

Saimaa University of Applied Sciences
Faculty of Business Administration, Lappeenranta
Degree Programme in International Business

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Challenges and Opportunities of Multi-unit Franchising in Fast-food Industry. Franchisee's Perspective

Thesis 2014

Abstract

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The purpose of this study was to find out the challenges and opportunities of developing and operating multiple fast-food restaurants under an area development agreement. The goal of this thesis work was to identify the issues a prospective franchisee has to be aware of in order to successfully manage his mini-chain.

The information for this thesis was gathered from literature, the Internet and by interviewing Russian area developers of different fast-food chains. The empirical data for this study was collected by interviewing companies' representatives in person and by conducting video conferences in Skype.

The results of this study indicate mainly the same issues that were expected to be found. These involve propositions concerning allocation of units, proximity of outlets, free-riding problems, uniformity of products, transfer of knowledge and local advertising practices, which were supported. The proposed agency problems were not found in the interviewed companies. Likewise, contrary to expectations, bulk purchase for multiple outlets is not what companies did to achieve economies of scale in procurement.

Keywords: multi-unit franchising, franchisor, franchisee, area development agreement, fast-food industry, agency problem, economies of scale

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1 Introduction

1.1 Background

Franchising has been growing rapidly in the U.S. since the 1950s. Many companies from different industries, such as fast-food restaurants, hotel chains, car rentals, have been actively using franchising to expand their operations elsewhere. The franchisor, owner of the business idea, shares his know-how with a franchisee. The latter can use the ready-made business model in exchange for a fee. Such an approach is called “business-format franchising” and the term “franchising” is generally used to refer to this particular type. By the end of the 1960s the franchising had lost its initial rapid growth due to increased competition and ultimately the U.S. market was saturated with franchised businesses. Consequently, franchisors began to expand their operations across the borders by means of foreign partners. By doing so franchisors managed to have their branches overseas without actually investing venture capital. The franchisees in-turn were able to adopt a ready-made business model to their local markets.

Nowadays franchising is a common way of doing business. Despite the fact that many franchisees operate only one outlet, it is important to point out that most franchised chains involve multi-unit ownership. This organizational arrangement allows the franchisee to operate more than one outlet in a particular franchise system. Several studies have indicated the importance of multi-unit franchising in the U.S. Kaufmann and Dant (1996) found that 88% of the 152 fast-food chains they surveyed had multi-unit franchisees. During the period of 1980-1990, 61.5% of all new McDonald’s restaurants were opened by existing franchisees (Kaufmann & Lafontaine 1994). Bradach (1995) conducted a study of five fast-food franchise systems and reported the average number of units per franchisee to range from 2.7 to 22. Finally, the IFA Educational Foundation (2002) reported that in the 145 franchised systems they had surveyed 20 percent of franchisees operated 52.6% of units. Based on this data, Blair and Lafontaine (2005, p. 50) concluded that *“multi-unit ownership is present at least to some degree in all franchised chains, and a large proportion of franchised*

units belong to multi-unit franchisees”. All in all, the findings above show that multi-unit ownership stimulated the growth of franchising as a whole and the fast-food industry in particular.

So far the studies on multi-unit franchising have mostly considered how this type of ownership affects the franchisor and his chain. One of its main advantages is the positive effect on the system’s growth rate (Kaufmann & Dant 1996). Bradach (1995) found that franchisors are exposed to less risk and have a better control of their foreign operations when allocating new units to existing franchisees. In addition, he reported that multi-unit franchising outperforms single-unit franchising in maintaining uniformity within the chain and system-wide adaptation to competition. He also noted that, on the downside, multi-unit owners might not adapt to local conditions as well as single-unit franchisees do.

Still the literature lacks the information about multi-unit franchising from the franchisee perspective. It would be useful to know the motivational factors that make prospective franchisees choose this type of ownership. In addition, it is in the author’s interest to find out what the challenges and opportunities of managing multiple outlets under an area development agreement are.

This survey focuses on the fast-food industry. This industry has always been associated with franchising. Although the U.S. market has become saturated with fast-food restaurants, this type of business still has great opportunities in other countries and keeps growing at a steady rate.

1.2 Objectives and delimitations

The purpose of this study is to find out the challenges and opportunities of developing and operating multiple units under an area development agreement. This study will be useful for those who are interested in opening a franchising business, particularly a fast-food restaurant, and consider multi-unit ownership.

This research is focused on franchising restaurants operating in the fast-food segment, such as burger restaurants, sandwich makers and coffee shops, although the findings might be applied to other types of businesses, too. Saint-

Petersburg and Moscow, the two largest cities in Russia, are the target regions. They have a big population and there are numerous restaurants operating in both of them. The considered franchisees are large area developers who have exclusive rights to open multiple units in a particular region.

1.3 Research question

The main question the author aims to answer is the following:

- *What are the challenges and opportunities of multi-unit franchising in the fast-food industry from the franchisee perspective?*

The questions listed below are the sub-questions that help to answer the major one:

- *What are the benefits and constraints of multi-unit ownership?*
- *Which factors have to be considered by a potential multi-unit franchisee?*
- *What are the determinants of success in this business?*

These questions are answered by reviewing literature and previous studies on multi-unit franchising. In addition, several area developers operating in Moscow and Saint-Petersburg are contacted. They share their knowledge and experience of managing multiple restaurants under an area development agreement.

1.4 Theoretical framework

This section develops a theoretical framework for the study. It begins with a general definition of franchising and its types. The franchise contract, its terms and conditions, as well as associated fees, are also covered.

In the section devoted to multi-unit franchising the author describes three types of multi-unit ownership: subfranchising, area development, and sequential expansion. These types of ownership are further analyzed in terms of their

benefits and constraints to the franchisor and the franchising system as a whole. After that the study considers the franchisee's perspective on multi-unit franchising with a greater emphasis on an area development agreement. Based on the franchising theory and previous research, the author develops a set of propositions concerning the possible challenges and opportunities multi-unit owners might encounter.

