ESSAYS ON GOVERNANCE PERSPECTIVE ON FRANCHISING

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INTRODUCTION

Franchising business model demonstrated tremendous growth over last two decades. It provides significant contribution to the US GDP and employment. In 2012 year alone, US franchising companies have opened more than 16000 outlets worldwide. The growth of franchising model is observed not only within existing industries, but also in emerging ones. Indeed, franchising has established itself not only in well-known hotels, restaurants, or rentals industries, but also in the new emerging industries, such as adult care, child centers, frozen ice cream and yogurt among others.

Franchising business model allows company, e.g. franchisor, to grant the rights to licensee, e.g. franchisee, to operate the given outlet under company’s brand in exchange for upfront payment fee and ongoing royalties (Barthélemy, 2008). Any service provider can establish a franchising network regardless of its company size. While established industries are primarily represented by large public franchisors, like McDonald’s, Yum! Brands, Hilton Worldwide, and Choice Hotels, emerging industries are mostly occupied by family-owned private companies and small- and medium-sized entrepreneurs. Regardless of the company and industry characteristics, franchising model provides vast opportunities for the companies’ growth both domestically and internationally (Dant et. al., 2011). Franchising model provides the company with three options of expansion: to open company-owned or franchised outlets. Up to this point, existing research spent significant amount of efforts primarily on developing the typology of these two options by highlighting the distinct characteristics of each type and their short-term and long-term performance outcomes (Combs & Ketchen, 2003; Dant et. al., 2011).

Expansion through company-owned outlets represents the most intuitive expansion option. Company chooses the location for the new outlet and establishes the whole outlet itself.
In this case, company is responsible for all start-up costs associated with the new outlet, such as construction, employee hiring and training, inventory stock up, local and national promotion campaigns (Perryman & Combs, 2012; Sorenson & Sørensen, 2001; Oxenfeldt & Kelly, 1969). In addition to start-up costs, company is responsible for operating expenses, which are quiet significant in service industries. Due to the close interactions with the customers, company should constantly monitor the industry trends and customer preferences to ensure the customer satisfaction. Moreover, Sorenson & Sørensen (2001) demonstrated that the service quality in company-owned locations should always be monitored due to the low motivation of employees, given that managers that operate a company-owned location are usually hired managers that do not have any personal investment in the company (Sorenson & Sørensen, 2001). Due to the lack of motivation, employee shirking becomes enlarged issue to the company. In order to minimize it and ensure that outlet holds high quality standards, company has to monitor outlets’ activity and day-to-day operations (Perryman & Combs, 2012). Close monitoring may be very costly, especially if company operates in large geographical area like the US (Kalnins, 2004; Perryman & Combs, 2012). Large investments and ongoing monitoring allow company to keep a full control over their outlets and claim all the revenue from it (Oxenfeldt & Kelly, 1969).

Franchising scholars agree that expansion through franchising generates the highest growth rates (Shane, 1998; Shane, 1996). Instead of committing the lots of resources into the new location, franchisor searches for a qualified franchisee that will open the new outlet for the company. The choice of new franchisees is a complicated process subjected to the agency issues, such as information asymmetry (Perryman & Combs, 2012; Jindal 2011). Franchisors prefer obtaining only those franchisees that possess significant amount of knowledge regarding the target market, experience in its industry, and sufficient amount of resources to open and operate
the new outlet(s) (Dant et. al., 1997; Dant et. al., 2011). Unlike company-owned, franchised outlets are funded by franchisees, which allows for a fast expansion by bringing additional franchisees. Since franchisees have their personal investments in the company, they were shown to be more motivated to succeed and perform necessary market adaptation to better suit the customer preferences (Perryman & Combs, 2012; Jindal, 2011). On the other hand, franchisees are agents that act on behalf of the franchisor and, according to agency theory, may behave opportunistically in order to maximize their own profits at the expense of franchisor (Sorenson & Sørensen, 2001; Oxenfeldt & Kelly, 1969). As a result, the need for monitoring is still present in franchised locations, but comparing the company-owned ones, the monitoring may be less frequent and, therefore, cheaper (Sorenson & Sørensen, 2001). The relationship between franchisor and its franchisees is defined and bounded by franchise agreement that dictates the mutual duties and responsibilities. The classic representation of agency problems in the franchising relationship limits franchisor’s control over the franchised outlets, since latter cannot be easily converted to company-owned ones or closed. In addition to limited control, franchisor receives only an ongoing royalty out of monthly or weekly revenues, which averages at approximately 5%. The limited cash flow from franchised operations is easily justified by minimized investments into the new outlets and shock resistance of the overall franchising system. The loss of a single franchisee does not lead to the failure of other franchisees or franchisor, overall franchising system was shown to have higher survival rates (Shane, 1998), performance (Medal-Bartual et. al., 2012), and growth rates (Shane, 1996).

The distinct point of interest in franchising research is internationalization of franchising. The agency issues, such as information asymmetry, adverse selection, and opportunistic behavior, are significantly magnified by market heterogeneity when franchisors decide to expand
internationally (Kretinin et. al., 2014; Perrigot et. al., 2013; Ghemawat, 2008). The differences among the markets do not only require the significant adaption to local customer preferences, but also create entry barriers and increase operating costs, primarily monitoring. Market differences prevent franchisor from creating a “copy” of domestic franchising system in the international markets (Kalnins, 2004; Perryman & Combs, 2012). As a result, the need and degree of adaptation increase significantly as company decides to expand into another country. Successful international operations require possession of international market knowledge and sufficient amount of resources (Hillman et. al., 2009; Quinn & Alexander, 2002; Lovelock, 1999). Given the established typology discussed above, extant research has demonstrated that franchising provides a better alternative for international expansion than company-owned outlets. Franchisees selected for international expansion usually are locals with the respect for given market. As a result, they are more knowledgeable about those markets and more capable of implementing a successful adaptation (Wang & Altinay, 2008). Moreover, the local status of franchisees also helps to mitigate administrative and political factors that may be imposed on franchisor. While solving several issues associated with market differences, international franchising makes monitoring routines very costly due to the travelling and difficult due to the information asymmetry (Perryman & Combs, 2012). As a result, the issues of franchisees’ opportunistic behavior become more severe. Existing research, however, claims that overall franchising provides a better and more efficient means of international expansion than company-owned outlets (Dant et. al., 2008; Dant et. al., 2011).

Significant research efforts invested in typology of outlets reached consensus regarding the differences, tradeoffs, and impact of each outlet type on franchisor’s performance, as discussed above. However, the fundamental questions in franchising are still left unanswered:
how should franchising companies look like in the long-run and why some companies tend to be fully franchised while others do not (Oxenfeldt & Kelly, 1969; Dant et. al., 2011, Combs & Ketchen, 2003)? Franchising industries demonstrate large discrepancies among the franchise networks: some companies successfully operate fully company-owned chains, while others rely solely on franchising. Moreover, the development strategies also demonstrate diametrical evidence: some companies convert their system to company-owned ones, while others do the opposite. Existing research approached these fundamental questions from outcomes perspective. Oxenfeldt & Kelly (1969) claimed that companies should ultimately become company-owned in order to keep a full control over the company and maximize its revenue. Shane (1998) stated that companies should become fully franchised in order to achieve the best growth rates and minimize franchisor’s investments. Kalnins (2004), Sorenson & Sørensen (2001), and Perryman & Combs (2012) showed that the choice between company-owned and franchised outlets should be dictated by geographical distance between franchisor’s headquarters and outlets. These findings were aimed at minimizing company’s expenses and maximizing its performance. However, they did not answer why some companies choose one type of outlet over the other.

This dissertation is devoted to fulfilling this gap in franchising research and providing an explanation of why and how do companies make their franchising decisions. This paper proposes an alternative approach to these fundamental questions. Applying governance logic that states that company’s actions and resources are the reflections of company’s owners and decision-makers (Kirca, 2012; Goodstein et. al., 1994), we demonstrate how ownership structure of the company and its board of directors (Hillman & Dalziel, 2003) impact the franchising decisions. The three essays format was chosen in order to provide a contribution to three distinct domains
of franchising: initial franchising decision, decision to expand franchising internationally, and supervision of franchising performance.

Essay 1 focuses on the franchisors’ ownership structure and explains how decision-makers’ type and power reflect the franchising decisions company makes. The research on franchising typology demonstrated that expansion through company-owned units provides franchisor with the full control over the company and maximizes the cash flow from retail operations (Sorenson & Sørensen, 2001). Due to the company’s investments in the outlets and limited growth rates, Madanoglu (2011) and collaborators claimed that expansion through company-owned outlets may not always positively impact the company’s market value. Contrary, expansion through franchising tends to increase company’s market value at the expense of loosened control over the outlets and diminished cash flow (Madanoglu et al., 2013; Madanoglu et al., 2011). These tradeoffs represent the preferences of the owners and hired managers outlined by the agency theory (Eisenhardt, 1989). Essay 1 states that decision-makers that are motivated by stock ownership are more interested in establishing the fast-growing franchising system. Contrary, if decision-makers do have significant stock ownership, but instead are motivated by company’s short-term performance, they will tend to favor expansion through company-owned outlets to maximize their own performance. In addition to the inside owners, the large portion of decision-making power comes institutional owners, the companies that hold significant portion of stock of the company (Deutsch, 2005; Hillman, & Dalziel, 2003). Institutional owners may hold franchisor’s stock for short- or long-term period for dividends or sale of stock for profit (Neubaum & Zahra, 2006). Therefore, in both cases the institutional owners are interested in increasing company’s market value or, in other words, in fast and efficient franchising expansion. In addition to the stock ownership, further alignment of
managers’ and owners’ interests can be achieved through objective monitoring of managers’ actions. In particular, the independence of board was shown to have a significant positive impact on the development of franchising system. Hypotheses of Essay 1 explain how companies may encourage its decision-makers to opt for franchising expansion instead of company-owned one. This essay provides a significant contribution to the franchising literature by demonstrating the governance perspective to franchising. Further contributions to academic research and suggestions for further research are discussed further.

Essay 2 further explores company’s franchising decisions by shifting the research focus to internationalization of franchising. Extant research is primarily concerned with impact of the characteristics of domestic and international markets (Elango, 2007; Dant et. al., 2008). Market differences create severe threats to company’s international performance and require company to possess significant amount of resources and information (Kirca, 2012; Ghemawat, 2007). Essay 2 approaches these resource deficits from the governance perspective. Kirca (2012) claims that company may reduce its resource dependency by expanding its board of directors. By bringing additional directors, company acquires additional expertise and connection possessed by these directors. According to the resource-dependence theory (RDT), company should bring resource-rich directors, e.g. the ones that possess valuable external connections and significant amount of experience in the desired filed (Hillman et. al., 2009; Pfeffer & Salancik, 1978). Such connections are operationlized through multiple directorships and directors employment and previous experience. Resource-rich directors help company to minimize the uncertainty associated with international expansion (Hillman et. al., 2009; Arthurs et al., 2009). On the other hand, increased workload associated with multiple directorships leads to director’s decreased output per company, making him/her less efficient. The minimized director’s input will diminish
the benefits from directors’ resources and make decision-making process more time-consuming and less efficient (Zahra et. al., 2000; Dalton et. al., 1999). The same logic applies to the total number of directors. From resource dependency viewpoint, greater number of directors provides more resources to the company but slows down decision-making process. Therefore, there is a tradeoff between the overall amount of resources possessed by the director and amount of input received (Zahra et. al., 2000). Internationalization decision in franchising is a very committal move, since it requires large investments in international advertising and creates greater information asymmetry between franchisor and franchisees. Essay 2 claims that there is a curvilinear relationship in a form of inverted-U between the board size, multiple directorships and the proportion of international franchised outlets.

