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ABRAKEBABRA:

SURVIVING THE FRANCHISEE REVOLT

TEACHING NOTE

This teaching note was written by **Peter Mc Namara and Rosalind Beere,** of UCD Business Schools. It was prepared to accompany the case "AbraKebabra: Surviving the Franchise Revolt". Financial support of a grant from **Davy Stockbrokers** to undertake a series of teaching case studies is gratefully acknowledged.

We wish to also acknowledge the help of AbraKebabra Limited, it's franchisees, and the 13 interviewees for their support in the writing of this case study. Thanks are also due to our Masters students with whom this case has been taught, especially Heiko Bennert, Shane Brodbin and Chunchreek Singhvi.

This teaching note, and the full version of the case study it accompanies, are both available from the ECCH at http://www.ecch.cranfield.ac.uk/

Disclaimer: This teaching note has been written for the purposes of class discussion and academic analysis rather than as an illustration of effective or ineffective managerial or administrative behaviour.

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SUMMARY OF CASE

In 1982 Graeme and Wyn Beere opened a new style of fast food restaurant in Dublin, calling it AbraKebabra. It filled a gap in the market by locating close to pubs and nightclubs, catering to revellers that spilled out of these outlets in search of food. Open until 4am, it provided a range of food including kebabs, burgers and chips. Customers could take-out or eat in the seating area. 4 restaurants were opened by 1984. Lacking capital needed to exploit multiple opportunities they created a franchising system of 59 outlets, 11 owned and managed by themselves. By 2003 AbraKebabra was the 2nd largest fast food franchise in Ireland with 55 outlets (Mc Donalds has 66). In 2002 Wyn sold his 50% share for € 3.8 million, valuing AbraKebabra at € 7.6 million[1]. Profits in 2002 were €900,000, up 350% on 2001.[2] Success did not come easily. AbraKebabra survived 2 recessions and a franchisee revolt.

In 1997 franchisees held a series of secret meetings with the objective of renegotiating the franchise contract, in particular the 7% levies on gross sales paid to the franchiser. About the same time, the brothers realised that they spent 80% of their time managing their own restaurants, which generated only 20% of profits. The decision was taken to franchise out these restaurants, thus AbraKebabra became a 100% franchising model. Franchisees were met individually. Frank discussions ensued about the benefits and obligations of both franchisee and franchiser. As a result a small number of franchisees left AbraKebabra. The revolt prompted the brothers to consider how they could improve the franchising model. They considered objectives and responsibilities of both parties and then re-designed AbraKebabra with these in mind. The main objective for both parties was maximization of personal wealth. The new system would create mutual wealth, whilst managing conflicts of interest.

The responsibilities of a franchisee are: pay a € 50,000 contract signing fee, pay 7% levies on all sales, conform to opening hours, menu, hygiene, and marketing requirements of their contract, and manage day to day operations. For new franchisees, the franchiser provides initial operational training, a powerful national brand (one franchisee reported that conversion to AbraKebabra enabled him to reverse a one third decline in sales caused by Mc Donalds opening in his town), and assistance in fitting out the restaurant. The franchiser has four main duties: brand identity (national TV and promotions), new product development, centralised purchasing (estimated to reduce costs by 12%), and training, mentoring and support services.

AbraKebabra faces three challenges: selecting quality franchisees, ensuring franchisees continue to improve standards in customer service, and accuracy of sales reports. Franchisees are selected using a funnel system. First point of contact is via an on-line application. Second, some applicants are invited to interview, after signing a confidentiality agreement. Third, they participate in on the job training with an established franchisee for a period of 2 weeks to 3 months. Finally, if acceptable by both parties a ten-year franchise contract is signed.

Franchisees receive 4 to 5 weeks of on-site support once the restaurant opens. Performance of restaurants is monitored via weekly sales reports, provided by the franchisees. Staff from the franchiser visits every 2 weeks to discuss operational issues. Every 6 weeks regional supervisors undertake a hygiene audit. Customer service levels are monitored via customer comment cards in all restaurants (sent directly to headquarters) and regular mystery shopper visits, who report their findings directly to AbraKebabra headquarters.