1.5 Empirical part

1.5.1 Case companies

The objective of this research is to identify the challenges and opportunities of multi-unit franchising from a franchisee perspective. In order to acquire empirical data, several area developers operating in Saint-Petersburg and Moscow are contacted. They are asked to share their knowledge and experience of managing multiple restaurants. In addition, a quick overview of the Russian fast-food industry is provided. This will help a prospective franchisee to get familiar with the past and current situation on this market.

1.5.2 Research method

The research method is qualitative and a semi-structured interview is conducted in order to gather the information. A set of open-ended questions are formed in advance and the interviewees are asked to give detailed answers and elaborate on certain topics if necessary.

The qualitative method allows the researcher to investigate social phenomenon and get an in-depth understanding of someone's viewpoints and attitudes. Although normally the sample is smaller than in a quantitative method, the research is focused to a larger extent on each particular case. (Saunders, Lewis & Thornhill 2009.)

The methodology chosen is appropriate because it gives the interviewee freedom to speak and helps interviewer to get additional information and come

up with new questions during the interview. However, such an approach might make it difficult for the researcher to generalize the findings due to a small sample. (Saunders, et al. 2009.)

1.6 Thesis structure

This research paper is organized in five sections. Section two presents the theoretical framework for this study and develops propositions based on existing literature and previous research. Those propositions are then tested in the light of the data gathered from the interviews. The research methodology and the case companies are described in section three. The findings are discussed in section four and a relevant conclusion is made along with recommendations for future research in section five.

2 Theoretical framework

2.1 Definition and types of franchising

Meaney (2004, p.11) defines franchising as *“a legal business arrangement, governed and created by a contract, under which the franchisor (owner/supplier) sells to a franchisee (retailer/buyer) the right to sell certain goods and/or services of the supplier under specific, agreed-upon conditions”*.

There are two major types of franchise arrangements: traditional (product or trade name) and business-format franchising. In traditional franchising the franchisee purchases the right to use the franchisor’s trademark/brand name and distribute his products. The franchisor acts as a manufacturer who sells his products to the franchisees for further reselling. He earns profit by imposing markups on those products. However, he does not receive any royalties (monthly payments) from sales. Automobile dealerships, gasoline service stations and soft-drink bottlers are the biggest users of traditional franchising nowadays. (Blair & Lafontaine 2005.)

In business-format franchising the franchisor provides a complete business model and continuous support to his franchisee. In exchange for that, franchisee pays franchising fee, a lump-sum fixed payment at the beginning of the agreement, and royalties, monthly payments calculated as a fixed percentage of franchisee's gross sales. In addition, all franchisees contribute specified portion of their revenues to a company's advertising fund. Typical examples of business-format franchising are retail stores, fast-food restaurants, hotel chains, etc. (Blair & Lafontaine 2005.)

2.2 Franchise contract

This section discusses the franchise contract and its terms. To begin with, there is a review of the monetary terms, such as franchise fees, royalty payments and advertising fees that a franchisee is obligated to pay to a franchisor. Then the discussion moves on to non-monetary clauses, such as the obligations of both parties and other terms of the contract.

2.2.1 Monetary terms

Franchise fee is an initial lump-sum fee that is paid only once at the beginning of the contract period. It may vary among the franchisees of a given chain for three main reasons. The first one is the size of the territory the franchisee is granted or its market potential. The second one is the type of the franchised unit. For example, a free-standing fast-food restaurant and one located at a food-court would be charged different fees. Thirdly, franchisors may require different fees for additional units sold to existing franchisees, or for area developers who are obligated to develop multiple units. This happens mainly due to the fact that the franchise fee is considered as a compensation to the franchisor for incurred costs of helping the franchisee to establish his business. Since existing franchises need less training and assistance, it is less costly for the franchisor to support them and, therefore, he requires a lower fee. Moreover, the franchise fees vary across industries. The fees in sit-down

restaurants are relatively high, whereas the fees for contractors and personal services sectors are lower on average. (Blair & Lafontaine 2005, pp. 56-60.)

In addition to fixed franchise fees, franchisors normally charge ongoing payments, called royalty payments, throughout the life of the contract. In most cases this payment is calculated as a percentage of gross sales. It may also be a fixed monthly or weekly amount. Some franchisors also require a minimum of royalty payments. Such an arrangement is especially justified when the franchisees' sales are low. The percentage rates may also increase or decrease for some franchisees as their sales reach target levels. Like the franchise fees, royalty payments vary across sectors. For example, lower royalty rates are prevalent in retail sectors, whereas higher ones are common in education, maintenance and personal services. (Blair & Lafontaine 2005, pp. 62-65.)

Advertising fees are additional payments stipulated in the franchise contract. They are defined as contributions to national, regional or local advertising budgets. Similar to royalty payments, advertising fees may be a percentage of gross sales or a fixed monthly/weekly payment. In the case of local advertising, the franchisor often defines a minimum amount or percentage of sales the franchisee has to spend on advertising. Franchisors may also change the rates later on as stated in the disclosure documents. The advertising fees are relatively high in a few sectors, such as automotive and health and fitness. In other sectors the fees are significantly lower. (Blair & Lafontaine 2005, pp. 69-71.)

2.2.2 Non-monetary clauses

This chapter discusses the obligations of the franchisor and franchisee. Most of the franchisee's duties are ongoing. The franchisee is generally obligated to:

- make on time payments
- contribute to an advertising fund
- use the system trademark in a predetermined manner
- follow the manual when operating the business

- operate within a specific territory or location
- attend a mandatory training program
- and maintain certain business hours (Meaney 2004, p. 96).

The franchisor's duties are basically immediate and not on-going. The franchisor is generally required to:

- grant a specific territory
- approve the initial location
- provide training
- give an operations manual
- assist with the grand opening
- help with the purchase of equipment and inventory
- administer the advertising requirements
- offer initial assistance and advice
- and buy from specified suppliers (Meaney 2004, p. 96).

