Strategic Agility Explanations for Managing Franchising Expansion During Economic Cycles

Abstract

Sustained economic growth is one of the key imperatives for an agile venture. Franchising is a hybrid form of business that includes both market- and firm-like characteristics, embodying some rigidity due to routines, standardization, and replication. However, by shifting resources between company-owned and franchising modalities franchising firms may also exhibit strategic agility through resource fluidity. An agile franchisor can manage system expansion during the economic cycle by shifting its resources. An analysis of a balanced comprehensive database of 151 U.S. hybrid franchising organizations, including observations for the years between 2001 and 2008 and using two time-series analytic approaches under varying economic conditions, reveals a curvilinear U-shaped relationship between the economic cycle and franchising expansion. Executives of franchising firms can create and sustain strategic agility as economic conditions change.

Keywords: strategic agility, hybrid organizational arrangements, economic conditions

1 Introduction

The increase in academic research on franchising corresponds with its worldwide growth (Bürkle and Posselt, 2008; Combs, Michael, and Castrogiovanni, 2004; Combs et al., 2011; Hendrikse, Hippman, and Windpserger, 2015; Lafontaine, 1992; Windsperger and Dant, 2006). Given its economic importance, scholars in several disciplines have been trying to understand why firms franchise. The field of finance views franchising as a form of capital, whereby the franchisor uses franchisees' equity to grow its franchising network (Carney and Gedajlovic, 1991). In entrepreneurship, franchising is a business form when one type of entrepreneur (franchisor) contractually permits another type of entrepreneurs (franchisees) provide equity to invest in his/her venture (franchising firm). There are two dominant theories (resource scarcity and agency theory) that have been heavily used to explain the reasons for franchising and the proportion of franchised units to total units. Although more recent explanations, such as institutional theory (Barthélemy, 2011; Combs, Michael and Castrogiovanni, 2009) and resource-based theory (Gillis, Combs, and Ketchen, 2014) have emerged, all these theoretical explanations suffer from a common shortcoming. That is, these theoretical arguments fail to consider how the external macroeconomic environment influences the use of franchising. Therefore, there exists a need to look at how environmental business conditions shape up the strategic entrepreneurship of franchising firms. That is, the strategic response of franchising firms to changing economic conditions is expected to offer a better explanation of why franchising stood the test of time and serves as one of the primary examples of enduring entrepreneurship.

This study aims to demonstrate how franchising firms were are able to withstand varying macroeconomic conditions and continued to grow. We use strategic agility as a theoretical framework to explain our phenomenon. Strategic agility is defined as "the ability to continuously adjust and adapt strategic direction in the core business, as a function of strategic ambitions and changing circumstances" (Doz and Kosonen, 2008a, 2008b). Acting and thinking with agility should help ventures improve their performance and, possibly, increase their likelihood of survival. Both proactive planning and strategic responses to economic fluctuations are underlying characteristics of strategic agility. In this article, we focus on the impact of the business cycle on resource fluidity, one of the three key meta-capabilities in agility theory.

"Strategic discontinuities and disruptions usually call for changes in the business model. But, over time, efficient firms naturally evolve business models of increasing stability—and therefore rigidity" (Doz and Kosonen, 2010). Growing ventures also seek stability, resulting in the pursuit of both efficiency and predictability, which, in some cases, may lead to rigidity. Additionally, one of the main purposes of a venture business strategy is to consider how to manage interactions with the environment. Companies pursuing a growth strategy are generally more vulnerable to environmental changes, especially when there is a downturn in the economy, and thus their business models need to encompass both agility and flexibility (Doz and Kosonen, 2010).

This study makes several contributions to the extant body of knowledge. First, we provide a novel explanation as to why franchisors choose to grow via different strategies as business conditions change. In essence, we demonstrate that franchisors have opportunity to behave entrepreneurially by opening their own units and/or select other entrepreneurs (i.e., franchisees) as partners by using their knowledge and capital depending on the macroeconomic

environment. Second, our results, can potentially serve as an explanation for when franchisee capital is more attractive (Gonzales-Diaz and Rodriguez, 2012). Last, we show that strategic agility provides additional insights into how and why some business models are more successful than others.

2 Theory and Hypotheses

2.1. Theoretical explanations of franchising

There are two dominant theories of franchising— resource-scarcity theory and agency theory—as well as several newly emerging theories of franchising. The two main theories are primarily static and utilize internal variables to explain franchising (e.g., age, size, royalties, franchising fees, and the amount of investment). The degree of franchising is determined by the life-cycle of the franchisor while the external environment is largely held constant. Both of these theories assume that firms will reach a steady state in terms of their proportion of franchising. Other theories are unable to predict how franchising will change in response to environmental changes. Table 1 below summarizes the major franchising theories.

Insert Table 1 Here

Given the rigidity of existing theories and the general paucity of theorizing regarding franchising, Gillis and Castrogiovanni (2012) suggest that future researchers should (1) expand the diversity of franchising theories, (2) employ large-scale and longitudinal data, and (3) challenge the implicit assumptions of the agency and resource-scarcity theories. Following these suggestions, this article highlights the weaknesses of current theories of franchising and proposes agility theory as a dynamic alternative to complement the existing theoretical literature. Agility theory is then tested using large-scale longitudinal data in an attempt to explain why franchisors may situate both franchising and company-owned units in the same location (this cannot be

explained by agency theory) and why franchising companies ultimately do not necessarily become wholly-owned (as is assumed by resource-scarcity theory).

