

CHAPTER 3: THE FRANCHISE PARADOX

“Challenge to Growth: Nothing New Under the Sun”

Martin Mendelsohn, 2001

“ That which hath been is that which shall be, and that which hath been done is that which shall be done; and there is nothing new under the sun, Is there a thing whereof it is said: See this is new?—it hath been already in the ages which went before us”

Ecclesiastes 1:9-10

3.1 INTRODUCTION

Franchising is seen as an entrepreneurial option towards creating and developing ventures (Bygrave: 1997). Michael (2003: 61) in agreement herewith, mentions franchising as a technique for entrepreneurs in service industries to assemble resources in order to rapidly create large chains and gain first mover advantage. Nieman *et al* (2004: 156) view franchising as a method of entrepreneurial expansion.

Franchising is an arrangement between two parties whereby the franchisor grants the franchisee certain rights to sell a firm’s products or services, as per guidelines set down by the franchisor (Nieman, 1998: 3). The Franchise Association of Southern Africa (FASA) defines franchising as, “a grant by the franchisor to the franchisee, entitling the latter to the use of a complete business package containing all the elements necessary to establish a previously untrained person in the franchised business and enable him or her to run it on an ongoing basis, according to guidelines supplied, efficiently and profitably”.

Mendelsohn (2003: 17) emphasises that a franchise relationship is not self sustaining, with basic issues being that the franchise cannot succeed without successful franchisees, franchisors to devote resources to enhance franchisor/franchisee relations, franchisor duty to establish and sustain a viable business, franchisors code of ethics, and that the franchisor must promote the basic principles upon which franchising is based. Franchisors in many sectors have recognised the benefits of multiple-unit franchisees (Johnson, 2004: 36), and this is seen as an entrepreneurial continuation of the franchise trend. Lindsay and McStay (2004: 3) further explored the entrepreneurial orientation of franchisees, together with the entrepreneurial drivers of franchisee performance. Their findings indicated a

proactiveness regarding entrepreneurial orientation, together with a risk-taking entrepreneurial orientation.

In an entrepreneurial context, franchising is viewed as an influencing factor on entrepreneurship development (Nieman *et al.*: 2003). Franchising is a relatively low-cost means of setting up a new-venture that has grown rapidly in recent years (Kirby, 2003: 67), both in South Africa and internationally. The entrepreneurial link to small business is facilitated by franchising, whereby a business owner sells to another the right to operate the same business in another location (Schermerhorn, 2002: 125).

The final section of the chapter investigates entrepreneurial orientation within a franchise system (franchisee specific); from a literature and empirical perspective. Tentative review is indicative of a relationship between the entrepreneur, intrapreneur and franchisee. Final analysis is however subject to an empirical study within a defined franchise system.

3.2 NATURE AND DEVELOPMENT OF FRANCHISING

Franchising is a method of marketing goods and services, which knows almost no boundaries (Mendelsohn: 2004). Franchising is considered as one of the most effective systems for distribution of goods and services (Nieman: 1998). In context of entrepreneurship, franchising has been argued to be a technique for entrepreneurs to assemble resources in order to rapidly create large chains and gain first mover advantage (Michael: 2003).

Dhir and Bruno (2004: 20) inform that franchising is an extraordinary international success story, generating millions of jobs and billions of dollars in economic activity. Franchising is enormous, especially in developing countries where discretionary income is increasing. Towards facilitating entrepreneurial growth, Johnson (2004: 35) advises that multiple-unit and multiple-brand franchising offer successful operators both the possibility of spreading risk over multiple units or brands and economies of scale. An example of this success is apparent within the Famous Brands (formerly Steers Holdings) franchise portfolio; housing Steers, Debonairs Pizza, Wimpy, Whistle-Stop, House of Coffees, Fish-Aways and Church's Chicken brands (excluding shareholding in Blockbusters Video). These multiple-brand franchise outlets dominate the South African

franchise food sector, and have won more Franchise Association of South Africa (FASA) awards than any of their competitors.

Franchising dates back to 200BC when Chinese businessman Los Kas created a franchised chain-store concept for the distribution of branded food items throughout China. However, the concept of franchising as we know it today originated in the United States where in the 1860's, the Singer Sewing Machine Company established a franchised network of dealers (Mendelsohn: 1992). The United States is regarded as being the full accreditors of developing the franchise system internationally. They are undoubted leaders in the exporting of franchise systems. Franchising in some form exists in over one hundred countries around the world, and is continuously growing.

From a pure historical point of view, the extensive 'pub' network in the United Kingdom may be the oldest franchise system in the world. This dates back to 740-750, during the Roman occupation of Britain. By 957 King Edgar decided there were too many alehouses, and decreed a limit of one per village. Standards were instituted and a monitoring system established, with fines levied against violators. Franchising was born (Monckton, 1969: 87). After the 1840's, two types of franchising evolved in the United States. Product franchising involved durable goods manufacturers integrating vertically, developing their own distribution channels. Business format franchising, created in the 1950's, results from evidence that the outlet itself could be a vehicle for entrepreneurial activity (Spinelli: 1997).

Three categories of a franchise system are identified; franchisor-operated outlets; franchisee-operated outlets or a combination thereof. Types of businesses generally included in business format franchising include food and non-food retailing, business services, restaurants and business services. Petrol stations and soft drink bottlers are excluded from business format franchising as they incorporate other forms of licensing and development arrangements. The International Franchise Association (1997) predicted that close to forty-three per cent of USA retail sales will be attributable to franchise sales.

3.2.1 Franchising link to entrepreneurship

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Sherman and Dewis (2003: 34) define franchising from a strategic viewpoint: "a franchising system is a distribution channel; a licensing of brands and systems by the franchisor to a dedicated network of franchisees who pay initial and ongoing fees (typically expressed as a per centage of gross sales) to operate businesses under contractually prescribed systems and standards. From a strategic perspective, franchising is a popular method of leveraging a company's intellectual capital by opening up new markets with a highly motivated owner-operator who will work harder than the average salaried manager to ensure the success of a particular location". The link to entrepreneurship is in that franchising is a capital efficient growth model. It provides the franchisor/entrepreneur with the opportunity to leverage the capital invested and the equity of the local franchisee operator to build and strengthen brands and systems of the franchisor.

The leadership and team facets (Bolton & Thompson: 2003) of entrepreneurship are interrelated with franchising in that a strong management team that is experienced in building brands and developing and enforcing operational and IT systems can operate with relatively low overhead. Healthy profit margins may be yielded when predictable

revenue streams provided by royalty payments are linked with this cost structure. Revenue growth platforms are opportunistic- ranging from sales to franchisees, to international expansion and acquisition of additional brands in the franchise system.

Franchising is not a business itself, but a way of doing business (Williams, 2000: 12). It is a marketing concept, being an innovative method of distributing goods and services. A rising sense of entrepreneurship among key groups within the American population (1950's), together with increasing limits on the ability of companies to expand by more rational means, provided a growing pool of potential franchisees and franchisors willing to undertake new ventures in response to these business opportunities. The term franchising describes a wide variety of different practices, which are used in different ways and with varying degrees of sophistication in many different industries.

Robert T. Justis, Professor of Franchising at the University of Nebraska, defines franchising as, “a business opportunity by which the owner, producer, or distributor (franchisor) of a service or trademarked product grants exclusive rights to an individual (franchisee) for the local distribution of the product or service, and in return receives a payment or royalty and conformance to quality standards”. A direct link to entrepreneurship is the unique association of corporate organisations and a unique form of raising capital. This is all part of the Facets entrepreneurial terminology (Bolton & Thompson: 2003); consisting of issues of dynamic relationships (between franchisor and franchisee), congruent goals, interdependence and focus.

Schaper and Volery (2004: 19) define franchising as, “an arrangement whereby the originator of a business product or operating system permits another business owner to sell the goods and/or to use the business operating system on the originator's behalf”. The most common form of franchising is business system franchising, whereby there is an arrangement in which the franchisor not only supplies the product, but also gives comprehensive guidelines as to how the business is to be run. Whilst entrepreneurial activity is linked to the franchisor, the link to the franchisee may be questioned. Non-entrepreneurial activities such as restricted growth, moderate flexibility and low flexibility in decision-making are representative of the franchisee (Schaper & Volery: 2004).

Hisrich *et al* (2004) inform that an advantage of buying a franchise (that is, as a franchisee) is that the entrepreneur does not have to incur all the risks often associated with starting a business from scratch. Typically, entrepreneurs often have problems in starting new ventures in the areas of product acceptance, management expertise, knowledge of the market, operating controls, and meeting capital requirements. These are all negated (to a large extent) in a successful franchise system. The disadvantage to the entrepreneur is that problems often occur between franchisor and franchisee, negating the entrepreneurial independence motive. The formal relationship may not be to the entrepreneur's liking. Seltz (1982: 1) defines franchising as, "an arrangement whereby the manufacturer or sole distributor of a trade-marked product or service gives exclusive rights of local distribution to independent retailers in return for their payment of royalties and conformance to standardized operating procedures". The franchisee is given the opportunity to enter a new business with a better chance to succeed than if he/she were to commence a start-up business (Hisrich *et al*: 2004).

Halloran (1994: 40) considers franchising as a way of becoming an entrepreneur with a built-in market and proven product. However, the downside is in the restrictions and regulations of many franchisors; taking away the feeling of independence and the satisfaction of self-determination that comes from new venture creation. He defines a franchise agreement as, "when one party, the franchisor, grants to another party, the franchisee, the rights to market/distribute a trademarked product or service in exchange for payment or royalties. Or in some cases the franchisee is granted the right to offer, sell, or distribute goods or services under a marketing format designed by the franchisor". Whilst the term trademark regularly appears in American texts, this may be somewhat misleading in a South African context. Many South African successful franchised organisations, particularly in the home entertainment industry; started out in franchising prior to trademark registration (Mr. VIDEO, Blockbusters, Stax Video and Video Town being examples). This however does not negate the importance of trademarks and registration whatsoever.

Deakins and Freel (2003) regard franchising as another market entry route, yet not always associated with entrepreneurship. Despite the loss of control in a franchise (as a franchisee), the popularity of franchising has mirrored the importance and growth of small firms in the economy. The franchisor undertakes much of the venture creation activities, including idea formulation, opportunity recognition, pre-start planning and

market research. Tikoo (1996: 78) places emphasis on the massive growth of franchised start-ups, with one in two franchise systems being less than five years old. The International Franchise Association (1997) estimate that one new franchise open every eight minutes. Dickie (1993), in an international franchise study, informed that forty-three per cent of franchises have fewer than ten outlets. Nieman *et al* (2004) regard franchising as an entrepreneurial expansion opportunity, placing emphasis on the expansion of the distribution channel.

