

Article

Franchisors' Strategic Pricing Approaches for Franchise Fee Decisions and the Moderating Role of the Competitive Condition: Evidence from the Korean Franchising Market

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Abstract: As franchising provides several benefits to both corporations and small business owners, a growing number of contracts have been written through which corporations offer the right to use their brand name and business model, and small business owners pay fees for accepting the offers. In this franchisor–franchisee market, the franchise fee plays a pricing role in the exchange between two parties. In this context, we investigate the influence of franchisors' strategic pricing approaches (i.e., cost- and value-based approaches) on franchise fee decisions. Furthermore, by examining the moderating effect of the competitive condition on the relationships between pricing approaches and franchise fees, we uncover franchisors' pricing practices in greater detail. The results show that both pricing approaches have significant influences on franchise fee decisions, and the competitive condition moderates the relationship between the value-based approach and franchise fees but does not moderate the relationship between the cost-based approach and franchise fees. The findings contribute to the franchising and pricing literature and to industry practitioners.

Keywords: cost-based pricing approach; value-based pricing approach; competitive condition; franchise fee decisions



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1. Introduction

Franchising has gained diverse interests due to its multifarious benefits as a business strategy. Corporations that possess brand names and business models are interested in this organizational structure because franchising helps them expand their business quickly and efficiently without spending their resources (Combs and Castrogiovanni 1994; Lafontaine and Kaufmann 1994). On the other hand, small business owners also pay attention to franchising because it enables them to run their business without having to bear the burden of developing their brands or business models (Combs and Castrogiovanni 1994; Lafontaine and Kaufmann 1994). In this sense, it can be understood that franchising offers benefits to both sides by satisfying each party's needs and thus has become a prevalent strategy in several industries.

The aforementioned benefits of using franchises for both parties motivate them to participate in the franchisor–franchisee market by developing several types of franchises. The types of franchising can be generally divided into five classifications: job franchises, investment franchises, distribution (product) franchises, business format franchises, and conversion franchises depending on the scale of the business, the amount of initial investment, and the types of offerings to the franchisees (Simpson 2022). Although each of the types has distinct characteristics, the business format franchise is the representative and most popular type of franchise system. The business format franchise is used mostly in services industries such as restaurant, retail, and business services (Simpson 2022).

In the franchisor–franchisee market of the business format franchise, where corporations seek to sell their business models, and potential small business owners seek to buy these models, the franchise fee can be recognized as a price for the exchange between sellers and buyers because sellers (franchisors) require buyers (franchisees) to pay the fees for entering into contracts that allow them to use their business models (Kaufmann and Dant 2001). Franchisors' decisions on how much to charge represent their critical strategic decisions, which influence the firm's competitive advantage and profitability (Lancioni 2005). As setting a price involves several organizational objectives (Guerreiro and Amaral 2018; Hinterhuber 2004, 2016), these decisions can be made through diverse perspectives depending on a firm's strategic characteristics. Thus, understanding the pricing mechanism of franchise fee decisions can be essential to identifying the strategic characteristics of franchising.

In the franchising literature, previous research has focused on the contractual features of franchise fees rather than the pricing context. Prior researchers have investigated the factors that influence franchise fees mostly based on agency problems and have suggested that the fee structure is determined to minimize agency problems between franchisors and franchisees and induce the best efforts of each party during the contract period (e.g., Brickley 2002; Lafontaine and Shaw 1999; Maruyama and Yamashita 2012; Mathewson and Winter 1985; Roh 2000; Vázquez 2005). Specifically, Zeißler et al. (2023) provided empirical evidence that factors to reduce the risk of opportunism (i.e., economic potential, legal right protection, and contract duration) are important for franchise fee decisions in the international franchise setting as well as in the national context, which confirms recent findings on the agency problems (Jayachandran et al. 2013; Lanchimba et al. 2018). These studies helped us learn the structural features of the franchise fee based on the contractual perspective. However, research on the determination of the franchise fees through the lens of looking at the fee as a price is scarce. Although Panda et al. (2019) investigated the influence of positioning strategies on franchise fees and found that successful positioning enables franchisors to increase their fees, the fundamental pricing theories to explain the strategic features of the price decisions are missed in their study. Overall, understanding the pricing mechanism (i.e., how the fee amount is determined) is limited in previous studies.

