

Multi-Unit Franchising: A Comparative Case Analysis

Dildar Hussain, University of Vienna, Austria
Josef Windsperger, University of Vienna, Austria

ABSTRACT

The objective of this study is to explain the franchisor's choice between single-unit and multi-unit franchising. We employ a comparative case analysis method to compare the theoretical patterns with the empirical patterns of the governance forms. We selected two multi-national franchise networks based in Austria. Our findings suggest that franchisor's multi-unit franchising strategy can be explained by monitoring costs, franchisee's transaction-specific investments, franchisor's system-specific assets, and franchisor's financial resources scarcity.

Keywords: Multi-unit franchising; agency theory; transaction cost economics; resource-based and organizational capabilities view; comparative case analysis

1 INTRODUCTION

The role of franchising in national economies is becoming more and more important (Kaufmann & Dant, 1996) by creating employment opportunities and service provision (Spinelli, Rosenberg, & Birley, 2004). Franchising is the fastest growing form of retailing and a major portion of the recent growth can be attributed to the emergence of multi-unit franchising (Grünhagen & Dorsch, 2003; Kaufmann, 1993). Multi-unit franchising (MUF) refers to an organizational arrangement where one franchisee operates two or more franchised outlets in the same franchise system (Kalnins & Mayer, 2004). On the other hand, single-unit franchising (SUF) refers to the traditional format where one franchisee operates only one franchised outlet.

In the recent years, MUF has been examined from agency-theoretical, transaction cost and resource-scarcity perspectives. MUF can address a number of agency problems in a more effective way compared to SUF (Garg, Rasheed, & Priem, 2005; Kalnins & Lafontaine, 2004; Kalnins & Mayer, 2004; Vázquez, 2008). Especially, multi-unit franchisees are better motivated to reduce the monitoring costs. Geographical contiguity of franchised units positively influences the use of MUF (Gomez, Gonzalez, & Vázquez, 2010). The franchisors prefer MUF as compared to SUF to reduce the risk of free-riding at the local outlets. Bercovitz (2003) investigates MUF from a transaction cost perspective. She argues that MUF increases the franchisee's quasi-rents based on higher outlet-specific investments and thereby increases the self-enforcing range of the franchise contract (Klein, 1995). If the self-enforcing range is higher under MUF compared to SUF, the opportunism risk is lower, and the franchisor less frequently uses disciplinary measures (litigation and termination) for contract enforcement. Consequently, MUF reduces the hold-up risk due to the stronger incentive effect compared to SUF. Furthermore, MUF-systems have a relative advantage over SUF-systems (Kaufmann & Dant, 1996) under the resource scarcity view. The positive relationship between MUF and system growth has been evidenced in the previous research (Bradach, 1995; Kaufmann & Dant, 1996; Kaufmann & Kim, 1995). Conversely, MUF-systems have lower local market capabilities compared to SUF-systems, due to SUF's higher degree of local responsiveness (Bradach, 1995). Contrary to the predictions of resource scarcity theory, the use of MUF increases with size and maturity of the franchise system (Weaven & Frazer, 2007a; Weaven & Herington, 2007). MUF increases the organizational capabilities (such as monitoring, knowledge transfer, and innovation capabilities) and, consequently, strengthens the competitive position of the system. System uniformity, system wide adaptations, and system corporatization are examples of the organizational capabilities (Bradach, 1995; Weaven & Frazer, 2007a; 2007b). Therefore, franchisors that focus on system uniformity, system corporatization, and system wide adaptations are more likely to use MUF.

Although several empirical studies exist on MUF, transaction-specific investments (Klein, 1995; Williamson, 1983), system-specific assets, local market knowledge assets, and financial assets as determinants of the ownership strategy have not been investigated. Starting from this deficit, there is a need to apply multiple theoretical perspectives to explain this network form (Hussain & Windsperger, 2010). In this article, we develop a set of hypotheses by extending the existing literature in the following way: First, we apply the agency theory by investigating the influence of monitoring cost; second, we examine the bonding and scale efficiency effects of the higher transaction-specific investments from a transaction cost perspective; third, we examine hypotheses based on resource-based view. The article is organized in five sections. In section two, we develop a theoretical framework to explain the franchisor's choice between single-unit and multi-unit franchising. The details of research methodology and the findings are presented in sections three and four. The last section includes discussion and conclusion.

