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Why flexible franchises win in financial markets

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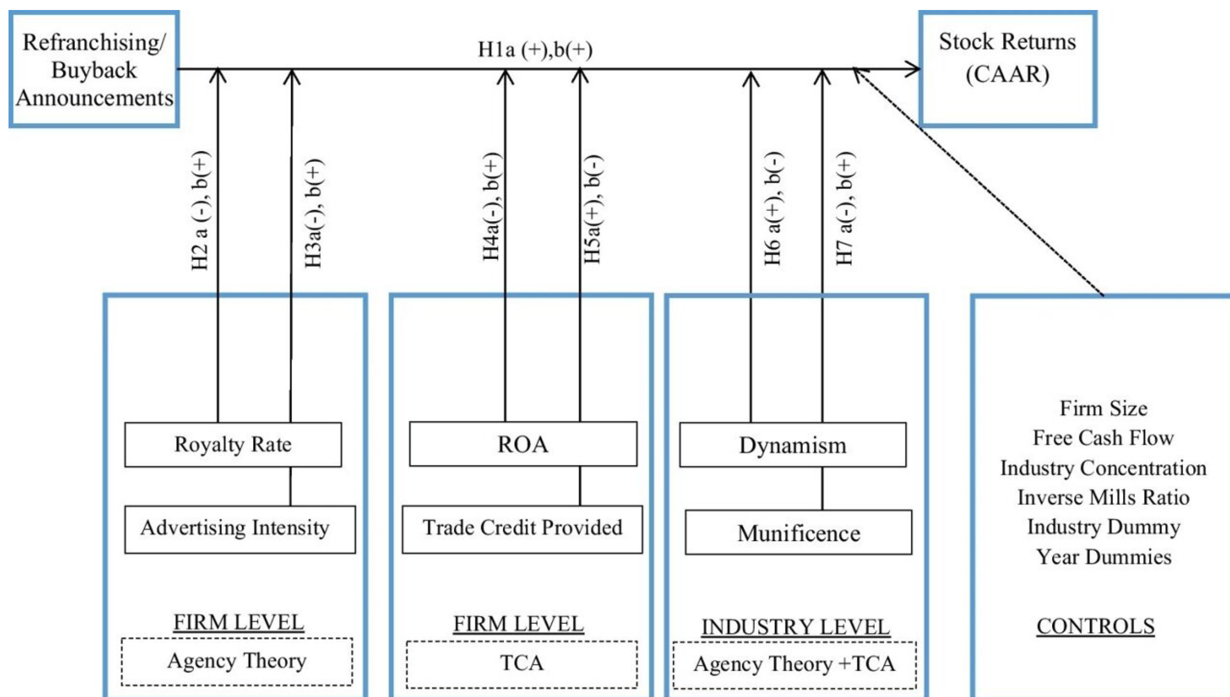

Theoretical framework. Credit: *Journal of the Academy of Marketing Science* (2023). DOI: 10.1007/s11747-022-00921-3

If you've stayed at a brand-name hotel or eaten at a fast food restaurant recently, it's more likely than not that you've supported a franchised company. Franchising is a distribution strategy where a larger company, the franchisor, licenses the rights to its brand, products, and procedures to a smaller establishment, the franchisee, in return for an initial fee and

ongoing share of sales revenues.

Behind the scenes, stores can change ownership from company-owned to franchised through a process called refranchising, and franchised stores can be put back into company hands through buybacks. Since the overall service rarely changes, consumers are usually unaware of franchising decisions.

In the first quarter of 2022, Papa John's refranchised 90 restaurants; other dining chains, such as Chili's and Texas Roadhouse, have recently been going the buyback route. In a recent paper for the *Journal of the Academy of Marketing Science*, George Mason University School of Business professor Saurabh Mishra is the first to connect refranchising and buyback decisions to stock market outcomes. (The paper was co-authored by Anna Sadonikova of Monmouth University and Manish Kacker of McMaster University.)

The paper analyzes refranchising and buybacks at publicly traded chains, and how financial markets responded to these relevant events. The analysis found that as a whole, the stock benefits of both were almost exactly equal. Refranchising and buybacks produced median share-price gains of $8 million and $8.1 million respectively on the day of announcement.

Summarizing his findings, Mishra said that "The unique thing about this paper is what we show is that for the stock market, it really doesn't matter whether you do one or the other… If the signal that the stock market is getting is that you are alert to your market conditions, and you are changing the distribution strategy….both these strategies can work out on their own so you can benefit."

Shareholder rewards were even greater for companies whose strategic choices matched their deal-making leverage with franchisees.

Corporations that could keep royalty payouts low and offer high levels of trust-building trade credit, got a bigger bump from refranchising. Those with higher royalty payouts and return-on-assets reflecting core business strengths received better-than-average rewards from buybacks.

Since there is no one right answer to the question of refranchising or buying back, it's important to look at the benefits and risks behind both methods.

While it's easy to see buybacks as slowing down growth to control risks, there are situations where a buyback can be just as beneficial to shareholders, sending the message that the company is working hard to manage their high-value brand.

"Buyback is essentially getting the channel into your own boundaries…So that has a positive effect provided the stock market views that as a sign that you thought that the risks are too much for refranchising for you to trust your franchisers," Mishra explained. In some cases, the increased monetary risks from buying back can pay themselves off through an increased market value. "When industries are growing really fast, buying back is actually even better," said Mishra.

Mishra's research tells us that the processes of refranchising and buybacks are not a one-way street, but instead tools of management a franchised business can use to maximize growth and shareholder value. A company gains value not by committing to one process, but finding a healthy mix of refranchising and buybacks.

"You need to keep balancing that mix based on changing market conditions and based on your own market conditions," Mishra said. "If you do that, it shows that you're agile, your distribution strategy is agile and the stock market rewards you for that."

Speaking on the benefits of franchising more generally, Mishra explained that "You can essentially spread your risks a little bit with your partners." Spreading the risk can allow a company to grow faster than if they were to keep their operations in-house. This is part of why you can find a McDonalds on nearly every highway exit. Franchisees can also provide knowledge of local markets, which will allow the individual store to fare better than if the parent company were to manage it.

There is, however, an important drawback to franchising. "In some ways when you franchise you are giving your brand and other marketing assets away to somebody who can….give a bad experience to customers," Mishra explained. "This can hurt your image and that's a big asset for you."

In short, while franchising a business decreases the risk of profit loss, it opens up a larger risk of devaluing a company's brand. To reduce the potential risks of franchising, companies should pay close attention to their distribution strategies and stay on top of changes in the market.

More information: Anna Sadovnikova et al, Franchising structure changes and shareholder value: Evidence from store buybacks and refranchising, *Journal of the Academy of Marketing Science* (2023). DOI: 10.1007/s11747-022-00921-3

Provided by George Mason University

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