To address this gap, the current study adopts a traditional theoretical background to examine how franchisors' strategic pricing affects their franchise fees as a price. In the pricing literature, diverse perspectives related to setting an appropriate price have been discussed, and those perspectives are usually categorized into two distinct approaches—quantitative and qualitative approaches. Cost-based approaches and value-based approaches, which are the representative approaches of each method, have been traditional and basic foundations for the pricing mechanism (Amaral and Guerreiro 2019; Avlonitis and Indounas 2006; Hinterhuber 2008; Indounas 2009; Ingenbleek et al. 2003; Raju and Zhang 2010; Shipley and Jobber 2001). The cost-based approach has been recognized as the most prevalent method in practice because collecting supporting data for decisions is easy, and the method provides clear guidelines for profitable prices (Fabiani et al. 2005; Guerreiro and Amaral 2018). The value-based approach has been emphasized by marketing scholars who insist that perceived value or benefits are prime factors that firms must consider for price decisions (Hinterhuber 2004, 2008; Töytäri et al. 2015). The two approaches have been used to explain how pricing decisions are made depending on the strategic orientations of a firm. Based on this discussion, we argue that the two pricing approaches can be applied to a franchisor's fee decision making that aligns with each firm's strategic objectives.

To uncover a more detailed view of the pricing mechanism of franchise fees, we further address that, along with the aforementioned two approaches, pricing practices can also be influenced by business environment conditions. Porter (2008) mentioned that market turbulence has profound effects on the market structure and thus individual firms' competitive positioning. It can be suggested that the competitive power distribution in the market affects a firm's position and that firms incorporate this information into their

strategic decision making. Thus, franchisors' strategic positioning when they are making pricing decisions is impacted by the competitive condition, which ultimately affects their franchise fee decisions (Sudhir 2001; Ziari et al. 2022). Based on this rationale, we argue that competitive conditions moderate the influence of cost- and value-based approaches on franchise fees.

The aim of this study is to explore and analyze the impact of the two pricing approaches (i.e., cost- and value-based approaches) on franchise fees and the moderating impact of competitive conditions on the relationships between pricing approaches and franchise fees. In particular, by examining the moderating effect, we seek to extend the understanding of how competition influences franchisors' decision-making processes for their franchise fees. The findings of the study contribute to the existing knowledge in the franchising and pricing literature by showing that the franchise fee decision process can be explained through traditional pricing approaches. Additionally, both franchisors and franchisees will find the findings of this study beneficial. Learning about the industry characteristics related to pricing practices can inform franchisors and offer them directions when adapting their fee-setting strategies to survive in the market. Franchisees can gain knowledge regarding fee-setting mechanisms to help them make better purchasing decisions.

This study is organized as follows: We first review the relevant literature on the topics of the strategic pricing approaches and then develop hypotheses for the relationships between pricing approaches and franchise fees and the moderating effect of the competition on the relationships. Next, we describe the data and methods for the empirical tests, and the results are provided. Last, the findings of the study and limitations are discussed.

2. Literature Review and Hypothesis Development

2.1. Prior Research on Pricing Approaches

The research on strategic pricing is summarized based on two main approaches to explain how firms make pricing decisions: the cost- and value-based approaches. The two dominant approaches have been developed as a set of theoretical foundations that explain firms' pricing practices. Researchers in each stream have contended that each method could be superior in understanding firms' pricing behavior (e.g., Courcoubetis and Weber 2003; Guerreiro and Amaral 2018; Hinterhuber 2004, 2016).

Practical results show that cost-related information is most frequently used for pricing decisions because it is easy to attain from accounting data (Amaral and Guerreiro 2019; Fabiani et al. 2005; Govindarajan and Anthony 1983; Guerreiro and Amaral 2018; Hanson 1992; Noble and Gruca 1999). Using the cost-based pricing approach, firms decide prices by totaling direct and overhead costs and markups (Calabrese and De Francesco 2014). The advantage of using this method is that cost-related information enables firms to discover the marginal line where prices can produce positive profits (Courcoubetis and Weber 2003; Hinterhuber 2004, 2016). Based on the empirical evidence, Amaral and Guerreiro (2019) mentioned that the cost-based approach is recognized as an essential method for pricing since it also incorporates competitors and value information. Ali and Anwar (2021) specified the cost-based approach into detailed strategies such as penetration pricing, price skimming, and competitive pricing and found them to have substantial magnitudes of influence on the pricing. These findings provide a strong background for understanding that the cost-based approach is identified as the most prevalent method across companies.