2 DEVELOPMENT OF HYPOTHESES

2.1 Monitoring Costs

According to the agency theory (e. g., Brickley, Dark, & Weisbach, 1991; Lafontaine, 1992), monitoring costs result from behavioral uncertainty due to shirking of the network partners. The franchisor has two possibilities to reduce the agency costs: On the one hand, to reduce the residual loss by increasing the monitoring activities and, on the other hand, to increase the incentive by allocating a higher fraction of residual income to the franchisee. Higher motivation of the franchisees at the local outlets results in lower shirking under MUF compared to SUF. On the other hand, additional monitoring costs may arise, due to agency problems between franchisees and their outlet managers in the mini-chains. However, economies of monitoring and coordination of the mini-chains may mitigate this effect (Grünhagen & Mittelstaedt, 2002; Weaven & Frazer, 2003).

Hypothesis 1: The franchisor's expectation of higher monitoring costs results in a higher tendency toward multi-unit franchising.

2.2 Franchisee's Transaction-specific Investments

Transaction-specific investments of the franchisee have the following effect on the governance structure: If the franchisee is a multi-unit owner he has to undertake higher transaction-specific investments to open up the local network compared to SUF. On the other hand, the additional investment costs are decreasing with the number of units in the mini-chain. This bonding effect increases the franchisee's dependency and hence his motivation to act cooperatively. In addition, franchisee's investments also increase the franchisor's dependency if these investments have both a selfish and cooperative element (Che & Hausch, 1999). This latter effect results from synergies between franchisee's and franchisor's investments that increase the self-enforcing range of franchise contracts (Klein, 1995). Furthermore, the cost of higher transaction-specific investment is mitigated by the franchisee's expectation of higher residual income due to the scale efficiencies (Grünhagen & Mittelstaedt, 2002). Decreased marginal cost for opening additional outlets and increased franchisee's economic rents due to economies of scale (for example, lower royalties, centralizing of purchase) and splitting operational costs (for example, monitoring and advertising expenses) result in higher motivation of the franchisee.

Hypothesis 2: The higher transaction-specific investments by the franchisee increase franchisor's likelihood to use multi-unit franchising due to bonding effect and scale efficiencies.

2.3 Franchisor's System-specific Assets

The franchisor's system-specific assets refer to brand name capital and the system-specific know-how (Hall, 1993; Klein & Leffler, 1981). MUF increases the organizational capabilities and hence the competitive position of the system by more efficiently deploying the system-specific assets. MUF results in higher monitoring and knowledge transfer capabilities for the network compared to a system with SUF because the franchisor can delegate some tasks to the multi-unit franchisee that has special market knowledge and realizes economies scale. These higher organizational capabilities enable the franchisor to more efficiently exploit the system-specific assets.

Hypothesis 3: The franchisor's system-specific assets are positively related to the use of multi-unit franchising.

2.4 Franchisee's Local Market Assets

According to the resource-scarcity view, the franchisor does not have enough local market knowledge at the beginning of the life-cycle of the franchise system (Kaufmann & Dant, 1996; Oxenfeldt & Kelly, 1968). Franchising enables him to overcome this scarcity problem. The question to ask is: Does MUF additionally mitigate this scarcity problem for the franchisor and hence contribute to explain the tendency toward franchising? Local market knowledge can be more efficiently acquired by single-unit franchisees compared to employees of the multi-unit network because the single-unit entrepreneur (as residual claimant) has higher entrepreneurial capabilities and is more motivated to exploit the profit opportunities at the local market environment than the multi-unit employee.

