The diffusion of innovation in franchising: managing the exploration and exploitation paradox

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ABSTRACT: The need to balance standardization with innovation has been identified in franchising networks as the paradox of exploitation and exploration. Literature suggests that the Plural Form, i.e. the simultaneous presence of company-owned and franchised outlets, might be a useful and appealing way of dealing with this paradox. This paper poses that there are yet alternative ways of dealing with difficulties associated with innovation diffusion, while keeping standardization in the network. This paper seeks to identify those means by analysing two contrasting Portuguese franchising companies. The results show that by sidestepping the classic top-down relationship and exerting a participative leadership, the franchisor might motivate franchisees to be more willing to adopt innovations.

Keywords: Case Study, Franchising, Innovation, Plural Form, Standardisation

1. INTRODUCTION

Franchising is usually depicted in the literature as a growth strategy adopted by companies that own a brand which assures customers that the product or service on sale meets a certain set of specific - many times idiosyncratic - features and, in particular, a known standard of quality. This brand is usually considered to be an 'identifiable brand name'. Aspects of image, value, quality, or uniformity are central in the franchising literature. According to Brickley and Dark (1987: 403), "companies involved in franchising generally have identifiable brand names that help to assure the customer of uniform product quality". Norton (1988: 203) defines 'brand name capital' as "specific assets acquired by a firm that signal that its selling prices are justified by their quality level and that provide information value to consumers." The author gives as examples the Holiday Inn logo and the yellow arches of McDonald's. Minkler and Park (1994: 411) consider the marketing and advertising campaigns like "methods available to franchisors to increase investments in brandname capital". Norton (1988: 211) suggests that "some of the more successful franchise systems are known for the unusual strength of their brand names and their advertising and promotional expenditures". Lafontaine (1992: 273) states that the franchisor "provides a trade name and sees to it that its value is preserved or enhanced".

The importance of standardization as a central feature in and for franchising is well established (e.g. Streed and Cliquet, 2010; Blair and Lafontaine, 2011; Pardo-del-Val *et al*., 2014). Standardization can here be seen as an organized set of policies and practices aimed at inspiring

a sense of 'sameness' across each franchise site. Customers' trust and confidence in brandnames result here from the confirmation of expectations, i.e. that the defining characteristics of products or services are stable across sites.
However, there are a few problems arising from this need for uniformity. One of such problems is the urge to balance standardization with innovation, which some authors identify as the paradox of exploitation and exploration (e.g. Croonen, 2003). Literature suggests that the Plural Form – the simultaneous presence of company-owned and franchised outlets – might be a way of dealing with this paradox. This paper addresses and explores alternative ways of dealing with the difficulty of diffusing innovations while keeping standardization in the network.

2. STANDARDISATION AND INNOVATION IN FRANCHISING

2.1. The importance of standardisation

Franchising emerges and strives as a corporate strategy for growth in different economies, markets, and activities. The importance it has reached as an engine for economic activity and wealth creation worldwide have led to its study in several fields of the scientific literature and, therefore, to different views about this phenomenon. Franchising has therefore been studied from a myriad of perspectives viz. economic, sociological and management. Regardless of the perspective, the importance of standardization in franchising is well established.

According to Streed and Cliquet (2010: 206) "the rationale behind standardization is the ability to protect the brand integrity, to realize economies of scale by implementing turn-key systems, and to provide a consistent experience to the consumer". In fact, the uniformity of the network's image and the standardization of the goods and/or services provided are central features in franchising. And yet, while image can be seen as a central and defining characteristic of uniformity in the goods and/or services provided, the sense of 'sameness' customers may find across sites is also ensured via more intangible yet structural elements, viz. policies, practices, procedures, routines, prices and even discourses adopted. Franchising networks benefit from the increased mobility and time restrictions of consumers, which result in increased reliance on brand names to ensure them consistent experiences (Blair and Lafontaine, 2011). When a recurrent client enters a different unit for the first time, he/she expects the product and/or service to be perfectly identical to those which are provided by other units. In other words, the confirmation of expectations is likely to generate economic value. In a geographically distant market that is unknown to the customer, the brand as well as the aesthetic image of the point of sale allow him/her to identify a place where he/she might purchase a product and/or a service to his/her liking (Brickley and Dark, 1987).