The value-based method is proposed by another stream of the research on strategic pricing approaches, primarily in marketing. Scholars in marketing have emphasized the value of products or services as the most important factor to be incorporated into pricing decisions (Hinterhuber 2004, 2008; Kienzler 2018; Liozu and Hinterhuber 2012; Töytäri et al. 2015). Hinterhuber (2004) noted that assessing customer value is key to discovering a profitable price. Specifically, since customers make purchasing decisions by comparing the value from products or services that they can earn with the monetary value that they are spending, an understanding of customer values allows firms to determine a specific range

of prices that primarily far exceeds cost. Calabrese and De Francesco (2014) mentioned that since it is difficult to implement, this approach may not be widely used in a service environment. It is also acknowledged that capturing value requires significant effort for pricing decisions (Christen et al. 2022; Raja et al. 2020). Although implementing the value-based approach is considered to be challenging, scholars have insisted that value-based pricing is a powerful tool to capture an appropriate price (Hinterhuber 2004, 2008) and is a superior method for maximizing profits (e.g., Monroe 2002) and gaining a competitive advantage (Dutta et al. 2003).

Given these perspectives, situational factors are considered to influence pricing practices based on the proposition that the most effective strategy depends on contingencies (Donaldson 2001). Using contingency theory, scholars have attempted to delineate pricing practices by incorporating environmental factors into firms' pricing decision-making processes (Chen 1996). Ziari et al. (2022) noted that competition in the market is a crucial factor for pricing decisions, especially in today's market, which is highly dynamic and competitive. Competitive conditions influence a firm's market position, which is closely related to its capacity to choose a specific strategic plan. Therefore, firms must incorporate competitive conditions to adopt the most effective pricing strategy (Sudhir 2001). The competitive condition is viewed as a significant influencing factor for strategic pricing determination.

Avlonitis and Indounas (2004, 2006) investigated price-setting practices based on market conditions and discovered a relationship between pricing methods and market conditions. In their study, market-based information was found to play a role in determining more precise pricing points. Indounas (2008) concluded that companies that are more professional when making pricing decisions devise a holistic approach that combines costs and market information for price decisions. Indounas and Avlonitis (2011) concluded that the most appropriate strategies consider information that is both internal and external to the company. The findings of these studies show that incorporating market information could provide better results in determining prices. In this sense, it would be reasonable to understand that market competition acts as a situational factor for determining the pricing approach (i.e., cost- and value-based approaches) that is better suited to the existing environment. Based on this understanding, we assume that competitive conditions enable firms to determine their own competitive situations in the market and thus make better pricing decisions.

2.2. Cost-Based Approach and Competitive Condition

The influence of a franchisor's cost on its franchise fee can be clearly understood using evidence from prior research. When franchisors determine how much of a fee they need to charge for their business model, they may need to focus on internal situations. They calculate the costs that they spent for producing business models and services and add a specific margin to earn a profit (Sammut-Bonnici and Channon 2014; Ziari et al. 2022). Thus, franchisors with an efficient cost structure are able to set prices that are lower than those of competitors by as much as is the gap between their costs and others' costs. Since a lower price is mostly a component of creating a competitive advantage when other factors remain constant, franchisors are likely to charge a lower price for their business model. On the other hand, franchisors with higher costs must set their fees higher to make their business profitable. Based on this rationale, we hypothesize that costs have a positive influence on franchise fees.

Hypothesis 1 (H1). *Costs and franchise fees have a positive relationship.*

We further hypothesize that the positive relationship between costs and franchise fees can be weakened as the franchisor experiences strong competitive conditions. When a firm has relatively lower market power compared to its competitors, it may feel strong pressure in the market. To overcome this situation, the firm chooses to increase or at least not lose its market power by lowering its prices. In this case, the market penetration strategy can

be considered the most effective option to overcome this circumstance (Chang and Horng 2010). Firms may offer cash discounts to lower their prices, which is expected to stimulate consumers to buy more of their products. As a result, the firm could successfully gain or sustain its market share by breaking through an existing market situation. Using this strategy, a franchisor may not be able to sustain its price above the desired margin or at least its cost level. In this situation, it would be difficult for the franchisor to incorporate cost information to determine its price. Thus, the strength of the relationship between the cost-based approach and franchise fee decisions is weakened.

