European Journal of Operational Research 198 (2009) 655–665

Contents lists available at ScienceDirect

European Journal of Operational Research

journal homepage: www.elsevier.com/locate/ejor

Interfaces with Other Disciplines

Advertising strategies in a franchise system

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ARTICLE INFO

Article history:
Received 1 March 2007
Accepted 1 September 2008
Available online 4 October 2008

Keywords:
Game theory
Marketing
Franchising
Cooperative advertising
Horizontal cooperation

ABSTRACT

The main question of this research is: Who should undertake promotional and brand-image advertising if the franchisor and franchisees act so as to maximize their respective profits? To address this question, we study a two-stage advertising game between a franchisor and two adjacent franchisees. In the first stage of the game, the franchisor chooses between three advertising models – centralizing or delegating the two types of advertising to the franchisees or delegating only promotional advertising. In the second stage, given the franchisor's choice of an advertising model, the two franchisees decide whether or not to cooperate. Our main findings are that (1) the franchisees should cooperate if the franchisor delegates either both brand-image and promotional advertising or promotional advertising, although cooperation between franchisees does not necessary improve the franchisor's profits. (2) The choice of an advertising arrangement critically depends on the margins as well as the costs of performing both promotional and brand-image advertising. We also discuss the conditions under which the three advertising models should be implemented.

1. Introduction

The issue of advertising is regarded as one of the most contentious in many franchise systems (Mathewson and Winter, 1985; Dant and Berger, 1996). According to Dant and Berger (1996), there are at least two fundamental sources of conflict over the advertising issue. The first is the opportunism between partners within a system. The second is the misunderstanding about the role of advertising and promotion in market development in general, and more specifically, the ignorance about the payoffs of cooperative advertising and promotion. Commonly, it is argued that the franchisor should undertake national advertising to maintain and to develop the brand-image and franchisees invest in local advertising to boost sales in their respective areas.

The basic argument supporting the franchisor's national image advertising has been economies of scale (Rubin, 1978). However, as noted by Dant and Berger (1996), some franchisees assert they are not receiving a fair share of the benefits of the franchisor's national brand-image advertising. Other franchisees strongly believe that the franchisor's national advertising is only intended to attract new franchisees, not to enhance and maintain the brand-image (Berman, 1996). It is reasonable to postulate that in such a situation, franchisees would prefer to receive support from franchisors to undertake brand-image advertising by themselves in their respective market areas. Other marketing scholars note that, when it is possible, the franchisor should undertake regional promotional advertising directly to overcome promotional competition between franchisees (Bergen and John, 1997).

To illustrate the complexity of this issue, consider a franchisor dealing with two competing franchisees. Suppose that the franchisees' and the franchisor's advertising are perfect substitutes (Doraiswamy et al., 1979), thus either the franchisor or the franchisees can undertake promotional or/and brand-image advertising. We define promotional advertising as advertising intended to inform potential buyers of special sales. It could be specific to a franchisee's store and aims exclusively at stimulating current sales (e.g., features and displays). Conversely, brand-image advertising contributes to building the whole franchise goodwill and influences both current and future sales. It benefits the whole franchise system. If the franchisees take control of brand-image advertising, they will create a free-riding problem for their brand-image advertising expenditures. If the franchisor controls promotional activities, he is likely to promote less than would competing franchisees. Delegating both promotional and brand-image advertising to the franchisees is also a real concern: While each franchisee will be willing to invest on promotional activities related to his store, neither will invest the appropriate level of effort on brand-image advertising since they cannot appropriate all the benefits from the effort (Rubin, 1978, 1990; Michael, 1999). Although some of these arguments are well known and established in the literature, very little has been done to evaluate formally their impact

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doi:10.1016/j.ejor.2008.09.027

on the franchisor's and the franchisees' advertising strategies and payoffs.

The purpose of this paper is to fill this gap by examining how the franchisor and the franchisees determine their advertising strategies. Brand-image advertising is known to have carry-over effects and requires us to investigate dynamic strategies for the franchise members as a myopic strategy would lead to under-spending on advertising (Chintagunta and Jain, 1992). Specifically, two questions are addressed in this research: (1) who should undertake promotional and brand-image advertising – the franchisor or the franchisees? (2) Does advertising cooperation among franchisees improve the overall franchise system profits? Incidental to these two questions, we also examine how the horizontal interactions among the franchisees influence the franchisor's cooperative advertising programs that partially fund franchisee advertising expenditures.