The franchising contract also contains the following items:

- duration of the agreement
- the franchise purchase price
- financing terms
- size and exclusivity of the territory
- renewal terms
- termination of the contract
- transfer or sale of the franchise
- product and equipment purchase requirements (Meaney 2004, pp. 97-98).

2.3 Multi-unit franchising

2.3.1 Types

Unlike single-unit, multi-unit franchising involves ownership of multiple units within a certain area or in different locations. This type of ownership requires

higher initial investments but also lowers the risk since the company is not dependent only on one unit. Also multiple units are typically sold at a reduced rate - this is another benefit of multi-unit franchising.

There are two types of multi-unit franchising: master franchising and sequential expansion. Firstly, master franchising is a form of an umbrella licensing agreement which has two essential points: it grants an exclusive territory to the franchisee and creates an additional layer of control between store level management and the franchisor. Master franchising is further divided into subfranchising and an area development agreement. In subfranchising the franchisor grants the master franchisee (subfranchisor) the right to sell franchises to third parties (subfranchisees) within a specified territory. The master franchisee does not operate the subfranchised units himself. Instead, he assumes the role of franchisor and provides the recruitment, training and supervision of subfranchisees. (Kaufmann & Kim 1995.)

In an area development agreement, the master franchisee (area developer) is granted the right to open outlets within an exclusive territory. He is not only entitled, but also obligated to develop a specified number of units within a particular territory. The developer signs an area development agreement in the beginning and separate franchise agreements for each individual unit opened. The area development agreement also sets the timetable for opening each outlet. (Kaufmann & Kim 1995.)

Secondly, the sequential expansion is another form of multi-unit ownership. After the franchisee has demonstrated his ability to manage a single unit, he is granted the right to open additional ones. Quite often each additional unit requires a lower franchising fee, which is a good incentive for a franchisee. (Blair & Lafontaine 2005.)

2.3.2 Franchisor's perspective

Multi-unit franchising is a pervasive phenomenon nowadays and many franchisors encourage this type of ownership. This section will describe the reasons why franchisors are interested in multi-unit commitment.

The primary factor that most of researchers have considered in favor of multi-unit franchising is the higher system growth rates. Kaufmann and Dant (1996) argue that multi-unit franchising allows the franchisor a greater access to capital, which facilitates the system's growth. This is especially noticeable in area development where franchisor has an access to large blocks of funds provided by franchisees (area developers). Kaufmann and Kim (1995) note that an area development agreement permits the franchisor to focus on recruiting, screening and training of a single area developer in each particular market who then, in-turn, develops his territory. This allows parallel development of multiple markets and positively affects system growth.

On the other hand, the franchisor assumes a great risk when he grants the right to an exclusive territory to the area developer. The success of a chain in a particular market is then dependent on the performance of the local developer who controls his mini-chain. In addition, the franchisor has to spend more resources and time on recruiting, screening and training of the area developer than he would do for a single-unit owner. (Kaufmann & Kim 1995.)

In the case of sequential expansion, increases in growth rates arise from less time spent on recruiting, screening and training. Current franchisees have the necessary experience and skills to conduct these procedures more efficiently than the first-comers would do. In this type of ownership it is easier for the firm (franchisor) to control adverse selection and moral hazard and thus reduce agency costs. Still the sequential nature of this expansion puts significant limits on the system's growth. (Kaufmann & Dant 1996.)

In subfranchising, like in an area development agreement, the franchisor can achieve higher growth rates by developing several markets in parallel. He conducts the recruiting, screening and training of the individual subfranchisors,

who then sell the franchise rights to their subfranchisees. It is more difficult to recruit a subfranchisor than a single unit franchisee due to the up-front fee charged for the right to subfranchise. However, it takes less time and effort to recruit a subfranchisor than an area developer since the former does not have to invest as much capital to open the stores. (Kaufmann & Kim 1995.)

Despite the benefits of subfranchising, it might be quite challenging for the franchisor to screen and train subfranchisors in each market. Sometimes he would also need to screen potential subfranchisees, even though the subfranchisor has already done it. This might slow the rate of growth within each market. In addition, subfranchising creates an additional layer of control between the system franchisor and the subfranchisees and therefore involves additional management costs. Furthermore, the system does not benefit from the economies of scale of a large chain since subfranchising spreads the units across various markets. (Kaufmann & Kim 1995.)

2.3.3 Franchisee's perspective

In general, multi-unit franchising helps a franchisee to lower the business and financial risks of a single restaurant by spreading them among several units. In addition, it tends to minimize fixed costs per each outlet and maximize sales potential on the market. Furthermore, it normally helps to strengthen the relationship with the franchisor by means of higher commitment resulting from operating multiple units.

Multi-unit franchising allows franchisees to enjoy economies of scale derived from operating a chain of outlets. This is mostly noticeable in an area development agreement, where the operator creates a mini-chain from the outset. However, the area developer invests significantly more capital and assumes a greater risk than a single-unit owner. (Kaufmann & Kim 1995.)

In addition, the area developer faces the same agency problem in managing the outlets as the franchisor does in running the company-owned units. The problem arises from a possible shirking and moral hazard of the store level

managers who operate the units. It is particularly hard for the franchisee to monitor his operations if the territory is large and the units are geographically dispersed. (Kaufmann & Kim 1995.)

In subfranchising, the master franchisee benefits from the franchise fees and ongoing royalties received from his subfranchisees. Nevertheless, he has to pay the up-front fee and take the obligation to develop his territory by means of selling subfranchise rights. Therefore, he has to utilize his resources on attracting potential subfranchisees, their screening and initial training, and assistance in opening the units. He is also in charge of forming the advertising budget and collecting advertising fees. (Kaufmann & Kim 1995.)

2.3.4 Area development agreement

This chapter focuses on area development agreement and its elements. Also the challenges and opportunities of this type of ownership in relation to a franchisee are reviewed.