The appeal of the reduced risk, while still retaining elements of entrepreneurship has been a powerful motivating factor for entrepreneurs, and the growth of franchising appears likely to continue unabated in the new millennium (Deakins & Freel, 2003: 69). The potential of franchising within the emerging entrepreneurial sector in the South African context is supported by government initiatives towards sustainable development of small to medium and micro enterprises (SMME). Economic empowerment and the upliftment of the redistribution of wealth to the previously disadvantaged make franchising a unique and competitive means of development (Nieman *et al*, 2003: 207). Emerging entrepreneurs, particularly in developing rural areas, may benefit from the franchise system. Franchising is seen as a key determinant towards the upliftment and development of the micro- and small business sector growth in South Africa (FASA 2002).

3.2.2 Franchise rationale

Prior to looking into the merits and demerits of a franchise system, becoming a franchisee versus starting a stand-alone business requires evaluation. Spinelli (1997) informs that this evaluation hinges on the mitigation of risk by the trademark value, operating system, economies of scale, support process of the franchise and the personality/management style to sharing decision-making responsibilities within the system. To quantify the evaluation, Spinelli (1997: 365) derived the following:

Franchise Fee + PV of royalty = PV of the increased net income from the value of the franchise trademark. PV is the present value of a sum of money. An analysis of services provided by the franchisor requires review.

3.2.2.1 Real estate development

Many business format-franchising systems include a real estate ingredient, therefore sight selection and development is an integral part of franchising. This predominantly surfaced during second generation franchising in the 1950's, when Harlan Sanders (Kentucky Fried Chicken) and Ray Kroc (McDonalds) built national chains along the developing interstate networks. Ray Kroc is generally recognised as the founder of business format franchising, and based his initial model on real estate development (Williams, 2000: 7). Market research into the primary target audience (PTA) includes viability studies including the market that will patronize the franchise outlet. Real estate development includes:

- Cost, location standards for successful expansion
- Population, how wide a market area, PTA members, pro forma market share
- Traffic volume, pedestrians, traffic flow, shoppers
- Traffic patterns, timing, bottlenecks, peaks and troughs, seasonality
- Visibility, impulse, signage, building, entrance
- Zoning and permits, local councils, governing bodies, landlords
- Ingress and Egress, entrance to and from the site
- Location success factors, link to business format, rental relationship.

3.2.2.2 Construction specifications and supervision

The franchisor usually has a standard set of blueprints, despite modifications per site. Those strong on brand reputation and consumer sovereignty will include building contracts, specifications, and usually supply their own, or accredited outsourced partners to do the construction and layout.

3.2.2.3 Training

The licence agreement should stipulate the time and cost of trading, pre-opening and ongoing training, and specifying the form in which the franchisors responsibilities span (Spinelli, 1997: 372). The trademark and name are the most important assets in a franchise system, and franchisees should be adequately trained to uphold the desired value. A poor training regime will inevitably dilute the standardized and consistent

delivery, and reduce or tarnish trade name value. Mendelsohn (2003: 113) informs that franchisees must be trained in the system and business methods which the franchisor has developed, including any special methods of production/value added, processes to be applied to goods, methods of preparation and manner of providing services. Training is also to be provided in methods of marketing and merchandising.

3.2.2.4 Pre-opening support

Preopening support is a concentrated, multifunctional program to launch the new franchise (Spinelli: 1997). The franchisor has the expertise in place to provide sophisticated start-up assistance, and is leveraged in a partnership association, to the benefit of franchisee and franchisor alike. After training, assistance will be given in getting the business ready to open for trading (Mendelsohn, 1992: 4).

To develop the local target market in the area of the new franchise, the franchisor is obliged to assist the franchisee in localised marketing communications. The new franchisee is unlikely to have the competence to implement this task, thus necessitating franchisor assistance (Nieman, 1998: 33).

3.2.2.5 Continuing support

Not only must the franchisor create a market for the brand/service, but also all participants in the system must be sustained and nurtured (Spinelli: 1997). As such, the actions of each franchisee have bearing on overall franchise performance. Unfortunately, the degree of franchisor support is usually inversely proportionate; in that struggling franchisees receive more attention and support. A key ingredient for success is a balance of franchisor resources. Apart from the proper level of support in the business operation, the franchisor should be creating good franchisor-franchisee relations on an ongoing basis. Mendelsohn (2003: 153) suggests a range of ongoing services to include:

- Monitoring and support
- Training
- ‘Head office’ organisation
- Market research
- Advertising and promotion

- Communications.

3.2.2.6 Performance standards and monitoring

By developing and implementing a variety of financial and operational information systems, the franchisor may identify exceptional and sub-par performance. The franchisor has to support and maintain the business format, image and quality of services provided in the franchise system (Nieman, 1998: 134). The entire franchise system should deliver the same quality to the customer. This is also facilitated by monitoring relationships and performance management (Section 2.8.4). Sophisticated computer interface management information systems not only provide a channel of franchise communications, but that of management interaction. This is a distinct advantage of network communication not available to individual or stand-alone outlets.

3.2.2.7 Field support

Franchisor staff to regularly interact with franchisees in relation to trade, activities including operating procedures, business and performance reviews, field training, relationship management, supplier compliance, local marketing and overall operations audit. Field visits go a long way towards franchisees justifying royalty payments. Advantages include corrective action when franchisees are not following the system correctly. Mendelsohn (1992: 112) recommends that the franchisee should contact his field support representative from time to time if he has not been visited, even if just to catch up on other successes within the franchise operation.

3.2.2.8 Operational research and development

Although standards and operational management maintenance across operating units must be adhered to, it must not be seen as a hindrance to change and innovation. A benefit regarding research and development centres on economies of scale in a franchised system, being optimally achieved through centralized and monitored inputs. The franchiser should constantly be seeking innovative methods for improving the business of the franchised network (Mendelsohn, 2003: 113). Important research and development activities can include the exploitation of new sources of supply, good quality materials and products for the franchise system, facilitating both quality and cost.

3.2.2.9 Marketing, advertising and promotions

Varying amongst franchisors, the standard format is a group-advertising fund, resultant from franchisee royalty payments (Nieman: 1998). Management thereof is usually contractual, either at the discretion of the franchisor, or most often in the control of a franchise council or franchisee representation of sorts. Mendelsohn (2003: 86) advises that there are three alternative methods of dealing with the expense when the franchisor undertakes the obligation to advertise and promote:

- The franchisee is charged a sum calculated as a per cent of the franchisee's gross income (similar to franchise fees)
- The advertising expense is included within the continuing franchise fee and undertakes to spend not less than a minimum per centage of such fees
- The franchisor undertakes all marketing communications activity without collecting a contribution for this purpose.

3.2.2.10 Product purchase provision

Economies of scale take effect, particularly regarding quantity discounts, group buying and related discounts and trading terms. Rebates and confidential allowances are usually paid to the franchisor, and depending upon contractual obligations, may be shared between the franchisees. Confidential allowances have been an issue of contention in the industry, being the reason for ethical evaluation into franchise business practices. Included may be contractual provision for approved suppliers and distributors, and method of procurement. Franchise system purchasing usually covers three areas (Nieman, 1998: 86):

- Purchases of the franchisor/franchisee
- Group purchase programmes
- Product and supply restrictions.

The report of the competitions board (Act 96 of 1979) is relevant, investigating acquisitions, monopolies and restrictive practices. The home entertainment industry was subject to such investigation in 1997/8, with respect to restrictive sale of intellectual property.

3.2.2.11 The operations manual

Often the heart of the franchise asset, as it delineates the manner in which the trade name and mark are to be delivered to the customer (Spinelli: 1997). Failure to operate within the confines of the manual often leads to dispute within the franchise system. To this end, an operations manual should include a dispute resolution process. Williams (2000: 17) advises that the operations manual should be supplemented with administration/reporting manuals; corporate identity manuals; speciality manuals, training manuals; trouble-shooting guide; Franchisor manuals and ongoing development and upgrading of system. Nieman (1998: 51) informs that as the franchise system develops, the operations manual usually becomes the backbone of the system. Together with the trade name, the know-how detailed in the manual is the most important asset of the franchise. Mendelsohn (2003: 183) lists an overview of suggested operating instructions, to be included in the manual:

- Hours of operation
- Trading patterns, peaks and troughs
- Franchisee involvement and staff schedules
- Standard forms and procedures (including invoicing and brand-name communication)
- Staff appearance (such as uniforms)
- Staff training procedures
- Employment of staff (statutory requirements included)
- Disciplining staff
- Product, pricing and promotional policies
- Customer service policies
- In-store appearance and ambiance
- Purchasing policies
- Product standards
- Customer complaint procedures, such as listening posts
- Service standards
- Staff duties, including job descriptions, methods of performing responsibilities
- Payment of franchise fees, calculation and timing thereof
- Accounting, generally accepted accounting practices

- Marketing communications, local marketing, group cohesion and offering, selling techniques, customer retention
- Use of trade-name, trademark usage in course of business
- Operational policies and procedures
- Communication channels within the franchise system.

3.2.2.12 Specialist support

Depending on the nature of the business, the franchisor should provide the necessary professional support. Not only related to business activity or discipline, this also includes participation in industry initiatives and proactive market environment activities. Such examples involve membership and participation in FASA, Video Software Dealers Association of America (VSDA), representative bodies in training, financial institutions and governance.

3.2.2.13 Territorial rights

Robinson (2004: 79) informs that the setting and operation of territories is one of the more complicated components within franchise systems. Second only to fees, territories are potentially the most contentious issue for franchise networks. Demographics are a constantly evolving factor, hence the true market area will inevitably change (Spinelli: 1997). A relocation clause is most often associated to territorial issues, contained within an exclusive territory clause or operations clause. Robinson (2004: 80) identifies different basic structures and applications in territory allocation:

- No territory, with no territorial or geographic restrictions, but may be limited to specific location only
- Regional territories, possibly limiting the number of franchisees per region
- Non-exclusive territories, nominal territories in which the franchisee operates, normally restrictions of sort
- Exclusive territories, no other franchise of the same system can be established or operate in a given territory. Issues involve the right to establish further territories, right to expand trading operations, right to subdivide territories and sub-franchising.

When developing territories, Robinson (2004) highlights the inclusion of:

- Population size
- Number of dwellings
- Growth of an area (normally via population or dwellings)
- Number of businesses/commercial premises
- Number of businesses within certain industry types
- Level of income/economic strata
- Other demographic data such as racial mix, age, psychographics
- Price of housing
- Road traffic, foot traffic
- Amount of competition in the area
- Proximity to other key influencers or sources of business, such as shopping malls
- Planned roading changes or shopping complexes
- Market media used to attract/secure business, such as direct mail areas, television regions.

A territory may be defined in a number of ways. The most common way of dividing physical territories is via a detailed map, which is often appended to the franchise agreement. Some franchisors set their territories to toll free number areas and then use that toll-free number for all promotion, secure in the knowledge that responses can be directed to the correct territory (Robinson: 2004). Entrepreneurs are quick to adapt and accept new technologies, and the internet may not only provide opportunistic distribution channels, but conflict within the distribution channel (Porter: 2001). The key to success with territories and the internet is to take a fair and long-term approach, either directing the business from the internet to the relevant franchisee, or involve a specialist internet franchisee. Another possible option is that franchisees should each own a share of the internet marketing channel so that they can all profit from internet sales (Robinson: 2004).