Hypothesis 2 (H2). *The franchisor's competitive condition weakens the positive relationship between costs and franchise fees.*

2.3. Value-Based Approach and Competitive Condition

The value-based pricing approach considers what consumers perceive from experiencing a firm's offerings (Hinterhuber 2016; Töytäri et al. 2015). Specifically, value can be defined as the perceived worth in monetary units of the set of benefits that customers receive in exchange for the price paid for the product offering (Töytäri et al. 2015). Since customer value measures how much customers are willing to spend for the offerings, this approach is known as a reliable pricing method (Guerreiro and Amaral 2018; Hinterhuber 2016; Hinterhuber and Liozu 2012).

Potential franchisees perceive higher value if the franchisor's business model is well developed such that replicating it gives the franchisor higher profits. For example, operational value includes specific benefits or support that franchisees can utilize from a franchisor for successfully managing their operations. Strategic value refers to the advantages that franchisees can gain from a franchisor when it clearly sets its goal and possesses successful plans and knowledge to achieve those goals. If a certain franchisor is evaluated as better able to provide these values than other brands, potential franchisees would be willing to pay higher fees for the franchisor. Thus, the franchisor can determine a higher franchise fee.

Hypothesis (H3). *The value of a franchisor and the franchise fee have a positive relationship.*

We also propose that the positive relationship between value and the franchise fee is influenced by competitive market conditions. If a firm faces strong competitive power from its competitors in a market, another way to overcome this challenge is to create a new market by differentiating itself from existing products/services. This competitive response is usually shown by firms that pursue dynamic competition (Jacobson 1992). We assume that franchisors are likely to take this position because they are capable of adjusting themselves to consumers' needs and developing a new market offering by utilizing their own knowledge and experience as well as that of their franchisees (Cox and Mason 2007; Dada and Watson 2012). These innovative actions enable them to offer higher values to their franchisees in the end. Therefore, franchisors become able to adjust their fees based on the increased values to produce higher profits. In this sense, the relationship between the value-based approach and the franchise fee is strengthened by the competitive condition of the franchisor.

Hypothesis (H4). *The franchisor's competitive condition strengthens the positive relationship between value and the franchise fee.*

3. Methodology

3.1. Data

Data were collected from franchise restaurants operating in the Korean market. Franchise firms' financial data and their franchising-related information were retrieved from the franchise disclosure documents (FDDs) in the database managed by the Korean Fair Trade Commission (KFTC). To protect franchisees' right to check their franchisors' managerial condition, KFTC requires franchisors to submit their managerial information, such as

balance sheet components and franchising conditions. Additionally, we collected the brand equity index of franchisors from the Korea Brand Power Index (K-BPI), a national indicator of a firm's brand power released by Korea Management Association Consulting (KMAC). The sample period ranges from 2017 to 2021 since the most recent 3 years of FDDs are stored in the database, and each FDD contains 3 years of data.

3.2. Variables

The dependent variable of this study is the franchise fee as the price of a franchise business model. The franchise fee is usually known as having two parts: a lump-sum amount of the initial fee and a continuing fee. However, the structure of the franchise fees can have diverse forms according to markets and countries (Blair and Lafontaine 2005; Maruyama and Yamashita 2012). One of the most substantial differences in the franchise fees in the Korean market compared to those in other markets is that the majority of franchise contracts do not request continuing fees from their franchisees. Some franchisors officially announce that they do not receive continuing fees. As a result, only the initial fee is recognized as the price charged for purchasing a business model when franchisees enter into a franchise contract. Franchisors set their initial fee as a franchise fee and attempt to incorporate margins into the price of raw materials (Lee and Seo 2022). Therefore, in this context, to examine franchisors' pricing practices, it is reasonable to use the initial fee as a price of a franchise business model. The initial fees include registration, training services, and other fees to support all of the activities and help launch franchisees' operations.

The independent variables are franchise firms' cost level and customer value. The cost level was measured as the proportion of operating expenses to total revenue, which indicates how efficient a franchisor is when producing their business model and operating and managing the entire brand. This measurement is considered a representative variable to capture the cost structure of companies (Shipley 1983; Hanson 1992; Noble and Gruca 1999; Indounas and Avlonitis 2009, 2011).

