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DIRECTLY OPERATED STORES VS FRANCHISE BUSINESS MODEL - A COMPARATIVE ANALYSE OF STARBUCKS AND DUNKIN'

Abstract

The purpose of this article is to identify differences, similarities, advantages and disadvantages of directly operated stores and franchises. Both are successful business models. Differences can not only be described about traditional variables and context, such as capital structure and agency costs, but also about new technologies and strategies.
In addition to theoretical review, a comparative analyse was made through the examples of Starbucks and Dunkin's, showing that both models are successful, even with specific strength and weaknesses in relation with nowadays challenges such as e-commerce encroachment and increased competition. Franchising has been constantly evolving in recent decades, with gradual evolution towards the dominance of multi-unit solutions and structured formats that can enable consistent national and international replication. One of biggest challenges that franchisors will face in the future due to the development of e-commerce is the alternative between establishing an "e-profit sharing" system and strengthening the franchise or reducing the readiness for growth and thus investing more in directly operated stores.
On the other hand, one important challenge of a premium price directly operated store like Starbucks comes from low entry barriers and price competition.

Keywords: distribution network, business model, franchising, directly operated stores, encroachment
JEL classification: M2, M31, M39

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INTRODUCTION

In this article, we analyses two business models: directly operated stores and franchises. In addition to the theoretical review, a comparative analysis of two global companies, Starbucks and Dunkin' shows that despite some differences, both models are successfully applied in structuring companies distribution networks, enabling them to achieve global market position as successful restaurant chains specializing in coffee. Conclusive remarks are about the ability of each company and system to defend their competitive advantage and positioning against new challenges such as increased competition and the long-term effects of encroachment with e-commerce.

We also propose the implementation of new solutions to manage omnichannel strategies in franchising. These solutions would counterbalance the threats to franchise development arising from e-commerce encroachment on local franchised stores.

1. LITERATURE REVIEW

Selecting the right channel has always been a critical decision for a company, both about the degree of vertical integration and costs (Watson, Worm, Palmatier, Ganesan, 2015). Researchers discussed about two different main roles of distribution channels, communication and sales (Lusch, 1979).

A monobrand store is a retail concept where a single brand exclusively sells its products in a standalone outlet. It aims to promote the brand's products and create a unique shopping experience centered on the brand's identity. Monobrand stores strengthen the distintive brand's image, control the customer experience, establish a direct connection with consumers and foster customer loyalty.

A lot has been done in academic research in last four decades about transaction cost analysis (Dant, 1996), resource scarcity theory, resource based view of firm and agency theory (Castrogiovanni, Combs, Justis, 2006) to explain reasons and conditions that suggest companies to franchise their monobrand store business and form hybrid networks of both, directly owned and franchised stores.

Franchising is a better option than directly operated stores when franchisor has not enough resources to develop many stores needed to compete and develop brand both nationally and internationally; also, franchising is an interesting option when business format know-how can be standardized and transmitted to

franchisees who work in the store, monitor operations at store level, align goals of store management with those of franchisor. Franchisees are business partners: treating franchisees as franchisor's employees would be wrong; relating to them as they were traditional indipendent multibrand distributors in wholesale business would be equally wrong. They are indipendent entrepreneurs but also interdependent with franchisor. Some kind of authonomy must be given to franchisees, within the boundaries of common and accepted framework of marketing mix and business values.

From a brand strategy perspective, franchised stores can be risky for franchisors because franchisees may engage in opportunistic behavior, such as reducing customer service efforts if they believe customers are unlikely to return. This could happen in tourist resorts on islands where visitors typically make only one trip. Conversely, directly operated stores in remote locations present challenges for franchisors, as monitoring and controlling store managers from a distance can be difficult, potentially leading to underperformance. Therefore, choosing between directly operated stores and franchised outlets is a complex decision.

Since the choice between franchised and directly operated stores has often been analyzed based on the ability to control franchised stores (ideally making them operate as if they were directly operated), academic research has explored the consequences of using power in distribution channels.

To analyze interorganizational relationships, one of most popular framework is that of power bases (French and Raven, 1959), that mainly consider five forms of relational power, coercive power, rewards, legitimation, expertise, and identitification, so-called referent power. The framework was originally developed to describe interpersonal relationships, proved to be useful to analyze different kind of relational contexts, from interorganizational relationships in distribution channels to relationships between brands and customers (Manaresi, 1999).