Essay 3 further extends the nomological net of governance perspective on franchising by uncovering the effects of governance tenure on the performance of franchising system. First two essays are focused on the first function of the governance – strategy formulation, e.g. franchising and internationalization. Essay 3 focuses on the second function of the governance – supervision of the company’s performance. Once the strategy has been formulated and implemented, governance, e.g. the board of directors, should supervise implementation and performance of the chosen strategy and adjust and adapt it in order to maximize its performance (Hillman & Dalziel, 2003; Johnson et. al., 1993). Adjustments and adaptation are the keys to success in the service industries due to the constantly changing customer preferences and economic conditions (Vargo & Lusch, 2004). Change in market conditions creates not only the need for adapting company’s offerings, but also a chance for franchisees to engage in opportunistic behavior due to the increased information asymmetry (Perryman & Combs, 2012). In order to minimize opportunistic behavior and successfully satisfy customer demands, franchisors have to constantly
monitor the market and franchisees activity, and perform adjustments as needed. Adjustments to company’s strategy require company to deviate from its existing policies and/or offerings. Existing research demonstrated that company’s willingness to adjust heavily depends on organizational tenure of its directors (de Villiers et. al., 2011; Lynall et. al., 2003). When directors are initially brought to the company, they bring new knowledge to the company, learn its culture, and try to maximize its performance in order to achieve personal promotions within the company. Once they spent significant amount of time in the company, they tend to resist changes, commit to existing policies and status quo. As a result, company becomes less adaptable and performs on “industry averages” (Finkelstein & Hambrick; 1990). Existing research demonstrated that franchising system tend to positively impact franchisor performance. Essay 3 demonstrates that this positive effect of franchising is not linear, but in fact has a curvilinear effect in a form of inverted-U shape and depends heavily on mean organizational tenure.

Hypothesized relationships are tested using the unique dataset compiled from several secondary data sources. The dataset consists of US public franchisors, which were shown to represent more than 80% of all franchising industries. The Franchising Handbook was used to identify all publicly-traded franchising brands with US origin to ensure homogeneity of the sample. The companies that reported the details on its franchising system, governance structure, and financial performance were included in the dataset and organized on the brand level. The NAICS codes were collected from every company, and used to identify non-franchising companies that compete in the same industries. The resulting dataset includes information on 158 companies from 27 industries for period from 2004 till 2014. The franchising information was further supplemented with governance data from proxy statements and EXECUCOMP and
general accounting information from COMPUSTAT. The dataset contains companies that illustrate aforementioned discrepancies in franchising industries, including the following phenomena: different franchising strategies and tendencies, companies that exited the industries, companies that changed its public/private status, brands were subjects to mergers and acquisitions, e.g. changed their parent companies. The linear model with panel corrected standard errors that includes controls for heterogeneity and time-lags was utilized to test the hypotheses. Overall, model estimations mainly provided significant support for hypothesized relationships and demonstrated a good fit to the data (judging by variance explained indicators).

This dissertation provides several significant contributions to the academic research. First, this dissertation provides one explanation on one of the most fundamental questions in franchising literature: why some companies choose to expand via company-owned outlets, while others choose to establish a franchising system. It fills the gap in the literature by showing how companies make this decision and what motivation they use in doing it. Second, it expands the nomological net of franchising by introducing the governance perspective and identifies first company-level antecedents of franchising. It demonstrates how ownership structure can be utilized in order to explain company’s franchising decisions. In particular, company decision-makers can be encouraged by stock options to expand through franchising. Also, it demonstrates how franchisors may encourage internationalization of franchising system by minimizing uncertainty and providing additional resources via expanding its board of directors and its connections. Third, this dissertation ties the antecedents of franchising to its consequences by demonstrating how company’s governance performs its two major functions, strategy formulation and supervision. Essay 3 illustrates that performance of franchising system depends on mean organizational tenure of its board of directors. Fourth, the nomological net of
franchising is further extended by application of resource-dependence and upper-echelon theories. Significant support to the hypothesized relationships in Essays 2 and 3 demonstrates that these theories provide meaningful explanation and contribution to the franchising research. This dissertation also provides additional support to the governance literature by applying and testing existing arguments on specific domains of franchising, service industries, and internationalization.

This dissertation encourages further research on governance perspective of franchising. These essays cover general publicly-available factors, such as ownership, multiple directorship, and organizational tenure among others. More detailed research is needed to establish the impact of other incentive strategies available to the companies on franchising decisions. While this dissertation cover general characteristics of the board of directors, it is important to uncover the impact of personal and background data, such as education, previous employment, etc.

Moreover, further research should consider including other decision-makers, such as CEO, CFO, COO, Chief Franchising Officer into the analysis. Primary data collection should be performed in order to obtain and analyze more detailed background information that will help to better understand the franchising decisions.

Considering the sample frame of this dissertation that consists of public companies, it is crucial to retest these hypothesized relationships in private companies. Durand & Vargas (2003) demonstrated that public and private companies are significantly different in their strategy formulation and resource allocation. Therefore, the sample of private firms should be considered in the future. The expansion of the sample is also needed with the respect to the country of origin. Elango (2007) and Dant et. al. (2008) demonstrated that franchisors with from different
countries significantly differ from one another due to the cultural and political characteristics of the home country.

This dissertation also provides some important suggestions to practitioners. Essays 1 and 2 highlight governance motivation factors that favor franchising expansion. Companies should consider these findings and form and incentify their decision-makers appropriately keeping their particular goals in mind. If company wishes to expand through franchising or increase its international presence, they should provide their policy-makers with stock instead of just regular salary in order better align their goals. Finally, it is important to consider limiting the maximum organization tenure for the board members in order to maximize company’s flexibility and adaptation to the constantly changing market conditions.
ESSAY 1. THE IMPACT OF OWNERSHIP STRUCTURE ON FRANCHISING SYSTEM

1.1 Introduction

Service industries demonstrated a tremendous development over several decades. US service-companies developed their home and international markets saturating them with franchised and company-owned outlets. Extant academic research has devoted substantial amount of work to understanding pros and cons of both types of outlets by means of comparing the characteristics and consequences of each outlets type (Perryman & Combs, 2012; Combs & Ketchen, 2003; Sorenson & Sørensen, 2001). While some researchers claimed that companies should expand through their own outlets in order to claim all the profits and avoid any agency issues (Oxenfeldt & Kelly, 1969), other scholars argued that franchising outlets provide better expansion alternative due to the franchisees’ knowledge, resources, and motivation (Perryman & Combs, 2012; Combs & Ketchen, 2003). Over the last three decades, franchising research stream tried to reach consensus in explaining why franchisors utilize different expansion strategies and what are their long-term perspectives: ones claimed the companies will tend to become fully company-owned (Oxenfeldt & Kelly, 1969), while others argued that companies should become fully franchised (Combs & Ketchen, 2003). In particular, extant research zoomed in to the characteristics and geographical location of the market in order to suggest which outlet type should be established in the given area (Sorenson & Sørensen, 2001; Perryman & Combs, 2012). However, the close examination of franchise industries suggests that companies pursue different expansion strategies. It is still unclear how companies make their franchising decisions and why we observe significant differences in franchising systems. This paper is devoted to resolve this incongruence by exploring the antecedents of the structure of franchising systems. Building my arguments on governance literature and existing typology of outlets types, we demonstrate why
companies choose one type of outlet over another. In particular, we claim that company’s owners (major stockholders) utilize their decision-making power to pursue their goals of maximizing the company’s value via fast and efficient franchising expansion. In other words, individuals and parties with greater stock ownership will favor fast franchising expansion to maximize their value.

Company makes its major decisions on the corporate level, e.g. its board of directors and major stockholders. As company grows, owners hire executives to operate on their behalf and to maximize company’s value. However, once ownership and decision-making is separated, the agency problems occur due to goal conflicts. Hired managers tend to maximize their own profit at the cost of shareholders’ value (Fama & Jensen, 1983). Governance literature claims that there are two solutions to this opportunistic problem: supervision by the board of directors (Zahra & Pearce, 1989) and alignment of managers’ goals with the company by providing stock ownership (Hillman & Dalziel, 2003). Company’s board of directors is called on to supervise the top management and ensure that managers act on behalf of shareholders and not on their own benefit (Zahra & Pearce, 1989). Similarly to the managers, directors also receive stock ownership to better align their interests with the company’s ones (Hillman & Dalziel, 2003) and provide the incentive for directors to monitor company’s operations and decisions more carefully (Hillman & Dalziel, 2003; Zahra, 1996). When inside decision-makers (e.g. managers and directors) are compensated with stock, they become self-interested in maximizing the company’s value, e.g. aligned with the owners’ goals (Arthurs et al., 2009; Zahra et. al., 2000; Zahra, 1996). Alignment of interests makes managers and directors to prioritize company’s value maximization, which is achievable when company grows and increases its market share. Existing franchising research suggests that expansion through franchised outlets provides the better opportunity for fast and
efficient expansion than through company-owned outlets. Considering this existing typology, this paper claims that the providing stock incentives to inside decision-makers will be positively associated with the expansion through franchised outlets.

Companies decision-making is also influenced by institutional owners, such as portfolio holders, banks, pension funds, investment funds, insurance companies, etc. (Baysinger et. al., 1991). Institutional owners hold significant amount of stock, which enables them to exercise their decision-making power, and, as a result, possibly possess the highest motivation to maximize company’s value (Neubaum & Zahra, 2006). Institutional owners may hold the stock for long period of time and participate in the decision-making, if their businesses somehow relates to the company (Neubaum & Zahra, 2006) or may not be willing to intervene with company’s operations and sell the stock at their own convenience for profit (Zahra et. al., 2000). Similarly to the inside owners, institutional owners are interested in continuous growth of the company and its value maximization. Therefore, the decision-making power of institutional owners (stock ownership) should be positively associated with franchising expansion.

The primary function of the board of directors is to supervise the companies’ decision-making and to ensure that shareholders’ interests are considered. In order to maximize the objectivity of the supervision, companies are required to employee the independent directors, e.g. directors that do not have personal interests or investments in the company. Existing governance research suggests that the boards consisting of greater portion of independent directors are characterized by more objective decision-making that better suits its shareholders. Since the strategy is formulated in interactions among board members, executives, and institutional owners, the more independent and objective board of directors will be able to supervise this decision-making process more objectively. Therefore, the greater degree of board independence
will make sure the decision-making will maximize company’s value, e.g. will enable company to efficiently expand through developing franchising system.

This paper develops a nomological net of franchising by uncovering the company-level antecedents of franchising system. We integrate governance research stream to shed light on decision-makers’ toward franchising and demonstrate why some companies opt to expand through franchised or company-owned outlets. We provide empirical support to our claims using a 10-year panel data set that covers nearly 30 franchising industries.

The paper is organized as follows. First, we review the existing typology of franchised and company-owned outlets, highlighting the differences and trade-offs between the two, and discuss how they impact the company’s value. Second, we describe the ownership literature and demonstrate how company owners may maximize company’s value in franchising. Third, we describe the methodology, e.g. data, variables, models, and results. Finally, we summarize the study, conclude the results, and discuss theoretical and managerial implications along with the limitations of the study and potential for further development.

1.1 Theory and Hypotheses Development

1.1.1 Overview of Franchising: Franchised vs. Company-Owned Outlets

Service industries are characterized by almost simultaneous production and consumption of services. Therefore, service providers have to establish their presence in the given market by establishing the brand outlet in the given area (Vargo & Lusch, 2004). The first expansion option for the company is to invest directly into opening new outlet, e.g. open a company-owned location. In this case, company is responsible for all start-up costs associated with the new outlet, such as construction, inventory, hiring employees and managers, and training them (Dant et. al., 1997). In addition, company becomes responsible for monitoring its managers in order to prevent
shirking, and, most importantly, company is responsible for adaptation to changing market conditions (Sorenson & Sørensen, 2001). Adaptation to the changing market and consumer preferences is the most pressing and difficult task, especially when company expands to distant markets (Kretinin et. al., 2014). Successful adaptation to the market requires significant market knowledge and fast response to the change in market conditions (Perryman & Combs, 2012). Existing research agrees that company-owned locations are costly way of expansion that requires extensive market knowledge, but it provides company with total control over the outlet (Oxenfeldt & Kelly, 1969).

The second expansion option is franchising. Franchising business model allows company, e.g. franchisor, to grant the rights to licensee, e.g. franchisee, to operate the given outlet under company’s brand in exchange for upfront payment fee and ongoing royalties (Barthélemy, 2008). Franchising business model became the most popular expansion strategy for service providers globally. Franchised outlets are opened at the expense of franchisees, which are responsible for all start-up costs. Therefore, franchising provides franchisor with fast expansion capabilities cheaper than opening the company-owned outlets (Perryman & Combs, 2012; Combs & Ketchen, 2003). Franchisor always tries to attract franchisees that are knowledgeable of the target market in the target region. Due to franchisees’ knowledge, franchised outlets are very adaptable to the market and more efficient in responding to the changing market conditions (Perryman & Combs, 2012). Franchisees are claimed to be more motivated to succeed due to their personal investment into outlets (Windsperger & Dant, 2006; Eisenhardt, 1989). Moreover, new outlets are opened on attracted franchisees funds, so all the risks are also shifted to franchisees. Existing research claims that franchised locations allows franchisor to expand
quicker and cheaper than through opening company-owned outlets (Mitsuhashi et. al., 2008; Sorenson & Sørensen, 2001).