[1] "Desmond Invest €3.8 million in AbraKebabra. *Sunday Business Post*, 25 May 2003.
[2] Business News (2004). AbraKebabra works its magic. *Sunday Business Post*, 22 February 2004.

TEACHING OBJECTIVES AND TARGET AUDIENCE

This case is suitable for **final year undergraduate and postgraduate management students**. The case has been designed for use in general management and strategy courses, but also has application in economics courses teaching agency theory.

I have taught this case both in **Ireland** (seven times) and **internationally** (once in France). In Ireland students are familiar with the product and engage immediately with the case. I was surprised that after showing the company web-site (including web-streamed advertisements) and briefly summarizing the customer proposition to French MBA students that they were very engaged in the case. The most surprising thing was that one of the French students explored the option of setting up his own AbraKebabra franchise in France!

The primarily teaching objective of the case is to illustrate **control systems and agency theory** in action. Important issues include alignment of principal and agent objectives, and both the evolution of franchisee selection systems to manage adverse selection risks and control systems to manage moral hazards.

Secondary teaching objectives include: **organisational renewal, franchising systems** and the **fast food business**.

ADVANCE PREPERATION BY STUDENTS

Typically I will break the class into groups and ask them to write a five page report on the below questions. At a minimum I ask them to have read the case in advance and considered it in the context of the below questions. Clearly students would need to have had a lecture on agency theory prior to addressing these questions, or alternatively have had a reading on agency theory. I find that advance preparation will mean that all group discussions within class are informed by theory, making for a more successful class.

1. Who are the <u>key Principals and Agents</u> in the AbraKebabra case? What are their <u>main objectives</u>?
2. Select <u>one principal-agent relationship</u> and outline the <u>main information asymmetries</u> that exist within this relationship. What are the main <u>implications</u> of these asymmetries?
3. How does AbraKebabra Limited manage <u>adverse selection and moral hazards</u> over time?
4. Imagine you are Graeme Beere. What strategy would you suggest to follow for the next five years?

An outline of how these questions can be analysed is provided in a separate section of this teaching note.

TEACHING TIMETABLE AND CONTENT

I like to teach this case by breaking the class out into smaller groups of 3 persons to discuss points in the case, feeding back their findings to the class as a whole and then the teacher discusses the connections between group findings and implications of these for management control systems. I teach the case over **80 minutes**, however it has been taught in **60 minutes** by reducing, or eliminating, small group discussions. Using the one page summary of the case provided at the start of this teaching note I have also taught the case in **30 minutes**. Below is the timetable that I use.

Introduction: 10 minutes

18 to 25 year olds constitute one of the main customer segments for AbraKebabra, thus Irish students are very likely to have visited an AbraKebabra at least once. Normally in my class it transpires that a considerable number of students have been to AbraKebabra at least once in the last month. If you are teaching this case **outside Ireland** (I have taught it in **France**), then I suggest that you start the class with a brief overview of the customer experience. I will outline both approaches below:

International Students:
Abrakababra is an Irish owned franchise network, not dissimilar to Mc Donalds. The menu consists primarily of French fries (known in Ireland as chips), burgers, kebabs, and various baguettes. This food can be sold to take away, or alternatively just like Mc Donalds you can sit and eat your food. A full menu can be found at www.abrakebabra.net In international settings I have found it helpful to show this website live at the start of class. You can see the menu and also advertisements, which show the inside of the restaurant.

A central aspect to Abrakababra is that it is open late and located within walking distance of as many pubs and nightclubs as are practical. The busy times in an AbraKebabra outlet are after pub and nightclub closing times, which in Ireland is anytime between 11.30 pm and 3 am. It would be fair to say that this outlet is aimed primarily at customers who have been out drinking and dancing as opposed to a family audience. Thus both in terms of menu (over half of all sales include a kebab) and customer audience AbraKebabra differ from Mc Donalds. This is not to say that AbraKebabra does not have a family market in the day time, just that the main sales period is late at night.