As mentioned above, an area development agreement grants the franchisee the right to develop a certain number of franchised units within a specified territory over a given period of time. The area granted to the developer is exclusive and no other franchisee can open units within this territory without the franchisor's permission. The area developer agrees to comply with a development schedule and open new units by certain dates. (Lowell 2006.)

Normally, the franchisor issues a single development agreement, governing the development of all units, and individual franchise agreements for each unit the franchisee is about to open. The development agreement locks in the conditions applicable to all units to be developed, such as site selection and construction provisions, whereas individual franchise agreements reflect the then-current terms at the times the agreements are signed. (Lowell 2006.)

The development agreement has an expiration date and if the franchisee completes the development schedule prior to that date, he might be penalized for early loss of his exclusive rights. In other case, the franchisee might be

offered an option to develop additional units. He also has the right of first refusal to any additional franchise or development agreements the franchisor offers after the completion of the development schedule. (Lowell 2006.)

The franchisee pays a development fee for the right to develop the territory and franchise fees for each individual unit opened. As the developer opens more units, he is charged a lower franchise fee for each subsequent outlet. The franchisor may establish franchise fees in advance or at the time each unit is developed based on then-current market conditions. (Lowell 2006.)

In the case of the franchisee's default to meet the development schedule, the franchisor may impose certain sanctions, such as reducing the size of the granted territory, limiting development rights, or accelerating or slowing the development schedule. Termination of the agreement is an extreme penalty for the default. (Lowell 2006.)

2.4 Challenges and opportunities

2.4.1 Management problems

An agency relationship is a contractual arrangement under which one person (the principal) engages another person (the agent) to perform some service on his behalf. The agent is also granted some decision-making authority. Sometimes the agent does not act in the best interests of the principal – this is the so-called “agency problem”. The principal can avoid this problem by establishing appropriate incentives for the agent and monitoring the agent's behavior. (Jensen & Meckling 1976.)

The agency problem can be found in all organizational forms, and franchising is not an exception. In the beginning, company owners (franchisors) were considering franchising as a way to reduce agency problems in the company-owned units. They transferred the ownership of the units to the individual franchisees, who acted as the managers of those outlets. The franchisees had the incentives to do their job properly to make their restaurants prosper. When owning multiple units, however, the owner (principal) has to hire managers

(agents) to operate the outlets. Those managers do not have an ownership interest in the firm and normally have low incentives to act in the owner's interests. The owner, therefore, needs to monitor the behavior of the managers in order to ensure the success of his mini-chain. The problem is that it may be quite complicated to monitor all units, especially when they are geographically dispersed. (Kaufmann 1992.)

Brickley and Dark (1987) have supported their hypothesis that franchisor-owned units are better monitored if they are located close to the headquarters or to each other. It is possible to draw a parallel between franchisor-owned units and those owned by an area developer, since in both cases the owners need to hire managers. For this reason, the multi-unit franchisee might also be willing to form such clusters of units that are close to each other in order to make the monitoring process more efficient. Based on the above findings, the following two propositions can be made:

P1: Using an area development agreement creates an agency problem between the units owner and store-level managers.

P2: Proper allocation of outlets helps the owner to monitor the units more efficiently and thus reduce agency costs.

2.4.2 Proximity of units

One of the most noticeable issues in franchising is intra-channel conflict, called encroachment. When a franchisor adds new units in close proximity to the outlets owned by existing franchisees, those new units may cannibalize the sales of the existing stores. In order to prevent this conflict, some policymakers have introduced regulations aimed to defend the existing franchisees and even gave them an exclusive territory (Kalnins 2004).

Under an area development agreement, a franchisee is the only one who makes decisions upon opening new units within his territory. He, therefore, cannot face the problem of encroachment by definition. Nevertheless, he may

still allocate new units in an unfavorable way to the existing ones, as described further in this section.

The success of each new unit the franchisee considers to open depends upon the location chosen and the customer traffic, the number of people that walk by that place. A good example with high customer traffic would be a restaurant located at a food-court in a shopping center. Thanks to other tenants (shops, restaurants) there is a constant flow of people and some portion of them might stop by your restaurant. However, as many restaurants are willing to occupy those spots at food-courts, there is tough competition among brands for vacant spaces.

Based on the agency theory, it was suggested that in order to monitor the units more efficiently, the franchisee would like to have them close to each other. The question that comes next is how close the units should be located. Adding a new unit in very close proximity to an existing restaurant may steal some portion of its sales and thus jeopardize the performance of the existing outlet, just like in the case of encroachment. On the other hand, customers may get used to visiting one particular restaurant and adding another unit in close proximity may not provide significant benefits. A food-court restaurant in a shopping center can be an exception. If, for example, there are two closely located shopping centers with high customer traffics and there are restaurants of a particular brand in each of them, then both of those restaurants might operate successfully, all else equal. However, this is not the case for stationary restaurants that share the same boundaries.

To sum up, not only should a franchisee choose a location with high customer traffic for a new restaurant, but he also needs to assess the proximity of other restaurants of the same brand and their possible effect on the new restaurant and vice versa. The next proposition is as follows:

P3: Placing a new restaurant in close proximity to an existing one may negatively affect the performance of the existing outlet and vice versa.

2.4.3 Free-riding problems

The free-riding problem arises when some of the franchisees reduce the quality of their products or services to maximize profit, or contribute fewer resources to promotion or advertising. The incentive to free-ride is particularly high if the level of repeat customer is low. This behavior depreciates the overall reputation of the chain and the future profits. Nevertheless, franchisees who cheat on quality bear only part of this cost and free-ride on the services provided by the franchisor or other franchisees. (Brickley & Dark 1987.)