The differences between company-owned and franchised outlets are summarized in Table 1. Taking into account all characteristics of company-owned and franchised outlets, it is clear that if franchisor opens a company-owned location, it keeps control over the outlet, claim all the profits, but is responsible for all the costs, including adaptation. Expansion through company-owned outlets is expensive, and as a result, may be slow considering the total investment requirements. Therefore, the expansion through company-owned outlets can be characterized by an alternative that provides cash flow and fully controlled expansion. On the other hand, franchised locations provide an opportunity for fast expansion and more efficient adaptation due to franchisees’ personal investments and expertise about the given market. Although expansion through franchised outlets is faster, it does not provide franchisor with significant cash flow since it receives only ongoing royalties. Therefore, the trade-offs between franchised and company-owned outlets may be characterized as a choice between high cost, full control, and high cash flow of company-owned outlets versus low-cost and fast franchised expansion with limited cash flow.

---------- Insert Table 1 about here ----------

1.1.2 Franchising and shareholder’s value

Existing research has dedicated significant attention to the impact of franchising on companies value. Companies’ value is estimated by assessing companies’ market share, performance, and risks. Madanoglu and collaborators (2011) concluded that franchising
outperform all the company-owned chains. Extant research provides a robust evidence of franchising value creation (Madanoglu et. al., 2013; Madanoglu et. al., 2011). Several indicators were utilized for this conclusion, such as franchisor’s and franchisees’ profits, and different performance indexes (Madanoglu et. al., 2011). Higher adaptation capabilities of franchisees explain superior performance of franchised outlets comparing to company-owned ones. Therefore, such superior performance is achieved without creating additional investment risks for franchisor (Spinelli et. al., 2003). While franchising minimizes franchisors’ financial risks and maximizes expansion rates, it creates a brand image risks due to agency issues in franchisor-franchisee relationship (Perryman & Combs, 2012; Fama & Jensen, 1983). Such brand image risks are not present in company-owned outlets due to the lack of managers’ personal investments in outlets (Sorenson & Sørensen, 2001). However, existing franchising research claims that opportunistic behavior among franchisees can be minimized via further alignment of interests (Combs & Ketchen, 2003), thus claiming that brand damaging opportunistic behavior should not cast a significant impact on company’s value. Longitudinal analysis of public franchisors demonstrated that expansion through franchised outlets provides positive market value to the shareholders, while expansion through company-owned units may produce mixed results (Spinelli et. al., 2003).

1.1.3 Overview of Company’s Ownership Structure

Extant governance literature claims that company’s strategy and decision-making reflects its top management and owners (Hambrick & Mason, 1984; Dalziel et. al., 2011). Top management is responsible for operating the company, developing it, and maximizing its market value on behalf of its stockholders. However, due to the separation of ownership and control, the misalignment of company’s strategy and owner’s interests may occur (Fama & Jensen, 1983),
e.g. top management may undertake the strategy that undermines company’s market value (Zahra et. al., 2000; Fama & Jensen, 1983). The need for minimizing such goal misalignment requires company to motivate managers to focus more on increasing company’s efficiency and profitability by means of supervising and combining control with ownership (Hillman & Dalziel, 2003). Supervising function is performed by the board of directors, which is called on to monitor managers’ activity and ensure that company undertakes an efficient strategy (Johnson et. al., 1993). Board of directors intervenes with managers’ decision-making process if top management makes inefficient moves. Existing research claims that top management may become more efficient if they obtain some ownership in the company, e.g. company’s stock (Johnson et. al., 1993). If company’s decision-makers own stock within the company, their interests become more aligned with company (Zahra et. al., 2000; Hillman & Dalziel, 2003). In addition, Zahra (1996) argued that possession of company’s stock, makes top management and board of directors more motivated to supervise company’s operations and improve its market position (Hillman & Dalziel, 2003). In this paper, we consider the following classification of company’s governance structure: inside and institutional owners (Zahra, 1996), and dependent and independent directors (Zahra & Pearce, 1989). According to governance literature, these types of owners are different in terms of their goals and interests (Zahra & Pearce, 1989; Fama & Jensen, 1983).

1.1.4 Insiders’ Ownership

By inside owners we understand top managers and the board of directors of a franchise public company. High managerial equity holdings aligns managers’ interests with the company’s ones (Zahra, 1996). Managers on regular salary do not possess high motivation to improve company’s efficiency, but instead they may be concern with keeping full control over the company (Deutsch, 2005). The lack of motivation and initiative by top management may lead to
delayed response to market changes, e.g. cause inefficient adaptation (Hillman & Dalziel, 2003; Kretinin et. al., 2014; Perryman & Combs, 2012). Instead of maximizing company’s market value, managers without stock ownership tend to maximize short-term profits, possibly neglecting its long-term perspectives. Therefore would claim that managers with low equity ownership should prefer to expand through company-owned outlets, since this type of expansion better suits their preferences and maximizes personal gains. Since managers that motivated by current company performance, their personal salary comes from maximizing revenue. Company-owned outlets provide the greater cash flow than franchised ones. Moreover, if company-owned outlet is underperforming, managers may just close it, improving short-term efficiency and decreasing market value, e.g. short-term profit maximization; while franchised outlets may not be easily closed due to the franchise contracts. On the other hand, if company grants equity ownership to top management, managers should shift their goals from short-term performance maximization to the maximization of company’s market value. Market value of franchising company depends on its market share and growth rates, therefore, managers will try to maximize company’s growth rates. In franchising industries, the highest growth rates are achievable through franchising outlets instead of opening company-owned ones. Therefore, we claim that higher equity ownership by company’s managers will motivate them to maximize company’s growth rates through franchising.

Similarly to the managers, board of directors should be motivated high enough to intervene with managers’ decision-making process (Hillman & Dalziel, 2003). Although directors’ interests are more aligned with the company’s ones, directors may not step up in the decision-making process unless company becomes inefficient or undermines its market value (Johnson et. al., 1993). Following Zahra (2000), directors may not possess sufficient motivation
to closely monitor company’s activity unless they own company’s stock. In this situation board of directors will not ensure that managers’ activity maximize company’s market value instead of short-term profitability. On the other hand, if board of directors has motivation to supervise, company’s strategy will better represent stockholders’ interests. Extant research demonstrated that directors’ motivation may be increased by providing them with equity ownership.

Therefore, we claim that higher insiders’ equity ownership will better align managers’ goals with owners’ ones to pursue a fast-growing strategy and better motivate directors to supervise top management in their decision-making. As a result, higher stock ownership should lead to company’s market value maximization that can be achieved through high growth rates, e.g. opening franchising outlets. In other words:

\[ H1: \text{There is a positive association between the insiders’ stock ownership and the proportion of franchised outlets.} \]

1.1.5 Institutional Ownership

The third type of stock owners is institutional owners. Institutional owners are external companies that hold a significant portion of stock. Governance literature differentiates two types of institutional owners: short-term and long-term investors (Neubaum & Zahra, 2006). Short-term investors are banks, insurance companies, and investment funds. They are characterized by frequent transactions of stock for the profitability purposes (Bushee, 1998; Baysinger et. al., 1991). Long-term investors, such as pension funds, tend to keep stock ownership for longer period of time (Baysinger et. al., 1991). Existing governance research claims that short-term investors tend to discourage company from undertaking long-term risky investments, such as R&D or corporate entrepreneurship, since short-term investors are evaluated quarterly by their portfolio performance (Zahra et. al., 2000). As a result, short-term investors tend to influence
company’s decision-makers through their significant ownership (Clyde, 1997). Oppositely, long-term investors tend not to intervene with company’s decision-making process, but encourage the long-term value creation (Neubaum & Zahra, 2006; Clyde, 1997). Existing research on institutional owners has primarily focused its efforts on high-tech industries and focused on uncertain and risky activities such as R&D, radical innovation, and entrepreneurship. Due to the uncertain nature of these activities, existing research differentiated between short-term and long-term institutional owners. However, the impact of institutional ownership in less uncertain environments like restaurants all hotel industries was mostly neglected. Since franchising industries are not usually engaged in long-term costly and uncertain R&D, the differences between short-term and long-term institutional owners should be less salient. Instead, both types of institutional owners should be concerned with rapid expansion of franchising system. The value creation process in franchising is best achieved through extensive franchising expansion, which allows franchisor to expand quickly with minimal costs (Spinelli et. al., 2003). Therefore, we claim that both types of institutional investors will encourage company to expand through franchising. Institutional investors are motivated to supervise managers due to their high ownership (Zahra, 1996), institutional investors are external to the company, and as Neubaum & Zahra (2006) claimed that they may be the most objective in their managers’ evaluation. Since both types of institutional owners are interested in company’s market value, but not short-term performance, institutional owners should encourage company to engage in the development and growth of its franchising system. Therefore, we claim the following:

H2: There is a positive association between the institutional stock ownership and the proportion of franchised outlets.
1.1.6 Board Independence

According to the agency theory, board of directors helps company to control managerial decisions (Hillman & Dalziel, 2003). Directors should make sure that managers do not maximize their own benefits, secure their job, or maximize short-term profitability instead of maximizing company’s market value (Zahra et. al., 2000; Zahra, 1996). There are two types of directors on the board: dependent and independent. Dependent directors are characterized by the presence of personal interest in the company, such as investment, employment, or employed relatives (Johnson et. al., 1996). Extant research claimed that dependent directors may lack objectivity of judgment due to their personal interest in the company (García-Meca & Sánchez-Ballesta, 2010). The second type of directors is independent. Independent directors do not have any personal interest in the company. Governance literature claims that independent directors are more objective in their evaluation of managers (García-Meca & Sánchez-Ballesta, 2009). Their external to the company background provides them with different perspectives and understanding of company’s position. Therefore, the larger proportion of independent directors in the board should make the board of directors more objective in their supervising and decision-making functions (Peng, 2004) and reducing agency issues in the company (Zahra & Pearce, 1989). We claim that the larger proportion of independent directors should enable the board to more efficiently interact with and supervise managers to ensure that latter pursue companies’ value maximization goals instead of their own ones:

\textit{H3: The proportion of independent directors on the board with positively moderate the association between insiders’ stock ownership and the proportion of franchised outlets.}
Institutional owners may closely interact with the board of directors during the decision-making process. They have high motivation to intervene company’s decision making since they possess significant amount of stock (Clyde, 1997). As discussed earlier, institutional owners will try to maximize the company’s market value by promoting fast franchising expansion, similarly to independent directors. The interaction of independent directors and institutional owners did not receive significant attention in literature. On the one hand, both independent directors and institutional owners possess the most objectivity in their evaluation and decision-making (Zahra et. al., 2000; Deutsch, 2005; Zahra & Pearce, 1989). Therefore, their interaction should lead the company for value-maximization decision. Moreover, independent directors and institutional owners come from different backgrounds, which may improve the quality of the decision-making (Horwitz & Horwitz, 2007). On the other hand, diversified background may create issues with cohesion and decision-making (Simsek et. al., 2005). In case of franchising, both type of decision-makers should favor fast franchising expansion in order to maximize company’s value. Therefore, we claim that higher board Independence should provide closer alignment of institutional owners’ and inside decision-makers’ goals. Increased objectivity should assist company with decision-making aimed to achieve higher growth rate and, as a result, higher value. Therefore, the interaction among the decision-makers should easier achieve consensus that will favor franchising expansion even stronger:

**H4: The proportion of independent directors on the board with positively moderate the association between institutional stock ownership and the proportion of franchised outlets.**
1.2 Methodology

1.2.1 Data

The population of interest for this study consists of US public franchise companies. Franchising Handbooks of 2004 and 2014 was utilized to find all public franchising companies that operate in the US. Further, private portfolio holder companies that operate one or multiple franchising brands were excluded due to the lack of publicly available information. Only public companies of US origin were selected in order to obtain homogeneous sample that provides sufficient amount of information annually. The NAICS codes were collected in order to find non-franchising companies that compete with franchising ones in the given industry. The resulting sample frame was used to find information on publicly available sources such as SEC website. The resulting sample is a panel that consists of 158 companies that operate in 27 industries defined by NAICS code providing N=4221. Due to mergers and acquisitions, company fails, and introduction of new brands, the resulting data set is unbalanced panel. Several sources of information were combined in order to obtain the data on franchising systems and company governance structure. COMPUSTAT and annual (and quarter) reports were used to obtain the information on franchising systems and companies’ performance. The information on governance structure was obtained from proxy statements and EXECUCOMP. The sources or the data were previously utilized by multiple researchers and showed its credibility (Kretinin et. al., 2014; Dalziel et. al., 2011).