Given that the strength of franchising is its ability to standardize operations and replicate successful routines (Winter et al., 2012), how does a hybrid franchising organization display strategic agility? This leads to the franchising-agility paradox—franchising depends on standardization of the business format to expand a "proven" business system, but this very same system creates rigidity that limits the firm's ability to change. Thus there are two conflicting demands (Pache and Santos, 2010). Agility in hybrid franchising organizations is manifested by the firm's ability to control the proportion of ownership, thereby to adjust capital-risk exposure to economic fluctuations and to achieve synergies between the two business forms. An agile hybrid franchisor can respond to the changing environment through resource fluidity, and shifting between internally-generated and externally-generated financing growth. Hybrid franchising organizations seek growth by expanding the system either by operating company-owned units or by selling distribution rights to a third party (i.e., the franchisee). In either case, a fairly rigid business formula is followed in order to maintain system quality and brand-image consistency.

This study focuses on an observable and testable pillar of strategic agility—resource fluidity—to support the agility theory of franchising. Agility theory consists of three meta-capabilities: strategic sensitivity, leadership unity, and resource fluidity. According to Doz (2011), strategic sensitivity refers to seeing and framing opportunities and threats in new insightful ways; leadership unity involves making difficult collective decisions that are put in place and implemented; and resource fluidity refers to rapid and efficient mobilization of resources. We focus on the resource fluidity of agility not only because of its more "observable"

nature but also due to its prominence as an outcome-based measure. It is more difficult to observe leadership capabilities, top team collaboration, mutual dependency, or strategic sensitivity via high-quality internal dialogues, strategic awareness, or experimentation. It may also be argued that without the other two meta- capabilities, resource fluidity is less likely to take place. Resource redeployment is an outcome of a shared managerial vision, sensitivity to changes in the environment, and a willingness to take collective action. We further contend that because there are switching costs between the two modalities of expansion (franchising and company ownership) and a U-shaped relationship exists between economic growth and franchising expansion.

2.2. Explanations of franchising and agility theory

In franchising, in order to finance growth there is a substitution between two types of "capital" resources (i.e., internally-financed company-owned growth and externally-financed franchise growth). Norton (1995) suggests that franchisees provide a source of competitive capital to franchisors who, in turn, are able to grow more quickly. Resource redeployment in franchising has been studied extensively in the franchising literature as it relates to the redirection of ownership, particularly in the U.S. context, with the two leading theories (agency and resource-scarcity) dominating the available explanations.

In the past three decades several theories, in particular agency theory (Jensen and Meckling, 1976) and resource-scarcity theory (Oxenfeldt and Kelly, 1969), have been employed to explain why firms engage in franchising. These theories have been tested extensively by numerous scholars (Alon, 2001: Carney and Gedajlovic, 1991; Combs and Castrogiovanni, 1994; Combs and Ketchen, 1999, 2003; Dnes, 1996; Elango and Fried, 1997; Lafontaine and Slade, 1997; Pizanti and Lerner, 2003). In these theories, franchising is viewed as a potentially useful

strategy to pursue growth (Carney and Gedajlovic, 1991). For example, a recent study in entrepreneurship by Gonzalez-Diaz and Solis-Rodriguez, 2012 uses informativeness principle of the principal-agent problem to add to this line of inquiry by investigating when the capital supplied by franchisees becomes attractive to franchisors.

Other emerging theories applied to franchising (reviewed in Table 1) include institutional theory (Combs et al., 2009), search cost theory (Minkler, 1992), and signalling theory (Gallini and Lutz, 1992.). What is common among these theories is that they are primarily internally-oriented, and they have few links to the external environment. To date, there has been little research on how environmental factors such as the business cycle affect franchising.

Agility theory complements the dominant approaches, thus overcoming some of the limitations of the earlier theories. It provides a building block to understand when and why firms adopt franchising by accounting for the effects of the macroeconomic conditions. That is, strategic agility considers not only internal organizational factors but also external economic conditions. It can potentially explain how franchisors may have hybrid organizations in the same location and also suggests that optimal franchising may change over time depending on the economic cycle and changes in the business environment.

2.3.The agility theory of franchising

A theoretical framework that offers a more complete explanation for why firms franchise is the theory of strategic agility (Doz and Kosonen, 2008a). More specifically, the unique influence of economic conditions requires that franchising firms become strategically agile (Doz and Kosonen, 2008a). This suggests that successful firms are those whose business models evolve in the direction of increasing stability. When a firm's resources are scarce, because, for example, of an economic recession, it may seek to grow by franchising. When domestic markets are saturated, it may seek international franchisees to supplement its growth. This is because

strategic firms look toward the future, make long-term and firm commitments, and employ a dedicated leadership that will allocate precious resources to meet their commitments (Doz and Kosonen, 2008a). However, successful firms should also be able to shift and change rapidly (i.e., be agile). Agility requires that firms remain flexible, constantly re-evaluating past decisions and always ready to take actions as conditions in the business environment change (Doz and Kosonen, 2008a).

Strategic agility consists of three pillars. These are called "meta-capabilities" (namely, strategic sensitivity, resource fluidity, and leadership unity) (Doz and Kosonen, 2008a) . These meta-capabilities are portfolios of core competencies based on the tenets of resource-based theory (Penrose, 1959) and dynamic-capabilities theory (Teece et al., 1997). That is, these meta-capabilities allow a firm to use its organizational capabilities to achieve a competitive advantage in rapidly changing environments.