A multi-unit owner is extremely concerned with the quality of the products, since he assumes a greater risk of losing his customers caused by the quality disregard of other franchisees. The multi-unit owner might suffer even more from quality debasement at another unit if it is situated in close proximity to him. The best way to combat this problem would be allowing a franchisee to own geographically close units. Brickley (1999) suggests that using an area development agreement would be an effective way to solve the free-riding problem. Under an area development agreement the franchisee is the exclusive owner and operator of the units in a particular market. Therefore, he has high-powered incentives to provide high quality products and services to sustain a good image among his customers.

P4: Using an area development agreement helps a multi-unit owner to avoid free-riding problems by controlling all units within his market and ensuring the quality of products and services provided.

2.4.4 Uniformity of products

In addition to good quality, customers expect to get uniform products in any outlet within the franchised system. They might not like a product that is different from the one they used to have in other stores. The franchisees, therefore, need to have consistency of their operations and maintain uniformity of their products and services in order to meet customers' expectations.

Uniformity brings several operational advantages. According to Blair and Lafontaine (2005), uniform operations across the units facilitate economies of scale in procurement and marketing. In addition, uniform operations allow easier and less costly introduction of new products and processes. It would be much easier for the head office to establish, for example, new production procedures across units that are similar to each other. Finally, uniformity helps to collect and compare the information about the performance of different outlets, for example sales, costs, and best practices. It helps a franchisee to evaluate individual units and transmit the information to store-level managers. Ultimately, this reduces training and monitoring costs.

Bradach (1995) has found a positive effect of using multi-unit franchising on maintaining uniformity within the chain. It can be presumed that this effect is strengthened in the context of an area development agreement, since all units are operated by a single owner. He, therefore, has better incentives to maintain uniformity within his mini-chain and enjoy corresponding operational advantages.

P5: Using an area development agreement helps to maintain uniformity within a mini-chain and obtain corresponding operational advantages.

2.4.5 Transfer of knowledge

Multi-unit ownership can facilitate transfer of knowledge between units. Some outlets may experience efficiencies in their operations, for example in procurement or production, and later on share their practices with other restaurants. This approach facilitates improving the overall performance of the chain and disposing of certain defects in the system. Such an ability to transmit knowledge between units makes multi-unit franchising an efficient form of organization.

Darr, Argote and Epple (1995) have found that it is easier and more likely to transfer knowledge between commonly owned stores than between individually owned units. Basically, outlets can transmit knowledge through regular

communication, personal acquaintances and frequent meetings. The stores owned by the same franchisee tend to communicate more frequently and have more meetings and therefore create a greater transfer of knowledge. Darr et al. (1995) also noted in their study that the stores of single-unit owners were not able to benefit from the production experience at other stores, and therefore were less productive than their multi-unit counterparts.

As the number of units grows, so does the overall learning process and transfer of knowledge within a chain. Each new restaurant can come up with a new solution to routine problems and suggest it to other stores. The geographic proximity of commonly owned units is expected to facilitate regular communication and frequent meetings between store managers and induce a mutual learning process. Consistent with these statements, an area development agreement would be an effective way to transfer knowledge between the units and ultimately increase the efficiency of the mini-chain.

P6: Using an area development agreement helps to induce mutual learning and transfer of knowledge between commonly owned units.

2.4.6 Bulk purchases

A business owner can achieve great savings in procurement if he purchases in bulk. The franchised restaurants not only offer uniform products, but also use standardized inputs to produce them. If they purchase large volumes by aggregating their orders, they can negotiate good deals and get sufficient discounts from local vendors. Small chain operators cannot achieve economies of scale in procurement on their own. A multi-unit owner, on the contrary, can combine orders from his units and purchase greater volumes (Hashim 2010). He can form a wholly-owned purchasing division, similar to a purchasing cooperative owned by different franchisees, and place orders from different units through a centralized system. On this way he will not only achieve economies of scale in procurement, but also get uniform products for all his units (Loonam 2010).

Through a centralized system, operators of commonly owned restaurants may place orders based on the individual needs of each outlet. Those orders might then be consolidated and forwarded to the chosen vendor. The supplier can streamline his operations and achieve efficiency in production by producing large quantity of goods, which by-turn gives him an incentive to lower prices. (OECD 2000.)

Despite the efficiency of this approach, it might be quite complicated to ensure smooth flow of goods to the restaurants. By combining orders from different units the franchisee gives up the flexibility in procurement of individual store. Some restaurants may have specific requirements depending on their level of output. As a result, it would be challenging to satisfy procurement needs of different units simultaneously.

P7: Multi-unit owner might achieve economies of scale in procurement by purchasing in bulk for several restaurants.

2.4.7 Advertising

As the number of units grows, the economies of scale in advertising increases as well. The fixed costs of advertising are spread out over more units, thus making the average cost per outlet lower. Blair and Lafontaine (2005) have suggested that while individual units can specialize in production and distribution processes at the local level, the franchisor can focus on national or regional advertising that will benefit all the units in the chain. As a result, the system as a whole will enjoy economies of scale in both sets of activities.

According to Blair and Lafontaine (2005), advertising in the franchise system is a public good for all the franchisees, since all of them benefit from the same advertising. However, each restaurant has to contribute some percentage of their gross sales to the advertising budget. The bigger the number of outlets the franchisee operates, the more money he has to contribute. Therefore, a multi-unit owner would contribute more funds to the advertising budget comparing to a single-unit franchisee. In addition, under an area development agreement, the

franchisee would be the only one who contributes to the local advertising fund and therefore would bear the full cost of local promotional activities. At the same time, he would be the sole person, who makes decisions upon the media selection and promotion techniques in his region. In addition, he would make sure that all the money spent on advertising would go directly to fulfil this purpose.

P8: Under an area development agreement, the franchisee bears the full cost of local advertising and has an authority to make decisions on budget allocation and promotional techniques.

3 Research design

3.1 Research method

The empirical part of this study was carried out using a qualitative research method. The qualitative method allows the researcher to investigate social phenomenon and get an in-depth understanding of someone's viewpoints and experience. Although normally the sample is smaller than in a quantitative study, the research is more intensively focused on each particular case. (Saunders, et al. 2009.)