1.2.2 Dependent Variable

Proportion of Franchised Outlets (Franchise) – is calculated as a percentage of franchised outlets from total number of outlets, e.g. franchise = number of franchised outlets divided total
number of outlets. This measurement represents the structure of franchise system, and is used very frequently in franchising research (Hsu & Jang, 2009). This measurement is continuous, and can take value from 0 to 1. If company expands only through company-owned outlets, then the value of franchise variable is 0, and if company utilizes only franchising as a means of expansion, the value of franchise variable is 1. This variable changes every quarter due to the openings of new outlets, closing existing ones, or changing ownership of existing outlets.

1.2.3 Independent Variables

*Insiders’ Ownership (Inside own.)* – this variable is composite measurement that represents the percentage of shares owned by company’s top management and directors. Inside ownership is calculated as follows (Zahra et. al., 2000):

\[
Inside \text{ ownership} = \sum_{i=1}^{n} \frac{Stock \text{ Ownership}}{Total \text{ Shares Outstanding}}
\]

Where \( n \) is the number of top managers and directors. This measure is continuous, and may take values from 0 to 1. Inside ownership represents the portion of stock owned by top managers and directors, and represents their decision-making power. Companies are obliged to report in annual proxy statements. Since top managers and directors may receive stock as their compensation, and company constantly changes the total number of shares outstanding, this variable varies over time.

*Institutional Ownership (Inst. Own.)* – represents the total percentage of shares owned by institutional investors. Similarly to the inside ownership variable, it is calculated as a portion of stock owned by institutional owners, and represents their decision-making power (Neubaum & Zahra, 2006).

\[
Institutional \text{ ownership} = \sum_{i=1}^{n} \frac{Stock \text{ Ownership}}{Total \text{ Shares Outstanding}}
\]
*Proportion of Independent directors (Independence)* – this variable represents the portion of independent directors presented in the board of directors in the given year (Wincent et. al., 2009; Zahra & Pearce, 1989).

\[
\text{Independence} = \frac{\text{Number of Independent Directors}}{\text{Board Size}}
\]

This variable is reported annually in annual proxy statements. This variable has to be greater than 0.5 and smaller than 1 (due to the US legislature that requires companies to have non-less than 50% of board to be independent).

**1.2.4 Control Variables**

*Board size* – this variable represents the number of directors on the board in the given year. The control for board size is very common for governance research due to its the impact on decision-making process and the amount of information, resources, and connections available to the company (Wincent et. al., 2010; Zahra et. al., 2000).

*Number of insiders (Insiders)* – this variable represents the total number of directors and executives that hold some portion of stock and influence company’s decision-making.

*Number of institutional owners (Institutes)* – the number of institutional owners that hold more than 5% of stock.

*Number of company-owned outlets (Company-Owned)* – this variable represents the total number of company-owned outlets operated by franchisor at the given time. This is a continuous variable that may take any non-negative integer value. Number of company-owned outlets is frequently utilized in franchising research as a proxy for company’s size and franchisor’s exposure to the market knowledge (El Akremi et. al., 2011; Sorenson & Sørensen, 2001). We claim that franchisor’s market knowledge and skills to operating outlets will influence its further expansion decisions.
Royalty Rate (Royalty) – this variable represents the percentage of profit that franchisee should pay to franchisor weekly/monthly as a rent for using franchisor’s brand and advertising support (Shane et. al., 2006). This variable is continuous, and rarely changes. However, it is used as a proxy for franchisor’s attractiveness: according to the signaling theory, higher royalty rates signal strong brand image to the franchisees (Kaufmann & Dant, 2002).

Franchising age (Age) – this variable represents the amount of experience that franchisor have with franchising practices (Jindal, 2011). Franchising experience influences the efficiency of franchise contracts. It also controls for franchisor’s confidence in using franchising due to the monitoring experience (Perrigot et. al., 2013).

Parent company and industry fixed effects – this set of dichotomous variables represents the parent company of the given brand and industry it operates and. Since the dataset is organized on brand level of analysis, there is a need to control for any endogeneity with a parent company. There may be significant differences among the industries, so it is important to control for unique effects of every industry.

1.2.5 Statistical Analysis

The descriptive analysis of our data indicated that the run no violations of normality of our continuous variables. The correlations among the variables of interest do not exceed the standard cutoff point of 0.6. However, the board size does exceed the aforementioned cutoff point and correlates highly with the number of insiders and institutional ownership. Existing empirical research allows this variable to correlate highly with other control variables (Johnson et. al., 1993) Descriptive statistics can be found in Table 2.

---------- Insert Table 2 about here ----------
We applied the linear regression with panel corrected standard errors and control for autocorrelation and heterogeneity (Greene, 2012). We performed three models to test our hypothesis. The control model contains only control variables and serves as a base for comparison for other models with more sophisticated model that test our hypotheses. Model 1 is utilized to test the main effects of insiders’ ownership and institutional ownership, e.g. hypothesis 1 and 3. Hypothesis one claims that insiders ownership is positively associated with the proportion of franchised outlets in the system. Our estimation shows the positive and significant coefficient for insiders ownership, thus providing the support for hypothesis one ($\beta=0.06$, $p<0.05$). Hypothesis three claims that the amount of institutional ownership should also be positively associated with the proportion of franchised outlets. However our model estimates that the coefficient is negative and marginally significant ($\beta=-0.05$, $p<0.1$). Thus, we obtain the opposite effect of the one that predicted. The introduction of two main effects variables improve the model fit and its explanatory power as indicated by $\Delta R^2=0.04$. Model two is utilized to test the interaction hypothesis two and four. The inclusion of interaction terms to the model improve the explanatory power by 6%. Hypothesis three claims that the effect of insiders ownership on proportion of franchised outlets will increase as board independence increases. Model to provide support for hypothesis three by positive and highly significant coefficient $\beta=0.03$ ($p<0.01$). Hypothesis four claims that the impact of institutional ownership on the proportion of franchising will be higher for more independent boards. Model two provides support for hypothesis four ($\beta=0.11$, $p<0.05$).

### 1.2.6 Post Hoc Analysis

Our estimation supported our claims that insiders ownership has positive effect on the proportion of franchised outlets and that this effect is contingent upon the board independence.
However, this act of institutional ownership was estimated as negative, while we expected a positive effect. On the other hand, the interaction between institutional ownership and board independence is positive and significant. Therefore, it is possible that the effect of ownership on the franchising structure is nonlinear and depends on board independence. We performed post hoc analysis in order to uncover the nonlinear effect of institutional and insiders ownership. We utilized the similar linear regression with panel corrected standard errors and included squared terms for insiders ownership in model three and institutional ownership in model four. Model three demonstrates that the fact of insiders ownership has an inverted-U shape, which is highly significant ($\beta=-0.32$, $p<0.01$). Moreover, the interaction term between the nonlinear effect and board independence is positive and highly significant ($\beta=0.42$, $p<0.01$), which further supports hypothesis three. Model four resolves incongruence associated with the effect of institutional ownership on the proportion of franchised outlets. Model four demonstrates that the effect of institutional ownership also has an inverted U-shaped, which is negative and highly significant ($\beta=-0.03$, $p<0.01$). Moreover, the interaction between the squared term of institutional ownership and board independence provides further support for hypothesis four ($\beta=0.04$, $p<0.01$). The inclusion of squared term and eats moderation into the model further strengthen the explanatory power of the model by adding additional 5% of variance explained.

---------- Insert Table 3 about here ----------

---------- Insert Figure 2 about here ----------

---------- Insert Figure 3 about here ----------

---------- Insert Figure 4 about here ----------

---------- Insert Figure 5 about here ----------
1.3 Contributions and Limitations

Despite the tremendous development of franchising industries over the last decades, academic research has not highlighted the decision-making process of franchising companies. This paper provides a unique contribution by shifting the analysis from comparing the outcomes of franchising to its antecedents. Previous research has primarily focused on the differences between franchised and company-owned outlets and their performance in different market conditions. While trade-offs between the two outlet types are clearly understood, the process of companies decision-making is neglected. This paper fills this gap by introducing the governance perspective to the franchising literature. By focusing on different types of decision-makers we demonstrate why companies may choose franchising or company-owned outlets. We found support for our main effect hypothesis 1, which suggest that the company’s choice between two expansion options can be explained by highlighting the decision-makers and their incentives. In particular, insiders who are rewarded with company stock are more motivated to establish a fast-growing franchising system instead of company-owned one. We have obtained a negative direct effect of institutional ownership on the franchising system, while interaction with board independence was positive. This finding encouraged to pursue with our analysis and examine a nonlinear effect ownership on franchising structure. Our post hoc analysis revealed that the effect of ownership has an inverted U-shaped form. The nonlinear effect of insiders ownership can be explained by the amount of stock that insider has. While small stock ownership may not provide enough incentives to pursue a franchising strategy, the average amount would align decision-makers goals with the ones of the owner. However, once a decision-maker possesses a large amount of stock, he or she technically becomes an owner. Existing research demonstrated that owners have emotional and personal attachment to the company or the product and, as a result,
tend to preserve a full control over it and, potentially, resist any changes. If a decision-maker opts to keep a full control of the company, the development of franchising will be very limited since franchising diminishes franchisor’s control over the outlets. Therefore, the stock incentives should be high enough to motivate the manager to pursue the fast franchising expansion to maximize the company’s value, but not too high in order to prevent any personal attachment and loss of objectivity in decision-making. The inverted U-shaped impact of institutional ownership on franchising system can also be explained by the decision-making process. Unlike managers, institutional owners’ goals are aligned with other company owners due to the high stock possession. The effect of small number of institutional owners may not be enough to significantly impact the decision-making process of the company, since other influential owners such as founders may pursue preservation of control of their company. On the other hand, the high percentage of institutional ownership may prevent company from efficient decision-making. The decision-making process may become much more complicated if the large number of institutional owners of different origins try to reach consensus. Therefore, the average amount of institutional ownership would be the most beneficial since their goals of maximizing company’s value are aligned and decision-making process will not suffer from group dynamics. We have also found that the more independent boards also tend to promote franchising expansion because of their objectivity and goal alignment. Obtained the support for our moderation hypotheses that state that board independence helps company to make a franchising decision that should maximize company’s value and ensure its further growth. This paper suggests that franchising can be viewed not only in the lens of market characteristics, but from the perspective of decision-makers.
These results encourage further studies to broaden our understanding of the impact of ownership and governance characteristics of the company on its franchising strategy. While this paper applies agency theory to explain how different goals and incentives of decision-makers influence the choice of franchising, it is necessary to understand what knowledge, skills, and resources are used or required by decision-makers in franchising companies. Further research should address the question what type of governance is the most beneficial to franchising. Governance research utilizes several theoretical lenses, such as the resource dependency theory, that can also be applied to the franchising research domain. Since franchising is interdisciplinary concept, it is utmost important to study from different theoretical lenses in order to create the full picture of this concept.

This paper provides valuable suggestions for practitioners. First, business practitioners may utilize the findings of this paper to achieve the desired franchise structure by distributing ownership accordingly to the study findings. Second, researchers may utilize publicly-available data to predict the strategy of the given public franchisor. Third, franchisors may use the findings of this study to set up a compensation system for its governance structure, keeping in mind tendencies and preferences described in this paper.

While this paper provides valuable contributions to further research and practitioners, we realize the limitations of this study. First of all, the sample used in this study consists only of public companies. According to Durand & Vargas (2003) public companies exhibit different resource allocation strategies and governance structure from private companies. Therefore, further research should address this gap by sampling and studying the private companies for further generalizations of findings in this paper. Secondly, companies studied in this paper are of US origin. Elango (2007) demonstrated that franchisors from different countries follow distinct
expansion strategies due to cultural, economic, and political differences. Further research should account for such differences by studying the franchising companies from distinct origins and compare the findings. It is crucial to account for any possible country level differences in order to fully understand the decision-making process in franchising companies that operate globally. Finally, this paper only suggests that stock ownership may serve as a good incentive for creation of franchising system, however, further studies should attempt to find the most beneficial incentive structure for decision-makers.
ESSAY 2. EXPLORING THE ANTECEDENTS OF FRANCHISE INTERNATIONALIZATION

2.1 Introduction

Franchising has proven itself as a very efficient and effective expansion strategy for service industries. Industry examples demonstrated tremendous growth of franchising companies in the US market and their global expansion. Although existing research on franchising has devoted extensive attention to the benefits of franchising such as profitability, value creation, survival, and growth rates, the research has primarily neglected the international aspects of franchising. As a result, our understanding of internationalization drivers of franchising is very limited to conceptual works and limited empirical testing. McIntyre & Huszagh (1995) proposed the stages of internationalization of franchising. Welch (1990) and Eroglu (1992) found out that home market saturation leads to internationalization of franchising. Quinn & Doherty (2000) provided the evidence based on case studies of issues of power distribution in international franchising. Several authors performed comparisons among domestic and international franchisors (Elango, 2007) and franchisors from different countries (Dant et. al., 2008). Finally, Wang & Altinay (2008) brought our attention to the difficulties of franchisees’ selection for international franchisors along with potential solution framework. Therefore, we may conclude that international franchisors are significantly differently from domestic ones due to the differences among the countries and high level of uncertainty associated with international expansion. However, we still cannot say why some franchisors expand internationally and others do not. In other words, we do not know the company-level antecedents of internationalization of franchising. This paper is devoted to fulfill the gap in existing franchising research by highlighting the company-level factors influencing franchisors to expand internationally. The
governance research streams claim that all company’s decisions are made on the corporate level by the top management team and the board of directors (Baysinger et al., 1991). Following Kirca (2012) that claimed that governance structure is an antecedent of company’s internationalization, we build our arguments on resource dependence theory (RDT) and claim the board size, structure, and board capital will impact the internationalization of franchising.