The customer value of a franchise is measured as a brand equity index of a franchise brand. As secondary data for the values that franchisees perceive from franchisors, brand equity can be a reasonable measure because it is possible to infer the degree to which a franchise brand offers benefits to franchisees through this measure. The strongest motivation for potential franchisees to engage in the franchise contract is that franchising can help them start their own business using an already established brand name (Calderon-Monge and Heurta-Zavala 2015). Through the recognized brand, franchisees can take advantage of its image, which is beneficial for promoting their business. Additionally, the fact that a franchise has great brand equity could be evidence that customers are highly satisfied with the brand experience. This means that the franchise model is successfully operated and managed, which can benefit existing franchisees of the brand. Thus, the higher the brand equity of a franchise, the higher the value that it could provide to its franchisees. To measure brand equity, the K-BPI was collected from the database developed by the KMAC. KMAC is one of the largest Korean consulting firms and provides business analysis and management consulting services, as well as marketing research. K-BPI is a widely accepted measure of brand equity in Korea and has been adopted in previous research (e.g., Lee et al. 2021).

The moderating variable is the competitive condition faced by an individual franchise firm in the markets. According to Chen et al. (2007), the competitive condition in a market has a different magnitude of influence on each player even in the same market. Based on this notion, we used Cool and Dierickx's (1993) rivalry index to measure the competitive condition of each franchisor. According to Cool and Dierickx (1993), each firm's degree of rivalry is calculated by excluding the squared value of a firm's market share from traditional concentration measures. Each market is defined according to the industry categorization by KFTC.

Control variables are included to control for the possible confounding effects on the relationships between franchisors' pricing approaches and franchise fees. Franchisors' firm

size, measured as the number of outlets, is used to control for the influence of the size of the brand (Panda et al. 2019). Franchisors' operating experience is employed to control for the possible effect of operating knowledge accumulated in the organization on their pricing behavior (Calderon-Monge and Heurta-Zavala 2015). The contract period of the franchise contract is included in the model due to its possible influence on the determination of the franchise fee (Roh 1998). Franchisors' degree of engagement in franchising, measured as the proportion of franchised outlets to the total number of outlets, is used to control for the influence of the strategic importance of franchising on pricing determinations (Sun and Lee 2016). The franchisee's operating performance, measured as franchisees' average sales of a brand, is included because it possibly influences franchisees' purchasing decisions.

3.3. Econometric Estimation

$$\text{Model 1: Franchise fee} = \beta_0 + \beta_1 \text{Costs} + \beta_2 \text{Brand} + \beta_3 \text{Rivalry} + \beta_{4\sim 8} \text{CVs} + \varepsilon$$

$$\text{Model 2: Franchise fee} = \beta_0 + \beta_1 \text{Costs} + \beta_2 \text{Brand} + \beta_3 \text{Rivalry} + \beta_4 \text{Costs} \times \text{Rivalry} + \beta_{5\sim 9} \text{CVs} + \varepsilon$$

$$\text{Model 3: Franchise fee} = \beta_0 + \beta_1 \text{Costs} + \beta_2 \text{Brand} + \beta_3 \text{Rivalry} + \beta_4 \text{Brand} \times \text{Rivalry} + \beta_{5\sim 9} \text{CVs} + \varepsilon$$

Franchise fee is a lump-sum amount of the initial fee that franchisees are required to pay when purchasing a business model; costs is a franchisor's cost level; brand represents brand equity, which is a proxy for the perceived value of a franchise; rivalry is an individual franchisor's competitive condition; and CVs are control variables in both analysis models, such as firm size, franchising experience, franchise contract period, degree of franchising engagement, and average franchisee performance. Model 1 is used to check the main effects of the two pricing strategies (i.e., cost-based and value-based approaches) on the determination of the franchise fee. Model 2 is used to analyze the moderating effect of the competitive condition on the relationship between the cost-based approach and franchise fees; thus, it includes an interaction term between cost level and rivalry. Model 3 is used to analyze the moderating effect of the competitive condition on the relationship between perceived value and franchise fees; thus, it includes the interaction term between brand equity and rivalry.

To control for the unobserved effects originating from the panel dataset on the estimation, we employ the econometric estimation appropriate for the panel datasets. Since the models include a time-invariant variable (i.e., contract period), it is not possible to use a fixed-effects model in this analysis. Thus, a random-effects model is selected for the estimation. To prevent endogeneity issues, cluster-robust standard errors are used and are expected to account for heteroskedasticity in the unexplained variation in the model (MacKinnon et al. 2022).