3.2.2.14 Terms of the agreement

At the heart of almost every franchise relationship is a lengthy legal document, the franchise agreement. Agmen-Smith (2003) explains the franchise agreement as setting out

the rules by which the franchisor (who owns the franchise network) and the franchisee will have to live by for the period of the franchise. It is by far the most important of the franchise legal documents. Mendelsohn (2003: 184) refers to the franchise agreement as the moment of truth, where the franchisee and franchisor formally agree to their relationship. It should be read alongside the franchise operations manual, which every full format franchise will have. The franchise agreement usually refers to the operations manual and disclosure document, binding the franchisee (and franchisor) to certain obligations within the manual. The operations manual usually forms an integral part of the franchise relationship, and requires that the franchisee operate the business according to the systems and methods set out in the manual. Franchise agreements start by identifying the parties, a background to the agreement itself, then a rendition of the main terms. At the end, there are schedules including specific duties such as dates, values, territory boundaries and renewal rights. Other documents may include non-disclosure agreements; together with a disclosure statement, providing financial and other information about the franchisor. Successful franchised systems should include a full presale disclosure in a document that provides information about aspects of a franchise offering (Hisrich & Peters, 1998: 554). Kauffmann & Robbins (1991: 100-105) summarize a twenty-point disclosure document:

- Identification of the franchisor, affiliates and business experience
- Business experience of each of the franchisor's officers, directors, management and personnel responsible for services, training and other aspects of the franchise
- Lawsuits in which the franchisor and its officers have been involved
- Previous bankruptcies of franchisor officers
- Initial franchise fee and other initial fees to obtain the franchise
- The continuing payments that franchisees are required to make after the franchise opens
- Any restrictions on the quality of goods and services used in the franchise and where they may be purchased, including restrictions requiring purchases from the franchisor or its affiliates
- Any assistance available from the franchisor or its affiliates in financing the purchase of the franchise
- Restrictions on the goods or services franchisees are permitted to sell
- Any restrictions on the customers with whom franchisees may deal
- Any territorial protection that will be granted to the franchisee

- The conditions under which the franchise may be repurchased or refused renewal by the franchisor, transferred to a third party by the franchisee, and terminated or modified by either party
- The training programs provided to the franchisee
- The involvement of any celebrities or public figures in the franchise
- Any assistance in selecting a site for the franchise that will be provided by the franchisor
- Statistical information about the present number of franchises; the number of franchises projected for the future; and the number of franchises terminated, the number the franchisor has decided not to renew, and the number repurchased in the past
- The financial statement of the franchisor
- The extent to which the franchisees must personally participate in the operation of the franchise
- A complete statement of the basis of any earnings claims made to the franchisee, including the per centage of existing franchises that have actually achieved the results that are claimed
- A list of the names and addresses of other franchises.

Should a franchise have a consolidated and accurate disclosure document, the franchise contract will be understood more easily. The Federal Trade Commission (USA) requires all franchisors to supply prospective franchisees with the disclosure document at least ten days before entering a purchase contract (Halloran, 1994: 44). The franchise agreement between the franchisor and franchisee is the legal document that details the franchise relationship. It also shows how the information in the disclosure document applies to the franchisee.

The franchise agreement is often an exhaustive, lengthy and sometimes complex legal document, the most important contents being:

- Period of grant of rights. The franchise agreement is usually established on a long-term basis, with a 15-20 year period being the norm (Spinelli: 1997). The key is however in the renewal rights, and absence thereof is indicative that the franchisor is predisposed not to grant renewals. Renewal provision includes required notice periods; payment of a renewal fee; allowing the franchisor to change the wording

of the franchise agreement upon renewal and allowing the franchisor to change the size of the territory of the franchisee. The franchise may be likened to a lease, allowing the franchisee to ‘rent’ the right to the franchise system for a set number of years (Agmen-Smith, 2003: 31)

- Payments and fees. A large initial up-front payment is usually required, most often consisting of a registration or acceptance fee. The identification hereof will depend on the franchise package (Mendelsohn, 2004: 85). The sale of the franchise package may be that of turnkey methodology, whereby the franchisor is involved in acquiring the premises, shopfitting and equipping so that it is ready for the franchisee at the commencement of business (Mendelsohn, 2003: 93). This also includes set-up and other initial fees, all dependent on the type of franchise. This follows ongoing payments during the franchise term. These are primarily made up of royalty payments on a regular basis (usually monthly), based upon gross turnover, a set amount (flat fee), or combination thereof. Other fees include levies for advertising and training; with obligations for brand renewals, re-launches, conferences and meetings. Marketing (includes advertising and promotions) costs are usually provided for from contributions of the franchisee, by the way of a levy. There are often agreements on what the funds may be spent on, with the franchisor usually having full discretion. This is an avenue of conflict within the system, hence the formation of franchise councils, acting as a communication conduit between franchisor and franchisees. Franchisees are usually required to co-operate with major promotions, such as recommended price discounts and ‘specials’
- Opening. Most often there are requirements for the franchisee to spend a specified minimum amount on store launch promotions. Store layouts and fitment is usually a prerequisite of the franchisor, together with working capital requirements. This includes, but is not limited to signage, décor, shopfitting, landlord requirements and municipal costs
- Premises, leases and mobiles. Since location plays a vital role in the success of the franchise, the franchisor is most often actively involved in site selection. The franchise agreement will usually contain various provisions relating to leases (Agmen-Smith: 2003). The leaseholder may be the franchisee or franchisor, dependent on the objectives of the franchisor. Regarding mobile franchises, the franchisee may be required to implement vehicle sign writing, and the franchisee may be required to purchase the fully set-up vehicle from the franchisor.

Mendelsohn (2003: 95) regards leasing as “a complex aspect of franchising, with problems which arise not only from the legal implications but also the attitudes, practices and balances of negotiation power which are prevalent in the property market at the relevant time”. This notion is predominant in the South African context, where Franchisors have standing relationships with landlords, often negotiating prime sites at competitive rates

- The franchise business. Both the term ‘business’ and the term ‘system’ (which refers to the method of operating the business) will be formally defined and regularly referred to in the contract. The operations manual usually defines and explains many of the franchise business terms
- The manual. Most often initial training programmes review a ‘how to do it’ manual, a blueprint for franchise operations. The agreement normally provides that a manual will be supplied, normally remaining the property of the franchisor; to be returned at the end of the term. The agreement will allow for the manual to be updated from time to time
- Obligations. These include clauses setting out initial and ongoing obligations of both franchisor and franchisee. There will invariably be strict obligations on the franchisee to keep accurate and up-to-date accounting records (Agmen-Smith, 2003: 33), with requirements of electronic linking of point of sale systems to the franchisor
- Intellectual property rights. These are legal rights, which have developed to protect ownership of inventions and creations of various types. These include copyright, trademarks, designs, layout designs and patents
- Sale or termination. Totally dependent on the terms of agreement, and the type of business. Most agreements will allow for the sale of the business during term, with the franchisor usually having first option to repurchase. Spinelli (1997: 379) refers to this as right of first refusal, whereby the price should be equal to or a premium of the *bona fide* third-party offer. Upon sale of an existing franchise, the incoming franchisee must be approved by the franchisor, and undertake the required training. A new transfer or approval fee may be applicable. The franchise agreement may run its original term, or a new contract drawn up. The agreement may also be terminated prematurely. Events such as death or incapacity of the franchisee (Spinelli: 1997), bankruptcy, liquidation, criminal convictions, termination of lease of franchise premises, and failure to pay money due to the

franchisor, as well as breaches of party obligations may also qualify for termination

- Disputes. Most agreements now provide for mediation or arbitration should disputes not be resolved by discussion. The objective is minimising disturbances to franchise operations, whilst maintaining harmonious franchise relationships
- Cooling-off periods. Many Franchise Associations, such as Franchise Association of South Africa (FASA) and Franchise Association of New Zealand (FANZ) requires its members to provide an option for franchisees to withdraw from the agreements. This is currently within a 7-day period after signing the agreement. Inclusions of such clauses are usually a favourable indication of the franchiser's intentions and approach (Agmen-Smith: 2003).

Parties are not always limited to franchisor and franchisee, but may include master franchisors, sub-franchisors or area franchisees. A franchisee may also elect to open up a franchise in the name of a limited liability company or partnership.

3.2.3 Challenges to growth: nothing new under the sun

Franchising is a relatively low-cost means of creating new ventures which has grown rapidly internationally (Kirby, 2003: 67). Mendelsohn (2001: 16) breaks down the growth challenges of franchise systems into two headings, internal and external issues.

3.2.3.1 Internal issues

Within the franchise system, it is the opinion of Mendelsohn (2001: 16) that many franchisees confronted with problems treat the symptoms and not the underlying cause. As such, once realizing what they have done, the problem has multiplied from its original complexity. Franchisors are well advised to go back to the basics (issues addressed in Section 2.8.3) before addressing the symptoms. In going off the beaten track, there is a chance that franchisees have been receiving conflicting messages. The franchisees join the life cycle of the franchise system, keen to get started. Some stay keen and succeed, others do not achieve such levels of success and most often demand a disproportionate share of the system (franchisor) resources. Mendelsohn (2001: 16) further identifies two major ingredients of internal issues:

- The product. The challenge for the franchise system is in appreciating that the product offering has a life-cycle, and that strategic initiatives are in place to anticipate market demands; prior to being forced to making changes. Proactivity and not reactivity is the key. Market research, market testing, innovation and opportunity spotting should receive priority from the franchisor. These issues relate to the facets of the entrepreneur as well (Bolton & Thompson: 2003)
- Systems growth. With growth in franchisees, there will come a time when franchisor and franchisee disagree. It is the duty of the franchisor to ensure principles of relationship management are maintained, resulting in strong and well-founded relationships. Franchisees should in turn feel proud to belong to the system, and that the value they receive is greater than the price they pay for it (Mendelsohn, 2001: 16). It is however difficult to analyse why a franchisee is failing or has failed. It may be location, but since much of a franchisee's success is in his own hands, the franchisee that faces up to his responsibilities will do best (Mendelsohn, 1995: 66).