Irish Students
I find that the following questions help to get the class talking and interested in the case:

1. How many people here today have ever visited an AbraKebabra?

   Typical answer:
   - In Dublin I normally get about three quarters of the class putting up their hands to this question.

2. How many of you have been to AbraKebabra in the last month?

   Typical answer
   - Again a substantial number of students raise their hands.

3. What time of day did you visit AbraKebabra and why?

   Typical answer
   - Most students say that the last time they visited AbraKebabra was after a night out on the town. We have taught this case 7 times in Ireland and only twice has any student said their last visit to AbraKebabra was during the day and on an occasion unconnected with drinking or a social event.

4. What do you think is the essence of the AbraKebabra customer proposition is?

Typical answer

- Consistent 'quality', competitively priced food before or after a night out on the town.

Question 1: 10 minutes

Q 1. Who are the key Principals and Agents in the AbraKebabra case? What are their main objectives?

I tell the students that for the purpose of this class we will focus on the following:

Principal = **Franchiser** (on the basis that they control the contract with franchisees. It is non-negotiable and set by the franchiser, page 6 of case)

Agent = **Franchisee**

I ask the class to break into groups of three persons. For **5 minutes** half of these groups are to consider question 1 from the perspective of the franchiser and the others from the perspective of franchisees.

Take **5 minutes** to summarise the objectives of franchiser and franchisees on the white board via group feedback.

Question 2: 15 minutes

Q 2. Select one principal-agent relationship and outline the main information asymmetries that exist within this relationship. What are the main implications of these asymmetries?

Get the class to return to their groups, splitting them into franchiser and franchisee groups. Let them spend **10 minutes** discussing what are the main types of information that they possess that they do not want their exchange partner to know about in full (ie what are the most valuable information asymmetries that agents and principals can exploit).

Take **5 minutes** to highlight the main information asymmetries to the class and what the implications of each are.

Question 3: 35 minutes

Q 3. How does AbraKebabra Limited manage adverse selection and moral hazards over time?

From here on I get the class to take the perspective of the principal (franchiser) only. This question has two discussion parts: adverse selection and moral hazards.

Adverse selection

Split the class into groups of 3 and spend **5 minutes** discussing how they would minimize the risks of adverse selection by designing an effective process of franchisee (agent) selection. In this discussion they should be mindful of the information asymmetries that they identified franchisees would like to have in question 2.

Bring the class together and spend **10 minutes** discussing how AbraKebabra managed adverse selection over time by increasing the 'gates' prospective franchisees had to go through prior to signing a ten-year franchising contract.

Moral hazards
Get groups to spend **10 minutes** discussing how they would design a monitoring and control system to minimize the risks of moral hazards. Again they should be mindful of the information asymmetries that they identified agents might wish to maintain in question 2.

Bring the class together and spend **10 minutes** discussing how AbraKebabra managed moral hazards by using more sophisticated monitoring and control systems.

Question 4: 10 minutes

Q 4. Imagine you are Graeme Beere. What strategy would you suggest to follow for the next five years?

Ask the class: what should Grame Beere do next to grow this business? When students suggest internationalization, for example, ask them what implications this would have upon both franchisee selection and on-going monitoring and control to ensure that international franchisees accurately report sales (upon which the 6% levy is based) and also monitor and control branding and operational standards abroad.

READING MATERIAL

The core reading that we use to teach this case is:
Bensanko, D., Dranove, D. and Shanley, M. (2000). *Economics of Strategy*. Second Edition, John Wiley and Sons. **Chapter 15 Incentives and Agency.**

This reading is suitable for final year or postgraduate strategy students.

The third edition of Bensanko et al covers the agency topic across more than one chapter. Personally I prefer the second edition coverage of agency theory as it is shorter. A single supplementary chapter is more suited to courses that use a mainstream strategy text, (such as Grant, R, 2003. *Contemporary Strategy Analysis*, Blackwell), most of whom do not cover agency theory in a full chapter. For people wishing to follow this approach, I recommend that you contact the permissions department of Wiley, phone USA 001 – 201 –748 – 6000. They can arrange a two-year permission to copy the chapter at a reasonable price.