4. Results

4.1. Descriptive Statistics

The basic statistics of the variables are presented in Table 1. The mean value of the franchise fees is USD 132,387, and the standard deviation is USD 1,083,383. The cost level of the franchisors has 0.9367 as its mean value, and the result shows that franchisors have an average cost ratio to revenues of 93.67%. The mean of brand equity is 333.75, and its standard deviation is 178.57. The mean of rivalry is 0.2507, and its standard deviation is 0.1387. The mean firm size is 777.13, indicating that franchise firms have an average of 777.13 stores. Average franchising experience is 22.76 years, and the standard deviation is 38.32 years. The average contract period is 2.92 years, and the standard deviation is 1.06. The mean of franchising engagement is 0.9292, and the standard deviation is 0.1508. Therefore, the proportion of franchised outlets is 92.92% of the total number of outlets of the brand. The mean of franchisee performance is USD 290,858. In other words, the average annual sales of franchisee operations is USD 290,858.

Table 1. Descriptive statistics and results of the Pearson correlation test.

	Variable	Mean	S.D.	1	2	3	4	5	6	7	8	9
1	Franchise fee ^a	132,387	1,083,383	1								
2	Cost level ^b	0.9367	0.1145	0.332 ***	1							
3	Brand equity ^c	333.75	178.57	0.418 ***	0.095	1						
4	Rivalry ^d	0.2507	0.1387	0.029	−0.078	−0.133	1					
5	Firm size ^e	777.13	711.86	0.037	−0.068	0.487 ***	−0.123	1				
6	Franchising experience ^f	22.76	38.32	0.199 **	0.122	0.157 *	−0.277 ***	0.217 **	1			
7	Contract period ^g	2.92	1.06	0.585 ***	0.309 ***	0.289 ***	−0.016	−0.067	0.074	1		
8	Franchising engagement ^h	0.9292	0.1508	−0.586 ***	−0.257 **	−0.106	0.058	0.239 **	−0.000	−0.513 ***	1	
9	Franchisee performance ⁱ	290,858	195,736	0.628 ***	0.123	0.515 ***	−0.238 **	0.234 **	0.098	0.397 ***	−0.503 ***	1

^a Measured as the up-front franchise fee and converted from Korean won to US dollars (1 dollar = 1200 won). ^b Measured as the ratio of total costs to total revenue. ^c Measured as the Korea Brand Power Index (K-BPI). ^d Measured as the condition of rivalry. ^e Measured as the total number of outlets of a franchise brand. ^f Measured as the number of years the franchisor has been operating. ^g Measured as the number of years of the franchising contract period. ^h Measured as the ratio of the number of franchised outlets to the total number of outlets. ⁱ Measured as the average annual sales of a franchisee operation and converted from Korean won to US dollars (1 dollar = 1200 won). * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table 1 also contains the results of the Pearson correlation test. Franchise fees are positively correlated with cost level and brand equity at the 0.001 level ($\rho = 0.332$ and 0.418). Specifically, when franchise fees increase, there is a tendency for cost levels to also increase, and vice versa, and the magnitude of the relationship is 0.332, a relatively weak positive correlation. Also, regarding the correlation between franchise fees and brand equity, when franchise fees increase, brand equity tends to go up as well, and the magnitude of the relationship is 0.418, a moderate positive correlation. Among the control variables and the dependent variable, the correlation between franchise fees and franchisee performance is 0.628, which is the highest relationship at the 0.001 level. The correlation between franchise fees and franchising engagement is -0.586 , which is the second highest value ($p < 0.001$). Contract period has a 0.585 correlation with franchise fees ($p < 0.001$), and franchising experience has a 0.199 correlation with franchise fees ($p < 0.01$).

4.2. Results of the Main Analysis

The results of the panel data estimation are included in Table 2. All three models have main effects of cost level and brand equity on franchise fees that are significant at the 0.01 and 0.001 levels, respectively ($\beta = 0.573$ and 0.2476). These results provide evidence that cost level and franchise value have positive influences on franchise fees, thus supporting Hypotheses 1 and 3. To examine the moderating effect of competitive condition on the main association between cost level and franchise value and franchise fees, the interaction effects are tested in Models 2 and 3. The interaction between cost level and rivalry in Model 2 does not have a statistically significant result at the 0.05 level. Therefore, Hypothesis 3 is not supported. However, the interaction between brand equity and rivalry is found to be significant and positive at the 0.01 level ($\beta = 0.1869$). This result supports Hypothesis 4, which identifies the moderating effect of competitive condition on the association between franchise value and franchise fees.

Table 2. Results of the main analyses.