3.2.3.2 External challenges

These challenges are generally not in the direct control of the franchise system, mostly part of the macro-external environment. These predominantly refer to opportunities and threats:

- Economic downturns. Cyclical trends should be analysed, and the franchisor must ensure that they have capacity during peaks, together with market stimulation activity during troughs. The problem is often that of motivating franchisees during times of uncertainty
- Regulatory and legal issues. The unfortunate intervention of regulatory and legal issues in many cases is the product of a lack of information and not founded on any market behaviour, which needs correction (Mendelsohn, 2001: 17). This is not an issue of dominance in the South African context, as the franchise system is relatively well developed (Mendelsohn, 1997: 46). Mendelsohn (1995: 66) relates that the lesson to be learned from the USA is that legislation, regulation and contention should be avoided. He believes such measures stifle franchise opportunities. Mendelsohn (1997: 46), after a visit to South Africa assumed that

according to indication that the government will continue to take a keen interest in franchising, making entry prospects good

- Availability of franchisees. Real estate availability is the biggest threat in most South African franchised systems. As such, there are not always sufficient prospective franchisees available to meet the requirements of franchise systems
- Market forces. The franchise environment is very competitive, with many franchise systems not effectively differentiating. The result is many new systems opening, which are not significantly different from existing systems. Notwithstanding this, competitors still eat into the systems market share. Due to the lack of differentiation, many of these systems compete on price alone. This in turn places stress on the franchisor to negotiate better terms with suppliers. Other alternatives are to achieve competitive advantage by being the cost leader or differentiation (Porter: 1995). Another response is the expansion of current offerings, replacing that which has become unpopular.

Mendelsohn (2001: 17) concludes by stating that the basic principles of franchising have not changed since 1964. Mendelsohn (2003: 24) identifies these basics as:

- Only franchisors with successful franchisees succeed
- The franchisor must establish a viable and successful business
- The franchisor's support role must provide value in excess of the cost thereof to the franchisee
- The franchisor must recognize and promote the basic principles upon which franchising is based
- The franchisor must initiate relationship marketing, enhancing networks and ensuring franchisor/franchisee relationships are at a high level of mutual cooperation.

The author of Ecclesiastes was right, there is nothing new. Emphasis is placed on strategising, using the past as a gauge. "The task is meeting the challenges with an open mind and a sense of historical experience" (Mendelsohn, 2001: 17).

3.3 FRANCHISE SYSTEM RELATIONSHIPS

The franchise system constitutes a long-term relationship from the moment of first contact to the development and continuation of a mature network (Mendelsohn, 2004: 153). This research study however examines relationships in the continuation of mature networks phase (Ostgarrd & Birly: 1996). Mendelsohn (1992: 142) advises that franchising involves the development of a multiple chain of outlets in multiple ownership. It however does not involve multiple ownership of a multiplicity of subtly different outlets. As such, it would appear that franchise agreements are rigid, with minimal qualification. This notion facilitates objectivity within the system. Mendelsohn (2003: 148) identifies that mutual respect (franchisor/franchisee) must be present, particularly in the following areas:

- Respect by both parties for the basic marketing principles on which the franchise system is based
- Respect by the franchisee for guidance provided by the franchisor, particularly in respect to the intellectual property of the name, system and know-how
- Respect by the franchisor for achievements and contributions of the franchisee.

Good franchisor-franchisee relationships require a conscious effort (Mendelsohn, 1992: 150) from both parties, with the economic motive being enhanced accordingly. In taking cognisance of the maturity phase (Nieman, 1998: 130) of relationships, the following is identified:

- Macro trends influencing relationships
- Basic principles of franchise system relationships
- Cooperation within the system
- Franchise system leadership
- The product of conscious efforts
- Guidelines for good franchise relations
- Common franchise relationship problem areas and resolving franchise disputes
- Relationships and quality control and relationships requiring a solid foundation
- Franchise councils and franchise system network.

Bloom (2003) informs that successful franchise systems are the result of strong relationships built upon careful listening and mutual respect between franchisors and franchisees (Szarka: 1990). Amos (2003: 20) identifies franchising as one of the most synergistic relationships in all business.

3.3.1 Macro trends influencing relationships

Four primary macro-trends are seen as influencing franchise relationships in the new millennium (Amos, 2003: 21). The first is the globalisation of franchising, followed by the involvement of mega-franchisees as multiple-franchise owners. Third is the emergence of self-regulation within the franchise community; and fourthly, as key to franchising in the new millennium, relationships between the franchisor and franchisee.

3.3.2 Basic principles of franchise relationships

The basic premise of respect between franchisor and franchisee is of paramount importance to both parties. Mendelsohn (2003: 145) identifies respect based on basic principles of the franchise system itself; franchisor respect for achievement and contribution of franchisees, and franchisee respect for achievements and guidance of franchisors. Without this mutual respect, a relationship of trust will not be possible.

3.3.3 Franchise system cooperation

Other than trust and respect (Mendelsohn: 2003), it has become apparent that franchisors are listening more than ever to franchisees. Moreover both are cooperating to build brand identity and integrity, which is essential to a profitable and lasting franchise system (Amos & James, 2003: 21). A study was conducted by Maritz (2004) which highlighted the cooperation and trust involved in the branding decisions of co-branded franchise systems. Cooperation was evaluated as one of the most important aspects of the co-branding venture. Mentoring and cooperative programmes have played a major role in facilitating these open relationships. Amos and James (2003) also identify how franchisors and franchisees are cooperating more often on marketing efforts and effective training programs for franchisees.

Das & Teng (1998: 492) examined confidence in partner cooperation, highlighting two distinct sources; trust and control. In generating confidence, these two sources were seen as supplementary. The benefits of trust in franchise relationships appear wide ranging in character, including lowering transaction costs (Gulati, 1995: 87), inducing desirable behaviour (Madhok, 1995: 127), reducing the extent of formal contracts (Larson, 1992: 79), and facilitating dispute resolution (Ring & Van de Ven, 1994: 111). Lane (1996: 371) however argued that, whereas trust is a contributor in partner cooperation, along with control, certainty of partner cooperation cannot be equated with trust, which is merely about positive expectations of partner motives. Since trust and control are the two contributory factors of confidence in partner cooperation, either one by itself is insufficient to explain this confidence.

3.3.4 Franchise leadership

Amos and James (2003: 20) inform that leadership in a franchise system is about being solution-oriented as opposed to conflict-oriented. They inform of a leadership approach being that of an art, practiced with care, concern and diligence. Leadership is however lacking at most levels of franchise relationships, and the deficit may be felt exceptionally hard in the world of franchising. Amos and James (2003) believe this to be the result of the requirement for enlightened leadership that is necessary to manage the franchisee-franchisor relationship. They inform that this leadership is neither top-down nor bottom-up; recognising that business is more about people than it is about pro-forma models, net-present values and spreadsheets. Identified are elevated levels of integrity, values, motivation and performance. They further identify focus on softer business issues, recognizing that core values have a greater potential to influence behaviour than process or system. Amos and James (2003) identify culture as being the glue that holds any organisation together, reflecting the beliefs and values of the people making up the system. They place emphasis that these values and beliefs are set by leadership and executed with the permission of the culture. The importance of the macro-trends is further amplified whereby enlightened leadership at all levels of the franchise system are recognizing how critical this relationship is and how important it is to the continued growth of the most powerful economic engine in the world (Amos & James, 2003: 21). Amos and James (2003: 22) conclude as follows, “the essence of practising the leadership art of franchise relationships is to always be faithful to a set of core values and traditions that has the greater good in view for the greater number”.

3.3.5 Franchise relationships as products of conscious efforts

Ties that bind: Franchise relationships, like marriages, are products of conscious effort. A USA national survey, “Franchise Relationships, The State of the Nation 2003”, revealed that 39 per cent of all franchisees rate their franchisors fair or poor overall. Nearly half would not recommend their franchise to a friend or family member, and more than two in five franchisees would not purchase their franchise again if they had known then what they know now. It is obvious that many franchise relationships are in need of repair-even major overhaul (Johnson, 2003: 22). Johnson (2003) believes that one of the best strategies is to head off problems before they start by creating avenues for meaningful franchisee participation. Examples are advisory councils and policy boards; together with giving franchisees advance say in store policies and procedures. Johnson (2003: 24) advises that one of the most important rules for franchisors is simply to follow through on promises; facilitated by an environment of respect.

Johnson (2003) further comments on the role of franchisees, placing emphasis on the importance of letting go of old grudges and biases that have nothing to do with the people and situations at hand. In agreement with Amos and James (2003); Johnson (2003) believes the best franchise systems are those in which mutual trust and shared objectives are the norm. The requirement is the open, resolute and ongoing application of specific policies that affirm the value of franchisor and franchisee goals and abilities. Meaningful communication and growth is the result when franchisees and franchisors join forces to each other’s mutual benefit.

3.3.6 Guidelines for optimal franchise system relationships

Nieman (1998: 129) makes mention of the notion that the franchisee is in business with someone else, and not by themselves. This special relationship should be one of mutual trust and independence, notwithstanding the performance motive. A guiding coalition between the two parties facilitates this independence. Towards a guideline hereof, Justis & Judd (2002; 1989) developed an independent framework, identified in Table 3.1 on the following page.

TABLE 3.1 Guidelines for optimal franchisor-franchisee relationships

Guideline	Franchisor	Franchisee
Training	Development of appropriate training programmes and facilities	Active participation and involvement of franchisee and related staff
Meetings	Facilitate regular meetings, conferences and system interaction	Active participation and attendance
Franchise advisory committee (FAC)	Develop FAC, joint consultation with franchisees	Participation of relevant parties to FAC
Advertising committee	Facilitate and support advertising committee, provide required information	Involvement and proactive participation relevant to franchise system objectives
Information exchange	Develop newsletters and other means of information exchange	Provides information and achievements
Electronic media	Intranet, internet, email and electronic interface communication development	Involvement, participation and competence
Internal marketing	Franchise system advisory medium development, communication to franchisee staff	Communication and information flow to franchisee staff
Marketing communication and localised marketing	Development of generic marketing materials, theme promotions, branding specifications	Adherence to franchise system branding and programmes
Performance Incentives	Develop franchise system incentives	Participation in incentive programmes
Award Structures	Develop recognition awards	Active participation in award recognition process
Operational, financial and management reports	Provide pertinent reports, templates and structures.	Use reports, provide information for reports
Field interaction	Provide field support	Allow field support full access
Basic commitments	Support, assistance and interaction.	Interaction, franchise fees and report requirements.

Source: adapted from Justis and Judd (1989: 501)

3.3.7 Common franchise system conflict areas

Predominantly due to rapid growth, competitive forces and business dynamics, franchise systems often concentrate on expansion, losing the quality of relationships focus (Nieman, 1998: 135). Justis and Judd (2002: 497) identified guidelines for resolving various problems in the system. For his part, the franchisor must concentrate on maintaining and improving the quality of his services (Mendlesohn, 2003: 108). Spinelli (1997: 386) implies that there may be problem areas between franchisor and franchisee in areas of pricing, promotion, and operational issues. The potential for conflict is exacerbated by the phenomenon of larger and more sophisticated franchisees in the system. Potential conflict areas are depicted in Table 3.2 on the following page.