Standardization brings along an important set of advantages for the franchise chain, namely protecting brand integrity and promoting economies of scale. Basically, franchisors benefit from "comparative advantages in creating brand recognition and capturing economies of scale" (Blair and Lafontaine, 2011: 1) in input acquisition, marketing and management activities. The dispersion of standardized units helps the franchisor to make sense of and cover the market, strengthening the brand and protecting it against rivals (Caves and Murphy, 1976). Moreover, franchisors benefit from economies of scale in the promotion and marketing of the brand as well as economies of scale in general management tasks and, in addition, savings in input acquisition due to higher volumes of standardized purchases (e.g. Oxenfeldt and Kelly, 1969; Rubin, 1973; Caves and Murphy, 1976). Finally, according to Sorenson and Sørensen (2001), standardization also allows the dilution of the costs of creating and acquiring knowledge among the units of the network. Therefore, uniformity might be vital for good network performance.

2.2. The problem of innovation diffusion in franchising

Innovation diffusion in franchising is not a trivial issue. Bradach (1998) identifies four challenges facing the franchisor: (1) maintaining the uniformity of the shared identity in the network; (2) answering to specific local features; (3) making modifications to the global identity; and (4) adding new units to the network.

Keeping uniformity might be a problem to franchisors. First of all, adaptation to local market specifications and requirements might be at odds with keeping the standardized features of the business. Finding the right balance between keeping uniformity and responding to specific characteristics of each particular location is a problem (Cox and Mason, 2007). This problem arises when a franchise network covers many different markets especially if these are spread worldwide. An internationalized franchisor company must find a balance between uniformity and the necessity to perform some local adaptations to, for example, local consumer habits, culture and legislation.

Kaufmann and Eroglu (1998) focus on the issue of local responsiveness and argue that the franchisors' problem is to decide which features can and need to be changed locally and which elements must be kept unchanged. They consider that the features of a franchised business can be divided into "core" and "peripheral'' components and that only the latter can be adjusted to local characteristics whereas the former have to be preserved. Pardo-del-Val et al. (2014) suggest that although the dilemma between standardization and local responsiveness is recognized, the literature does not provide a clear answer on how to deal with it. The authors conclude that the complexity of this dilemma depends on five interrelated aspects: (1) the sources of competitive advantage and the need to share them among a large number of units in the network, (2) the incentive for opportunistic behaviour by franchisees, (3) the heterogeneity of local markets (4) the need for contingent adaptation and (5) the network's life cycle.

Local responsiveness is not the only problem associated with uniformity. Franchising companies need to develop the franchise concept, i.e., they need to innovate in order to survive. However, the introduction of a simple innovation can be extremely difficult in a franchising network (Cliquet and Nguyen, 2004). Franchisees are not normally contractually obliged to accept every change imposed by the franchisor, particularly if those modifications require capital investment.

Indeed, franchisees may not want to adopt the innovations the franchisor desires, either because they do not want to take the risk, or because they do not want to spend the money. As franchisees' under-investment might harm the standardisation of the chain, some franchisors, to whom this problem becomes too acute, buy back the deviant outlets and invest in the implementation of those improvements, aiming at guaranteeing the network's standardization (Brickley and Dark, 1987; Brickley *et al*., 1991).

The difficulty in reconciling the uniformity of the network with the need for innovation is known as the paradox of ' self-correction ' and ' self-renewal' in franchising (Bradach, 1998). Croonen (2003) identifies this difficulty with March's (1991) paradox of 'exploration and exploitation', i. e. the need to balance the exploitation of present elements (exploitation of old certainties) with the exploration of future elements (exploration of new possibilities). The 'exploitation of old certainties' regards production, selection, implementation and refinement of present elements. The 'exploration of new possibilities' refers to research, experimentation, innovation, discovery and variation of elements in the future. According to March (1991), if the company only focuses on exploration of the present, it gets stuck in a situation that could be improved. If it only cares about the exploration of the future, it bears the cost of experimentation, but does not gain all its benefits. Therefore, finding the right balance between exploitation and exploration is important for the development of the organization.

2.3. The plural form

Aiming at understanding how the franchise partners deal with the paradox of the exploitation and exploration, Croonen (2003) suggests that the networks that have adopted the plural form (Bradach, 1998), i.e. that simultaneously have company-owned and franchised units, seem to be more prepared to manage it. According to this author, vertically integrated units are more prone to exploitation, while franchised units seem to be better adapted for the exploration of future elements.