On an advanced postgraduate strategy course I get the students to read the following additional papers on agency theory:

Alchian, A. and Demsetz, H. (1972). Production, Information Costs and Economic Organization, *The American Economic Review*, Vol. 62 (5), pp 777-795.
Hendry, J. (2002). The Principal's Other Problems: Honest Incompetence and the Specification of Objectives. *Academy of Management Review,* Vol. 27 (1), pp 99-113.

Alchian and Demsetz (1972) is a classic and I have found that both undergraduate and postgraduate students have little difficulty in reading this article.

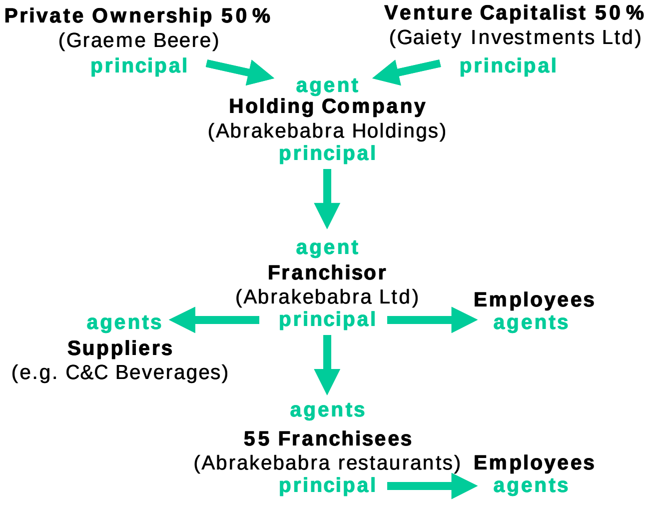
Hendry (2002). The research project from which this case flows was originally a case design to solicit managers perceptions of which applied to their business most: classical agency theory, or Hendry's perspective of agents as **honest stewards**, who can be honestly incompetent, with principals unable to always fully specify their objectives. The reality of the AbraKebabra case and subsequent discussions with senior management was that they completely rejected the Hendry perspective and argued that the behaviour of both principals and agents in their firm was motivated by self-interest. Their management systems are almost classical agency theory in action, with no evidence of the Hendry perspective emerging. The clash between the uplifting perspective of Hendry in terms of positive human behaviour, and the reality of the case can lead to interesting class discussions on the theoretic and practical benefits of stewardship versus agency perspective.

ANALYSIS OF THE CASE:

Q 1. Who are the <u>key Principals and Agents</u> in the Abracadabra case? What are their <u>main objectives</u>?

Depending upon your perspective there can be a number of principals and agents in this case. The perspective that I take is that the principal is the person who controls the terms of the contract and hires the agent to undertake a given activity. In the AbraKebabra case this suggests that the owners of the franchiser are the ultimate principals – they control all intellectual property rights and can close the business down if they wish (within contractual boundaries). The management of the franchiser are their agents. The franchiser is the principal and the franchisees are their agents. Finally within a given franchise the franchisee is the principal and his/her employees are the agents. This nested set of principals and agents was nicely represented in figure one, which is reproduced from a student report on the case.

Figure One: Embedded Network of Principal-Agent relationships: A Student perspective



This figure is extracted from master's student report, written by (and reprinted with the permission of) Heiko Bennert, Shane Brodbin and Chunchreek Singhvi, 2004.

Taking the main principal, agent relationship as franchiser – franchisee, then objectives can be specified as below:

Franchiser objectives:

- Maximize shareholder value – see page 4 of case quote from financial accountant
  - How can this be achieved?
    - Profit through on-going operations:
      1. Maximize franchisee revenues – get levies from gross sales;
      2. Control franchiser costs (e.g. marketing and bulk buying).
    - Capital appreciation
      1. Attract new franchisees (€50,000 sign up fee);
      2. Sell the business to investors (€3.8 million was obtained from Gaiety Investments for Why Beere's 50% stake).