3.2 Overview of the Russian fast-food market

The Russian fast-food market has been growing since 1990, when the first McDonald's restaurant was opened. Although there were quite many restaurants of domestic cuisine, such as pancakes, pasties and dumplings, Russian customers have become interested in new concepts. After foreign players saw a significant growth potential in the Russian market, they have been actively expanding their operations there. McDonald's, Baskin Robbins, Subway and Sbarro were among the first entrants (Memoid 2011).

Since 2000 the Russian fast-food market has experienced a rapid growth, and by 2006 the annual growth rates were more than 30%. The annual turnover in 2008 was \$2 billion and by 2010 it has reached the level of \$3 billion. In 2012 the turnover was estimated to amount to \$7.8 billion. (Alto Consulting Group 2013.) The global recession gave an additional boost to the growth of the fast-food industry and provided significant benefits to operators. During the period of 2008-2009 the rents dropped by 20% in shopping malls and by 15-30% elsewhere. Despite the decline in sales volume, the number of new customers increased. People were forced to cut down their spending on eating out in expensive restaurants and switch to cheaper alternatives. (Kommersant 2009.)

As for the total number of Russian fast-food outlets, in 2013 it was 3,354. Subway was the absolute leader in the number of restaurants, 514 units in Russia. It was followed by McDonald's owning 413 outlets. KFC, one of the most popular chains among Russian customers, had 201 units. Overall, the fast-food market grew by 16% in 2013. Many experts believe that it is not yet saturated and is open for new entrants, especially in regional areas. (FranchisingINFO 2014.)

3.3 Case companies

For the purpose of this study, a search was made to find large area developers in the Saint-Petersburg and Moscow regions, who had exclusive rights to open outlets within their area. Most of the operators developed units in their regions, while also selling subfranchise rights to franchisees in other towns. As was found, all area developers under study were legal entities with sufficient capital and previous experience in the restaurant business. They have proven their ability to maintain a mini-chain of outlets and were committed to long-term development process. After careful screening and assessment, area developers of five restaurant chains were selected: Carls Jr., Coffeeshop Company, Dunkin' Donuts, Baskin Robbins and Wendy's.

The first area developer is OOO Bright Star, a master franchisee of Carl's Jr., an American burger restaurant chain. Since 2006 it has developed more than

30 restaurants, 26 of which are located in Saint-Petersburg. In 2013 it started implementing sub-franchising, selling the franchise rights to other franchisees, and is planning to expand across the country. (Carl's Jr. Official Website.)

The second one is OOO Coffee Set, a master franchisee of Austrian coffee house chain Coffeeshop Company. The company is actively developing its franchising network in Russia and so far has opened 78 coffee shops. The majority of outlets have been opened in Saint Petersburg by the company itself. The remaining ones are subfranchised to other cities. (Coffeeshop Company Official Website.)

OOO Donuts Project is the exclusive owner of a master franchise of Dunkin' Donuts, an American brand specializing in donuts and coffee beverages. The company operates restaurants solely in the Moscow area. Since 2010 it has developed 30 units. (Dunkin' Donuts Official Website.)

ZAO BRPI is a master franchisee of the ice cream shops chain Baskin Robbins. Baskin Robbins is the oldest franchised chain in Russia. The first café was opened in 1992 and now there are 278 cafes across the country. 55 of them have been opened in the Moscow area by ZAO BRPI. (Baskin Robbins Official Website.)

OOO WenRus Restaurant Group is a master franchisee of the American burger restaurant chain Wendy's. Since 2011 it has opened 8 restaurants in Moscow and is planning to start selling subfranchises to other regions. (Wendy's Official Website.)

3.4 Data collection and analysis

For the purpose of collecting data, the semi-structured interview format was chosen. This type of an interview aims to explore events or phenomenon and allows obtaining a rich and detailed set of data. The researcher forms a list of themes and open-ended questions to be discussed, although they may slightly vary during the interviews. He may also change the order of questions if necessary. The respondents are free to elaborate on certain topics and can

lead the discussion into an area not previously considered by the researcher, but significant for his study. Thus, the interviewer may come up with new questions during the interview and even omit some of the previously formulated. (Saunders, et al. 2009.)

The interview also helps to establish a personal contact with the respondent. Managers are more likely to be interviewed, rather than asked to complete a questionnaire, as it gives them an opportunity to talk freely about a certain topic without writing anything down. They may also be encouraged to give detailed and relevant information about a subject that is of particular interest to them. (Saunders, et al. 2009.)

However, this research method is non-standardized and cannot be easily replicated, therefore affecting the reliability of results. In addition, it is hard to make generalizations about the entire population due to a small sample. (Saunders, et al. 2009.)

The interview might be recorded to get more reliable data. Doing so allows the interviewer to concentrate on questioning and listening. It also enables to re-listen to the interview at some point in the future. Furthermore, it helps to record the questions asked and repeat them in later interviews. (Saunders, et al. 2009.)

The researcher has applied two ways to conduct interviews. Representatives of the companies located in Saint-Petersburg were met in person. Those people who represented Moscow-based companies were interviewed by using video-conference in Skype. Both types of interviews were conducted in a similar manner without any constraints or technical problems. The duration of interviews ranged from 20 to 25 minutes. All interviews were recorded with the permission of respondents and the obtained data was transcribed for further analysis. The quotes from the interviews were translated from Russian to English.

4 Findings and discussion

4.1 Propositions 1 and 2

The findings did not support the first proposition. All respondents did not indicate significant problems with their store managers. Consistent with the theory, the managers did not have high-powered incentives to act in the best interest of their owners. Nevertheless, they were doing their jobs well. One of the respondents noted (Interview no. 5):

“Perhaps it is great work of our human resource managers, who have hired them... In addition, we cannot guarantee that their behavior would be the same without our regular inspections.”