TABLE 3.2 Franchise system potential areas of conflict and resolutions

Conflict areas	Resolutions
Training standards and implementation	Revamp training in accordance to franchise system objectives and franchisee needs analysis
Operations manual	Update and revise appropriateness of operations manual
Information disclosure	Improve facets of internal marketing, franchisee communication (see Table 2.13)
Availability of advice	Develop channels of clear communication, training for franchisor staff, improve field services
Marketing communications	Franchisee involvement in advertising committee
Marketing and industry research	Implement research activities (inclusion of advertising committee involvement)
Ongoing support	Franchise Advisory Council (FAC) and advertising committee recommendations). Renew standing operating procedures.
Site selection	Optimal site selection, in accordance with franchise system requirements, leasing facilities and availability
Discriminatory practices	Evaluate deviations by franchisee, uniformity in accordance to franchise agreements

Source: adapted from Justis and Judd (1989: 502)

3.3.8 Resolving franchise system disputes

Franchising is an ongoing relationship between two or more parties and it is inevitable that disputes will periodically arise. Newton (2003: 71) identifies disputes commonly arising, together with recommended methods of resolving them:

- Quality, price or delivery of products or services, recommended or required by the franchisor. A franchisor can legitimately require franchisees to source their supplies from a particular supplier where this is relevant to uniformity of the quality or nature of the franchise system
- Franchisee royalties and payments due. Franchisees may fail to pay the franchisor amounts due, which may be a reflection of the fact that the franchise is just not proving financially viable for the franchisee. It may also be due to some other dispute as a result of which the franchisee withholds payment of royalties or other amounts
- Alleged misrepresentations, misleading conduct or unconscionable conduct by the Franchisor. These allegations are often raised as an expression of the frustration of franchisees in a dispute situation. Mediation, arbitration or the courts however often resolve perceptions of the franchisees. Newton (2003) advises that the dispute is usually about something else and these allegations are raised as a supplementary item

- Other disputes, including, but not limited to disputes about the franchised territory, termination of the franchise agreement, franchisor advertising, franchisor competing with the franchisee, franchisee not following the franchised system, franchisor communication, rent or lease obligation (franchise system dependent), initial franchisor disclosure, provision of operations manuals and/or other information and amount of the franchise royalties.

Newton (2003: 72) goes on to advise on negotiating solutions to franchise problems:

- Negotiating with the person who can do something about the problem
- Research and preparation of facts prior to negotiation
- Identify value of the franchise relationship, highlighting positive aspects
- Briefly state the problem objectively (non-blaming, neutral)
- Listen to responses, asking for disclosure of reasons for their point of view
- Concentrate on the problem (issue on hand), leave personalities out of it
- Acknowledge your understanding of the process thus far
- Assert an objective rendition of the problem from a point of view, providing reasons and details
- Focus on needs and objectives rather than rights
- Attempt to understand the other party's needs and objectives
- Attempt to identify realistic solutions that meet both parties' objectives
- Be prepared to consider more than one alternative
- If not successful at first, attempt to negotiate with higher authority.

The negotiating meeting itself requires factors including timing; agenda items; venue; freedom of interruptions; representation equality; final decision-makers and participants. Legal action is advisable where one side is using trade marks without permission; has been fraudulent; refuses to negotiate or enter mediation; or has failed to implement an agreement at mediation.

Most literature reviewed however holds the opinion that successful franchise relationships are borne on pro-active participation, and identifying issues prior to reaching conflict (Mendelsohn, 2003; Newton, 1993; Spinelli, 1997; Johnson, 2003; Justis & Judd, 2002; Bloom, 2003; Agmen-Smith, 2003).

3.3.9 Franchise relationships and quality control

Franchising involves the marketing of goods and services. It is a powerful and effective marketing strategy, placing emphasis on networks (Kirby, 2003: 68) and market entry methods (Kirby, 2003: 223). It is also about good marketing and business practices which must be of a high standard, and franchisors and franchisees must understand that they are in the relationship business (Germann, 2002: 39). He proclaims the relationship between franchisor and franchisee built on trust and respect. Germann (2002) informs that all franchise relationships require a purpose, a sense of belonging and the wish to be treated with respect and good relationships allow businesses to expand and flourish so that all parties succeed. He places emphasis in the fact that there is quality control at all levels in franchise relationships. Customer retention depends on this quality aspect, with customer satisfaction a result thereof. Germann (2002: 39) identifies the franchise system relationship link to customer service:

- Accepting that it is everyone in the franchise system's responsibility to keep the customer happy
- Customer service is the key issue in franchise system survival
- Customer satisfaction is the key to long term success
- Give authority to staff in the front line as no person can do everything themselves
- Bad news travels fast and good news rarely overtakes it
- Dissatisfied customers tell eight to ten others of their dissatisfaction and one in five will tell twenty people. Five will tell a total of sixty people, some of whom will tell others
- It costs six times as much to attract a new customer as it does to keep an existing customer
- Sixty per cent of customers say that a company does not pay enough attention to them and does not value them
- The majority of customers are reasonable people and all you require is the first chance to satisfy them.

Together with franchise system links to customer satisfaction, Germann (2002: 40) believes the link to quality is an essential component. Towards this justification, he regards quality in the following light: quality defined as conformance and not goodness;

all non-conformances are caused; anything that can be caused can be prevented; and it has been known for generations that organisations that do what they promise to do, and take good care of their franchisees in the process, always come out top. Germann (2002) concludes by stating it is essential for both franchisors and franchisees to have a policy on quality which should be along the lines that they will deliver defect-free products and services to customers, both internal and external, on time and thereby show reliability.

3.3.10 Franchise system relationships require a solid foundation

Only three elements must be present in a transaction for a business to be considered a legal franchise: trademark licensing; substantial assistance with the business's operations; and the payment of a franchise fee; according to Washington, D.C. based franchise attorney Andrew A. Caffey. While this definition is technically true, the relationship between franchisor and franchisee is far more complicated (Haneborg, 2003: 35). Crucial elements such as trust, communication and relationship-building must be present for both franchisor and franchisee to reach their fullest earning potential (Gulati: 1995; Larson: 1992; Ring & Van de Ven: 1994; Madhok: 1995). While franchise relations issues exist in any economic condition, bear markets are indicative of shrinking profits, tough competition, taking its toll on franchise system relationships.

Haneborg (2003) believes that adhering to team mentality; facilitating open communication and practicing the basics, are primary factors that determine the long-term viability of the relationship. With regard to field franchised operational staff, Haneborg (2003) believes that they, together with the franchisee's staff, should know what the organisation's goals and objectives are, and the role each person plays to achieve those goals. Both the franchisor and franchisee are in the business to make money and grow. The franchisee wants to grow their business, while the franchisor is working to grow the brand.

Haneborg (2003: 36) believes communicating is more than just talking; not just hearing, but listening to franchisees, and asking how the franchisor can assist in creating a solution. Many franchisees believe in the notion that 'a franchisor needs to remember that the franchisee is closest to the dollar'. She concludes that it is up to the franchisor to foster a symbiotic relationship; listen to all comments and complaints, and to take action; and reinforce the basics of the business that will ensure their relationship is built on a

solid foundation. Mendelsohn (1992: 151) believes the franchisor must not only give the franchisee value for money, but the franchisee must perceive the value as greater than the money paid to the franchisor. This requires rock-solid communication between the parties.

3.3.11 Franchise system advisory association/council

Two distinct groupings are identified as external and internal associations. External associations refer to governing bodies for the industry, examples being the Franchise Association of South Africa (FASA), Franchise Association of Australia (FAA), Franchise Association of New Zealand (FANZ) and the International Franchise Association (IFA). Of pertinence in this study are the internal associations, those formed within a particular franchise system, commonly referred to as Franchise Advisory Councils (FACs). Bloom (2003: 27) regards FACs as franchisee organisations formed to provide valuable input into different operational aspects of their franchise system, ensuring that franchisees can accomplish this goal in an organized manner.

Franchisors may also then be in a position to realize that franchisees have valuable contributions into operational issues, including marketing campaigns, new product development, training, or any franchise system functions. Patel (2000: 56) informs that the FAC is an idea intended to benefit both parties. Instead, it too often causes frustration for franchisees and fear for franchisors. The FAC is either subsidized by the franchisor or is independent and funded by the franchisees. The disadvantage of the former is that the franchisor controls the activities; whilst the drawback of the latter is that the FAC is seen as a threat by the franchisor. Patel (2000: 56) recommends that for a FAC to be truly effective, the following factors must be synergized:

- Candid, complete and continuing communication, between FAC members themselves, and also between the members they represent
- The advice offered by the FAC should be taken and considered seriously by the franchisor, tokenism is unsatisfactory
- In their dealings and discussions, both sides must be realistic, mature and flexible.

The primary role of the FAC for franchisees is that of access to other franchisees, access to franchise executives and access to franchise data. These usually revolve around the collection of franchise fees and funds available for marketing communications support. The primary role of the FAC for the franchisor is also access based, being access to franchisee feedback. Patel (2000: 57) thus informs that the overriding objective of the FAC is access, and this should be the driving force behind the council. Apart from access, the FAC can be valuable in replacing dysfunctional relationships with co-dependency (Justis & Judd, 2002: 496). There is a connotation that the name is inappropriate to relationship management, with suggestions for a name change to “franchise-owners council” or “franchise-relations council” (Patel, 2000: 57).

Mendelsohn (2003: 158) informs that FACs born out of frustration and dissatisfaction of franchisees should be avoided at all costs. These allow for hostile positions between the parties, however, they may be a means of resort for franchisees. Mendlesohn (2003: 159) identifies areas in which the FAC can operate effectively:

- Communication; improvements, ideas, new technologies, identification of barriers to communication, style and content of communication
- Franchisee experience in the field may be relayed to the franchisor, facilitating functionalities
- Sharing of new ideas and franchise system innovations via franchise grouping
- Suggestions for improvement of procedures, an example being the operations manuals
- Training, re-training procedures, training needs from franchisees
- Field support recommendations and requirements
- Reporting and accounting opportunities and problems, identified and rectified
- Proposals for contractual changes
- Marketing communications funding and allocations
- New product, development and research initiatives including franchisee participation
- Raising topics of concern to franchisees.

Patel (2001: 21) identifies the merits of the FAC as three tiered towards evaluating, reviewing and revising franchise systems from the franchisee’s point of view.

3.3.12 Franchise system networking

The view of integrating entrepreneurial activity and strategic service within a franchised system may best be explained in the context of networks. The most widely held view of 'network' refers to an organized system of relationships, linking a defined set of persons, objects or events (Nelson: 1988; Szarka: 1990). This networking in small business serves to provide owner-managers with the necessary support, contacts, and credibility (Ostgarrd & Birley: 1996). Consequently, the owner-managers will benefit from obtaining necessary information and will learn more about their own capabilities relative to their competition, thereby minimizing the harsh lessons the market place may present (Dilts: 2000). As such, networking is seen as a major tool for achieving desired business results, and as a key source of resources that are typically outside the reach of many entrepreneurs (Zhao & Aram: 1995). This network view correlates entrepreneurship and franchising, yet entrepreneurial orientation amongst franchisees in the franchise system requires investigation.