Hypothesis 4: The franchisee's local market knowledge assets are negatively related to the franchisor's tendency toward multi-unit franchising.

2.5 Financial Assets

Empirical studies show that MUF and system growth are positively related (Bradach, 1995; Kaufmann & Dant, 1996; Kaufmann & Kim, 1995). MUF offers additional growth opportunities for the franchisor compared to the MUF strategy because multi-unit franchisees are often less constrained to finance the local outlets compared to the single-unit franchisees.

Hypothesis 5: Higher financial resources scarcity at the franchisor's end is positively related to franchisor's tendency toward multi-unit franchising.

3 METHODOLOGY

The objective of this study is to link the theoretical predictions with the empirical patterns on MUF. Case study methods are appropriate for the emerging research topics that have not been researched enough yet (Bradach, 1995; Eisenhardt, 1989; Eisenhardt & Graebner, 2007; Kaufmann & Dant, 1996; Kaufmann & Kim, 1995). We use a comparative case study method for this investigation as this research design provides multi-dimensional evidence and allows the researchers to match theoretical patterns with empirical patterns (Choo, 2005). Pattern matching is not always simple process of agreement or disagreement; the analysis may take new directions and also generate novel results (Dubois & Gadde, 2002). Therefore, we argue that the use of comparative case study method is an appropriate research design for this investigation.

3.1 Case Selection

The investigation was designed as a comparative case study and an extensive desk research was conducted to purposely select two appropriate cases for this study from a population of 266 franchise systems in Austria. "A-COM" and "B-COM" (names changed for confidentiality reasons) were selected keeping in mind that they could provide us with some best insights about the phenomenon being investigated. As suggested by Yin (2008), case studies can generate rich qualitative data. The basic idea behind selection of these two franchise cases rests on the fact that the both systems are of the same age i.e. established in 1999, have multi-national franchise networks, are operating in the same business sector, and have comparable sizes. Additionally, both companies had a vast experience in roasting and selling coffee and subsequently decided to enter into gastronomy business. A-COM dominantly employs a MUF strategy and B-COM uses a SUF strategy. The comparison of these two franchise systems could provide a useful and in-depth view of the factors influencing franchisor's choice between MUF and SUF strategies and enable us to make a valuable contribution to the literature by comparing these factors with the theoretical predictions.

3.2 Data Collection and Analysis

The data were collected by interviews, documents, and online resources. The use of in-depth interviews has been endorsed by researchers in franchising (Kaufmann, 1996; Kaufmann & Dant, 1999). The previous MUF research lacks in theoretical foundations and well-defined constructs (Dant & Peterson, 1990); therefore, we consider the use of in-depth interviews appropriate for this study. The documents included articles and information about the companies available on their own and third party websites. Multiple resources of data strengthen the positive points of qualitative data and contribute toward validity and reliability of the findings (Yin, 2008). Four in-depth personal interviews in June-July 2009 were conducted with the top executives primarily responsible for expansion and selection of franchising strategy. Some of the interviewees had very rich and diverse experience in franchising operations gathered while working at McDonald’s, Pizza Hut, Burger King, and finally at the franchise systems under study. The interviews were loosely structured and lasted for 30-150 minutes. The questions focused on the general franchising strategy, the factors that influence franchisor’s choice between SUF and MUF, and finally some of the unanswered research questions were presented for comments and discussion. One interview was conducted in English while remaining three were conducted in German and later translated into English. The respondents may be reluctant to provide sensitive information (Kaufmann & Dant, 1999) so anonymity and confidentiality were assured to increase their comfort level.

In the first step, we used the with-in case analysis approach (Miles & Huberman, 1994) and developed detailed case study write-ups for each case. Despite being descriptive in nature, these write-ups help in getting detailed insights (Gersick, 1988). Secondly, we coded the data in the light of hypothesis using Emergent Coding (Stemler, 2001) for the ease of analysis. Finally, we make a comparison of cross-case patterns and examine the model using these patterns.