- Minimize capital investment – see page 4 "The management team could see the obvious benefits of franchising as a system of growth and they redefined and reasserted the advantages of such a structure. The company had achieved rapid expansion and market penetration with relatively low capital investment."

  In essence the franchiser faces a **wealth constraint**. They lack the capital to exploit all opportunities to use the AbraKebabra brand and system across Ireland. Thus they use franchising to enable growth to 55 outlets, far beyond the capital they would have available if they pursued organic growth.

Franchisee objectives:

- Maximize personal wealth (see page 5 of case)
  - How can this be achieved?
    - Maximize revenues.
    - Minimize costs.
      - Could hide true revenues, reducing cost of levies to franchiser.
      - Cut operational corners to save costs, would compromise long-term viability of the AbraKebabra business model.
- Lower risks of starting a new business (case page 5).
- Be their own boss (page 5 of case).

Q 2. Select <u>one principal-agent relationship</u> and outline the <u>main information asymmetries</u> that exist within this relationship. What are the main <u>implications</u> of these asymmetries?

From page 6 of the case we learn that AbraKebabra controls the terms of the contract and that this is non-negotiable, thus it is reasonable to argue that the franchiser is the principal (contract setter) and the franchisee is the agent (contract taker). The main information asymmetries that each party possess are as follows:

Franchisee:

- Actual sales of the restaurant – where sales are reported by the franchisee in weekly reports there is an opportunity not to declare all revenues to the franchiser.
- Cost of sales per restaurant.
- Local knowledge of clientele.

- On-going levels of service provided to customers by night and day.
- On-going hygiene standards.
- Competency of staff and practicalities of**:**
    - Design of restaurant in terms of efficiency of production processes;
    - Operational realities versus operations manual.

Franchiser:

- Performance of AbraKebabra network by restaurant, region and nationwide.
- True cost of shared services:
    - Brand and advertising – in particular relative to the subsidy that AbraKebabra receives from C&C for advertising (case page 8);
    - New product development;
    - Bulk buying – for example - who is the true owner of the suppliers;
    - Training;
    - Monitoring systems.
- Identity of mystery shoppers and content of their reports.
- True profitability of the network. AbraKebabra is a private firm and it is very difficult to get data on the actual sales, costs and profitability of the firm from an independent source (case page 3).

Implications from the franchiser perspective

1. Lack of knowledge of actual sales means that AbraKebabra may not be collecting the full 6% franchising fee on gross sales per restaurant and the additional 1% advertising levy. (case page 1 – 2).
2. From the franchisers perspective it is essential that there is a consistency across all franchisees restaurants in terms of: brand identity, store design, health and safety, product quality and customer service. This consistency enables the network to:
    a. Attract and retain customers across the network; and
    b. Attract and retain new franchisees.

   Any information asymmetry the franchisees retain that could compromise consistency across the network in these issues impacts upon the profitability and survival of the AbraKebabra business format franchise system.

Q 3. How does AbraKebabra Limited manage <u>adverse selection and moral hazards</u> over time?

Adverse selection

Adverse selection in this case is the risk that AbraKebabra will sign a 10-year contract with a franchisee who transpires to be ineffective in operating a restaurant, or alternatively who provokes another revolt. Management have installed a number of systems to minimize these risks. I like to think of these franchisee selection systems as a funnel. At one end of the funnel lie thousands of potential franchisees, the system seeks to obtain data on their potential and at each stage eliminates the most unpromising from the next stage of the process, until ultimately there are only a few candidates remaining. As you move through the process the amount of information asymmetries between agent's knowledge of their competency and motives and that of the franchiser declines, however the cost of information rises.