We formulate an advertising game in which the franchisor and/or both franchisees set the rates of promotional and brand-image advertising. When franchisees incur advertising expenditures, the franchisor needs to determine the rates of support to the franchisees' for such expenditures. Three models or advertising arrangements dealing with intrabrand competition and/or free-riding effect on the franchise trademark are examined. In the first model, the franchisor delegates both the promotional and the brand-image advertising decisions to the franchisees and shares their advertising expenses. In the second, the franchisor delegates promotional activities and controls the brand-image advertising decisions but shares the promotional expenses with the franchisees. In the last model, the franchisor centralizes both brand-image and promotional advertising decisions. Two different scenarios are considered in each of the first two models, non-cooperating and cooperating franchisees. The franchisor plays the leader and the franchisees the followers in the Stackelberg game. Besides the appropriate advertising levels, the franchisees also choose the nature of their horizontal interactions with each other – either non-cooperative or cooperative.

The rest of this paper is divided into five sections. The first section briefly reviews some related literature. The second section introduces our models and their optimal outcomes. The franchisee's choices of horizontal interactions are presented in third section. The fourth section deals with the choice of an advertising arrangement, and the last section discusses managerial implications and concludes.

2. Literature review

The allocation of functional roles between vertical channel members has received little attention in the analytical literature, although it was a real concern in the early microeconomic channel research (Stigler, 1951; Bucklin, 1960; Mallen, 1973). The starting point of this analysis is that channel functions (activities) can be allocated in different combinations to channel members, and a well determined functional mix can improve channel efficiency. In this spirit, Rubin (1978) suggested that the franchisor should perform functions whose costs fall at a substantial level of output, while the franchisees should perform functions whose average cost curve turns relatively sooner. These studies are qualitative in nature and do not explicitly take into account the decision making processes of both the franchisor and the franchisees.

Doraiswamy et al. (1979) are among the first to address the channel advertising issue in a game setup. They studied a duopoly case with exclusive retailers and found that, if consumers are unable to discriminate between the manufacturers' advertising efforts and those of the retailers, it is better for the manufacturer to delegate the channel advertising decisions to retailers. Our study differs from Doraiswamy et al. in the following ways. First, we introduce a distinction between promotional and brand-image advertising. Promotional advertising is store related and influences current sales, while brand-image advertising, through the goodwill stock for the overall franchise influences current and futures sales (Jørgensen et al., 2000). Second, we deal with intrabrand competition in promotional advertising and the free-riding problem associated with brand-image advertising among the franchisees.

Betancourt and Gautschi (1988) show that the manufacturer's exclusive control over distribution services in a conventional marketing channel has a limited effect on the manufacturer's relative power (ratio of profit margins) over the retailer when the manufacturer leads the channel. Conversely, the retailer's exclusive control over distribution services gives more power to the retailer. Although, this research does not address explicitly the impact of the functional mix on the overall channel efficiency, it suggests that when either channel member can perform distribution services, it matters as to which channel member performs them.

The richness of franchising as a method of channel organization has not been fully investigated in the marketing literature. It is commonly argued that an optimal franchise contract should prevent horizontal free-riding between franchisees (Lal, 1990). The implicit assumption underlying this argument is that each franchisee acts so as to maximize his own profit. This assumption may be controversial, in view of evidence of cooperative interactions among franchisees in some franchise systems. Horizontal collusion between franchisees may be formal through franchisee associations or bodies such as *Franchise Advisory Councils*, or informal between franchisees in the same region to deal with common problems (Dant and Berger, 1996). For instance, Muhleman (1994) reports that in some franchise systems, the franchisees within the same geographic areas pool their advertising funds. This practice has increased these franchises' brand-image and led to bigger profits. According to Bergen and John (1997), franchisees sometimes pool their local advertising dollars and give them to the franchisor. The franchisor then decides where and how to spend the money. Dant and Berger (1996) also recognize that typically franchisees set their advertising decisions cooperatively. This horizontal collusion may increase their bargaining power vis-à-vis the franchisor and/or solve some common local problems such as intrabrand competition or free-riding on the franchise trademark. Notwithstanding these insights, there are no formal studies that address these issues in the franchising literature. Our study is the first to investigate if such horizontal advertising cooperation may be worthwhile for both the franchisor and the franchisees.

A few studies have addressed the issue of vertical cooperative advertising in the literature. Some of them focus on a case of a manufacturer providing advertising support to an exclusive retailer (Dant and Berger, 1996; Jørgensen et al.,2000, 2003, 2006). Bergen and John (1997) extend this setup to a case of two competing manufacturers dealing with two competing retailers in a conventional channel. This study incorporates spillover effects, inter and intrabrand competition, but assumes no cooperation between retailers. Although our study only addresses intrabrand competition and spillover effects, we allow cooperation among franchisees. As we will demonstrate later on, the franchisor's advertising support to the franchisees' advertising expenditures will change according to the nature of interaction (cooperative or non-cooperative) chosen by franchisees. In that respect, our study also extends the existing literature on cooperative advertising.

Jørgensen et al. (2000) demonstrate that a cooperative advertising program is Pareto-improving and that it is important to design and implement a specific program for each of the two types of retailer advertising. Building on their results, our paper investigates advertising in a different channel setup in which a franchisor deals with two (adjacent) franchisees. Unlike Jørgensen et al., our focus