Agility theory is a phenotype and an outgrowth of resource-based abilities, which can be regarded as genotypes. Phenotypes allow for observation of the company characteristics as a result of its interaction with the environment, whereas genotypes are the distinguishing DNA of the organization. Strategic agility has a high degree of commonality with its organizational capabilities genotype. Although organizational-capabilities theory has grown out of resource-based theory, the former distinguishes between resources and capabilities (Teece et al., 1997). Resources may be transferred, but capabilities are specific to the firm.

Resource fluidity is perhaps one of the most discussed and most important pillars of strategic agility partly because the other two meta- capabilities potentially can be regarded as determinants of resource fluidity. In other words, a given firm needs to possess strategic sensitivity and display a collective commitment (leadership unity) in order to reach a decision to

reconfigure its capabilities and redeploy its resources (i.e., to achieve resource fluidity). The redeployment of resources can be viewed as the reactive aspect of resource fluidity because in the case of franchisors these firms are reacting to the changing economic conditions. Hence, the franchising agility paradox can be solved by understanding resource fluidity.

2.4.Agility theory of franchising and economic fluctuations

When economic conditions are favorable, hybrid organizations may elect to open more company-owned units since it may be easier to secure financing and the risk levels of future cash flows may be low. However, against the background of negative economic conditions, hybrid firms will need to manage risks and thus will seek growth primarily through franchising. Martin and Justis (1993) find that firms use more franchising when interest rates increase the cost of capital. In the same vein, Gonzalez-Diaz and Solis-Rodriguez (2012) report that franchisor resort to opening more company-owned units when cost of capital is low. There is also a common belief that franchising may boom during periods of economic recessions (Hall and Dixon, 1989). This belief stems from the fact that some individuals who became unemployed during a recession may enter franchising as an alternative to self-employment (Frazer et al., 2007).

In the case of franchising firms, the reactive aspect of resource fluidity (e.g., redeploying capital and managerial talent) is achieved by switching between the two business models to achieve growth. That is, hybrid organizations elect to grow through franchising when capital and human resources are scarce. However, when the costs of access to capital are low and when managerial talent is abundant, franchisors will generate profits through both company-owned units and franchising. Resource fluidity in franchising is based on several factors. First, franchising firms can adjust downward the proportion of franchised units in a network by no longer offering franchising opportunities, closing units, refusing to renew franchise contracts,

taking over franchised operations, or launching new company-owned units. In contrast, franchisors can increase the proportion of franchised units by recruiting new franchisees or by selling their company-owned units to franchisees. Franchisors can then in turn use these proceeds to open additional company-owned units in locations with high business potential. By shifting resources, franchising firms have the unique ability to pursue strategic agility and stable business growth, irrespective of the economic conditions. That is, during both economic recessions and during boom periods firms will rely on franchisees that presumably have better local expertise and will help the franchisors develop shorter "time-to-market" reactions to the changing economic realities.

The agility of franchisors may be demonstrated by the following example. When economic forecasts are pessimistic, then franchising firms can be proactive by attempting to grow via multi-outlet franchising agreements. By engaging in multi-outlet franchising, they are able to cut franchisee-recruiting and selection costs. Franchising firms, which do not invest in company-based expansion during turbulent economic times, may still be able to reap returns via royalties and franchisee fees from a growing family of franchisees. But when economic forecasts are optimistic, then franchising firms are able to both recruit franchisees and to open company-owned units.

Strategic-agility theory suggests that in order to survive and prosper firms need to be proactive with respect to changing their strategies. As the business cycle challenges the business fundamentals, hybrid companies are able to shift toward relatively more franchising. Companies must quickly change their future growth expectations to and from franchising based on whether the economy is expanding or contracting. Therefore, during economic downturns, although others may lose their market share, an agile franchisor may be able to gain market share by

engaging in more franchising, even if at the cost of forgoing the full profit potential of the business.

The business cycle (or fluctuations in the macroeconomic environment) has an impact on all forms of business growth, but it has a unique impact on hybrid organizations. As noted, franchising is a substitute for capital expansion: by allowing others to make financial investments in the system, the franchisor uses the franchisees as investors to make use of the franchisor's intangible assets.

Franchising firms, like other hybrid organizations (Battilana and Dorado, 2010), face economic or legal switching costs (also called adjustment costs) when they convert their company-owned units to franchised units or when they buy back franchised units (Combs et al., 2009). Furthermore, internal inertia and the type of industry may also have an effect on the switching between company-owned and franchised units (Combs et al., 2009). However, existing research shows that franchising firms are able to minimize the switching costs by quickly adjusting their target proportion of franchised units due to their ability to open new franchised units or to redirect ownership (Gonzalez-Diaz and Solis-Rodriguez, 2012).