The goal is to avoid contracting with franchisees who are:

1. Not competent to run a fast food restaurant;
2. May provoke a future revolt; and/or

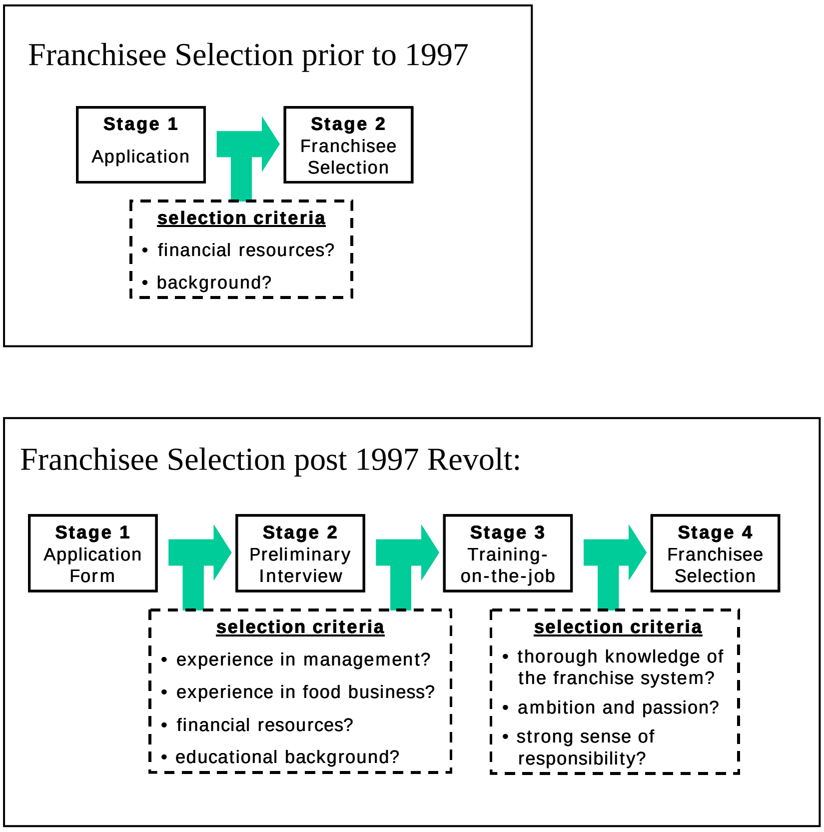
3. Lack capital to fund a restaurant.

The stages of the selection process are outlined on pages 6 and 7 of the case.

1. Application form – basic demographic data and capital availability (see www.abrakebabra.net for a copy of the application)
2. Sign a confidentiality form prior to interview
3. Preliminary interview with franchising director
4. 2 weeks to 3 months on the job training in an experienced franchisee's restaurant and working along side a headquarters trainer.
5. If after training the candidate is found to be both competent and committed to becoming an AbraKebabra franchisee, then a 10-year contract is signed.

This process was nicely summarised in a student project in figure two below:

Figure Two: The Process of Agent (Franchisee) Selection over time: A Student Perspective



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Moral Hazard

The problem here is that current franchisees may exploit information asymmetries. To manage the implications of these asymmetries as outlined in question two the following control systems have been installed.

1. Contract specifies minimum standards of how a restaurant should be run.
2. Monitoring systems:
    a. **Financial**

    i. Weekly sales figures reported by franchisees to headquarters – these are checked against previous years sales to see if there is a likelihood of a managerial or reporting problem that need intervention (case page 10); and
    ii. Modems have been introduced in four restaurants to automatically and accurately record sales (case page 10).

b. **Operational standards**
    i. Headquarters staff visit each restaurant every two weeks to see if standards are being maintained across all franchisees and to intervene with support if there is a problem (page 10 of case); and
    ii. A hygiene audit is conducted every 6 weeks by headquarters staff (page 10).

c. **Customer service**
    i. Customer comment cards, available in every restaurant and sent directly to headquarters; and
    ii. Mystery shoppers – identity not known to franchisee. File reports directly with headquarters.

This cascade of controls seeks to minimize the most important information asymmetries between franchisee and franchiser. The cost of each system is higher than the previous one and is implemented due to the emergence of risks over time that are unacceptable to the franchiser.

Q 4. Imagine you are Graeme Beere. What strategy would you suggest to follow for the next five years?

I leave this discussion entirely open as per the section on teaching timetable and content.