Companies have learned from experience and academic research that maintaining high levels of control over franchised stores is challenging. If conflicts arise between franchisors and franchisees, they are difficult to resolve, and sales and brand strategy can suffer if franchisees do not adhere to the franchisors' expectations.

Franchisors that build relationship with franchisees on coercion and rewards, risk to create conflict (Lusch, 1976). On other hand, the possession and use of non coercive sources of power, that are legitimation due to contract or tradition, expertise (innovation, product quality, information about market), and referent

(identification) power are much more effective in creating a non conflictual relation between franchisor and franchisee; even if is clear that non coercive sources of power are bases and starting point to develop a partnership relation in franchise networks, it's also equally clear that such sources of power cannot be developed in short time and are difficult to build. For example, referent power is typical of franchisor companies that have strong ethical values or strong personality of founding entrepreneur (The Body Shop was one good example, when was controlled by the founding entrepreneur, Anita Roddick); expert power is created over time, and it can be used once franchisor has accumulated long history of technical innovation or good service; legitimation such franchisors can tell franchisees what to do, rather than just on what is written on contracts, depends very much on traditions and routines, and they all take time to establish. For the reason that franchisors can control in a non conflictual manner their network of franchisees if they have relatively long hystory of success of some kind (because this allows them to develop "right" sources of power, the non coercive ones), they are usually recommended to launch franchising only after experimenting for some time business format in their own directly operated stores.

Studies on aftermath of conflict, and on impact of conflict on company performance highlight the importance of constant need to monitor state of vertical and horizontal relationship in franchise channels. As suggested by Chinese military strategist and philosopher Sun Tzu, the art of managing opportunism in relationships may lie in mitigating conflicts of interest without costly confrontations between parties. The investigation about non coercive power sources offers important implications for franchise managers: non coercive power sources, by mitigating conflict of interests, tend to align goals of partners and prevent conflict and its consequences.

2. FRANCHISE AND DIRECTLY OPERATED STORES – A COMPARATIVE ANALYSE OF STARBUCKS AND DUNKIN'

Franchises and directly operated stores are effective ways to develop a brand and gain market share. Both models primarily differ in ownership, profit allocation, risk, control, and marketing strategy. Some companies may strategically choose to combine both models when structuring their distribution networks. For example, in United States, such pluralistically organized chains have already overtaken purely franchised competitors (Ehrman & Spranger, 2005).

When it comes to ownership, in directly operated stores, a parent company owns

the stores and has power to make business decisions centrally. In franchise, each store location has its own ownership and ability to make operating decisions. Contrary to the original and well-known hypotheses from Oxenfeld and Kelly (1969), franchisors, even at a later stage of company development, do not see shifting to directly operated stores as preferred solution for growth. Instead, they prefer to invest resources and expand internationally while maintaining the role of franchisor by licensing master franchises or multi-unit operations to business partners.

In terms of the profit allocation, in directly operated stores, parent company receives all profit from stores which operates in different locations; in franchise, profit comes in form of royalties shared with the franchisor.

Risk distribution is also different. In directly operated stores, parent company assumes all the risks; in franchise, franchisor and franchisee shares the operational risks. Similarly, the control is centralized in directly operated stores; in franchises, franchisor has less control over franchisees. Franchisees often adapt the product range and other marketing variables such as price and communication to local customers, either contractually or without franchisor's awareness.

About marketing strategies, franchising is generally more suitable for culturally diverse markets (Petkovska & Petkovska Mirchevska, 2014); the franshises can provide adaptation that is not easily managed in directly operated stores, where most location serves as test sites for consumer research and commercialization of new products.

In franchising, a multi-unit franchise plays an important role. They are entrepreneurs with numerous touch points (stores and people) in the market, which gives a more balanced perspective on market trends and customer behavior influenced by specific events that occur in individual locations. Their point of view is more realistic than the single-unit franchises, so franchisors should pay more attention to them.

Based on the above, we conducted a comparative analyse of the applied business models in two largest restaurant chains specializing in coffee. The relevant data of the US coffee and snack market shows that the most powerful coffee and snack retail brands are Starbucks and Dunkin'. While Starbucks leads with 36.7%, Dunkin' holds the second position with 24.6% of the market share. There is a fierce competition between Starbucks and Dunkin'. Both continuing to expand their businesses, sharing territory and customers; on one side are Starbucks supporters who prefer brand's wide choice of drinks; on other side are Dunkin' followers, for whom pastries and donuts take precedence over drinks (Kadri Hassani, M.A., 2020).