3.3 A-COM

A-COM is a part of an Austrian family enterprise with its headquarters in Austria. The parent group brings along almost 60 years of experience in manufacturing high quality coffee making machines and roasting and selling coffee. They founded A-COM in 1999 and opened their first coffee shop in Vienna.

“We tried this concept because we had the coffee machines, and the coffee and all other knowledge to build this up and then we wanted to see how it works. ...People flooded our first shop and everybody wanted to know that how a “to go” concept works. ... We changed the typical self-service coffee shop concept to a full-service concept to get a wider range of customers.”

As of September 2009, A-COM had 196 units in 14 countries in four continents (see table 1 for details) and their network is continuously growing in existing markets and penetrating into new ones. They had only 20 units in 2004 and their network has grown up to 196 units in the last five years. A-COM dominantly uses MUF for its expansion.

Table 1: A-COM Number of Outlets

| Sr. No. | Country | Outlets | Sr. No. | Country | Outlets |
|---------|----------|---------|---------|----------------|---------|
| 1 | Germany | 70 | 8 | Czech Republic | 6 |
| 2 | USA | 38 | 9 | Egypt | 4 |
| 3 | Austria | 34 | 10 | Turkey | 3 |
| 4 | Hungary | 10 | 11 | Croatia | 2 |
| 5 | Poland | 9 | 12 | Macedonia | 2 |
| 6 | Slovakia | 9 | 13 | Bahrain | 1 |
| 7 | Russia | 7 | 14 | Saudi Arabia | 1 |

3.4 B-COM

The parent company of *B-COM* has been roasting “Vienna Coffee” for around 100 years and the idea of *B-COM* was originated by a customer.

“The parent company sells about 5 different kinds of coffee. We blend and roast them at our own and then sell them afterwards to gastronomy. This all begins with cheap breakfast coffee and goes further to high quality espresso. In mid 90s we were present at the exhibition “GAST” in Salzburg, Austria and Mr. Gerlicher, a guy from Germany, came to us and said ‘Wow, you have a great coffee, you should get more out of it’. ...We tried this and the first, relatively small, store was opened in a shopping mall in 1999.”

B-COM had 65 outlets in 10 countries as of September 2009. The company exclusively employs *SUF* strategy. Table 2 appended below presents the details of *B-COM* network.

Table 2: B-COM Number of Outlets

| Sr. No. | Country | Outlets | Sr. No. | Country | Outlets |
|---------|---------|---------|---------|---------|---------|
| 1 | Austria | 38 | 6 | UAE | 3 |
| 2 | Germany | 7 | 7 | Cyprus | 1 |
| 3 | Hungary | 5 | 8 | Egypt | 1 |
| 4 | Italy | 4 | 9 | UK | 1 |
| 5 | Turkey | 4 | 10 | Romania | 1 |

4 FINDINGS

A-COM started with *SUF* and after sometime they realized that it could be difficult for them to efficiently monitor the large number of franchisees and also that they may not achieve the targeted growth rate, therefore, they shifted toward *MUF* as their expansion strategy. On the other hand, *B-COM* is sticking to its *SUF* policy. In following sub-sections, we examine the factors that motivated these franchisors, with many similarities, to choose different franchising strategies. Table 3 shows a summary of the findings.

Table 3: Summary of Findings

| No. | Variable | Predicted Effect | <i>A-COM</i> | <i>B-COM</i> |
|-----|--|------------------|--------------|---------------|
| H1 | <i>Franchisor’s Expectation of Monitoring Costs</i> | + | Supported | Supported |
| H2 | <i>Franchisee’s transaction-specific investments</i> | + | Supported | Supported |
| H3 | <i>Franchisor’s system-specific assets</i> | + | Supported | Not Supported |
| H4 | <i>Local market knowledge assets</i> | - | Supported | Supported |
| H5 | <i>Franchisor’s financial resources scarcity</i> | + | Supported | Supported |

4.1 Monitoring Costs (H1)

A-COM considers monitoring costs as an important determinant of franchising strategy.