	Model 1	Model 2	Model 3
Cost level ^b	0.5730 ** [0.2187]	0.7092 [0.6655]	0.5432 * [0.2138]
Brand equity ^c	0.2476 *** [0.0660]	0.2465 *** [0.0066]	0.5542 *** [0.1342]
Rivalry ^d	0.0412 [0.0457]	0.0480 [0.0551]	-1.0474 * [0.4200]
Cost level ^b × Rivalry ^d		0.0987 [0.4557]	
Brand equity ^c × Rivalry ^d			0.1869 ** [0.0717]
Firm size ^e	-0.00008 [0.00005]	-0.00007 [0.00005]	-0.00008 [0.00005]
Franchising experience ^f	0.0013 [0.0007]	0.0014 [0.0008]	0.0015 * [0.0007]
Contract period ^g	0.1474 *** [0.0310]	0.1478 *** [0.1478]	0.1422 *** [0.0303]
Franchising engagement ^h	-0.8536 *** [0.2449]	-0.8607 *** [0.2471]	-0.8440 *** [0.2391]
Franchisee performance ⁱ	0.0014 *** [0.0002]	0.0014 *** [0.0002]	0.0014 *** [0.0002]
Chi-squared	320.36 ***	320.50 ***	341.96 ***
Number of observations	150	150	150

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$; ^b Measured as the ratio of total costs to total revenue. ^c Measured as the Korea Brand Power Index (K-BPI). ^d Measured as the condition of rivalry. ^e Measured as the total number of outlets of a franchise brand. ^f Measured as the number of years the franchisor has been operating. ^g Measured as the number of years of the franchising contract period. ^h Measured as the ratio of the number of franchised outlets to the total number of outlets. ⁱ Measured as the average annual sales of a franchisee operation and converted from Korean won to US dollars (1 dollar = 1200 won).

5. Discussions and Conclusions

5.1. Research Implications

The current research focused on an investigation of the strategic pricing practices of franchising firms. As franchise fees are one of the important revenue streams in the franchising business, the business model pricing decision is crucial for a profitable business. How franchising fee decisions are made needs to be studied to comprehend firms' real practices and to provide advice for making better management decisions.

Based on the previous literature on the pricing approach, cost- and value-based approaches were used to examine how franchisors determine their franchise fees. Furthermore, to understand how the two approaches function differently in the pricing mechanism according to a firm's competitive condition, we investigated the moderating effect of the competitive condition on the two main effects of the pricing approaches. The findings of the study showed that cost- and value-based approaches have significant influences on franchise fee decisions. Moreover, when the competitive condition that a firm faces increases, the positive influence of value-based approaches on franchise fees is strengthened, whereas the influence of cost-based approaches does not significantly change. The findings are specifically discussed as follows.

First, we found that the cost-based approach has a significant influence on franchisors' pricing decisions. As prior research has suggested, the reasons the cost-based approach is actively used in the pricing mechanism are as follows: (1) cost-related information provides a clear direction toward the possible price range, which guarantees positive profits to firms (Hinterhuber 2004, 2016); and (2) in most cases, this type of information is available in the organization, and collecting and understanding the data is easy and clear for any decision maker (Fabiani et al. 2005; Govindarajan and Anthony 1983; Guerreiro et al. 2006). The findings of this study showed that franchisors consider cost-related information to be useful for setting the prices of business models, thus supporting prior research (e.g., Ali and Anwar 2021; Amaral and Guerreiro 2019). The positive relationship between the cost level and franchise fees suggests that firms with lower cost levels decide lower fees and vice versa. This finding further suggests that franchise fees can be determined by the franchisor's ability to manage their cost structure.

Second, the moderating effect of a franchisor's competitive condition on the positive influence of the costs on franchise fees was not statistically significant. This result suggests that the importance of the cost-based approach for franchise fee decisions stays the same even when a focal firm's competitive condition differs. This nonsignificant result can support the notion of the prior research that the cost-based approach is the prevalent pricing practice in reality (Amaral and Guerreiro 2019; Fabiani et al. 2005; Guerreiro et al. 2006). This finding can be interpreted as regardless of the competitive condition, cost-related information plays an important role when franchisors set their prices. Therefore, the influence of the cost-based approach does not change, which confirms the suggestions of prior studies (e.g., Amaral and Guerreiro 2019; Fabiani et al. 2005; Govindarajan and Anthony 1983; Guerreiro and Amaral 2018).