Company’s decision to expand internationally is under two on the corporate level by executive managers. Due to the separation of ownership and control, public companies call on the board of directors to supervise top management and ensure that owners’ goal are pursued (Zahra & Pearce, 1989). As a result, company should align managers’ interests to the owners’ ones by providing incentives, support, and supervision. Managers tend to maximize short-term profitability and avoid long-term uncertain commitments (Zahra et al., 2000).

Internationalization process is highly associated with uncertainty, and require substantial amount of resources for market entry and adaptation due to market and environmental differences (Hillman et al., 2009; Quinn & Alexander, 2002; Lovelock, 1999), and franchising industries are not an exception from it (Kretinin et al., 2014). Therefore, managers who are evaluated by short-term performance may be discouraged from international expansion due to the high level of uncertainty. Therefore, board of directors should perform appropriate supervision and provide assistance to the managers in order to ensure that company pursue a long-term development. According to the Dalziel (2011), board of directors can assist managers by bringing environmental knowledge and connections to the company that may reduce uncertainty and provide additional resources to company (Hillman et al., 2009; Arthurs et al., 2009), thus providing more confidence to top management to proceed with international expansion. From RDT perspective, the more external environmental connections the board has, the more benefit
will be provided to the company. The larger board size and multiple directorships, the more resources, connections, and advices can be provided to the company. On the other hand, the larger workload for directors may diminish the performance and larger boards may experience integration and decision-making difficulties (Zahra et. al., 2000). Therefore, we claim that board size and multiple directorships will have non-linear negative quadratic effect on franchisor’s internationalization.

Even though board serves as a monitoring and supporting instrument, directors may still be inefficient and subjective in their managers’ evaluation (Hillman & Dalziel, 2003). Extant research argues that the highest objectivity is achieved when directors do not have any personal interest in the company, e.g. when directors are independent (García-Meca & Sánchez-Ballesta, 2010). The lack of personal interest or affiliation with the company makes directors more efficient and motivated to act on behalf of company’s owners (Deutsch, 2005). The more independent directors present in the board, the higher board independence from managers is, thus, the board will be more willing to push managers toward long-term value creating investments (Zahra et. al., 2000; Zahra, 1996; Sanders & Carpenter, 1998), such as internationalization. Therefore, we claim that board independence will positively moderate the relationships between board size and multiple directorships and company’s internationalization.

This paper claims that the board size, structure, and capital are the antecedents for franchisor’s internationalization. In order to test these hypotheses, we collected the panel dataset of public US franchisors over the 10-year period (2004-2013). The panel data estimation will enable me to utilize time lags and perform causality tests.

The paper is organized as follows. First, we overview the research on international franchising, e.g. obstacles and issues of international expansion and existing claims on market-
level antecedents of franchisor’s internationalization. Second, we discuss the structure and impact of governance structure on company’s strategy. Third, we develop the hypotheses based on RDT and agency theory. Fourth, we discuss methodology, analysis, and results of the study. Finally, we conclude the paper with theoretical contributions, suggestions to practitioners and future research developments.

2.2 Literature review and hypotheses development

2.2.1 Internationalization of Franchising

Lots of franchising companies have increased their international presence over the last decade once economist became more open. International expansion provides great benefits to the company, such as market diversification, additional revenues and market share, and potential for company’s value increase (Spinelli et. al., 2003; Welch, 1990; Baena & Cervino, 2012). However, the process of internationalization is also associated with severe problems. First of all, international expansion provides lots of uncertainty. Because companies enter distant country/region, they have to compete in new market with different environment. Countries are different with respect to their political and economical systems, administrative and law procedures, and cultures (Kretinin et. al., 2014; Lovelock, 1999). Each of these factors plays a crucial role in company’s expansion. The difference between economic systems defines customers’ purchasing power and expectations (Ghemawat, 2007; Kretinin et. al., 2014). Administrative and law procedures cast the impact on company’s entry mode and expenses associated with bureaucratic procedures (Lai et. al., 2012; Kretinin et. al., 2014). Cultural differences among the countries play the crucial role in customers’ consumption and traditions (Ghemawat, 2007; Kretinin et. al., 2014). Companies should also consider political stability in the country/region as another risk factor (Ghemawat, 2007). Summarizing all the differences
among the countries, we can conclude that in order for company to succeed, it should possess a
great amount of knowledge and be capable of applying this knowledge to adapt to the given
market. In addition to the market differences, company faces different competitors. Dant (2008)
compared franchisors from Brazil, France, and the US, and found out the different market
conditions create significantly different franchisors. Naturally, local franchisors are fully
knowledgeable of their home market, while expanding company does not possess that
knowledge. Such information asymmetry creates problems not only for company’s operations,
but also for partner selection. Latter is crucial for franchisor because franchising expands
internationally primarily via franchised outlets (Jindal, 2011; Perryman & Combs, 2012) and,
thus, it has to find franchisees that suppose to be knowledgeable and experienced in the given
country/region (Wang & Altinay, 2008). As a result of information asymmetry between
franchisor and its international franchisees, power within a franchise system may shift (Doherty
& Alexander, 2006). Clearly, information asymmetry and uncertainty create significant barriers
for franchisor’s international expansion. If franchisor does not possess enough market
knowledge, it cannot proceed with international expansion.

2.2.2 Corporate Governance Perspective on Internationalization

Naturally, all the company’s major decisions, such as internationalization, are made on
the corporate level. Governance literature has claimed that the company’s governance is an
antecedent of company’s critical decisions (Goodstein et. al.,1994). Extant research
demonstrated how corporate governance plays its role in company’s innovativeness (Baysinger
et. al., 1991), entrepreneurship (Zahra, 1996), and internationalization (Simsek et. al., 2005).
Even though, CEO and top management team contribute a lot to the company’s strategy, they
may not act on behalf of shareholders due to misalignment of interests (Fama & Jensen, 1983;
Hambrick et. al., 1993; Hillman & Dalziel, 2003). Such issues are most salient when company decides whether it should undertake a risky or uncertain long-term investment, such international expansion. In this case managers tend to avoid any commitment like that in order to secure their jobs and maximize their paycheck. Indeed, the majority of managers are evaluated monthly or quarterly, therefore, long-term risks may diminish their performance evaluation. In order for these issues to be solved and long-term uncertain projects promoted, two governance functions should be realized: provision of additional information and resources to managers and supervision (Lynall et. al., 2003).

Extant research argues that these two functions are implemented by the board of directors (Hillman & Dalziel, 2003). Board of directors is called on to supervise managers and ensure that they act on behalf of shareholders maximizing company’s value and not their own salary (Zahra & Pearce, 1989). These two functions are attributed to two different, but most common theories in governance research: agency theory and RDT. While agency theory primarily concerns with separation between ownership and control, and the need to align the two (Fama & Jensen, 1983; Eisenhardt, 1989), RDT primarily focuses on the board capital as a resource for company’s management (Lynall et. al., 2003; Dalziel et. al., 2011).

2.2.3 RDT Perspective. Board size and multiple directorships

According to RDT, companies depend on external environment since they need to constantly obtain sufficient resources from latter for its successful operation. The seminal work by Pfeffer & Salancik (1978) claims that board of directors can minimize company’s dependency through directors’ connections. As a result, RDT researchers see the board of directors as a source of resources, connections, and information for company. Researchers found out that the board of directors is a reflection of company’s external needs (Hillman et. al., 2009). External
needs may be different depending on the nature of company’s operations. For example, the presence of directors that have connections with bank sector grants better access to finance, directors may possess strong environmental ties that may improve company’s legitimacy, etc (Dalziel et. al., 2011). Therefore, according to RDT, board of directors implements four crucial functions: provision of advice to managers, access to environmental information, access to resources, and improving legitimacy (Hillman et. al., 2009; Dalziel et. al., 2011). Therefore, board of directors may potentially minimize managers’ uncertainty.

2.2.4 Board size

RDT researchers claim that the provision of vital resources and information are the most important function of the board. Therefore, the more connections the board of directors has, the greater company’s benefit due to the larger number of connections (Hillman et. al., 2009). Most importantly, companies tend to increase the boards if they experience environmental uncertainty (Certo et. al., 2006). Since uncertainty is one of the key issues in company’s internationalization, board size should be able to mitigate it through acquiring additional knowledge. Such uncertainty reduction is possible if company brings a director(s) with a certain expertise or background (de Villiers et. al., 2011). This claim received empirical support by Sanders & Carpenter (1998) who found out the board size is positively associated with company’s internationalization. As a result, RDT claims that board size should be positively associated with performance and internationalization of the company (Certo et. al., 2006; Sanders & Carpenter, 1998).

Although additional directors bring more knowledge and capabilities to the company, extant research demonstrated that large boards may be a disadvantage to the company. On the one hand, as discussed above, larger boards are the most beneficial from resource-point of view. On the other hand, large boards may become inefficient due to the group dynamics. Jensen
(1993) argued that boards of seven or eight directors would be the most efficient. First, as group size increases, individual effort from each of the directors may decrease (Kidwel & Bennett, 1993). Second, large boards may experience difficulties with information flow. If information flow is limited within the board, than management may attempt to manipulate the board and diminish its supervision abilities (Jensen, 1993). Third, it is more difficult for larger board to reach consensus. As a result of different backgrounds, group size, and complication task, board may experience group conflict (Zahra et al., 2000). Such conflicts jeopardize company’s ability to respond quickly to market conditions and agree on strategic decision (such as internationalization) (Dalton et al., 1999).

Summarizing all arguments above, we claim that company does need to bring additional directors as it faces significant uncertainty or resource scarcity. In particular, bringing additional directors that are knowledgeable or experienced with international expansion or country of interest may increase company’s internationalization and its performance. However, company may experience problems if it continuously increases its board of directors.

The internationalization of franchising is associated not only with higher degree of environmental uncertainty due to the market differences, but also with more complicated monitoring and communication of franchisees. On the one hand, market differences require company to adapt its offering in order to succeed in the foreign market place. Adaptation of franchising companies usually involves deviation from existing franchising practices. As a result, such deviations may potentially allow franchisees to behave opportunistically. Therefore, franchisor is required to have enough information and resources to understand the foreign market, control its franchisees, and to have an efficient information flow within the company in order to react on market changes and adaptations in a timely manner. Following the arguments
above, large boards provide additional resources, connection, and information, but they also become inefficient in its decision-making. Therefore, company should have large enough board to have sufficient amount of resources and small enough to be efficient and react in a timely manner. In other words:

**H1:** *Board size is associated with proportion of international franchised outlets in a form of inverted-U relationship.*

### 2.2.5 Multiple Directorships

The major trait of director, according to RDT, is his/her external connection. Every director is evaluated in terms of connections, knowledge, resources, and board experience (Hillman et. al., 2009). Directors that possess the most of benefits are considered resource-rich directors (Hillman et. al., 2009; Arthurs et al., 2009). Naturally, presence of resource-rich directors on the board grants company access to director's connections. According to RDT, resource-rich directors are the most valuable and should be brought to the board. One of the most obvious type of connections is multiple directorships, e.g. when director also serves as a director in other company(ies) (de Villiers et. al., 2011). If director serves on several boards, s/he brings experience from one company to another. As a result, there are chances that director will bring desired experience and knowledge to the company. According to RDT, the greater number of multiple directorships is strongly desired because of the multiple connections provided by a single director.