Relationship management within the franchise system will be incomplete without prioritising the effect of the internet and electronic commerce on strategy (Porter, 2001: 63). Perry (2002: 27) identifies that technical and social bonds contribute to the success of a relationship. He identifies social bonds as including trust, commitment, equity, conflict and benevolence. Technical bonds identified include competence (the degree to which business transactions meet performance expectations) and investment. Perry (2002) postulates that the trend to invest in information technology to replace mail, fax, telephone and face-to-face contact may make the relationship between buyers and suppliers technically and economically more efficient, whilst simultaneously enhancing the social bonds between the parties.

Information must flow freely for franchise arrangements to be successful. Such examples include the franchisor informing franchisees about new procedures, prices, products, marketing information and training. Franchisees too must regularly communicate performance information to the franchisor. There must also be communication with external parties such as suppliers, banks, advertising agencies and consultants.

3.3.13 Franchise system merits

In an entrepreneurial context, franchising is viewed as an influencing factor on entrepreneurship development. Franchising is a relatively low-cost means of setting up a new-venture and has grown rapidly in recent years (Kirby, 2003: 67), both in South Africa and internationally. The entrepreneurial link to small business is facilitated by franchising, whereby a business owner sells to another the right to operate the same business in another location (Schermerhorn, 2002: 125). Franchising is a means of expansion using limited equity finance (Nieman *et al.*: 2004: 157).

Franchisees join franchise systems because of the advantages offered (Lindsay & McStay, 2004: 2). These include affiliation with a trademark or trade name (Knight, 1986: 7; Stanworth: 1977), franchisor support (Hough: 1986), proven business format (Withane, 1991: 24), established name, lower development costs, and training (Peterson & Dant, 1990: 49). Mendelsohn (2003: 19) informs that the failure rate of new franchise businesses is one-tenth that of non-franchised new businesses. The risk inherent of a new business is reduced, but by no means totally marginalized. In evaluating reasons to purchase a franchise, Lord (2003: 8) identifies the following:

- Many managers/workers are specialists and do not have the knowledge to successfully operate a new venture. Franchising provides the training and ‘know-how’ to overcome this weakness
- Franchising offers a freedom of lifestyle, a choice between indoors/outdoors; an office or shop; premises/home; alone or with spouse; the opportunities are virtually endless
- The opportunity to use existing skills in another context
- Transformation from employment to self-employment made easier in that you are part of a group, in business for yourself, but not by yourself (Nieman: 1998)
- Large variety of opportunities, with the initial investment most often proportional to the possible return
- Part-time or full-time, with many start-ups being run by one person, with a second only entering the system once the start-up has grown
- Regional franchises offer opportunity for the more experienced individuals, when a higher risk-reward is sought. This may be more applicable to entrepreneurs.

Master franchises are usually a longer term investment, with high financial outlays.

Hisrich *et al* (2004: 486) consider the merits of franchising from the point of view of the franchisee and the franchisor. They consider these merits from the point of view of entrepreneurial activity. One of the most important advantages of buying a franchise is that the entrepreneur does not have to incur all the risks often associated with starting a business from scratch. Entrepreneurs typically have problems with starting new ventures in the areas of product acceptance; management expertise; meeting capital requirements; knowledge of the market, and operating and structural controls (Hisrich & Peters, 1998: 548). Franchising minimizes the risk associated with these factors through the franchise relationship.

From the point of view of the franchisor, advantages to the entrepreneur are related to expansion risk, capital requirements, and cost advantages due to extensive buying power. However, Schermerhorn (2002: 237), in agreement with Hisrich and Peters (1998: 550) and Hisrich *et al* (2004: 488), advise that the franchisor must have established an entity of value and credibility that someone else is willing to buy.

Mendelsohn (2003: 36) believes that the proven success formula leads to a number of advantages from which the franchisee may benefit. On the other hand, certain disadvantages to the franchisee may be seen. Freel & Deakins (2003: 69) also evaluate similar advantages and disadvantages, however from an entrepreneurial perspective. The main salient activities from Medelsohn (2003) and Deakins and Freel (2003) are depicted in Table 3.3.

Deakins and Freel (2003) conclude that despite the loss of control in a franchise; the reduction of risk while still retaining elements of entrepreneurship, has been a powerful motivating factor and the growth of franchising appears likely to continue unabated in the new millennium.

Table 3.3 is represented on the following page.

TABLE 3.3 The main advantages and disadvantages of buying a franchise as a means of business start-up

Advantages	Disadvantages
Franchise usually based on a proven recipe for success	A proven recipe for success usually comes at a price, at a premium to the franchisee
Benefit from economies of scale, such as marketing and group buying	Although the business may be sold to another taking over your role as franchisee, this may be less than could be achieved with <i>de novo</i> entrepreneurship
Market research usually undertaken by the franchisor	Trading limited to a geographical area and location, with marginal growth capabilities
Training provided by the franchisor	Possibility of franchise disputes with the franchisor or fellow franchisees
Early stage advice, as the franchisor may act as a mentor	Innovation and creativity limited due to the franchise operating to strict formula for production, sales and marketing
The franchise package most often includes a turn-key operation, facilitating a time and effort advantage	The turn-key advantage comes at a price, and the franchisee may not agree with certain initial undertakings, such as computer systems
Benefits from a strong brand name	Brand image of the franchisor may be tarnished, reflecting on all the franchisees
Franchised systems are often favoured by investors and banks due to established track records	Entrepreneurs may feel confined working within the systems, guidelines and requirements of the franchisor
The franchisee has the disposal of the franchisor's expertise	Imposition of control, disturbing the facets approach of the entrepreneur
The franchisee has the services of field staff from the franchisor, to assist with any problems which may arise	Difficult to assess the quality of the franchisor
Usually a lower investment than setting up a new venture, due to experience gained by the franchisor from pilot and other operations	The franchisee may become too dependent on the franchisor, failing to produce the required personal drive
Guidance of regional activities, including municipal approvals, regional council grants, planning zones, shop fitting, refurbishments	Franchisor's policies may affect the franchisees proactivity regarding local marketing initiatives
Social entrepreneurial activities of integrating opportunities from fellow franchisees	Although relatively independent, the entrepreneur is not master of his own destiny in a franchise environment, always bound by the intellectual property of the franchisor

Source: adapted from Deakins & Freel (2003: 69) and Mendelsohn (2003: 32-33)

3.4 ENTREPRENEURIAL ORIENTATION IN A FRANCHISE SYSTEM

The global contribution and growth of the franchised system has been the subject of much research; however, the research exploring entrepreneurial orientation (EO) in these systems is scant (Lindsay & McStay, 2004: 1). Lumpkin & Dess (1996: 137) refer to EO as the organisational processes, methods, styles, practices and decision-making activities employed by entrepreneurs that lead to new ventures. Bird (1991) identifies new ventures as a start-up firm, via an existing firm, or internally via a larger corporation. Lumpkin & Dess (1996) advise that entering new or established markets with new or existing goods or services can attain new ventures.

3.4.1 Franchisee entrepreneurial orientation literature

From an entrepreneurial perspective, franchising is seen as an entrepreneurial route towards starting and expending new ventures (Bygrave: 1997; Deakins & Freel: 2003). Franchising literature is however dominant in the areas of franchise system relationships (Hopkinson & Hogarth-Scott: 1997; Lewis & Lambert: 1991; Fayerman: 2002; Mendelsohn: 2003; Amos: 2003); franchise system functioning and objectives (Sherman & Dewis: 2003; Deakins & Freel: 2003; Nieman & Pretorius: 2004; Mendelsohn: 2001); and the development of franchising in an international arena (Dhir & Bruno: 2004; Nieman: 1998). Limited literature is available regarding entrepreneurial orientation of franchisees (Lindsay & McStay: 2004).

Entrepreneurial orientation from the franchisor's point of view is not disputed (Bygrave: 1997; Spinelli: 1997; Sherman: 2003); however, this orientation is questioned from a franchisee point of view (Hisrich *et al*: 2004; Kuratko & Hodgetts: 2004). Klein (2002) believes that individuals with an entrepreneurial personality should think twice about entering the franchise system as franchisees. Michael Seid (in Klein :2002), a franchising consultant based in West Hartford, Connecticut; emphasizes that franchisees often think of themselves as entrepreneurs, but they are not. His justification is that entrepreneurs want to start new businesses and they want to make their own decisions. They like to experiment and have the need to operate and market their business based upon their own vision of how things should be done. Franchisees, on the other hand, are contractually obliged not to deviate from the operational plans of the franchisor (Newton: 2003).

Deakins and Freel (2003) however believe that despite the appeal of reduced risk; elements of entrepreneurial activity in a franchise system are motivators for prospective franchisees. Halloran (1994) believes franchising is a way of becoming an entrepreneur with a built-in market and proven formula. Spinelli (1997) developed a value model depicting merits and demerits of entrepreneurs becoming franchisees, concluding that if the present value of the outcome is positive; the franchise system route is recommended. It is the objective of this study to empirically demonstrate the entrepreneurial orientation of franchisees, with the author of the opinion that franchisees do exhibit an entrepreneurial orientation in certain situations. This will however not apply to all franchisees in all franchise systems, but is largely dependent on character themes (Thompson: 2003).

In justification of this point of view, a review shall be conducted; identifying entrepreneurial thought from existing literature (Nieman *et al*: 2003; Hisrich *et al*: 2004; Kao *et al*: 2004; Kuratka & Hodgetts: 2004; Lumpkin & Dess: 1996; Bolton & Thompson: 2003; Bolton & Thompson: 2000; Thompson: 2003) coupled with a review of the franchise system literature (Mendelsohn: 2003; Nieman: 1998; Nieman *et al*: 2003; Deakins & Freel: 2003). Thereafter, an empirical study on constructs of proactivity, innovation and risk-taking is recommended (Lindsay & McStay: 2004). Links between entrepreneurship and franchising, with specific reference to franchisee entrepreneurial orientation revolves around highlighted relationships prior to empirical investigation. The literature analysis is depicted in Table 3.4 on the following page.

Cognisance must however be taken of the nature of entrepreneurial activity, varying between opportunity, necessity and social entrepreneurs (Bygrave *et al*: 2004). This classification identifies reasons for entering entrepreneurial activity, coupled with relevant entrepreneurial background (Frederick: 2001). Comparisons of entrepreneurial behaviour between the entrepreneur, intrapreneur and traditional manager also affect franchisee involvement in entrepreneurial activity (Hisrich & Peters: 1998). Nieman *et al* (2003) define an entrepreneur as an individual who establishes and manages a business for the main purpose of profit and growth; characterized by innovative and strategic behaviour. Pivotal to the definition is the creation of incremental wealth (Hisrich *et al*: 2004). Intrapreneurship in turn is entrepreneurial activity within an organisational context, receiving sanctions and resource commitment for the purpose of innovative results (Kuratko & Hodgetts: 2004). An assumption is made not to distinguish between entrepreneur and intrapreneur in the franchise context, as both involve entrepreneurial activity.