Due to franchisors' supervision and incentive schemes, managers of the company-owned units are more geared to the ' exploitation ', and franchisees appear to have a greater incentive for the 'exploration' (Sorenson and Sørensen, 2001). Two reasons might justify the relevant role of franchisees in the innovation process. First, they are less risk-averse than managers of company-owned units, otherwise they would not have become entrepreneurs. Second, they have longer time horizons, which allows them to have a long-term perspective and therefore to invest in innovative projects that may only deliver returns in the future.

But the plural form may display other benefits within the innovation process. According to Cliquet and Ngoc (2003), in the critical 'idea generation' phase of an innovation, the combination of franchised units and integrated units may provide the company with more sources of innovation. Innovation can take place at headquarters, at company-owned units or at franchised units. At this stage of the innovation process, the franchisees will be especially important as a result of their proximity to the customer and experience with the local market. The authors show that, due to that strong initiative, franchisees can be important sources of ideas. Moreover, according to Cliquet and Ngoc (2003), the existence of franchised units can make company-owned units' managers more dynamic and participative.

However, franchisees do not appear to have the same readiness to participate in the 'test and evaluation' phase of the ideas generated by the process of innovation (Cliquet and Ngoc, 2003). As mentioned before, franchising contracts do not normally require franchisees to test the introduction of innovations in the franchise concept and, simultaneously, franchisees may also lack the motivation for participating on the innovation process at this stage since they may not want to take the risk. Therefore, the units directly held by the franchisor company appear to have a central role at this phase of the innovation process. The introduction and subsequent testing and evaluation of new products, new services, new processes and changes in the aesthetic image of the brand, among other possible innovations, seem to be carried out almost exclusively by the units of the franchisor.

Finally, the integrated units seem to have an important role also at the 'implementation' phase. Normally, after being tested, innovations are firstly introduced in the units that are owned by the franchisor. This way, it becomes simpler to convince franchisees to adopt them. In fact, "When new ideas are successfully adopted by the units of the franchisor, why not implementing them in franchised units?" as Cliquet and Ngoc (2003: 10) question.

3. METHODOLOGY

In this paper, two contrasting case studies are discussed: a chain of language and information technology schools and a network of apparel shops. Both companies have adopted franchising as a strategy for growth and they both hold company-owned and franchised units, whose mix has been changing over time. These two cases are contrasting since there is a different level of complexity in the activities performed by local units. This may justify other differences found between the two networks.

This work is part of a larger study involving these companies. The cases were prepared following Yin's (1994) case study methodology. Information was collected by recording interviews to several managers both at the franchisor's and the franchisees' companies. Interviews have focused on the description of the innovation process, the description of the innovation diffusion process, the franchisees' role in these processes, the difficulties in balancing standardisation and innovation, and, finally, the strategies used to deal with this difficulties. To strengthen construct validity, other sources of information have been used, namely the franchising contracts written by those franchisors. Also, the final description of the case was sent to the main respondents for validation.

The recorded data has been transcribed and analysed using the Pattern Matching Technique which compares empirical patterns to those conceptually predicted (Yin, 1994). First, a single analysis of each case was performed and after a comparative cross analysis of the two cases was made seeking to explore the relevance of their idiosyncrasies in relation to the theoretical framework that supports the research. The aim was to identify other means besides the plural form that franchisors might use to balance Standardisation with Innovation. Hence, this paper describes and analyses how the two franchisor companies manage the Paradox of Exploitation and Exploration.

4. CASE STUDIES

According to the literature, one of the main problems faced by franchising businesses is to balance the need to maintain the uniformity of the network and the necessity to perform some adaptations to local contexts and develop the franchise concept in terms of image, and product and service provided (Bradach, 1998). In this chapter, we describe how this problem is address by two Portuguese franchising networks.

4.1. The Innovation Process at a Network of Languages and IT Schools

This company provides training in information technology and in several languages. The most important in terms of turnover is the English language. When this study took place, this network had 12 company-owned and 12 franchised schools, about 200 teachers and more than 6000 students.