The unique organizational form embodied in franchising suggests that the macroeconomic environment has a U-shaped impact on franchising. We base our U-shaped hypothesis on a combination of agility theory and the dominant paradigms (the resource-scarcity and agency theories). That is, during a negative business cycle, capital resources are scarce so companies will rely on franchising as their main growth strategy. Also, under adverse economic conditions, companies will prefer to franchise in order to reduce the risks associated with undertaking additional investments. Conversely, as an economy begins to recover and economic growth turns positive, profit potentials and resources also increase, giving rise to an expansion of

company-owned units. Since investment risks then decrease, companies will be more willing to provide their own capital. A growth-oriented economy will positively affect the profitability of all businesses, including company-owned units and franchised units. In the franchising sector, if the economy is growing, franchisors can increase the number of franchisees as well as the number of company-owned units. According to agency theory, a franchisor's decision to use one system of expansion over another depends on his/her ability to monitor units. During highly positive growth periods capital resources and liquidity will shift to remote, rural, and distant locations. Thus franchisors with available capital and an effective business model may prefer to own units that they can monitor and control and to franchise remote units that are difficult for them to monitor.

Inconsistencies regarding the impacts of capital scarcity, growth rates, the size of the system, and age on the use of franchising may be partially resolved by looking beyond simple linear relationships. Castrogiovanni et al. (2006), for example, find that there exists a cubic pattern whereby franchisors undergo three stages, first increasing franchising, then decreasing franchising, and, then again increasing franchising. Shane (1998) finds a curvilinear relationship, an inverse U-shape, between system size and franchising. Curvilinear relationships provide a richer explanation and insights into the inconsistent linear relations that are found by sampling firms at various stages of development and under differing economic conditions.

We have explained how hybrid organizations use franchising both in times of economic prosperity, when capital is abundant, and during periods of economic recession. A U-shaped impact of franchising growth is likely to occur when firms incur switching costs as they redeploy resources from plural form expansions to franchising approaches. There are several types of switching costs. As a firm moves from franchising to a company-owned outlet, it must expand

its resources to directly manage the firm. Agency costs may also increase due to the need for monitoring. During economic recessions, franchisors may redeploy resources to seek more franchisees. Also during such periods, significant franchise-relationship transaction costs may increase, for example, due to the need for additional legal services or due to the increased pressures to manage a larger franchise system. Because of the switching costs, we expect to see a lull in franchising development during an economic transition, that is, the period of resource fluidity. In sum, resources cannot be entirely adapted to alternative uses. The resultant relationship between economic growth and franchising is thus expected to be curvilinear which leads to our core hypothesis:

H1. There is a non-linear (U-shaped) relationship between economic growth and franchising such that growth through franchising will first decrease and then will increase based on the state of the economy.

3 Methodology

We tested our hypotheses on economic growth by analyzing a large dataset and by using several case firms to support our theoretical argument. Firm data comes from *Bond's Guide* which is commonly used in franchising studies and is believed to adequately represent the population of U.S. franchising firms (Azoulay and Shane, 2001; Scott, 1995). To increase the robustness of our findings we utilized two samples. The main dataset was a balanced panel database of 151 companies with eight observations for the years between 2001 and 2008. For robustness checks we utilized an unbalanced sample of 1,999 firms for the years between 1993 and 2008, resulting in 10,001 observations. The second dataset had an average of 5 observations per company, ranging from 1 to 14 observations. We also tested our models with and without

industry controls; these tests produced similar results. To supplement our analysis, we researched a number of specific case studies during an economic cycle and observed their franchising expansion. By supplementing the quantitative analysis with qualitative research, we were able to provide stronger support for agility theory.

3.1. Dependent variable

Using U.S.-based companies, our sample was based on *Bond's Guide for Franchise Opportunities* from 1993 to 2008. Our dependent variable was the number of expected franchising units. It was based on *Bond's Guide* questionnaire, which asks the number of new franchising units the company was planning to open within the next twelve months. This measure is superior to previous measures that have been used, such as the proportion of franchising, because it is more forward-looking, reflecting managerial plans during the time they are assessing the environment.

3.2. Independent variables

Our key independent variable is macroeconomic business cycles. We used five different measures to capture the business cycle during the same year as the planning for the new franchising units. The description of the variables and their respective hypothesized signs are shown in Table 2. The business-cycle variables are Gross Domestic Production (GDP) growth (annual percentage), GDP per capita growth (annual percentage), GNI growth (annual percentage), GNI per capita growth (annual percentage), and the unemployment rate (annual percentage). Based on the survey and the previous literature we also included variables to control for the resource-scarcity and agency theories of franchising.

Insert Table 2 Here

Data for five independent variables to measure the state of the economy were obtained from the *World Development Indicators* (WDI) provided by the World Bank database. Data for all the control variables came from *Bond's Guide for Franchise Opportunities* and were specific to each company. These variables are considered to be correlated with franchising growth and they are also proxies for the other two theories of franchising (agency and resource-scarcity). By using control variables representing the two most established franchising theories, we show the unique effects of strategic agility on franchising.

3.3. Control variables

We use four control variables which are commonly employed to test resource scarcity and agency explanations of franchising. Year founded and firm size are controls for resource scarcity. FOUNDED is year in which a firm was founded which is an inverse of firm age (Alon, 2001). Firm size (SIZE) is number of franchised units. We use franchised units instead of total units (Alon, 2001) because our dependent variable is number of expected franchised units. Geographic dispersion is one of the most long-standing measures under agency theory explanations for franchising. It is measured as number of states (STATES) (Combs and Ketchen, 1999). The last control variable under agency theory is average outlet startup costs (STARTUP) (Alon, 2001).