However, similarly to the board itself, researchers have demonstrated that large number of external connections may be detrimental to the company. On the one hand, the greater number of connections is desired and was shown to positively affect performance (Hillman et. al., 2009; Horwitz & Horwitz, 2007). On the other hand, as the workload of director increases, his/her
output per company may decrease. In addition, greater number of connections create a greater exposure of company across several other companies, which in turn may create negative information spillover effect.

Therefore, we claim that multiple directorship is desired for maximizing company’s exposure to environmental knowledge and resources. Such exposure is crucial in franchising since it allows franchisor to monitor market changes and franchisees’ activities. It may also bring additional efficiency to the franchising system if director has connections with the other franchising companies. However, multiple directorships is desired up to a point until it does not decrease the director’s input and effort in company’s board. It is important in service industries to react fast on changing consumer demands or market trends in order to satisfy the customer and prevent any opportunistic behaviors by franchisees. As a result, there is a trade-off between the number of connections directors have and amount of input directors provide to the given company. While additional connections a highly desired stay up to date with the market trends and franchisees activity, it is also important that the director may provide efficient supervising and input to the company.

H2: Multiple directorships are associated with proportion of international franchised outlets in a form inverted-U relationship.

2.2.6 Agency Perspective. Board Independence

The second mission of the board of directors is supervising managers to ensure that they maximize the long-term company value instead of short-term efficiency (Zahra & Pearce, 1989). Long-term company value is maximized through company’s growth, innovativeness, internationalization, and other long-term uncertain commitments (Zahra & Pearce, 1989; Zahra, 1996). Managers may hesitant to undertake these long-term projects since their own evaluation
may decrease, and they may lose their job as a result (Fama & Jensen, 1983). In order to monitor managers efficiently, directors should objectively evaluate the task and managers’ decision. Extant research demonstrated that the most objective and efficient evaluation is performed when directors are independent (Zahra & Pearce, 1989; García-Meca & Sánchez-Ballesta, 2010). Directors are classified as independent if they do not have any personal interest/dependency in the company, such as employment, personal investment, employed relatives, significant ownership (Johnson et. al., 1996). If director is independent, then s/he can more objectively evaluate the situation and will not be heavily influenced by managers (Jensen, 1993; Peng, 2004). Moreover, Zahra (2000) claimed that independent directors are more motivated to supervise managers.

When uncertain and long-term commitment is presented, managers tend to avoid it due to the uncertain outcome, which may decrease their personal performance (Zahra, 1996; Zahra et. al., 2000; Arthurs et al., 2009). Considering previous arguments, directors may diminish managers’ uncertainty by providing advice, knowledge, connections, and resources to the company. Therefore, managers’ only issue left is the duration of the project: long-term projects do not contribute to performance in the short-run, but require initial investments (Zahra, 1996). Therefore, directors should persuade managers to commit, e.g. directors should not be influenced by managers. Considering lack of personal interests of independent directors (Zahra & Pearce, 1989), more independent boards should be more objective and aimed on maximizing long-term company value.

The decision to expand internationally in franchising requires franchisor to commit to long-term expenses for international advertising for its franchisees and to trust and control international franchisees, e.g. be willing to lose a certain portion of control over the company.
The managers and decision-makers that are short-term oriented or characterized with uncertainty avoidance will be unwilling to commit to such conditions. In this case the supervision and advisory functions of the board of directors should play a crucial role in company’s decision-making. The board independence was shown to be positively associated with objectivity of decision-making and efficient supervising. Therefore, the higher board independence should be able to stimulate higher internationalization of franchising systems.

**H3: Board independence positively moderates the association between board size and proportion of international franchised outlets.**

**H4: Board independence positively moderates the association between multiple directorships and proportion of international franchised outlets.**

2.3 Methodology

2.3.1 Data

The hypotheses were tested on the longitudinal data that consists of US public franchisors. Franchising Handbooks of 2004 and 2014 was utilized to find all public franchising companies that operate in the US. Further, private portfolio holder companies that operate one or multiple franchising brands were excluded due to the lack of publicly available information. Only public companies of US origin were selected in order to obtain homogeneous sample that provides sufficient amount of information annually. The NAICS codes were collected in order to find non-franchising companies that compete with franchising ones in the given industry. The resulting sample frame was used to find information on publicly available sources such as SEC website. The resulting sample is a panel that consists of 158 companies that operate in 27 industries defined by NAICS code providing N=4221. Due to mergers and acquisitions,
company fails, and introduction of new brands, the resulting data set is unbalanced panel. Several sources of information were combined in order to obtain the data on franchising systems and company governance structure. COMPUSTAT and annual (and quarter) reports were used to obtain the information on franchising systems and companies’ performance. The information on governance structure was obtained from proxy statements and EXECUCOMP. The sources or the data were previously utilized by multiple researchers and showed its credibility (Kretinin et. al., 2014; Dalziel et. al., 2011).

2.3.2 Dependent Variables

Proportion of international franchised outlets (Int’l Franchising) – this variable serves as a degree of internationalization of franchising. It is calculated as follows:

\[
\text{Int’lFranchising} = \frac{\sum_{i=1}^{n} \text{Number of franchised outlets in international country}}{\text{Total Number of Outlets}}
\]

Where \(n\) is number of countries other than US, in which franchisor has its presence. The variable is continuous in nature, and can take values from 0 to 1. The calculation inputs for this variable are reported either annually or quarterly in company’s reports (Hsu & Jang, 2009).

2.3.3 Independent Variables

Board size – this variable measures the size of the board of directors of the given company in a given year (Zahra et. al., 2000). It equals to the number of directors that serve on the board. This variable is reported annually on company’s proxy statements (Dalziel et. al., 2011).

Multiple directorships – this variable represents the number of other boards where directors serve in addition to the given franchise company. It is calculated as an average of number of other boards for every director of the company (Wincent et. al., 2010). This variable is obtained from biography section of company’s proxy statements.
Board independence (Independence) – this variable represents the degree to which the board consists of independent directors (Johnson et. al., 1993). It is calculated as a ratio of number of independent directors to the board size. According to the US legislature, CES requires board independence to be greater than 50% (Zahra & Pearce, 1989).

2.3.3 Control Variables

Company-owned outlets (CO Outlets) – this variable represents the total number of outlets owned by franchisor, e.g. not franchised. It is frequently utilized by franchise researchers as a proxy for company’s size and market experience (Dant et. al., 1997; Jindal, 2011).

Royalty Rate (Royalty) – this variable indicates the percentage of revenue that franchisee must pay to franchisor monthly or weekly for using franchisor’s brand and receiving advertising and promotion assistance (Kaufmann & Dant, 2002). This variable was shown to have an impact on franchisor’s attractiveness through signaling theory (Dant & Kaufmann, 2003). Since our dependent variable in this study is a proportion of franchised units, we should control for franchisor’s attractiveness.

Franchisor’s Experience (Experience) – this variable represents the experience that franchisor has with franchising. It is calculated as amount of time since franchisor started franchising (Sorenson & Sørensen, 2001). This variable is utilized as a proxy for knowledge, experience, and efficiency that franchisor possess with respect to franchising practices (Sorenson & Sørensen, 2001).

Organizational Tenure (Tenure) – this variable represents the average amount of time that directors served on the board. Extant research claimed that as tenure increases, directors become more knowledgeable with respect to company’s procedure and communicate more efficiently and effectively (Wincent et. al., 2009).
2.3.4 Statistical Analysis

The descriptive analysis of the data identified no issues with correlation or normality of the data. Descriptive statistics can be found in table 4.

---------- Insert Table 4 about here ----------

We have performed a linear regression with panel correct that standard errors and control for heterogeneity (Greene, 2012). We can used five models to test our hypothesis. The control model was created as a base for comparison for our main effects and interaction models. Model one was utilized to test hypothesis one that states that board size has a negative curvilinear relationship with the proportion of international franchised outlets. The model estimated the coefficient of squared board size as negative and significant, thus providing the support for hypothesis one ($\beta=-0.24$, $p<0.05$). Model two was utilized to test hypothesis three that claims that the nonlinear effect of board size strengthen as board independence increases. Model two estimated the interaction term as insignificant, thus rejecting hypothesis three ($p>0.1$). Model three was used to estimate the effect of multiple directorships on the proportion of international franchised outlets. The main linear effect is negative and highly significant ($\beta=-0.2$, $p<0.01$), while square term is estimated as positive and highly significant ($\beta=0.1$, $p<0.01$). Therefore, we have obtained the opposite effect for hypothesis two. Model four was utilized to estimate the effect of multiple directorships contingent on board independence on the proportion of international franchised outlets. Model four estimated the interaction term as positive and highly significant ($\beta=0.08$, $p<0.01$). Therefore, we have obtained the support for hypothesis four.
2.3.5 Post hoc analysis

A close examination of models three and four reveals that the negative linear effect of multiple directorships has higher value than its positive square term. Therefore, the total effect may not look like U-shaped. We have constructed the square root term of multiple directorships and tested its effect on the proportion of international franchised outlets. The post hoc model indicated that the main effect square root term is negative and highly significant ($\beta=-0.06$, $p<0.01$). Moreover, the interaction of square root term and board independence is also negative and highly significant ($\beta=-0.14$, $p<0.01$). The model fit is similar to the one with squared term, which indicates that the total effect of multiple directorships has a form of diminishing returns.

2.4 Contributions and limitations

This paper undertakes unique approach to understanding the antecedents of internationalization of franchising. We have supplied the commonly used agency theory with resource dependence theory to explain how franchisor can minimize uncertainty. Following the governance literature, we demonstrated that franchisor may get additional resources and information that would help to minimize the uncertainty associated with international expansion from its board of directors. We have found support for hypothesized main effects of the board size and multiple directorships. They suggest that franchisor may increase its board size and supply additional connections through the multiple directorships and, as a result, increase its international expansion via franchising. However, consistently with extant governance research, we have found the diminishing returns of overloaded directors and large boards (hypotheses one
and three). The combination of agency theory and research dependence theory helps us to uncover the company level antecedents of internationalization expansion of franchising systems. We have also shown that the board structure positively impacts the internationalization of franchising system (hypothesis four). However, we have not found the interaction between the board size and the board independence. We believe that the insignificant effect of this interaction can be accounted to problematic communication and damaged group dynamics of the large boards. Once boards become too large, the decision-making becomes very inefficient due to the group dynamics. Board independence will not resolve this issue because independent directors come from different origins, which makes communication even more difficult.

This paper provides some interesting insights to the practitioners. First of all, we demonstrate the nonlinear effects of board size and multiple directorships. It may be intuitive for company to keep increasing the number of directors as company faces additional uncertainty. However, our study demonstrates that such increases have diminishing returns and, potentially, a negative effect on companies’ internationalization. Therefore, it is important for practitioners to consider the marginal benefit of each additional director and her connections. The new members should be added only if he or she provides a significant amount of useful connections to the company, e.g., classified as resource reach director. Secondly, the large number of connections also has diminishing returns. Practitioners should keep in mind that directors may simply be overloaded with their multiple positions. Therefore, they will not be able to efficiently apply these connections to the company. Practitioners should consider not only the nominal count of connections, but also an actual input the director may provide to the company. It is especially important in the service industries where companies closely interact with customers.
and require to perform the fast and efficient adaptation to the constantly changing customer preferences and market characteristics.

We recognize that this paper has several limitations that have to be addressed by further research. First of all, this study is conducted on secondary data sources and public companies. Therefore, its results may not be fully generalized on private companies, which were shown to have different governance mechanisms (Dant et. al., 2008). Second, the sample for this study consists of US public franchisors. Following Elango (2007), our results may not be fully applied to franchisors with international origins, which were shown to have significant differences due to the cultural, economic, and political conditions in the country of origin.
ESSAY 3. CONNECTING FRANCHISOR’S GOVERNANCE TO COMPANY’S PERFORMANCE

3.1 Introduction

Franchising has demonstrated tremendous growth over the last decades. Franchising industries have not only saturated the US market and expanded internationally, but also showed the development of the franchising concept itself by creating new industries, such as education centers, new specialty restaurants, etc. Existing research has devoted substantial research to highlighting the effects of franchising on company’s profitability (Madanoglu et. al., 2011), survival (Shane & Foo, 1999), growth rates (Shane, 1998), and efficiency (Medal-Bartual et. al., 2012) utilizing company’s franchising structure as predictor variable. While many researchers found positive relationships between the proportion of franchised outlets and firms’ performance or growth in the home market (Mitsuhashi et. al., 2008; Madanoglu et. al., 2013), some researchers claimed that franchising structure of the company does not always provide constantly positive outcomes due to the opportunism, market turbulence and heterogeneity, or franchisees’ bargaining power (Kretinin et. al., 2014; Sorenson & Sørensen, 2001). Therefore, franchisors have to supervise their operations to ensure high levels of efficiency. Company may possibly make changes to its franchising structure or practices to respond to market turbulence or continuously changing customer preferences. The need for constant supervision of company’s operations is more pressing when company operates internationally. The differences among the countries’ environments create even more severe issues for companies, forcing them to adapt almost immediately (Ghemawat, 2007). The question than arises: why some companies are more efficient than others? In case of franchising, supervising operations may be problematic for franchisor because franchisees are assigned to run outlets. Franchisor has to supervise not only
market environment with its competitors and customer preferences, but also franchisees in order to prevent any opportunistic behavior (Perryman & Combs, 2012; Oxenfeldt & Kelly, 1969).