Notwithstanding this assumption, it must however be highlighted that franchisees may well be intrapreneurs, particularly when commanding senior positions on franchise councils and advisory associations (Bloom: 2003). Franchisors may well delegate the necessary authority to relevant franchisees for the purpose of innovative results in the franchise system (Morris & Kuratko: 2002). The franchisor may well motivate an intrapreneurial environment, including the encouragement of new ideas; limited opportunity parameters; resource availability and accessibility and operations on the frontiers of technology (Hisrich & Peters: 1998).

TABLE 3.4 Entrepreneurial orientation of franchisees in a franchise system: a review of the literature across disciplines (entrepreneurship and franchising)

Entrepreneurial Orientation	Franchise System (Franchisee Involvement)
An individual who establishes and manages a business for the main purpose of profit and growth (Nieman <i>et al.</i> : 2003); profit-orientation (Schaper & Volery: 2004); leadership ability (Zimmerer & Scarborough: 1996)	Franchisees and franchisors are interdependent, the higher the franchisee income, the better for the franchisor (Tikoo: 1996); ignores the role of learning, preparation and serendipity in the process of entrepreneurship (Deakins & Freel: 2003). Franchising is the product of conscious efforts towards enhancing franchise system relationships (Nieman: 1998); Amos and James (2003) inform that leadership of franchisees is about being solution-oriented, corresponding to focus traits of the entrepreneur (Thompson: 1999)
Innovative behaviour, employing strategic management practices in business (Carland, Hoy, Boulton & Carland: 1984); entrepreneurship involves creativity and innovation (Thompson: 1999); creativity and flexibility (Zimmerer & Scarborough: 1996)	The creativity and innovation link is manifested in the ability of entrepreneurs to harness the potential of new technologies in turbulent environments (Lumpkin & Dess: 1996). Innovation is seen to be in the hand of the franchisor, whilst creativity a distinct franchisee trait (Lindsay & McStay: 2004); franchisees are an important part in the franchise system, enabling entrepreneurs in service industries to assemble resources in order to rapidly create large chains and gain first mover advantage (Mendelsohn: 2003)
An individual who sees an opportunity in the market, gathers resources and creates and grows a business venture (Nieman <i>et al.</i> : 2003); maximizing opportunities (Drucker: 1964; Shapero: 1975); the process of doing something new (creation) or something different (innovation) for the purpose of creating wealth and adding value to society (Kao: 1993); creating value for oneself and adding value to society (Kao <i>et al.</i> : 2002); entrepreneur as a leader (Kotter: 1999)	Bygrave (1997) believes the new business is much more likely to be of the incremental kind, as opposed to a revolutionary creation; the creation of mega franchisee multi-store ventures (Amos: 2003); The franchisee is in business for themselves with others (Nieman: 1998), and that the special relationship should be one of trust and mutual independence, notwithstanding the performance motive; Traditional entrepreneur stumbling blocks (knowledge of the market, management expertise, structural controls) eradicated by becoming a franchisee (Hisrich & Peters: 1998); Franchisee benefit from economies of scale, marketing and group buying (Deakins & Freel: 2003); Franchise leadership makes the difference, with franchisees being informal leaders in the system (Frith: 2004)
Taking Risk (Nieman & Bennet: 2002); Innovative risk-takers (McClelland: 1961); accepting risk of failures (Shapero: 1975); one who assumes the risk of gaining profits or incurring losses in the undertaking of commercial transactions (Halloran: 1994); Entrepreneurs manage risk (Thompson: 1999); calculated risk-taker (Deakins & Freel: 2003)	Halloran's (1994) definition of an entrepreneur includes entrepreneurs from all walks of life, and may be useful to incorporate 'calculated risk'. Risk must be taken in context, being risks that the franchisee as entrepreneur can understand and manage (Lindsay & McStay: 2004; Lumpkin & Dees: 1996). Calculated risk due to benefits from an existing brand (Mendelsohn: 2003); franchise system often favoured by investors and banks (Deakins & Freel: 2003)
Being rewarded (Nieman & Bennet: 2002); wealth creating opportunities, judging which opportunities to pursue, idea generators (Allinson <i>et al.</i> :2000); creating incremental wealth (Hisrich <i>et al.</i> : 2004)	Macro trends on franchisee performance include globalisation of franchising and involvement of mega-franchisees as multiple franchise owners (Amos: 2003), indicative of new venture creation (Bygrave: 1997); proven recipe for success (Mendelsohn: 1992); franchisees are undoubtedly wealth creators, often more successful than the franchisor (Dhir & Bruno: 2004)

Table 3.4 continued

Managing a business (Nieman & Bennet: 2002); vision (Deakins & Freel: 2003); desire for autonomy (Halloran: 1994); strategic orientation (Morris & Kuratko: 2002); Managing growth (Nieman <i>et al.</i> : 2004)	Cromie (2000) observes that some entrepreneurs are even deviants, reason why many franchise agreements often end up in disputes (Newton: 2003); from a strategic perspective, franchisees are committed to the long-term success of their venture (Sherman & Dewis: 2003); opportunities for self employment, combining the elements of the independence normally associated with self employment (Dant, Paswan & Stanworth: 1996)
Prefer to be in control of their own business (Nieman <i>et al.</i> : 2003); desire for responsibility (Zimmerer & Scarborough: 1996); internal locus of control (Schaper & Volery (2004); leadership ability (Zimmerer & Scarborough: 1996); independence of mind (Schaper & Volery (2004)	Entrepreneurial activity can be seen in organisations where they have the freedom to build their own organisation (Nieman <i>et al.</i> : 2003), often referred to as intrapreneurs. Pinchot (1983) identified the intrapreneur as an entrepreneur within an already established organisation; freedom of lifestyle (Lord: 2003); large variety of opportunities, with the initial investment most often proportional to the possible return (Lord: 2003)
Entrepreneurial orientation critical to the survival and growth of organisations (Nieman <i>et al.</i> : 2003); motivation to excel (Zimmerer & Scarborough: 1996); Maritz (2005)	Franchisees must initiate relationship marketing, enhancing networks and cooperation towards achieving system objectives, mutually beneficial to all participants in the franchise system (Mendelsohn: 2003); franchising is booming, franchisees are succeeding more so than small business (Halloran: 1994)
Importance to the prosperity of economic advantage (Nieman <i>et al.</i> : 2003); hard-work ethic (Schaper & Volery: 2004)	The franchisee as entrepreneur identifies that the franchisor's support role must provide value in excess of the cost thereof to the franchisee (Mendelsohn: 2003)
Entrepreneurial orientation is focussed by a unique combination of factors: culture, role models, education, work experience, personal orientation (Nieman <i>et al.</i> : 2003)	Franchisees come from varying roles and backgrounds (Mendelsohn: 2003). Franchisees are responsible for development of the culture in the system (Amos & James: 2003), with relationships being the product of conscious effort (Johnson: 2003)
Creating something different with value by devoting time and effort (Hisrich: 1990); creativity & flexibility (Zimmerer & Scarborough: 1996)	Entrepreneurs are able to timeously locate required resources via networking capabilities (Larson & Rogers: 1986), similarly, franchisees network to achieve business objectives (Mendelsohn: 1999)
Initiative taking, and the organisation of social and economic mechanisms (Hisrich <i>et al.</i> : 2004); Nieman <i>et al.</i> (2004)	Despite the lack of initiative as a franchisee, the popularity of franchising has mirrored the importance and growth of entrepreneurship in the economy (Deakins & Freel: 2003)
Entrepreneurs are determined in the face of adversity (Thompson: 1999); tolerance for risk, ambiguity and uncertainty (Zimmerer & Scarborough: 1996), self-confidence (Zimmerer & Scarborough: 1996); energy and diligence (Schaper & Volery: 2004)	Elements of self-belief, determination and motivation are inherent towards franchisee success, characteristics shared by entrepreneurs. Paradoxically, a school of thought suggests that entrepreneurs and franchisees can perceive failure as the price of their success (Kets de Vries: 1997)
Adding value to target markets (Hisrich <i>et al.</i> : 2004); combine resources in new and different ways to create value (Zimmerer & Scarborough: 1996); entrepreneurs add value (Thompson: 1999)	Sometimes instinctively, entrepreneurs adapt their offerings to the needs and wants of markets, whilst they add value through the transformation process (Thompson: 1999); Value adding requires performance measures, which is outcome-driven (Ostgard & Birley: 1996), a distinct franchise system characteristic (Mendelsohn: 2003)
Devotion of necessary time and effort (Hisrich <i>et al.</i> : 2004); creative energy (Halloran: 1994)	Entrepreneurs have certain flair to the way they approach things (Lumpkin & Dees: 1996); Franchisees are able to timeously locate required resources via networking capabilities (Lindsay & McStay: 2004)
The process brought about by individuals of identifying new opportunities and converting them into marketable products or services (Schaper & Volery: 2004)	Franchisees in many segments have recognised the benefits of multiple unit franchisees, creating new ventures in a multi-site network (Johnson: 2004). Franchisees as entrepreneurs join franchise systems because of the advantages offered (Lindsay & McStay: 2004)