Dunkin' began in 1950 as a restaurant Dunkin' Donuts, specializing in coffee and donuts. Since 1955, when first Dunkin' Donuts franchise opened, company has implemented franchise business model.[1]
Starbucks was founded in 1971, 20 years after Dunkin' Donuts. The company did not follow franchising model; it operated company-owned stores and joint ventures in over 60 countries and has stores in some of the most prime and strategic location across the globe (Geereddy, 2013).
Dunkin's franchise model has been a successful business strategy for over 70 years. Its franchise-oriented approach leads to a fundamentally different business structure than Starbucks' owner-operator model, impacting revenue streams and cost structures.
Compared to Dunkin', Starbucks is larger in terms of market capitalization and number of stores globally. Since its start in 1971, Starbucks has grown distribution network with numerous specialist coffee retailers. Its revenues are from various business segments: company-operated stores, consumer packaged goods (CPG) foodservice operations, and licensed stores (Glowik, 2017).
A specific characteristic of Starbucks' model is that company operates its own and licenses stores to third-party operators. Licensees pay a portion of all revenues generated by store in exchange for using brand name, products, detailed store operating procedures, and training classes similar to those provided to employees of company-owned stores. This results in higher operating profit margins for Starbucks than for company-operated stores. In addition to license fees and royalties, Starbucks gains additional market access and retail space, as well as local market data and expertise from licensees (Rothaermel, 2017).
Starbucks aims is to become most famous and respected global coffee brand. To achieve its goal, company continues to expand retail operations and sales while selectively pursuing other opportunities to leverage and grow its brand through introduction of new products and new suppliers globally. To increase the product demand, it focuses on marketing mix as a tool of external marketing strategy. Its organizational structure matches current business needs with new improvements; the functional structure groups operations based on business model, facilitates top-down monitoring and control, with president and CEO at the top (Azzriudin et al., 2020).

Starbucks' primary competitors are shops specializing in coffee, with Dunkin' being one of its main rivals. It has built more premium brand than Dunkin',

1 From 2018 rebranded and re-named to Dunkin'.

particularly by offering extensive product customization. Dunkin' has more competitive pricing, focusing on middle-class consumers. It licenses nearly 100% of its stores, owning and operating restaurants under corporate umbrella, which allows to focus on innovation and marketing without spending much time and effort on everyday operations. The franchise model also enables quickly expand of the number of stores without requiring large capital expenses (Rothaermel, 2017).
In addition to coffee and donuts concept, one of Dunkin's main strengths is the adaptability of franchise model to the new trends and innovations. The company invests in superior products and services through aggressive marketing; needs-based marketing activities are conducted during launchong new products, such as sampling around stores (Kadri Hassani, M.A., 2020).
Each of the Dunkin's market is different and company engages researcher teams to adapt their products to the local tastes. The business model gives the advantage over other foreign-owned brands, making it flexible for changes that can improve its positioning on the local consumers' needs. The company focuses on improving coffee sales by adapting on different tastes; in some markets, company sells more drinks than donuts; in other, donuts and other products generates more revenues. So, Dunkin' has the international recognition for its diverse products, strong brand awareness among best coffee sellers in the world, and aims to build customer loyalty through high levels of customer service in its stores (Kadri Hassani, M.A., 2020).

3. CHALLENGES OF DIGITAL CHANNELS TO RETAIL BUSINESS MODELS

In last twenty years, a large number of companies developed e-commerce channels that created one more distribution and communication tool to interact with customers. Franchisors launched their own centralized e-commerce platforms: when presenting this new channel, franchisors usually promised that there would be no negative effect on franchisees' business; in beginning of e-commerce age, franchisors mainly downplayed risk of encroachment as e-commerce was just small business with little data to rely on and few customers used to shop with digital channels; in short term, most companies successfully launched e-commerce service and kept it small for some time. In recent years, e-commerce became very big, and inevitable longer-term problem appears to be coming: franchisees started feeling worried about future; they perceived risk of being old age of retailing; some of them now feel that their role is