Third, the value-based approach was found to have a positive influence on franchise fees. This result provides empirical evidence supporting the concept that values present crucial information in pricing decisions; therefore, firms incorporate this information during the price-setting process (Hinterhuber 2004, 2008; Töytäri et al. 2015). Prior research has noted that price plays a role in connecting sellers and buyers in the exchange because the exchange occurs when the monetary value that buyers are willing to pay equals the price that sellers set for the offerings (Hinterhuber 2004; Liozu and Hinterhuber 2012). Therefore, it is necessary for sellers to determine how much value buyers perceive from their offerings for pricing decisions (Christen et al. 2022; Hinterhuber 2016; Raja et al. 2020). The finding of the current study extends and strengthens the notions by confirming the importance of the value-based approach for pricing decisions in practice in the franchising industry. Although prior studies have primarily proposed this notion without providing empirical evidence, the current research provides evidence that confirms the previous propositions.

Last, we found that the positive relationship between the value and franchise fees is positively moderated by the level of competition that a franchisor faces. This finding suggests that the influence of the value-based approach becomes stronger on franchise fee decisions when franchisors experience substantial competition in the market. It supports prior research that the competition in the market has a significant impact on pricing decisions (e.g., [Chen 1996](#); [Indounas 2008](#); [Indounas and Avlonitis 2011](#); [Ziari et al. 2022](#)) and further clarifies how franchisors use this information for their pricing. Specifically, this result suggests that substantial competition makes franchisors focus more on how differentiated their value is compared to that of competitors and then try to charge an appropriate price based on this information. It is interesting to learn that franchisors tend to overcome substantial competition by evaluating what they are offering to customers rather than trying to engage in a cost-leadership strategy.

Through this research, we make several theoretical contributions to academia. By providing empirical evidence about how traditional pricing approaches influence franchise fee decisions, we add to the discussion in the pricing and franchising literature. By taking a perspective to recognize the franchise fee as a price of the franchise business model, we open up a discussion about the pricing role of the franchise fee in the franchising literature. Furthermore, we extend our understanding of pricing practices by specifying the pricing mechanism depending on the competitive condition. The findings help us deepen our understanding of the pricing mechanism in more detail.

This study also has practical implications for the industry. Franchisors can learn the characteristics of their industry with respect to franchise fee decisions. The findings of this study that franchisors incorporate cost level and customer value into their fee decisions help to identify how other franchisors (i.e., possibly competitors) set their fees. As price is a critical component to gain competitive advantages, recognizing competitors' pricing strategies enables a company to analyze their price components and establish competitive prices for their offerings. Furthermore, the findings of the study of how the competitive condition affects the pricing decisions enable them to precisely predict how their competitors would act and/or react regarding franchise fee decisions based on each firm's competitive condition. This knowledge can help them select better strategic options to attain competitive advantages and survive in the market in the long run. Additionally, potential franchisees could find this knowledge useful when entering into franchise contracts. As a price, franchise fees are one of the primary and crucial factors for their decision making. Knowing how the franchise fee is determined would help them understand the reasons why they are required to pay the amount of fees for a certain franchise brand. This knowledge can assist them in gaining a deeper understanding of the franchise business, which could prove beneficial in managing their business more effectively.

5.2. Suggested Future Research and Limitations

This study has several limitations. First, we used initial fees as a proxy for franchise fees based on the fact that charging only initial fees to franchisees is a typical practice in the Korean franchise market. As franchise fees are generally composed of two parts—initial fees and ongoing royalties—in other markets, caution needs to be taken when generalizing the findings of this study. Future studies may apply the research question to other franchise markets, and it would be interesting if they discover different results and findings, thus contributing to the overall franchising academia. Second, the perceived value of the franchise model was measured using secondary data (i.e., brand equity index of the franchise). Although using secondary data gave this study advantages in collecting an objective measure of several companies and conducting a longitudinal analysis, the data might not perfectly align with what franchisees perceive from the values of each franchise brand. Collecting the primary data by interviewing franchisees would improve the construct validity. Finally, to measure the competition that each firm faces in the market, the markets were recognized based on the subindustry classification arranged by the KFTC. However, in reality, restaurant franchises compete with each other even if they are not in the

same industry categorization. It will be helpful to consider the firms that are recognized as competitors from a focal firm's point of view and use this categorization of markets for the data analysis. By using this categorization, future studies could scrutinize the franchisors' pricing practices close to real business environments in greater detail.

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