Indeed, most of the area developers agreed that they were monitoring the restaurants on a regular basis to ensure proper performance of the management team. They also supported the author’s proposition that allocation of units plays a significant role in the monitoring process. This is what the OOO Donuts Project development manager said (Interview no. 3):

“We have formed groups of units in certain districts: in the city center, up north, etc... This way we could lighten the work of our area managers. They do not have to go through the entire town to inspect a particular outlet; instead they have a specific location they are in charge of... We still have some locations where there are only few or even a single restaurant, but we take them into account when developing new units.”

So, based on the findings, it can be argued that the agency problem is not necessarily present under all area development agreements. Nevertheless, it is suggested that ongoing monitoring is required to sustain the proper behavior of store managers. Good allocation of units is an essential factor in achieving this goal.

4.2 Proposition 3

The findings supported this proposition. According to the respondents, a good location is a key to success in this business. But what is also important is maintaining a proper distance between the units. The OOO Bright Star managing partner stated (Interview no. 1):

“We surely take into consideration the proximity of other restaurants. In respect to the food-court restaurant it has less influence, since the shopping center itself does not lose any traffic. If we see a crowded shopping center with good tenants, then we might open restaurant in there, even though we have already got an outlet in neighboring shopping mall. Concerning stationary restaurants, we access it more deeply depending on the customer flow. For instance, we have one restaurant at [...] and another at [...]; the walking distance is 10-15 minutes. We know that one restaurant steals some portion of customer traffic from another, but the traffic is large enough for both restaurants to operate successfully. But, in general, we certainly do not place two restaurants close to each other.”

Some respondents noted they are sometimes forced to open restaurants relatively close to each other to increase their brand presence. This happens mainly due to an escalating pressure from competing brands. For instance, OOO WenRus Restaurant Group is a relatively young player on Russian market and they find it quite challenging to compete with established chains. This is what their franchising director mentioned (Interview no. 5):

“We know that if we do not open our restaurant at a particular spot, then our competitors will do that... You can see McDonald’s restaurants everywhere, and they always have numerous customers waiting in the lines, so it makes sense for them to open new units even close to each other. But we cannot let them occupy all decent spaces... ”.

So, based on the findings, it can be suggested that franchisees would not be willing to open units in close proximity to each other in order to avoid

cannibalization of sales, unless they are forced to do so in certain circumstances, for example escalating competition.

4.3 Proposition 4

This proposition was supported by the findings. As indicated by the respondents, one of the main incentives to step into an area development agreement was total control over the brand in a particular market, both in terms of revenue streams and quality assurance. The OOO Coffee Set franchising director said (Interview no. 2):

“We were excited to bring a new concept to our market. In the beginning it was challenging, as it required large investments and involved risks... Now we have an established chain of coffee shops where people can drink a perfect cup of coffee every day... From the very beginning, it was crucial to offer high-quality products to our customers. We did not want any other franchisee to screw it up, so we decided to open and operate outlets ourselves. Only after we have seen good results, we gradually started selling subfranchise rights to our partners in other towns...”

Most of the franchisees were concerned with the quality of their products in the first phase of their development process. They did not want to rely on an opportunistic behavior of other operators, so they preferred to keep control over the operations until they achieved desirable outcomes. Some of the respondents indicated that they would also be willing to manage stores in other regions, if it was physically possible. But due to scarce resources and geographical constraints they had to restrict their ownership to a particular territory.

4.4 Proposition 5

The findings supported this proposition. By owning and operating all the units within a region, franchisees could avoid any deviation from their concept and sustain uniformity of the products and services provided. This was especially

important in a market with a high level of repeat customers. The OOO Bright Star managing partner offered his opinion on this as follows (Interview no. 1):

“When customers come back, we have to offer a product that would be similar in every aspect. People like our signature burgers, design, way of serving, etc. This is what distinguishes us from other brands. So when the customer visits our restaurant over and over again, he has to be sure that he gets the same product he used to like...”

Concerning the operational advantages, they were also achieved under an area development agreement. Respondents could enjoy economies of scale in both procurement and promotion, as was expected from the theory. It was also easier to adapt to local market and introduce new products. For example, unlike American “Carl’s Jr.” restaurants, Russian ones offered an option to replace soft drink with a beer. This option was quite popular among Russian customers and they could do so in every restaurant. Finally, uniformity enabled franchisees to take quality and similarity of products in different units as given and evaluate the restaurants based on other indicators, such as sales, average receipt, etc.

4.5 Proposition 6

The findings partly supported this proposition. Some mini-chains have experienced a greater transfer of knowledge between commonly owned units by means of regular communication and meetings. The OOO Donuts Project developing manager told (Interview no. 3):

“We do have regular meetings for our managers and staff. The primary purpose of such meetings is professional development of workers. We organize them on a local level, so only closely located operators have an opportunity to attend these meetings...”

Other chains indicated using a centralized system to share information with their units. It did not facilitate the transfer of knowledge between outlets, but maintained communication between restaurants and the head office. The ZAO BRPI franchising director told (Interview no. 4):

“We assess the chain as a whole and establish practices applicable to all restaurants. They follow system-wide guidelines and do not interact with each other. The information goes to and comes from the central office, so it does not really matter whether the outlets are located close to each other...”

So, although in theory using an area development agreement is expected to facilitate frequent communication and transfer of knowledge between outlets, in reality this depends on the particular system and its specific norms and practices.

4.6 Proposition 7

This proposition was not supported by the findings. Although it seemed reasonable to coordinate orders from different restaurants in order to get quantity discounts, most of the franchisees found the process difficult. One of the franchisees noted (Interview no. 3):

“We cannot forecast the individual needs of different restaurants. It’s the job of our store managers to place orders based on their sales and inventory levels...”