“When the partner is far away, it doesn’t matter whether the partner is in Tyrol or in Russia, then you try to build him up as an organization and you consult an organization. So you do visit the owner or the marketing boss or the operations guy there. You don’t have to visit 55 units and then talk to each of them. This reduces monitoring cost and you cannot do a day to day monitoring in Cairo. ... Monitoring cost is something that influences the decision on doing single-unit or multi-unit franchising.”

On the other hand *B-COM* does not expect higher monitoring costs. Therefore, they do not realize any need to provide additional incentive to the franchisees by offering them additional units.

“...We have the lowest agency problems. As far as monitoring costs are concerned, we have almost the same efforts, no matter whether we have single-unit or multi-unit arrangements.”

The franchising strategies at both of the franchise systems are compatible with our monitoring cost hypothesis regarding the choice between single and multi unit franchising strategies. Hence, the results support our hypothesis regarding the positive effect of monitoring costs on the use of MUF.

4.2 Franchisee’s Specific Investments (H2)

We predict a bi-dimensional effect of the franchisee’s transaction-specific investments (i.e., bonding and economies of scale effect) on franchisor’s strategy. *A-COM* supports both effects of the transaction-specific investments.

“Exactly, when we talk about multi-unit franchising, the initial investment is higher. ... This has an influence on fees, because if you know that development is coming up, usually you negotiate fees. ... Higher investments have a bonding effect because you cannot go out easily. You have your money there and nobody takes risk for money. You will try harder to be successful.”

At *B-COM*, bonding effect of the franchisee’s transaction-specific investments is not very strong. On the other hand, as far as economies of scale are concerned, at *B-COM*, the franchisees are obliged to buy all the products from the franchisor. There is a little room to achieve economies of scale by centralizing purchases at the mini-chain level. The findings are compatible with Hypothesis 2.

4.3 System-Specific Assets (H3)

This hypothesis predicts a positive effect of system-specific assets on the tendency toward MUF. *A-COM* uses MUF to help transfer its USP to the local outlet level.

“Vienna has history, you know it’s romantic, it’s music, it’s theatre, Vienna has a coffeehouse tradition since 1684 after 2nd Turkish invasion, it’s something you can sell to people in every part of the world. So we took that part stronger into our concept. We are able to put two cultures together and create symbiotic approach to the customer that’s why we are there in Saudi Arabia, Bahrain, Egypt, and even America with Carnival Cruise Line Ships. ... We have our own equipment, our own coffee machines, our own coffee, our own technology, and our own know-how; we have a different strategic approach than that in other companies.”

B-COM considers system know-how very important for the success of their business. However, the franchising strategy at *B-COM* is not influenced by the specificity of the system assets.

In addition, *A-COM* claims to integrate culture with coffee and consider the “Viennese Coffee Culture” as an integral part of their system-specific assets that is difficult to transfer to local outlets.

“We transfer culture, history and a feeling, something that did not work for last 2000 years. ... We have a handbook that includes the important knowledge to be transferred to the franchisee but the most of the knowledge transfer is done personally.”

Furthermore, *B-COM* considers its system-specific assets highly non-transferable; however, contrary to the predictions, they do not use multi-unit franchising. The in-depth analysis of the detailed case write-up revealed that they are facing severe problems in transferring their system-specific know-how. Hence their ownership strategy might not be efficient, due to the importance of system-specific assets.

To conclude, the analysis of the *A-COM* data supports the hypothesis H3 that predicted positive effect of system-specific assets on the use of MUF. On the other hand, we found a misfit between theoretical and empirical patterns in the case of *B-COM*.