4 Analyses and Results

4.1.Empirical findings

As can be seen in Table 3, firms in our sample had a mean of 67 projected units. The average founding year was 1974 and the mean for number of franchised units was 644. Table 3 also shows bivariate correlations for independent and control variables. It should be noted that

correlations for count data (number of projected franchised units) are not relevant and thus not reported. While some of the control variables are significantly correlated with each other, those correlations are not strong enough to raise multicollinearity concerns. All economic variables except unemployment are highly correlated with each other. However, this again does not raise multicollinearity issues, since we use each of these economic measures in separate equations.

Insert Table 3 Here

Since our outcome variable is count data (i.e., number of expected franchised units), we are using Count Model panel data with a Poisson distribution. As a robustness check we employ GLS regression with panel data. Additionally, we ran fixed firm effects model to control for unobserved firm heterogeneity. In all cases, we find support for the resource fluidity meta-capability of agility theory in our tested empirical models of franchising. The U-shaped effect of the business/economic cycle on franchising is also strongly supported. In both datasets and in the five ways we calculated the business cycle we obtained a consistently significant U-shaped impact of the economic variables on franchising, therefore increasing our confidence regarding strategic agility. Table 4 presents the results for the main dataset using Count Model panel data with a Poisson distribution.

Insert Table 4 Here

In the first instance, there is a negative linear relationship between GDP-Growth and expected franchising. This provides partial support for the idea that franchising is less used during periods of economic boom, as one will attempt to capture more profits from ownership. The quadratic term of GDP-Growth is positively related to expected franchising. This implies that franchisors will resort to franchising during economic downturns. Therefore, these results lend support for our key hypothesis (H1). The U-shape is also supported when GDPPC-Growth

is used as a proxy for the economic environment. That is, GDPPC-Growth has the same impact on franchising as GDP-Growth. Last, GNI-Growth has a negative relationship with franchising, whereas the quadratic term of GNI-Growth has a positive relationship with franchising. As a consequence, we again find support for H1.

An additional strong signal supporting the U-shaped effect is revealed when unemployment is used as a proxy for the business cycle; however, in this case, we observe an inverse U-shaped effect. This is due to the fact that unemployment is negatively correlated with GDP-Growth, GDPPC-Growth, and GNI-Growth. When growth is low, unemployment is high, and vice versa.

Among the control variables embodying agency and resource scarcity, FOUNDED has a negative effect on franchising growth. This means that the older the franchisor, the more likely it is that the firm will prefer to grow via franchising. As for STATES, firms that have a presence in more states are less likely to franchise. The last control variable, STARTUP, has a negative effect on franchising, meaning that when the start-up costs to open a unit are higher, there is less of a likelihood that a firm will franchise its future units. We conducted a robustness check and we also obtained the same results when using GLS panel data. In addition, we re-ran our model by excluding quick-service restaurants because when discretionary income decreases during recessions, individuals may scale down on eating out and may prefer to visit quick-service restaurants over full-service restaurants. Our sample includes some franchisors which have domestic operations and these firms may have limited growth opportunities in recessions relative to international franchisors. To ensure that our results are not driven by international franchising we created a control variable where international franchisors were coded as 1, and domestic were coded as 0. We also replaced FOUNDED with franchising experience (number of years

franchising). We also included a variable to control for industry size (number of outlets in an industry). This is because mature industries with more outlets may have lower growth opportunities. In all cases, our results did not change as all independent variables were significant and had the same directional signs as in our main model.

The next step in our analysis includes the visual representation of our model. From the panel regression coefficients (presented in Table 4), we can calculate the incident rate ratios (IRR), allowing us to display the percentage change of expected new franchised units. Figure 1 presents the results for the IRR of GDPPC-Growth (annual percentage). The IRR for GDPPC-Growth is 0.969, and the IRR for GDPPC-Growth^2 is 1.02. This means that for each unit increase in GDPPC-Growth, the dependent variable will decrease by 3.1 percent and for each unit increase in GDPPC-Growth^2, the dependent variable will increase by 2 percent.

In Figure 1 we display the results for GDPPC-Growth between -1 percent and 4 percent. This is the range that represents U.S. GDPPC-Growth in the sampled years. The figure provides a graphic illustration of our significant results: During a negative business cycle with negative GDPPC-Growth, the expected number of franchising units increases. When the economy begins to grow and creates moderate positive GDPPC-Growth, the expected number of franchising units decreases. Finally, when GDPPC-Growth is high (above 1.6 percent), the expected number of franchising units will once again increase. When the economy is growing between 0 and 1.6 percent, we estimate the switching costs to be the highest. At this moderate level of economic growth franchisors expect the smallest increase in franchising; they either gear up for more company and franchising growth as the economic conditions improve and when economic prospects are declining they expand their franchising offerings both domestically and internationally.

Insert Figure 1 Here

4.2. Exemplar firms illustrating the impacts of economic fluctuations on franchising

Several cases illustrate how the U-shaped impact is created in franchising companies. The case of Checkers Drive-in Restaurants (hereafter Checkers), one firm in our empirical database, provides evidence for the U-shaped argument. During the 2001 recession, Checkers opened or reopened thirteen units. Since access to capital is difficult and investments are risky during periods of economic recessions, Checkers decided to franchise twelve of these new restaurants and to open only one company-owned outlet. However, when economic growth moderated, Checkers opened both franchises and company-owned units. For example, in 1996 Checkers opened five new company-owned restaurants and re-acquired eighteen restaurants from franchisees, making a total of twenty-three company-owned units. In the same year, franchisees opened twenty-five units and acquired fifteen units from Checkers, resulting in forty franchised units.