In this network, changes in brand image, like for example the introduction of a new slogan, the modification of the web site, or the insertion on the wall behind the reception desk at every school of a clock with the symbol of the brand, to name a few that have happened, are a result of an idea generation and implementation process that takes place at the franchisor's company.

This process, however, is very different when it comes to service innovation. The franchisor considers that both franchisees and managers of company-owned units give an important contribution to the improvement of the service. Some examples of local innovation are described in Figures 1 and 2. According to the network's pedagogical director, these contributions are always welcomed at headquarters and, if they are interesting, they are jointly analysed by both network and local directors during global meetings. The exact same approach is adopted when 'service innovations' originate from the network's headquarters.

Figure 1. Example n.1 of a local innovation

A local pedagogical director (LPD) of a school introduced a new field in the evaluation sheet so that the attendance of students would be informed to parents. She spoke with the network’s pedagogical director (NPD) at headquarters which approved the change and spread it across the network. The NPD recalls it as follows: "We [the NPD and the LPD] had a meeting and she showed me what I thought could be a good idea. I showed it to my people here [at headquarters] and everyone thought it was an important change. We had a meeting with all schools’ managers and franchisees and presented them the idea. Everyone liked it and started using it. The idea was spread across the network, but some schools only started using it at the beginning of the next school year ".

Figure 2. Example n.2 of a local innovation

The LPD of another school felt the need to offer an intermediate level of English teaching. Many children reached the last level intended for their age group and were reassigned to a class of adults. However, their lack of maturity did not allowed them to 'fit in'. So, the LPD spoke with the NPD at headquarters, who developed the new level. Following this decision, it was necessary to develop a new program and choose the manuals. These tasks were carried out jointly by the two directors. The idea widespread very fast among the chain.

At those global meetings, the local pedagogical directors evaluate the feasibility of these innovations, namely regarding the idiosyncratic context of their units, and discuss it among themselves and the franchisor. Depending on the arguments put forth by local directors, these changes may not be applied entirely to all units. After the meeting, the approved changes are spread over the network, being the local directors’ job to look out for the implementation of those innovations in their schools.

Within this network, the dissemination of changes either to the business format or to the service is perceived to be simple, as the franchisor describes this process as being ‘very peaceful'. According to the franchisor, the franchisees' reaction is always positive for two reasons. First, after the implementation of the innovations by company-owned units, the franchisees feel compelled to follow their example although that may take some time due to budget constraints. Second, and perhaps more importantly, in this network franchisees and local managers have the chance to participate with ideas and suggestions. Whenever there is a proposal for the introduction of an innovation, every school director is consulted and involved in the process. Thus, change is not seen or felt as something that is imposed from the top, but as a result of a process in which local units have participated and decided.

4.2. The Innovation Process at a Network of Apparel

This case focuses on a network of clothing and apparel retail. At the time of the study it had 55 units and 10 were franchised. Abroad, there were 3 units in Madrid, Spain.

In this network, the franchisor demands a very passive intervention of the franchisees in the innovation process, only expecting them to contribute to this process by using their local expertise in the choice of the collections. There are two meetings a year where all the franchisees meet with the franchisor. The franchisees travel to the network headquarters and meet with the network designers, commercial directors, top managers and other employees of the franchisor company. In these meetings the franchisor presents the collection proposals for the following year and receives feedback from franchisees as to what they consider to be the local preferences of their customers. The franchisees' participation in the innovation process is limited to this small role. The franchisor argues that there is no record of a franchisee's idea that has produced value to the network. The franchisor claims to have an attitude of resignation, not expecting the franchisees to have good ideas, as, in fact, it believes they could have, once they are closer to the market.

The franchisor acknowledges that the reformulation of the business concept can pose difficult problems in a franchised network. However, there is one important factor that the franchisor believes to have contributed to the diffusion of innovations in the network: most units are company owned therefore franchisees were never asked to make an investment that had not yet been tested at those units. This was, for example, the case of the introduction of clothing for woman which had proved to be a good bet and, as such, it was simple to convince franchisees to start marketing it, in spite of the needed investment in working capital. The fact that the brand was selling a broader range of products made it necessary to increase the average area of the units which in most cases meant to leave the old shop and opening a new, bigger one. The franchisor company says it has not had problems convincing the franchisees to invest in remodelling the stores because it has been able to demonstrate the financial advantages of the investment. Anyhow, the franchisor says that it also uses the threat of the non-renewal of the contract as a form of pressure. If the franchisee does not wish to carry out an investment, it should expect the franchisor to buy back the unit at the end of the contract or even to anticipate contract termination as, indeed, has already happened.