changing, being more instrumental to new business, e-commerce, about which the gains and profits would go to franchisors.
Some research has already been done about possible problems that franchisees might perceive and how franchisors could communicate with them to prevent these perceptions from hurting working relationship (Kremez, Frazer, Thaichon, 2019). What has been analyzed is franchisees behaviour and/or franchisors during a working relationship to cope with introduction of e-commerce in the network.
What has *not* been analyzed yet is longer-term effect on structure of store networks, including willingness of franchisees of different kind, mainly multi-unit franchisees vs single-unit franchisees, to invest more or enter in first place in franchising networks. Franchisees can perceive of being cut out of new e-commerce business, and this could be push for an ownership redirection of franchised stores towards larger percentage of directed operated stores. The starting percentage nowadays is often very low (less than 10%) of directly operated stores vs. franchised stores in large chains. What this research tells us about a franchise model as that of Dunkin', is that it could become difficult to sustain competitive advantage of large market penetration that is given by number of stores that franchising allow to develop; franchisees of many franchises could decide not to renovate or invest more in franchise, and sweitch to independent retailing or to other franchises. Multi-unit franchisees, that usually guarantee stronger part of a franchise, have more balanced power in relationship with franchisors, and could have more alternative opportunities, being an attractive target for franchises that can get franchisees involved in e-commerce business.
Different strategies to get franchisees involved need to integrate them into e-profit-sharing scheme, for example guaranteeing them a percentage of e-commerce sales generated in their territory, or even diverting e-commerce traffic towards their local store that at could so become logistic starting station for delivery of purchased product to final customers. A click-to-collect model in a franchisor's centralized e-commerce system, without an involvement of franchisee in that specific profit and deal (customers just buying from franchisor's e-commerce and collecting product in a franchisee' store) would not satisfy franchisee, as it does not generate enough additional business.
Challenges coming from digital marketing and channels to integrated network of stores like Starbucks can come from changing habits of customers. Product delivery to home and office of snacks and meals could be intermediated by new companies that, by putting themselves in the middle between company and

customers, could orientate demand and get significant percentage of original sales margin. When dealing with specific industry of coffee bars, it's important that a lot of "invisibile" competion come from vending machines in offices and coffee machines for nespresso and similar products, which have completely changed consumer's habits for coffee at home and offices in many countries.

CONCLUSION

Both systems, Dunkin' franchise and Starbucks directly operated stores, have proven successfuly in terms of global expansion and profit development. Thus, it's not appropriate to conclude that one system is necessarily better than other. Each has its own pros and cons, making them potentially more successful or vulnerable depending on different competitive and market evolution patterns and contexts.

Dunkin' franchise system's ability to adapt to local markets is a clear strength, especially when developing business in culturally diverse countries. However, same reasons that make company adaptable, franchise model can also become a source of vulnerability in an evolving market and technology context. Business format franchising, like Dunkin's, which was originally developed for agency reasons (lower local control costs) and capital structure optimization (rapid growth with investment from franchisees), creates touchpoints that replicate same business to some extent. However, it cannot perform exactly like a directly owned operation system. Even in a business format franchise, the degree of goal alignment between franchisees and franchisor and strategic control (over local prices, communication, product range, etc.) cannot reach high level achievable in a directly operated store model.

As described in this article, one of new challenges franchised companies like Dunkin' face is potential conflict between development of a franchisor's centralized e-commerce and physical franchised stores due to structural dissonance and difference of goals that makes encroachment become a potential source of conflict. Without some form of e-profit sharing between franchisor and franchisees, franchisees' willingness to invest and renew contracts may decline, decreasing future opportunities to expand network of stores without substantial capital investment in directly operated stores.

Starbucks operates a premium price business in highly competitive industry, such as coffee bar business. To achieve this, Starbucks keeps ownership of its retail operations to maintain maximum direct control over service experience, product quality and high pricing. To address encroachment issues and risks, such as those arising from centralized e-commerce with physical stores, Starbucks

system appears safer, as goal alignment is ensured through ownership. Brand extension to e-commerce, as Starbucks is doing with Nespresso, will not create relational problems with stores nor weaken long-term market penetration of physical store network.
On other hand, Starbucks has more demanding capital investment and cost structure. Not only are stores directly owned and operated, but they are also developed as large, attractive stores in prime high-street locations. This network is consistent with premium price positioning to be successful, which might make company more vulnerable when competing with more strategically agile and price-aggressive companies, like Dunkin' or new companies developing franchise formats in bubble tea or similar businesses in many countries. The constant entry of new competitors in the coffee bar industry indicates low entry barriers, as technology and locations are readily accessible. Future research needs to update and expand academic analysis and literature, considering ever-evolving context of market and technology, which presents new challenges even for succesfull companies and business models as Dunkin' and Starbucs.

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