The above example clearly indicates that over time Checkers engaged in an active rebalancing of its portfolio of company-owned and franchised units. In its annual report it is stated that its "growth strategy … is to focus on the controlled development of additional franchised and company-operated restaurants primarily in our existing core markets and to further penetrate markets currently under development by franchisees…" (Checkers Drive-In Restaurants, 2004).

A second case supporting our U-shaped firm growth argument comes from the UK-based frozen foods retailer Cook. Cook began franchising in 2009, a period of negative economic growth. The company reported that the response by prospective franchisees was very positive

and that the company hoped to franchise three stores in 2009 and eight more in 2010 (Brooks, 2009). Co-founder Edward Perry stated: "The recession was a 'great time' to franchise. There are plenty of high caliber people with redundancy checks … (Brooks, 2009). However, in 2012 a Cook spokesman noted that growth via company-owned stores would be central for the next three years (Montague-Jones, 2012). As the next three years (2013 through 2015) were expected to bring moderate economic growth, Cook's strategy was consistent with Figure 1 where firms tend to engage in less franchising during periods of economic growth. Another case that supports franchising during recessionary periods is that of the Red Mango frozen yoghurt company, which was planning to open forty units in 2009, most of which would be franchised.

The above examples show that a firm's growth strategy is influenced by the future economic outlook. That is, during periods when GNP growth is slowing down and capital is both scarce and risky, a firm tends to pursue growth via franchising. However, when the economy is growing at a moderate pace a firm may resort to opening more company-owned units or it may re-acquire existing units from franchisees.

5 Managerial and Theoretical Implications

Based on the resource-fluidity capability in the strategic-agility theory, this article presents a thorough explanation of why and when firms franchise under dynamic conditions of economic fluctuation. Although we agree that the resource-scarcity and agency theories provide partial explanations for why firms franchise, we contend that strategic-agility theory adds an important building block to explain franchising. We found a U-shaped effect of the local environment on the opening of new franchised units. The explanation for this U-shaped relationship is consistent

with the strategic-agility argument, thereby enhancing existing explanations based on the resource-scarcity and agency theories.

Research on franchising suggests that exact replications and standardization may enhance firm competitiveness. Franchising systems are inherently more rigid (the franchise-agility paradox), hence there is less of an ability to quickly adapt the business model. But the ability to shift resources among alternative uses of capital does exist among franchising systems. Hybrid franchising organizations make up in resource fluidity what they may lose in strategic sensitivity. Some forward-thinking franchisors develop franchisee advisory councils in order to sensitize themselves to the needs of both franchisees and final consumers as well as to the environmental changes that affect their business.

Our empirical test supports our claim that franchising firms use a hybrid growth strategy to achieve strategic agility. In the context of franchising, agility is a flexible response to changes in the business environment. In addition to flexibility, the hybrid growth strategy of franchising enables firms to rapidly match company strategy to the changing environment. In essence, franchising firms are able to achieve resource fluidity, one of the key meta-capabilities of strategic agility (Doz and Kosonen, 2008a).

This study can inform firm executives about the need to develop an ability to switch or to combine business models. In our case, two fairly rigid business models (growth via franchising and growth via company-owned units) are substituted or used jointly in order to remain flexible. Indeed, the flexibility of franchisors to adjust the proportion of their franchised units is one of the keys to their achieving strategic agility. In other words, the rigidity of a given business model should not impede a firm's quest to apply resource fluidity. An inability to substitute or to

combine rigid business models is one of the main dangers leading to business failure in the present economic environment.

Agility theory shows that franchising firms are networks of firms that have capabilities to switch between or to combine franchised and company units under various economic conditions. There is much to be said about adaptations and innovations within a given business model. Although franchising is particularly common in the service sector, franchisors can still engage in innovation by developing new products and services and by maintaining on-going dialogues with their franchisees and employee-managers. During the past two decades, franchisors have succeeded in updating their business models on both fronts. Some franchisors have used a number of variations of franchising, such as master franchising in international franchising, area development agreements, and multi-outlet franchising across markets. Other franchisors, such as OSI Capital Partners (also known as Outback Steakhouse), have implemented management compensation plans for their employee-managers. Yet another method is to implement a company-owned outlet strategy, often referred to as refranchising, whereby existing franchisee operations are re-acquired so as to increase profits.

We recommend that executives of present and future franchising firms re-evaluate the viability of their business models and remain creative and flexible as economic conditions change. Imitating the business models of successful franchising firms may also be a useful recourse. In particular, replication and rapid shifts from company-owned units to growth through franchising may be quite useful for franchising firms.

Existing research shows that growth through franchising has a non-linear effect on firm performance (Combs et al., 2004). Even though some firms will grow through franchising, the financial performance of other firms may be hurt by franchising. Strategic agility emerges as one

of the key explanations for this conundrum. Indeed, firms that use franchising as a growth vehicle during periods of positive economic growth may be better off if they open company-owned stores to realize their profit potential. Even though the average proportion of franchised units increased from 73 percent in 1980 to 81 percent in 1999, interviews with executives reveal that franchisors often seek a balance between the two business models and some franchisors may franchise their units whereas others will not (Combs et al., 2009). This offers some support for why firms may prefer to reconfigure their capabilities by opening company-owned units instead of growing solely via franchising.