Nevertheless, some franchisees agreed that they were granted certain allowances from their suppliers in exchange for ongoing orders from multiple units. According to the OOO Coffee Set franchising director, they have achieved such allowances (Interview no. 2):

“Basically, we purchase from a single supplier. We have established a high level of commitment and long-term relationship with him. Undoubtedly, the fact that we operate multiple units enables us to purchase greater volumes over some time and bargain good deals... We do not necessarily purchase in bulk, but we keep our supplier loaded with orders...”

So, as the findings suggest, multi-unit ownership may provide certain benefits in procurement. They do not necessarily come from a single purchase of a bigger size. Instead it is the process of continuous procurement for multiple outlets that makes a supplier willing to reduce prices.

4.7 Proposition 8

This proposition was supported by the findings. Multi-unit owners, especially area developers, have to spend greater sums on advertising than single-unit franchisees. In addition, they have to establish cooperatives with local media firms to promote their restaurants. Although they get ongoing support from the franchisor, they are in charge of running local marketing campaigns. The OOO WenRus Restaurant Group franchising director told (Interview no. 5):

“Our foreign partners supply us with advertising materials and all respective tools to promote our restaurants. They also show statistics in other countries. Still our market has its own specifics and we got to take into consideration people’s tastes and preferences. We spend substantial amount of our funds on marketing research and customer surveys...”

Most of the franchisees also agreed that being an exclusive owner allows them to spend the advertising funds in a way that maximizes their benefits. For example, they can focus on locations with low customer traffic and allocate more funds to promote nearby restaurants. The managing partner of OOO Bright Star supported this statement (Interview no. 1):

“We have one restaurant that has a huge star logo and people can easily notice it. This logo is somewhat of a promotion tool by itself. On the other hand, we have a restaurant at the alley just around the corner from the busiest street in town. Many people walk by and do not realize that there is a restaurant right next to them. In order to attract new customers, we need more intensive promotion of this outlet... We can easily spend more money from our budget on this particular restaurant...”

Finally, the operators in question had more freedom to choose promotional techniques for their stores. For example, one respondent mentioned that after opening a new restaurant in a shopping mall, they put a huge banner hanging from the roof on the first floor. It was a large outlay and, if they had shared the territory with other franchisees, it would not have been fair to have such a

promotional tool leaving others out of their share. But, thanks to the exclusivity of their territory, they could afford to do so.

5 Conclusion

This study has investigated the concept of multi-unit franchising from the franchisee perspective. Specifically, it focused on managing fast-food outlets under an area development agreement. First the paper introduced the benefits and constraints that affect a franchisee's choice of this type of ownership and continued with challenges and opportunities associated with developing and operating multiple units. For the purpose of this study, several propositions were made based on previous research and they were then tested by gathering and analyzing data via interviews with large area developers.

Most of the suggested propositions were supported. As the findings indicate, franchisees involved in area development agreements do not necessarily face the agency problems of their store managers. They do, however, monitor their outlets on a regular basis and allocate new units in a way that facilitates monitoring process. The proximity of other units is also an important factor in allocation decisions. In addition, an area development agreement enables sustaining the good image of a mini-chain by controlling all restaurants within the market and avoiding the free-riding problems of other franchisees. Uniformity of products and services is another advantage of an area development agreement that was predicted based on the theory and observed in the case companies. The findings did not completely support the proposition concerning knowledge transfer between commonly owned units due to differences in companies' practices. Concerning the procurement issues, all respondents did not indicate purchasing in bulk for multiple stores, so they could not achieve economies of scale in this way. Finally, consistent with the results, all area developers in question were in charge of deciding on the local advertising budget and making the only contributions, and had an authority to make the promotional decisions.

This study makes a contribution to the existing research on multi-unit franchising. It offers relevant data for both scholars and prospective franchisees. The scholars may use this study as a basis for future research and the prospective franchisees may find this material useful in assessing franchising opportunities. However, this study has certain limitations. First of all, the findings can be applicable mainly to fast-food restaurants. Secondly, the empirical data were obtained from Russian franchisees and might reflect the special features of this market. Finally, the sample is not large enough to make generalizations about the entire population. Therefore, further research might be needed to get more reliable and generalizable data.

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Interviews:

Interview no. 1. OOO Bright Star, Managing partner XXX XXXX

Interview no. 2. OOO Coffee Set, Franchising director XXX XXXX

Interview no. 3. OOO Donuts Project, Development manager XXX XXXX

Interview no. 4 ZAO BRPI, Franchising director XXX XXXX

Interview no. 5 OOO WenRus Restaurant Group, Franchising director XXX
XXXX

Appendices

Appendix 1: List of interview questions

1. Did you have any prior experience in restaurant business?
2. Have you used your own capital or borrowed funds for development?
3. How economic crisis has influenced Russian fast-food market and your restaurants in particular? How it has affected the system's growth rate?
4. Have you agreed on ultimate number of restaurants to be opened with franchisor?
5. Does franchisor specify concrete format of restaurant to be opened?
6. Have you experienced any problems with your store managers? Do you provide any incentives to improve their performance? Do you conduct monitoring of the restaurants? Do you allocate your units in a way that facilitate monitoring process?
7. Which factors do you take into consideration when choosing a place for new restaurant? Do you access proximity of existing restaurants? Have you experienced any negative outcomes of placing two or more outlets in relatively close proximity?
8. Do you know any quality debasement practices in stores owned by other franchisees of your brand? Have you managed to sustain good quality of products and services by owning all units in your region?
9. Does owning multiple restaurants under area development agreement allow you to maintain uniformity of your products and services? Have you managed to obtain such efficiencies, as (all prior-mentioned operational advantages)...?
10. Do you have any mechanisms of knowledge transfer and mutual learning between your stores?

11. Do you have a single supplier for your stores? Do you purchase in bulk for your restaurants by consolidating the orders? Do you get any corresponding discounts from the supplier?
12. How do you form your local advertising budget? Do you get any support from the franchisor? Do you have full discretion of spending advertising funds? Are you free to choose promotional techniques for your stores?