The UNIVERSITY of VERMONT

Benjamin Fenster
BSAD-150 (Noordewier)
17 December 2004

Franchising and Vertical Integration

I. Wholesalers and Manufacturers
    a. Expectations from Manufacturer
        i. Market coverage
        ii. Sales contact
        iii. Hold inventory
        iv. Process orders
        v. Have market information
        vi. Customer support
    b. Expectations from Retailer
        i. Product Availability
        ii. Provide assortment of merchandise ("Break Bulk")
        iii. Credit and Finance
        iv. Customer Service
        v. Advice and Technical Support
    c. Result
        i. Lots of pressure on wholesalers
        ii. Wholesalers used to be the selling arm of the manufacturer
        iii. Now with huge retailers (Home Depot, Wal-Mart) individual retailers have much more power – easier to work directly with the manufacturer.
    d. Break-up of Firm
        i. Excellent question of boundaries
        ii. What duties are in-house; what's outsourced?
        iii. Publishers supposedly have editing, printing, graphics
        iv. Really many publishers just decide what books to finance and then outsource everything else. Odd breakup of boundaries?

II. Franchising Terminology
    a. "Franchising" used in several ways
    b. Product / trade name franchising.
        i. Just authorizing resellers to use the brand name.
        ii. Franchisor: Licenses it out
        iii. Franchisee: Uses it
    c. Business Format Franchising
        i. Entire business format is licensed
        ii. Firm carries no competing products (usually)
        iii. Based on a huge contract spelling out the rights and duties of both parties.

III. Vertical Integration
    a. Possible Benefits
        i. Reduce / eliminate transaction costs (avoid negotiation, contract costs)
        ii. Specialized Investments protected from opportunism
            1. Could easily have separate oil fields, pipelines, refineries, etc cetera that worked together via contract.
            2. In reality don't have that.
            3. Specialized assets that aren't easily applied to other uses grant power to the owners. Pipeline owner would be able to choke off the entire supply or even renegotiate the contract for more money.
        iii. Better Monitoring (of trends)
            1. Clothing manufacturer could open a retail store just to watch trends
            2. Could also integrate upwards to tap into new technologies
        iv. Assure supply chain when it may otherwise be threatened
    b. Possible Costs
        i. Consumes capital
            1. Working with independent firms uses their capital.
            2. With vertical integration you need your own capital for everything

        ii. Reduces flexibility to change partners
        iii. Balance Problems
            1. The scale that was efficient for a manufacturer you buy may turn out to be more than you really need (more than you can absorb).
            2. Whether this matters depends on why you're thinking about vertical integration. If for cost this doesn't seem promising.
        iv. Managerial span of control is greater (hence worse).

IV. Why Franchise?
    a. Some say it's a way to build capital quickly
        i. As franchisee, want greater return on capital (since investing in only one outlet)
        ii. Franchisor thus gets *less* capital than from selling stock
        iii. Better to create portfolio of shares
    b. Monitoring distant outlets is hard
        i. If all stores are company-owned, monitoring them all becomes harder
        ii. With franchising, give ownership to local operators so they have incentive to perform well. Puts good monitoring right there at the local level.
    c. What's in it for the Franchisor?
        i. Initial fee, royalty fee
        ii. Rental, lease, management fee
        iii. Et cetera
    d. What's in it for the franchisee?
        i. Market Survey + Site Selection
        ii. Facility design (by suggestion or by contract)
        iii. Advice on lease negotiation
        iv. Financing Advice
        v. Operating manuals, training programs
        vi. Field supervision (good, since weeds out bad apples – supports perception of quality). This isn't something smart franchisees resent; they appreciate it.
        vii. Et cetera
    e. Who does what?
        i. Driven by economies of scale
        ii. Franchisees do things that get costly on a large scale
        iii. Franchisors do things for which there are economies of scale
        iv. Contracts
            1. Franchisors put into the contract all the legal protections they want
            2. Franchisees at something of a disadvantage
        v. Franchisor's Perspective
            1. Possess valuable trademark
            2. Also possess assets like trade secrets, …
            3. Potential for franchisee opportunism
                a. Lax McDonald's owner somewhere doesn't try quite so hard to keep things clean – reaps the benefits of having a giant McDonald's sign but actually detracts from brand equity
                b. Threat of termination helps govern this
                c. Less need to audit.
        vi. In reality, everybody really does want the system to work – everybody prospers!
        vii. Franchisees and Franchisors can both be opportunities, but are both usually shooting for a well-oiled machine.