The paradox of agility strategy is that efficient companies use business models that stress increasing stability (Doz and Kosonen, 2010), resulting in rigidity rather than agility (Doz and Kosonen, 2010). We argue that a business growth strategy should not limit the expansion of units to a specific type of ownership. Instead, such firms should adopt an agile strategy that is able to shift from company-owned units to franchised units and vice versa based on the business cycle, thereby partially solving the agility paradox. A business plan may be rigid and stable because it shapes and frames the goals of the current growth strategy. At the same time, a business plan may include environmental markers that will signal a shift from focusing on company-owned units to franchising-based growth. This hybrid, agile franchising growth strategy can be implemented in growing companies to avoid slow and rigid responses to the environment, while, at the same time, maintaining a stable and efficient business strategy.

The hybrid, agile franchising growth strategy that we describe in this article encompasses resource fluidity and also offers indirect support for strategic sensitivity and leadership unity. That is, franchising firms rely on strategic sensitivity to examine developments and changes in the economic environment. A shift from new company-owned units to franchisor-owned units is

based, in part, on changes in the external economic conditions. Successful implementation requires ongoing monitoring of the economic environment and business cycles so that the company can be proactive in making changes in response to the growth cycle. Due to the need of hybrid firms, such as franchising firms, to redeploy resources and reconfigure capabilities, they must exhibit leadership unity. That is, leadership unity is a key prerequisite for a hybrid, agile franchising growth strategy that can rapidly redeploy resources from internal-capital growth to external-capital growth. Leadership unity in the hybrid, agile franchising growth strategy requires a clear set of criteria in the business plan that will determine the shift from company-owned outlet dominance to franchisor-owned outlet dominance and vice versa. The criteria should be based on solid environmental conditions, such as GDP growth, the liquidity of debt markets, unemployment rates, and so on. This will allow management to make rapid decisions.

6 Limitations and future research

Our study is not free of limitations which we acknowledge. Our data does not encompass the number of company-owned outlets a firm is expected to open. Therefore, we are not fully able to directly assess the shifting strategies that firms apply. However, the use of exemplar firms offers some assurance that franchising firms are watching the state of the economy when they decided whether to open their own outlets or franchise them.

Our findings on the impact of the business cycle on the use of franchising refer to U.S., or developed, market contexts. But franchising in the emerging markets is growing rapidly. Given that the emerging-market economies embody different institutional environments (Hoskisson et al., 2013), it is not clear that our results can be generalized to other contexts. For example, franchising development in China has stalled not because of a recessionary environment, but

because of legal, political, and cultural constraints. As such, many franchise companies in China, such as Yum! Brands and McDonald's, have chosen to own most of their units so they can maintain control over quality, production, and expansion (Alon, 2010). Future research on franchising should explore how the agility meta-capabilities are impacted by the institutional environment and, more specifically, how the business cycle may affect franchising in the developing world. Another fruitful area for future research is to examine how the three meta-capabilities of agility theory interact with one another. We believe that resource fluidity is a resultant meta-capability that requires both leadership unity and strategic sensitivity, but we cannot verify this empirically. Last, we acknowledge the limitation that we do not directly control for switching costs which makes our findings more conservative.

A hybrid organization refers to an organization that consists of two co-existing logics, for both franchising and company ownership. It is difficult to apply agility theory to those firms that use only one type of expansion. Some franchisors only use franchising for expansion, whereas others, for example, retailers, may not use franchising at all. Subway is mostly franchise-based, whereas Darden is mostly company-owned. Given that these companies do not employ resource fluidity in ownership, they will have to use other meta-capabilities, i.e., leadership unity or strategic agility, to achieve agility. Our article, which focuses on hybrid organizations that use both franchising and company ownership, provides an opportunity to test the resource fluidity of agility. Future studies may focus on how non-hybrid organizations use the other meta-capabilities to achieve agility. Future studies may also explore those contingencies that enable firms that franchise all of their units achieve long-term growth and, if possible, to juxtapose the financial performance of purely franchising firms (100 percent of franchised units) with hybrid franchising networks.

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Table 1 Summary of established and emerging theories in franchising.

Theory	Key Assumptions	Key Predictions
Resource-Scarcity Theory	Firms seek to reach a minimum efficient scale Unit ownership is more profitable than franchising Capital and managerial resources (e.g., skills or talent) are easier to acquire via franchising	Young firms will franchise heavily during their early years Franchising will enhance the probability of survival Mature firms will later repurchase franchised units; the firms will ultimately be full-owned
Agency Theory	The involved parties are self-interested and rational Employee managers will exhibit shirking behavior Franchisees can potentially free ride on the brand name Vertical agency is more costly	Franchisees will be motivated as residual claimants on profits Firms that franchise efficiently will perform better Firms will franchise units that are difficult to monitor and where the probability of free riding is low
Search-Cost Theory	Franchisees provide valuable information about local markets	Newer franchisors will franchise less if they can acquire market information from older franchisors There will be franchising in unfamiliar places, whereas companies will be owned in familiar locations Franchising cannot be predicted based on the economic conditions
Signaling Theory	Information is asymmetric between the franchisors and the franchisees Franchisors need to signal the quality of their units to potential franchisees	Firms will use company-owned units to signal the quality of units to potential franchisors Firms will use company ownership minimally only to signal quality/proof of the concept
Institutional Theory	Common institutional, or industrial, environments influence franchisor decisions	Mimetic and normative pressures will influence the proportion of franchised units Firms will use franchising to imitate other

		industry players No prediction about franchising based on economic conditions

Table 2 Dependent, independent, and control variable measures.