5. ANALYSIS AND DISCUSSION

The two networks differ in the degree of complexity of the activities carried out by local units and, consequently, by the franchisees. The first franchisor is a company that operates in the education sector, while the second franchisor operates in the retail industry. Thus, the activities carried out at local level are quite different. In the case of the retail network, the chain's stores sell the franchisor company's products that are manufactured according to the franchisor's specifications by outsourced factories. These franchisor's suppliers are outside the franchising network. Franchisees sell the product of the franchisor using its selling techniques. On the other chain, local units provide a service using the method of the franchisor. Although the definition of the 'product' (definition of courses, programs, calendars) is made at headquarters, its provision takes place at the local units. In this regard, the role played by local units is more complex than those of the other chain. This conclusion may explain other differences found in the management of the two networks, namely how the franchisor looks at franchisees and what expects from them.

The relationship between franchisor and franchisees is very different in the two cases. In the first case, the franchisor exerts a participatory leadership, involving the franchisees in decision making. In this network, innovation takes place both at Headquarters and at local units. In the second network, the franchisor stimulates the existence of top-down relationships (e.g. Elango and Fried, 1997). It turns out that, in this network, innovation does not happen at unit level.

While the two networks face the Standardisation and Innovation Paradox, they tackle it differently. The first franchisor solves this problem by involving all network participants in the decision-making process. As franchisees feel that they take part in the decision-making process, they seem to accept more easily the implementation of innovations. The second franchisor deals with this paradox by demonstrating the financial advantages resulting from franchisees' investment. However, sometimes, this company needs to exercise its coercive power over its franchisees, associated with the option of non-renewal or termination of the contract, to ensure that its decisions are implemented. Still, sometimes that threat is not enough. In these cases, the franchisor buys back the franchised units.

6. CONCLUSION

In order to manage relationships within the chain, franchisors may adopt an assortment of strategies (Dant and Gundlach, 1999) which include different levels of appraisal regarding the franchisees' role, autonomy and control (Cochet et al., 2008; Pinzanti and Lerner, 2003). Surely, the degree of franchisor's control and franchisees' autonomy in a network will be dependent on the franchisor's expectations about the franchisees' role in the partnership. Anyhow, these are certainly important issues to think of when considering differences in networks' innovativeness processes and dynamics.

The cases that were presented and described in this paper differ as to how franchisees are perceived by franchisors. In one case, the franchisor values the franchisees' initiative and exerts a participatory leadership, involving the franchisees in the decision making process. On the other case, the franchisor values franchisees' obedience and passivity and promotes top-down relationships (e.g. Elango and Fried, 1997). The difference in the degree of franchisees' autonomy and franchisor's control found in these studies might result from the different level of complexity of the activities carried out at local level. But, that difference can also arise from the different perceptions of franchisors which stem from their knowledge and experience.

Nevertheless, in both cases, given their idiosyncratic knowledge about the local market (such as in Minkler, 1990) franchisees take part in the process of innovation promoted by the franchisor. However, the cases differ as to where innovation happens. In the first network, where the franchisor provides some autonomy to franchisees, e. g. involving them in the decision-making process, the innovation takes place both at headquarters and at the local units. On the contrary, in the second network, where the relationship between franchisor and franchisees is a typical top-down one (e.g. Elango and Fried, 1997), innovation happens at headquarters or centre level, not at the unit level.

This paper describes how two Portuguese franchisor companies manage the Paradox of Exploitation and Exploration. It concludes that as expected the plural form plays an important role in the diffusion of innovations (Cliquet e Ngoc, 2003). Both franchisors stressed that it is simpler to implement an innovation at a franchised unit after it has been tested and implemented at company owned units. But this work has also found other ways to deal with this paradox, namely the threat of termination (Brickley and Dark, 1987) and the active participation of franchisees at the innovation process. The first case study suggests the possibility that by exerting a participative leadership and by sidestepping the classic top-down relationship in franchising, the franchisor might motivate franchisees to be more willing to adopt innovations.

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