This paper is called on explaining the antecedents of franchisors’ efficiency in its operations. We build my arguments on upper echelon theory and claim that the franchisor’s performance will depend on characteristics of its governance. In particular, we claimed that the governance structure should be renewed in order to minimize inertia and maximize performance.

All strategic decisions are made on corporate level (Zahra & Pearce, 1989). Moreover, top management and governance are also responsible for supervising the execution of their strategy and making adjustments based on market conditions (Hillman & Dalziel, 2003). The role of governance as an antecedent of company’s franchise structure and internationalization was highlighted by researchers before (Sanders & Carpenter, 1998). After strategy is defined, corporate governance should implement its second function – supervision of the implementation of their strategy (Fama & Jensen, 1983; Johnson et. al., 1993). Extant research on governance demonstrated how characteristics of the board of directors impact its ability of effective and objective monitoring (Johnson et. al., 1993; Hillman & Dalziel, 2003). In particular, organizational tenure positively impacts directors’ ability to monitor company’s operations and maintain status quo (Hambrick et. al., 1993). Upper echelon theory suggests that corporate governance represents a human capital accumulated in the board. In other words, board of directors is viewed as a combination of knowledge and skills of its directors (Hambrick & Mason, 1984; Hambrick et. al., 1993; Arthurs et al., 2009). Once company acquired new directors, the new knowledge, ideas, and initiative may be brought into the organization. Since newcomers do not have any personal attachment or investment in the company, they should not resist changes in the corporate franchising strategy. However, once they spend significant
amount of time and efforts in the company, they become more attached to its existing practices and tend to neglect the outside knowledge (Keh et. al., 2007). Instead they specialize and focus on the practices and information that flows within the company. Service industries, which are characterized by close interactions with the customer and simultaneous production and consumption of services, tend to demonstrate rapid changes in customer preferences, especially on the international arena (Vargo & Lusch, 2004; Sorenson & Sørensen, 2001). Moreover, franchisors should monitor and be knowledgeable not only regarding the market trends, but also regarding its franchisees’ activities. Monitoring franchisees is crucial part of the franchising business model since it prevents franchisees from behaving opportunistically. As a result, it is important to make sure that decision-makers pay significant attention to the market tendencies in order to be able to respond to them by fast and efficient adaptation. If adaptation is late or inefficient, franchisors risk to lose their customers. Therefore, companies should prevent its governance from developing inertia by either bringing new people or limiting organizational tenure. In this paper we demonstrate that organizational tenure has a negative car really near relationship with the franchisor’s performance in the form of inverted U-shaped.

The paper is organized as follows. First, we describe existing research on franchisor’s performance. Second, we explain how corporate governance is related to company’s performance highlighting the importance of its supervising function. Third, we describe methodology utilized for hypotheses testing and discuss the results. Finally, we draw conclusion from the study, discuss theoretical contributions, provide practical suggestions, and address the limitations of the paper.
3.2 Literature review and hypotheses development

3.2.1 Overview of franchisor’s performance

Franchisor’s performance comes from company-owned and franchised outlets. Company-owned outlets operated by franchisors expose the company to market knowledge (Sorenson & Sørensen, 2001; Oxenfeldt & Kelly, 1969). Operation of company-owned outlets requires extensive monitoring from franchisor due to potential employees’ shirking (Perryman & Combs, 2012) and market turbulence (Sorenson & Sørensen, 2001). Although franchisor spends its own resources on opening and operating the location, it enjoys claiming full revenue from it. Therefore, operating company-owned outlet provides franchisor with valuable experience, resources, and a benchmark of comparison for franchised locations. On the other hand, company-owned outlets expose franchisor to risks associated with changes in the marketplace. When economy or consumer preferences change, franchisor has to react as soon as possible. However, Perryman & Combs (2012) demonstrated that managers in company-owned locations may not motivated to react on market changes efficiently. As a result, performance of company-owned location heavily depends on franchisors monitoring, which may be costly (Sorenson & Sørensen, 2001; Combs & Ketchen, 2003). The second expansion option, franchised outlets, provides franchisor with less risky alternative. All start-up costs are transferred to franchisees, which are also responsible for all operating expenses. However, franchisor receives only one-time upfront franchise fee and ongoing royalties, which are about 5% of outlet sales (Kaufmann & Dant, 2002). Existing research claimed that the fastest way of expansion can be achieved through franchising (Mitsuhashi et. al., 2008; Perryman & Combs, 2012). Moreover, utilization of franchising also provides high chances for system survival (Shane & Foo, 1999; Bates, 1998). Even though franchising outlets limit franchisor’s market learning, it brings the experience and
market knowledge of franchisees, which was shown to be extensive (Perryman & Combs, 2012; Kretinin et. al., 2014). Franchising was also shown to be a very efficient and effective way of international expansion. Franchisees, which are local to international market, provides valuable knowledge to franchisor and help to overcome some environmental obstacles, such as administrative bureaucracies (Kretinin et. al., 2014). In additional to knowledge, international franchisees also bring their resources for opening and operating international outlets, while franchisor is responsible only for nation-level advertising and promotional campaigns (Dant et. al., 2011). Existing literature and industry evidence demonstrate that franchising is a dominant way of international expansion for service industries. Therefore, we expect that it will also provide additional and positive impact on franchisor’s performance:

*H1: Proportion of franchised outlets is positively associated with franchisor’s performance.*

**3.2.2 Need for monitoring and improvements in franchising system**

Although existing research argues for franchising as a means of company’s fast growth and good survival rates, it also acknowledges that franchising has several issues that must be constantly addressed by franchisor. The first issue is franchisees’ opportunism. Franchisees operate on behalf of franchisor as self-motivated agents, who invested personal funds into their outlets (Barthélemy, 2008). As a result, they may tend to behave opportunistically to pay off their investments. For example, franchisee may cutoff employee’s training expenses or food quality to maximize its own profitability. Such opportunism will maximize the performance of a single franchised location, e.g. franchisee, at expense of franchisor’s image (Oxenfeldt & Kelly, 1969). In order to prevent franchisees’ opportunism, franchisor has to monitor its franchisees. Monitoring may be very costly, if franchisees operate in the distant markets (Perryman &
Combs, 2012; Kalnins et. al., 2006). Moreover, effective monitoring requires not only funds, but also sufficient market knowledge to objectively evaluate franchisees’ performance. Existing research demonstrate that franchisors may become more efficient in monitoring with time since they learn about monitoring techniques and logistics management (Perrigot et. al., 2013). Second issue is potential bargaining power that franchisee may obtain (Kretinin et. al., 2014). If franchisees possess and utilize their bargaining power, franchisor may potentially lose control over the franchisees, which may cause performance decline. Since bargaining power reflects the lack of franchisor’s control, this issue may be resolved through franchise contract. Existing research shows that franchisees become more efficient in creating franchise contracts as they age and become more experienced (Perrigot et. al., 2013; Jindal, 2011). Therefore, establishing franchising system is not enough for efficient operation of this system, continuous improvements in monitoring procedures and revisions of franchise contract are necessary. Moreover, franchising strategy may also be changed by manipulating the proportion of franchised outlets, and thus varying franchisor’s exposure to the market knowledge. All these decisions are discussed and made on the top corporate level of the company. Therefore, the board of directors should have an impact on franchising performance by supervising the performance of franchising system.

3.2.3 The Impact of Organizational Tenure on Company’s Performance

Company’s governance plays a crucial role in company’s decision-making as an antecedent of company’s strategy (Zahra et. al., 2000). The corporate governance is responsible for defining company’s structure, which in case of franchising, is the proportion of franchised outlets and the degree of company’s internationalization (Simsek et. al., 2005). Once the strategy and structure are defined, their implementation takes place. Corporate governance’s
responsibility does not end on strategy definition. It also involves supervision of the company’s performance and initiate changes if company slips (Hillman, & Dalziel, 2003; Johnson et. al., 1993). Extant research has demonstrated the significant impact of board structure on the implementation of its supervising function, which is crucial for successful franchisor’s performance due to employees’ shirking, franchisees’ opportunism, and market turbulence as discussed earlier (Hillman & Dalziel, 2003; Johnson et. al., 1993; Kretinin et. al., 2014).

Organizational tenure represents the amount of time that directors were employed in the company. Amount of time that directors spend in the company significantly impacts directors’ attitudes and behavior (de Villiers et. al., 2011). The second major function of the board of directors is supervision of the managers and company’s operations (Lynall et. al., 2003). In the beginning of the employment, directors bring new information, ideas, and resources into the company. During assimilation period, they spread this information within the company providing additional knowledge to the company and its decision-makers (Johnson et. al., 1993; Bell et. al., 2011). The knowledge dissimilation becomes faster and more efficient once directors learn company’s culture, values, and communication processes. Therefore, in the beginning of their tenure, directors provide additional resources to the company and expand its knowledge (Simsek et. al., 2005; Finkelstein & Hambrick; 1990). New coming directors do not have any personal or emotional attachment to the company’s current strategy. As a result, s/he will be willing to deviate from existing company’s strategy in order to improve company’s performance (de Villiers et. al., 2011). Director’s willingness to adjust company’s performance is further strengthened by personal determination to establish oneself in the company and receive the advancement in the career ladder (Finkelstein & Hambrick; 1990).
As directors spend more time in the company, they learn company’s culture and improve communication with other decision-makers (Johnson et. al., 1993). As a result, directors become capable to communicate and supervise company’s actions faster and more efficiently (de Villiers et. al., 2011). Average-tenured directors possess complete knowledge about the company and its strategy, but tend not to develop strong commitment to bureaucratic procedures and status quo.

However, once directors or decision-makers spend significant amount of time, funds, and efforts to establish a certain product or company structure, they tend to develop a personal attachment to it. Because of this attachment decision-makers with high organizational tenure may be unwilling to change the strategy since they tend to perceive it as cannibalization. The lack of sufficient adaption slows down company’s growth and diminishes customer satisfaction. As a result, inefficient deviation from existing practices, e.g. adaptation, will quickly jeopardize service companies’ performance due to constantly changing market preferences. Subsequently, the failure to better adjust company’s offerings to customer needs will result in company’s performance to be on industry-average levels (Ghemawat, 2007; Finkelstein & Hambrick; 1990).

The impact of corporate governance on company’s performance was in focus of numerous studies. This research direction still didn’t reach consensus due to the very contradicting results. The studies that dealt with board structure demonstrated positive, negative, and non-linear relationships between the board structure and company’s performance. Similarly, researchers who tackled with the impact of boards’ leadership on performance found contradicting results. Several meta-analyses were conducted in order to uncover population parameters, but failed to support any the relationship due to the insignificance of results (Dalton et. al., 1999; Dalton et. al., 1998; Certo et. al., 2006; Horwitz & Horwitz, 2007). We acknowledge, however, that Certo and colleagues (2006) and Horwitz & Horwitz (2007) and
associates demonstrated in their meta-analyses that governance characteristics do not influence company’s performance directly. The major samples of governance research on organizational tenure came from high-tech, innovation companies with major focus on new product development performance and corporate entrepreneurship (Zahra et. al., 2000; Zahra, 1996). Company’s performance in high-tech industries is influenced by numerous factors, but the impact of governance itself is very minimal. Contrary, service industries are not characterized by high R&D expenditures, but rather by high investments in marketing research and monitoring/controlling expenses (Dant et. al., 2011; Vargo & Lusch, 2004). Service industries require close monitoring of market changes and fast and efficient adaptation to these changes. Therefore, the role of product development and adjustment is placed on company’s governance in service industries, rather than on R&D department. Therefore, we believe that the impact of governance characteristics in service industries, and in particular, franchising, should be considered directly. Considering aforementioned discussion, we claim the following:

\[ H2: \text{The mean organizational tenure has a curvilinear impact in a form of inverted U-shape on the company’s performance.} \]

3.2.4 Organizational Tenure and Franchising Performance

In franchising industries it is crucial to realize the importance of fast franchising expansion. Lots of companies were hesitant to give up the control of their company-owned outlets to franchisees (Perryman & Combs, 2012; Sorenson & Sørensen, 2001). As a result, those companies lost its competitive edge and market share to fast-growing competitors. Franchisors whose decision-making heavily depends on initial founder tend to exhibit such strategy (Durand
& Vargas, 2003). In this case, the new coming directors may bring new perspectives to the company and enable it to expand with franchising since they do not have any personal attachment to existing company-owned outlets. Expansion through franchising provides better growth strategy as discussed in Essays 1 and 2.