Variable	Description	Source
Number of projected franchised units (PROJUNITS)	Number of projected franchised units to be opened in the United States	*Bond's Guide*
Gross Domestic Production (GDP) growth	Annual percentage growth rate of GDP at market prices based on constant local currency	WDI
GDP per capita growth	Annual percentage growth rate of GDP per capita based on constant local currency. GDP per capita is gross domestic product divided by mid-year population.	WDI
Gross National Income (GNI) growth	Sum of value-added by all resident producers, plus any product taxes (less subsidies) plus net receipts of primary income from abroad	WDI
GNI per capita growth	Annual percentage growth rate of GNI per capita	WDI
Unemployment growth	Annual percentage growth of unemployment	WDI
Year founded (FOUNDED)	Mature companies have developed better business routines and resources that allow for expansion. Moreover, franchising firms tend to utilize franchising more extensively over time	*Bond's Guide*
Franchised units (FRANUNITS)	The number of existing franchised units of the company, thus capturing the company's preferences	*Bond's Guide*
Number of states (STATES)	The number of U.S. states where the company has existing units. This measure captures the growth potential	*Bond's Guide*
Average outlet startup cost (STARTUP)	The size of investment per unit should negatively impact the number of franchised units to be opened in the near future	*Bond's Guide*

Note: WDI= World Development Indicators

Table 3 Descriptive statistics

Variable	Mean	S.D.	X1	X2	X3	X4	X5	X6	X7	X8	X9	X10	X11	X12	X13	X14	X15
X1.PROJUNITS	67.05	175.18															
X2.FOUNDED	1974.99	17.44		1													
X3. FRANUNITS	611.44	1242.52		-.29*	1												
X4.STATES	30.63	15.11		-.28	.39*	1											
X5.STARTUP	138.74	758.18		..03	-.03	.01	1										
X6.GDP	2.09	1.07		-.00	-.00	.02	-.01	1									
X7.GDP^2	5.49	4.00		.00	.00	.02	-.00	.95*	1								
X8.GDDPC	1.12	1.07		.00	.00	.01	-.01	1.00*	.96*	1							
X9. GDDPC^2	2.44	2.18		.00	.00	.02	-.00	.83*	.96*	.84*	1						
X10.GNI	2.34	1.02		.00	.00	.02	-.00	.67*	.53*	.66*	.35*	1					
X11.GNI^2	6.51	4.64		.00	.00	.02	.00	.51*	.40*	.50*	.25*	.97*	1				
X12.GNIPC	1.37	1.02		-.00	.00	.02	-.00	.68*	.55*	.68*	.37*	1.00*	.96*	1			
X13.GNIPC^2	2.92	2.68		-.00	.01	.02	.00	.40*	.32*	.40*	.21*	.92*	.99*	.91*	1		
X14.UNEMPL	5.27	0.53		.00	-.00	-.02	-.02	-.10*	.01	-.07*	.13*	-11*	-.13*	-.08*	-.10*	1	
X15.UNEMPL^2	28.02	5.62		.00	-.00	-.02	-.02	-11*	-.00	-.07*	.13*	-11*	-.13*	-.08*	-.10*	1.00*	

Notes: PROJUNITS=Number of projected franchised units, FOUNDED=Year founded, FRANUNITS= Number of franchised units, STATES= Number of U.S. States, STARTUP= Average unit startup cost outlet, GDP=GDP-Growth; GNI= GNI-Growth, GNIPC=GNIPC-Growth, UNEMPL- Unemployment; * $p<0.05$;

Table 4 Economic conditions and franchising.

	(1)	(2)	(3)	(4)	(5)
VARIABLES	Dependent variable: Projected new franchised units				
FOUNDED	-0.0225***	-0.0225***	-0.0227***	-0.0227***	-0.0225***
	(0.00437)	(0.00437)	(0.00437)	(0.00437)	(0.00439)
SIZE	0.0018	0.0036	0.0016	0.0012	0.0071
	(0.0048)	(0.0048)	(0.0049)	(0.0049)	(0.0048)
STATES	0.0095***	0.0095***	0.0098***	0.0098***	0.0091***
	(0.0008)	(0.0008)	(0.0008)	(0.0008)	(0.0008)
STARTUP	-0.001	-0.0011	-0.0015	-0.0042	-0.0029
	(0.0032)	(0.0032)	(0.0032)	(0.0032)	(0.0032)
GDP-Growth	-0.0705***				
	(0.0110)				
GDP-Growth^2	0.0201***				
	(0.00293)				
GDPPC-Growth		-0.0317***			
		(0.00610)			
GDPPC-Growth^2		0.0199***			
		(0.00302)			
GNI-Growth			-0.0510***		
			(0.0143)		
GNI-Growth^2			0.0107***		
			(0.0031)		
GNIPC-Growth				-0.0287***	
				(0.00896)	
GNIPC-Growth^2				0.0106***	
				(0.0034)	
Unemployment					0.407*
					(0.2400)
Unemployment^2					-0.0362*
					(0.0228)
Observations	1,078	1,078	1,078	1,078	1,078
Number of companies	139	139	139	139	139
Standard errors in parentheses					
*** p<0.01, ** p<0.05, * p<0.1					

Note: Standard errors are shown in parenthesis. The number of companies was reduced from 151 to 139 in the regressions due to unanswered questions (control variables) in the survey.

Figure 1 Percentage change in expected new franchised units