Specific Investments in Franchisor-Franchisee Relationships: A Model

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ABSTRACT

Franchisors are often faced with situations where they are called on to make relationship-specific investments in their extant franchise relationships to fully leverage new business opportunities. Such specific investments may, either by lowering economic costs or by facilitating the realization of unique value propositions, enhance value creation. However, these investments have negligible salvage value outside the relationship and imply potentially greater transactions costs (in terms of opportunistic behavior by the exchange partner) under conditions of high environmental uncertainty and bounded rationality. When should a franchisor make such investments? Should it make them even if they do not directly enhance exchange efficiency? Are there conditions where the franchisor should disregard potential opportunism arising from these investments? How do information asymmetries impact the investment decision? We investigate these questions using a formal, game-theoretic model of bilateral, sequential specific investment decisions in a franchisor-franchisee exchange relationship characterized by information asymmetry, with the franchisor better informed than the franchisee. A key result is that there are conditions where it is optimal for the franchisor to make a specific investment even when it is not reciprocated by the franchisee. Here, the franchisor’s specific investment does not increase exchange efficiency or lower transaction costs. Rather, it performs a purely signaling function. The extensive Transactions Cost Theory literature has largely focused on specific investments as an exogenous variable, leading to calls for a greater focus on specific investments as an endogenous variable. We contribute to this literature as well as research on franchising by identifying a new, signaling rationale for endogenous specific investments that allow existing franchisor-franchisee exchange relationships to fully realize business growth opportunities.

KEY WORDS: Franchising, Marketing Channels, Transactions Cost Theory, Specific Investments, Game Theory, Signaling,