Turbulent service markets require franchisors require constant monitoring, learning, and willingness to deviate from its existing practices in order to successfully compete in this type of environment (Baena & Cervino, 2012; Perryman & Combs, 2012). Deviation from existing practices may involve alternating company’s offerings, changing franchise contracts, or change outlet ownership in order to minimize opportunistic behavior and maximize the performance. In order to perform such adaptations efficiently, company should always have access to the relevant information and efficient communication. If franchisor does not possess up-to-date market knowledge, information asymmetry between franchisor and franchisees increases. Extant research demonstrated that information asymmetry is the one of the most important factor that influences franchisees’ opportunistic behavior. As a result, failure to perform necessary adaptations increases the probability that franchisees may engage in opportunistic behavior.

Therefore, it is important for franchisor to create the inflow of new information to the company by limiting organizational tenure and bringing new people into its governance (Simsek et. al., 2005; Hambrick et. al., 1993). By doing it, franchisor will maximize the amount of new information available to the company and minimize emotional attachment to the existing practices, e.g. incumbent inertia. As a result, company will be able to effectively adapt its franchising strategy to the changing market environment. As claimed above, franchisor can achieve such capability if it keeps organizational tenure limited and its directors motivated to perform necessary changes.
H3: The nonlinear effect of mean organizational tenure formed as inverted U-shape negatively moderates the association between proportion of franchised outlets and franchisor’s performance.

---------- Insert Figure 8 about here ----------

3.3 Methodology

3.3.1 Data

The population of interest for this study consists of US public franchise companies. Franchising Handbooks of 2004 and 2014 was utilized to find all public franchising companies that operate in the US. Further, private portfolio holder companies that operate one or multiple franchising brands were excluded due to the lack of publicly available information. Only public companies of US origin were selected in order to obtain homogeneous sample that provides sufficient amount of information annually. The NAICS codes were collected in order to find non-franchising companies that compete with franchising ones in the given industry. The resulting sample frame was used to find information on publicly available sources such as SEC website. The resulting sample is a panel that consists of 158 companies that operate in 27 industries defined by NAICS code providing N=4221. Due to mergers and acquisitions, company fails, and introduction of new brands, the resulting data set is unbalanced panel. Several sources of information were combined in order to obtain the data on franchising systems and company governance structure. COMPUSTAT and annual (and quarter) reports were used to obtain the information on franchising systems and companies’ performance. The information on governance structure was obtained from proxy statements and EXECUCOMP. The sources or
the data were previously utilized by multiple researchers and showed its credibility (Kretinin et. al., 2014; Dalziel et. al., 2011).

### 3.3.2 Dependent variable

*Franchisor’s performance (Net Income)* – this variable represents the measure of franchisor’s performance, e.g. outcome of franchisor’s strategy (Kretinin et. al., 2014). The net income operational is ace and was chosen in order to account for costs and potential inefficiencies since net income is calculated by subtracting all the costs from company’s revenue. This paper claims that company’s governance monitors and adjusts company’s strategy to market conditions in order to maximize performance and company’s value. Therefore, we claim that more efficient franchisors will be able to extract more benefit from similar strategy than experienced ones.

### 3.3.3 Independent variables

*Proportion of franchised outlets (Franchising)* – this variable reflects the structure of franchise system by identifying the proportion of franchised outlets (Hsu & Jang, 2009). This measure is continuous, and can take value from 0 to 1. It is frequently utilized in franchising literature, and defines the structure of franchising system: 0 being fully company-owned, and 1 being fully franchised.

### 3.3.4 Moderators

*Mean organizational tenure (tenure)* – average tenure per board per year. This measure represents the average number of years that directors spent in this company (Wincent et. al., 2010)

\[
Tenure = \left( \sum_{k=0}^{n} Organizational \ Tenure \right) / n
\]

Where \( n \) is the number of directors on the board.
3.3.5 Control variables

*Board size* – shows the size of the company’s board of directors in a given year. It is operationalized as a number of directors (Johnson et. al., 1993). Board size serves as a proxy for board’s connections and decision-making (Arthurs et al., 2009; Certo et. al., 2006).

*Company-owned outlets (C-O outlets)* – this variable represents the number of company-owned outlets under franchisor’s control in the given time (Kretinin et. al., 2014). It serves as a control for franchisor’s size and exposure to market knowledge (Sørenson & Sørensen, 2001; Windsperger & Dant, 2006).

*Franchisor’s age (age)* – represents the age of the company. It is calculated as a number of years that franchisor operates in the market. It controls for franchisor’s size and knowledge of the market (Kretinin et. al., 2014).

*Royalty rate (royalty)* – this variable represents the percentage of revenues that franchisees pay to franchisor for utilizing its brand and receiving assistance with national advertising. This variable serves as a control for franchisor’s income and attractiveness (Kaufmann & Dant, 2002).

3.3.6 Analysis

Descriptive statistics for our variables can be found in table 6. Correlation analysis indicates no correlation higher than the 0.6 cutoff point.

---------- Insert Table 6 about here ----------

We performed the linear regression model with panel corrected standard errors and control for heterogeneity. The control model was used as a base for comparison for more sophisticated
models with main effects and interaction effects included. Model one was utilized to test hypothesis one. The estimation indicates positive and highly significant coefficient for impact of franchising system on company’s performance ($\beta=3.98$, $p<0.01$). We found the support for hypothesis one that states that the impact of franchising structure on franchisor’s performance is positive and significant. The introduction of this variable increases the model feed by 8%. Model 2 estimated that the squared term of organizational tenure is insignificant ($p>0.1$), thus, rejecting hypothesis 2. Model three was utilized to test the interaction effect of nonlinear squared tenure on franchise-performance relationship. The interaction term was estimated as negative and significant ($\beta=-24.97$, $p<0.05$). Therefore our estimation support our hypothesis 3.

3.4 Discussion

This paper builds on governance literature that claims that the board of directors impacts the company performance indirectly by supervising and adjusting company strategy to the rapidly changing market conditions. We expand the franchising literature by demonstrating how board of directors plays the crucial role in performance of franchising system. Extant research has demonstrated that franchising is a very efficient and convenient way of expansion for service industries. However, we demonstrate that the franchising system may not perform at its maximum if it’s not properly supervised and adjusted. We claim that franchisor needs to establish a continuous flow of new information and ideas to the company by changing its directors. We have demonstrated that directors provide marginal benefits to the company at the
beginning of their tenure. However, these benefits are decreasing with time because director starts to develop emotional attachment to the company and may not bring the new information, e.g. starts to develop income and inertia. After certain point of organizational tenure, directors may resist changing company’s offerings or neglect perform an adaptation to the market conditions, and thus, jeopardize the performance of franchising’s system. Note that we did not find the direct nonlinear effect of organizational tenure on performance, which is consistent with the meta-analyses that indicated that governance characteristics do not influence company’s performance directly, but rather impact its performance as moderators (Certo et. al., 2006; Horwitz & Horwitz, 2007).

This paper provides several significant contributions to the literature. First of all, it demonstrates that the impact of governance structure on company’s performance can be established as a moderating effect and theoretically ported by one of two major functions of the board of directors, e.g. supervision of company’s strategy. Secondly, we further broadening the set theoretical lenses that can be used to better understand the franchising phenomenon. By applying the governance literature and upper echelon theory in particular, we demonstrate the new perspective on franchising performance. We encourage further research to build on it and expand our understanding of franchising governance by zooming into the more detailed characteristics of franchising governance and its directors and executives.

This study also provides valuable suggestions to practitioners. We demonstrate how important it is for a company to keep the inflow of new information and new perspectives to the company and minimize incumbent inertia even in the industries which are not characterized by high R&D expenditures. Franchising companies should always maintain a close surveillance on the market conditions and be able to implement required adaptation on timely manner.
We recognize that despite our contributions this paper is limited to the US sample. Therefore our results may be unique for its cultural, economic, and political characteristics.

The further research should address this limitation by collecting and analyzing sample from different countries. Also, our sample is limited to the public companies. Extant research demonstrated that private family companies exhibit different behavior on the marketplace, thus limiting the generalizability of our results. Further research should address this issue by zooming into the primary firms and uncovering the unique specifications of the owners and unique governance structures.
References


Appendix A. Table 1. Summary of outlet type properties

Table 1. Summary of outlet type properties

<table>
<thead>
<tr>
<th></th>
<th>Company-Owned Outlets</th>
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<td>Franchisee</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>Franchisor</td>
<td>Franchisee</td>
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<td>Adaptation</td>
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<td>High</td>
</tr>
<tr>
<td>Outlet’s workers motivation</td>
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<td>High</td>
</tr>
<tr>
<td>Franchisor’s control</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Franchisor’s profit</td>
<td>Full</td>
<td>Royalty</td>
</tr>
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<td>Growth rates</td>
<td>Slow/Average</td>
<td>Fast</td>
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<td>Market value</td>
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### Appendix B. Table 2. Descriptive Statistics for Essay 1

Table 2. Descriptive Statistics for Essay 1

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<th>8</th>
<th>9</th>
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<td></td>
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<td></td>
<td></td>
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<tr>
<td>3</td>
<td>Age</td>
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<td></td>
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<td>4</td>
<td>Insiders</td>
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<td>0.23**</td>
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† *p*<0.10, *p*<0.05, **p*<0.01
### Appendix C. Table 3. Model Summary for Essay 1

#### Table 3. Model Summary for Essay 1

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*† p<0.10, * p<0.05, ** p<0.01
## Appendix D. Table 4. Descriptive Statistics for Essay 2

Table 4. Descriptive Statistics for Essay 2

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† *p*<0.10, ‡ *p*<0.05, ** *p*<0.01
### Appendix E. Table 5. Model Summary for Essay 2

Table 5. Model Summary for Essay 2

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Appendix F. Table 6. Descriptive Statistics for Essay 3

Table 6. Descriptive Statistics for Essay 3

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**Appendix G. Table 7. Model Summary for Essay 3**

Table 7. Model Summary for Essay 3

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Appendix H. Figure 1. Conceptual Framework of Essay 1

Figure 1. Conceptual Framework of Essay 1
Appendix I. Figure 2. Essay 1, Hypothesis 3 – Interaction
Appendix J. Figure 3. Essay 1, Hypothesis 4 – Interaction
Appendix K. Figure 4. Essay 1, PostHoc Interaction Estimation of Insiders’ Ownership
Appendix L. Figure 5. Essay 1, PostHoc Interaction Estimation of Institutional Ownership

The graph illustrates the relationship between the proportion of franchised outlets and institutional ownership, distinguishing between low and high independence levels. The y-axis represents the proportion of franchised outlets, ranging from 0 to 1.2. The x-axis indicates institutional ownership levels, categorized into low and high categories. The line with solid markers represents low independence, while the dotted line represents high independence. The graph shows a trend where the proportion of franchised outlets increases with higher institutional ownership, with a slight variation for low independence compared to high independence.
Appendix M. Figure 6. Conceptual Framework of Essay 2

Figure 6. Conceptual Framework of Essay 2

Board Size

Multiple Directorships

H1: \( \cap \)

H2: \( \cap \)

Proportion of International Franchised Outlets

H3: +

H4: +

Board Independence
Appendix N. Figure 7. Essay 2, Hypothesis 4 Interaction

![Graph showing the relationship between Proportion of International Franchised Outlets and Multiple Directorships, with lines indicating Low and High Independence.](image)
Appendix O. Figure 8. Conceptual Framework of Essay 3

Figure 3. Conceptual Framework of Essay 3

- Franchising System
  - H1: +
  - H3: +
- Organizational Tenure
  - H2: ∩
- Franchisor’s Performance
Appendix P. Figure 9. Essay 3, Hypothesis 3 Interaction

![Graph showing the interaction between Franchisor's Performance and Organizational Tenure for Low and High Franchising.]