed lead to a firm’s intention to internationalise.

**Innovation**

From a business perspective innovation means implementing new ideas, creating dynamic products, or refining existing services. Innovation though difficult to accomplish can be a catalyst for the growth and success of a business in our case a franchise system. There are numerous multinational franchises spread across the world. However, it is believed that, it’s not just the expansion of the business that has defined their success but rather their ability to innovate and adapt to changes in the environment.

Franchise by its nature discourages innovation on the part of the franchisee, as they are required to follow very specific policies and procedures spelt out by the franchisors. In terms of what exactly should be sold, how the product should be made and delivered and how the outlets should look like. Still even the most meticulous franchisors remain hungry for new ideas as such franchisee can be innovative and creative in the marketing field. Due to large number of franchise companies the key to distinguish one system from the other can be through innovative marketing concepts. Thus, both franchisors and franchisees can engage in unique advertising campaign such as tv commercial and social media to attract potential customers. Which can increase the likelihood of the franchise system succeeding.
Responsibility

Franchisors have been gravely criticised of exploiting franchisee. This is due to the fact that franchisees are not informed about how profitable the franchise system is as well as the high level of contractual control from the franchisor. Thus, franchisees find themselves buying a bad franchise outlet due to limited information communicated to the potential franchisee until they have entered into a contractual relationship with the franchisor.

Due to the cost involved and level of trust and transparency required in this industry. Franchisors are being entreated to disclose their earning claim which is known as Item 19 in the franchise sector. This document spells out all the cost and profit involved in running such a franchise, as such it gives potential franchisees an idea of how the business works before they engage in any contractual relationship with the franchisors.

Furthermore, our findings also showed that firms that disclosure this document send a positive signal to potential franchisee about the quality of the system. Thus, only good firms are able to disclosure their earning and this shows how credible and responsible the franchise system is.

4.0 Reflection Note by Massiel Carolina Henríquez Parodi

Internationalisation

Franchising is a form of business entry mode that facilitates, through a contractual agreement, the access to new markets. Internationalisation is determined by the capacity to provide services and goods in markets that are not the domestic market of firms. For the new generation of managers and companies nowadays, internationalisation has gone beyond being something exceptional to become a threshold capability of firms. Globalisation has made internationalisation an obligation of modern businesses and, for those that do not manage to accomplish the goal of reaching new markets and finding blue oceans, go under the risk of failure and of staying behind the industry rivals.

In franchising, internationalisation has become a necessity for many firms: when markets saturate, expanding to new territories is the easiest and most profitable solution according to
the environmental and organisational factors of the firm. Franchising is a widely used entry mode strategy that facilitates the access to new markets, with lower financial commitment and lower risks. Internationalisation of franchise companies has been broadly studied and through our thesis we decided to analyse it from the perspective of signaling theory. This makes our work more unique and contributes to the study of the internationalisation dynamics within the franchising industry.

In our thesis, as has been previously mentioned, the main variable is internationalisation. We understood that if we are educated to be part of the body of global leaders in all spheres of economy and society, this is something that we need to be experts on due to its importance as well as its relevance in our field of specialisation, so we can provide the necessary skillset and expertise for our future and the future of the organisations that we will be part of.

**Innovation**

Innovation is creating something new or modifying something existing in an organization in order to improve the processes, services or products, with the final objective of decreasing the use of resources (time, materials, men hours) which should be translated into an increase of the profit levels of the company. In international franchising, when the business model first started in the United States, it was a new way of entering markets where the franchisee had the possibility to get the business model and everything necessary in order to operate the business. Even if it was something new at that time, since its beginning, the levels of innovation have generally stayed within the boundaries of the franchisor who is the original owner of the business. This discourages innovation from the part of the franchisee. In a franchising contract, the franchisee has to carefully follow regulations, specific policies and procedures that define how the services or products will be sold and also the appearance of the physical facilities. That is what makes franchising special and gives the franchisee a sense of confidence in a way that it is an already proven business model, that gives a high probability of success since it has already been tested.

Even if it is a very binding way of doing business from the part of the franchisee, it is still possible to stimulate innovation within the organisation. It is important that if the franchisee desires to innovate and modify things in the business, he or she needs certainty that it will not
breach any contractual agreement and that the modification that will come into place will be profitable and that it will not compromise the operation and reputation of the system.

**Responsibility**

In our thesis, one of the important findings was that the signals sent by the Item 19 or earnings disclosure and the membership to the International Franchise Association or Canadian Franchise Association communicate a positive message towards the internationalisation of the firm. Both variables have a close relationship with being a responsible company. It is of general knowledge that the franchisor benefits from the operations of the franchisees by the royalties and fees that are given through the contractual relationship. It is also known the existence of the agency issue that can be present within franchising and the information asymmetry between both parts.

The fact of disclosing the earnings, signals at certain extent the level of profitability that potential franchisees will have. This has helped me understand how important it is to be responsible in a corporate environment, specially within the franchising industry. Franchisors must be responsible with the kind of information they publish, which has to be as accurate as possible because a non-accurate publication of earnings can mean the bankruptcy of somebody who desires to be the owner of its own business, action that represents a life changing decision. Franchisees also have to be responsible when disclosing to the franchisor the reality of their earnings, avoiding to disguise or hide the levels of profitability that they are getting. This transparent relationship is what makes franchising a good alternative for doing business and what allows to build trust between both parts. Additionally, franchisors have to be transparent and trustworthy, also in a way that allows them to be part of a Franchise association, where they have to adhere to a code of ethics, which means being familiar with the values that are fundamental for constructing and maintaining franchise relationships (International Franchise Association, 2013). Such values are trust, truth, honesty, mutual respect, law obedience and conflict resolution.

Going beyond the responsibility that must be within the franchisee-franchisor relationship, there is a new form of franchising that shows responsibility towards other kind of stakeholders: social franchising. It consists on using the capabilities of business-format franchise systems to achieve social benefits (Alon, 2014). It contributes to improve the quality
of live of underserved populations (Social sector franchising, 2013), generate economic opportunities and provide services to people that otherwise would not have access to them. Social franchising uses the same system as commercial franchising with the difference that it has a social mission and it is not profit driven, instead, they aim to being financially sustainable and measure their performance by the number of people fed, served or by the jobs created in the developing countries where they operate. This form of franchising brings hope and demonstrates that the benefits of international franchising can be brought to a social arena, taking social responsibility within franchising to another level by targeting the alleviation of social issues and maximising the economic and social impact by using and replicating the franchise business format.