4.4 Local Market Assets (H4)

The main product (i.e., coffee) and local service of *A-COM* do not vary with local market characteristics. Hence, the franchisee's entrepreneurial know-how is less responsible for the success of the system. The data from *A-COM* provide a weak support for this hypothesis. *B-COM* completely adapts to the local market. Although most of their raw material is supplied by the franchisor, the product line at the local outlets is adapted to the local requirements. Therefore, the local market knowledge of the franchisee is very important. Hence the findings are compatible with Hypothesis 4.

4.5 Financial Resources (H5)

Financial resources scarcity is one of the major factors behind shifting from a single-unit to a multi-unit dominated strategy. *A-COM* started initially with SUF; however, they realized soon that system expansion is limited by the available financial resources. *A-COM* strongly supports the hypothesis that franchisor's financial resources scarcity leads to use a higher proportion of MUF. On the other hand, *B-COM* does not see any additional financial benefit from multi-unit franchisees. Hence we conclude that the findings are compatible with Hypothesis 5.

5 DISCUSSION AND CONCLUSION

This study focuses on explaining the franchisor's use of MUF by using a comparative case analysis. We analyze the franchising strategies at *A-COM* and *B-COM*, two multinational franchise networks based in Austria. Franchisor's expectation of higher monitoring costs leads them to use a higher proportion of multi-unit franchised outlets. The franchisors may realize economies of monitoring by delegating some monitoring tasks to the multi-unit owners. However, sometimes the franchisors (for example, *B-COM*) fear that very large franchisees will not be easy to control and they may create problems for them in future, such franchisors tend to use higher proportion of SUF. The multi-unit franchisees have to undertake higher transaction-specific investments compared to single-unit franchisees. The franchisee's transaction-specific investments have a dual effect on the franchising strategy. They increase the franchisees motivation to act cooperatively, due to the bonding effect and scale efficiencies. Grünhagen and Mittelstaedt (2002) also confirmed the scale efficiencies of multi-unit franchisees. The cost of higher transaction-specific investments can be mitigated by achieving scale efficiencies.

The data from the interviews suggest that transferring the system-specific assets to the local outlets is rather difficult because system-specific assets at both *A-COM* and *B-COM* show a high degree of non-transferability. *A-COM*'s low degree of transferability of system-specific assets is an important factor for using a higher proportion of MUF, particularly in the international markets. MUF helps *A-COM* transfer knowledge to their franchisees and ultimately results in successful transfer of the "*Viennese coffee concept*" to the local market outlets. Inconsistent with our prediction, *B-COM* applies a SUF strategy despite of having highly non-transferable system-specific assets. However, *B-COM* faces serious problems in transferring their system-specific know-how. Hence their ownership strategy might not be efficient. The use of MUF increases the franchisor's control by supporting the transfer of system-specific assets to the local outlets and enabling the standardization of administrative procedures and routines at the local market.

On the other hand, the local adaptation capabilities under MUF are lower than under SUF. The findings also suggest a significant effect of local market knowledge on the choice of franchising strategy. However, single-unit franchisees may not always have an advantage compared to multi-unit franchisees with regard to local market adaptation. *A-COM* argues that there are no significant differences between the local market knowledge advantages of single-unit and multi-unit franchisees. The reason behind this could be that the brand name of the *A-COM* is so important for the success of the system that local market adaptations do not generate additional residual income for the partners.

Although the study provides a detailed insight of the ownership strategies of *A-COM* and *B-COM* by comparing theoretical predictions with empirical patterns regarding the choice of ownership strategy in franchising, the findings of this study are subject to the standard limitations of case study research methodology. First, the major limitation of case study research is that the findings are rarely generalizable. Second, there is a lot data for analysis that sometimes leads to omission of some important information as it is difficult to use all the data at one time.

AUTHOR INFORMATION

Dildar Hussain is writing his PhD at the Center for Business Studies, University of Vienna under a fellowship from the Higher Education Commission (HEC) of Pakistan. The areas of his research interest include franchising, entrepreneurship, and strategic networks.

Dr. Josef Windsperger is an associate professor at the Center for Business Studies, University of Vienna. His research fields are strategy and organization, networks, and theory of the firm.

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