Table 3.4 continued

An integrated concept that permeates an individual's business in an innovative manner (Kuratko & Hodgetts: 2004); vision combined with capacity to inspire (Timmons: 2004); goal orientation (Halloran: 1994)	Franchisees make it their business to exploit all the resources available (Lindsay & McStay: 2004); Halloran (1994) considers franchising as a way of becoming an entrepreneur with a built-in market and proven product; the opportunity to use existing skills in another area (Lord: 2003); franchisees and franchisors interdependent to achieve system vision (Sherman & Dewis: 2003)
Someone who perceives an opportunity and creates an organisation to pursue it (Bygrave: 1997); Entrepreneurship is about spotting and exploiting opportunities (Schumpeter: 1949; Kirzner: 1973); Entrepreneurs find the resources to exploit opportunities (Kirby: 2003)	Entrepreneurship foundations are rooted in flexibility, and when resources are not 'state-of-the-art', entrepreneurs will select those that will perform satisfactorily. Within a systems context, such as franchising, the system should become increasingly knowledge based, to support sharing and learning (Lindsay & McStay: 2004)
A social orientation, whereby each individual is encouraged to be self-reliant, and an agent of innovation and creation (Kao <i>et al.</i> : 2002); conceptual ability (Timmons: 2004)	The franchisee as entrepreneur is given the opportunity to enter a new business with a better chance to succeed than if he/she were to commence a start-up business (Hisrich & Peters: 2004); the franchisee as entrepreneur is involved in a relationship, being one of the most synergistic relationships in all business (Amos: 2003)
Entrepreneurism is also very much alive in existing companies (Zimmerer & Scarborough: 1996)	Entrepreneurism can be found in all sectors of society, not just in new ventures (Zimmerer & Scarborough: 1996); the franchise system network correlates entrepreneurship and franchising (Zhao & Aram: 1995)
Organisational processes, methods, styles, and decision-making activities employed by entrepreneurs that lead to new ventures (Lumpkin & Dess: 1996)	Contingent on environmental and organisational factors, various studies demonstrate a positive EO relationship in entrepreneurial organisations (Covin & Slevin: 1989); Franchisees are instrumental in developing marketing entry methods (Kirby: 2003)
Proactivity, innovativeness and risk-taking activities (Wiklund: 1999; Miller: 1983; Covin & Slevin: 1999); Nieman <i>et al</i> (2003)	Franchisees exhibit proactive and risk-taking behaviour (Lindsay & McStay: 2004); ignores environmental factors that may be more important than personality (Deakins & Freel: 2003); regional franchises offer opportunity for the more experienced entrepreneur, when a higher risk-reward is sought (Lord: 2003)
A person who habitually creates and innovates to build something of recognized value around perceived opportunities (Bolton & Thompson: 2000); perception with foresight (Schaper & Volery: 2004)	Bolton and Thompson (2000) inform that a person can also be a group of people as it is possible to describe teams and even organisations as entrepreneurial. They also believe entrepreneurs are the people who possess the imagination and flexibility to ensure there is a causal link between them and the enterprise (such as a franchise system)
Initiative, imagination, achievement orientation, pragmatism, independence, flexibility (Thompson: 1999)	Inappropriate to search for a significant individual trait, comprises an essentially static approach to the dynamic process of entrepreneurship (Deakins & Freel: 2003)
Entrepreneurs are individuals who make a difference (Thompson: 1999); the need for achievement (Schaper & Volery: 2004)	Entrepreneurs transform a simple idea into an opportunity that works (Kets de Vries: 1997), similar to idea generation in franchise councils (Amos 2003); Justis and Judd (2002) provide guidelines for franchisees on advertising committees; advising on involvement and proactive participation
Entrepreneurs are good networkers (Thompson: 1999); good communication skills (Schaper & Volery: 2004)	Whilst being constrained by limited resources, the entrepreneur uses creativity, social networking and bargaining to obtain deals and activity (Perry: 2002); evident of franchisee participation in system decision-making (Johnson: 2003)

Table 3.4 continued

Entrepreneurs have ‘know-how’ and ‘know-who’ (Thompson: 1999); commitment to others (Deakins & Freel: 2003)	Gibb (1998) informs that entrepreneurs are aware of where they can obtain the required resources; namely in the case of the franchisee, assistance from the expertise of the franchisor (Spinelli: 1997); communication, knowledge-sharing and informal assistance are keys to franchisee success (Siegel: 2002)
Entrepreneurs create capital (Thompson: 1999)	Adding value, networking and acquisition of resources constitute the entrepreneur’s intellectual capital. These attributes are used to create financial capital, social capital and aesthetic capital (Covin & Slavin: 1989). So too, franchisees create capital by similar methods, predominantly through multi-site expansion within the franchise system (Johnson: 2004)
Entrepreneurs value individualism and freedom more than others, as they have a general dislike to rules, procedures and social norms (Kirby: 2003)	The individualistic value of the entrepreneur identifies areas of disputes in franchise systems, such as information disclosure, ongoing support, discriminatory practices and training standards (Justis & Judd: 1989)
Entrepreneurs put the customer first (Bolton & Thompson (2000)	Franchisees are integral at the moment of truth, being catalysts for service quality (Zeithaml & Bitner: 2003); customer retention and satisfaction is the result of franchisee relationships built upon trust and respect (Germann: 2002); everything a franchisee does, even with customers, is based on relationships (Siegel: 2002)
Thompson (2003) character themes: inventor, entrepreneur, leader, entrepreneur enabler and non-entrepreneur	Empirical study to evaluate entrepreneurial orientation in a franchise system in the home entertainment industry

Table 3.4 highlights many similarities of the franchisee and entrepreneur, with minimal contradictory literature findings. It is however the opinion of the author that the franchisee is more closely aligned to the corporate entrepreneur (also known as intrapreneur). Reasoning is due to the integration functioning of the franchise system (Mendelsohn: 2003), indicative of business relationships and paradigms similar to business organisations (Kuratko & Hodgetts: 2004). The family entrepreneur is another important form of entrepreneur (Maas: 2003), particularly due to family involvement in many franchise systems (Maritz: 2002). The development of an emerging entrepreneur into the franchise system (Hough: 2003) facilitates growth in the system, particularly in the case of the previously disadvantaged/ previous dispensation. This however warrants a study in its own right, being characterized by changes in tolerance levels (Hough: 2003) and cultural diversity (Nel *et al*: 2004).

Comparisons of the entrepreneur and intrapreneur are depicted in section 2.6.5, and summarized in Table 2.2 (Hisrich & Peters: 1998). Differences between traditional managers and entrepreneurs are depicted in table 2.3 (Kao *et al*: 2002). What follows is a brief rendition of the proposed similarities between the intrapreneur and franchisee, using

literature from prominent authors in the discipline. Research is indicative of similarities between the intrapreneur and franchisee. Findings are depicted in Table 3.5.

TABLE 3.5 The intrapreneur and franchisee: an adaptation of literature on the disciplines

Characteristic	Intrapreneur	Franchisee
Primary motives	Freedom of access to corporate resources: goal oriented and self-motivated, but also responds to corporate rewards and recognition	In business for oneself, but not by oneself (Nieman <i>et al</i> : 2003); an important goal for entrepreneurs running established business ventures is growth (Nieman: 1998)
Time orientation	End goal of three to fifteen years, depending on the type of venture; urgency to meet self-imposed and corporate timetables	End goal of twenty years, dependent on franchise contract (Agmen-Smith: 2003); focus often operational as opposed to strategic (Perry: 2002); personal and system differential (Mendelsohn: 2003)
Tendency to action	Gets hands dirty; may know how to delegate but, when necessary, does what needs to be done	Hands on, participative at franchise level (Mendelsohn: 1994); interactive at franchise council level (system specific) (Bloom: 2003)
Skills	Good business acumen, requires help with managerial or political skill to prosper within the organisation	Small business management and general managerial acumen (Schaper & Volery: 2004); Interpersonal and relationship management (Peck <i>et a</i> : 1999)
Focus of attention	Both inside and outside; sells insiders on needs of venture and marketplace but also focuses on customers	Inside and outside, plus within the system (Hopkinson & Hogarth-Scott: 1999); managing own franchised outlet, managing customers and interaction within franchise system (Bloom: 2003)
Attitude towards risk	Likes moderate risk: generally not afraid of being fired, so sees little personal risk	Moderate risk; operating a system within a system (Michael: 2003); guidance from franchisor on risk related factors (Spinelli: 1997)
Use of market research	Does own market research, an intuitive market evaluation, like the entrepreneur	Joint research with franchisor (Mendelsohn: 2003); own research when evaluating a multiple-unit system (Michael: 2003)
Attitude towards status	Considers traditional status symbols a joke; treasures symbols of freedom	Non-traditional, more hygiene factor sensitive, such as need for achievement (McClelland: 1961); franchisee performance, for example status of being franchisee of the year (Mendelsohn: 2003)
Decision-making style	Adept at getting others to agree with private vision; somewhat patient and willing to compromise than the entrepreneur but still a doer	Informal leadership qualities to gain support and commitment from fellow franchisees (Haneborg: 2003); impatient for short term results (Mendelsohn: 1994); vary with interest across the system and own interest (Mendelsohn: 2003)
Attitude towards the system	Dislikes the system but learns to manipulate it	Often critical, due to realising he/she is operating someone else's system (Mendelsohn: 2003); depends on hierarchy within the system (Mendelsohn: 1992)
Problem-solving style	Works out problems within the system or bypasses them without leaving	One on one with the franchisor, but may lead to disagreement if the environment is not conducive to trust and open communication (Das & Teng: 1998); solution oriented as opposed to conflict oriented (Amos & James: 2003)
Educational level	Often highly educated, particularly in technical fields	Moderate education levels, often from corporate sector (Amos & James: 2003)

Table 3.5 continued

Relationship with others	Perceives transactions within hierarchy as basic relationship	Essential to a profitable and lasting franchise system (Amos & James: 2003), the franchisee facilitates open relationships
Attitude toward courage and destiny	Self-confident and courageous; many are cynical about the system but optimistic about their ability to outwit it	Confident in own capabilities (Hisrich & Peters: 1998), but sceptical about franchisor and system if not involved in the decision-making process (Johnson: 2003)
Attitude towards failure and mistakes	Sensitive to need to appear orderly; attempts to hide risky projects from view so as to learn from mistakes without political cost of public failure	Open to constructive criticism from system participants (Das & Teng: 1998), confidence in partner cooperation, trust and control. However, resistance to adhering to non-agreed upon system initiatives (Madhok: 1995)

Source: original intrapreneur characteristics adapted from Pinchot (1985) and Morris and Kuratko (2002)

Contingent on environmental and organisational factors, various studies demonstrate a positive EO relationship in entrepreneurial firms (Lumpkin & Dess: 1996; Miller: 1983; Covin & Slevin: 1989). Entrepreneurial firms are actively involved in product-market innovations, participate in ventures requiring risk, and are proactive (Miller, 1983: 771). In contrast, non-entrepreneurial firms innovate very little, are risk averse, and imitate competitors (Miller, 1983: 771).

Research in the area of the franchise system lacks consensus of EO of franchisees in the system. Whilst the merits of the franchising system are primarily focussed upon risk reduction (Mendelsohn, 2003: 31; Deakins & Freel, 2003: 69), this somewhat negates the risk facet of the entrepreneur (Bolton & Thompson: 2003). The demerits of the system (Table 3.3) are also indicative of minimizing entrepreneurial creative and innovative talent (Bolton and Thompson: 2000).

Intrapreneurial leadership characteristics, most often shared by the entrepreneurial franchisee include (Hisrich *et al.*: 2004): understanding the environment; visionary and flexibility; creating management options; encouraging teamwork; encouraging open discussion; building a coalition of supporters and persistence. Of the dominating traits, it can be identified that relationship management (Peck *et al.*: 1999) is paramount towards the achievement of personal and system objectives. Without mutual respect, a relationship of trust towards the smoothly operating system will not be possible (Mendelsohn: 2003).

Whilst many similarities are evident in the intrapreneur and franchisee relationship, the talent, temperament and technique (Bolton & Thompson: 2004) of all individuals differ.

The empirical research shall analyse these individual traits (Chapter 7). As a concluding remark on the literature review of franchisee and entrepreneurial orientation; the author supports the following characteristics of entrepreneurial (intrapreneurs included) and franchisee mindset (McGrath & MacMillan: 2000):

- They passionately seek new opportunities, staying alert and profiting from change
- They pursue opportunities with enormous discipline, and act on these opportunities
- They pursue only the very best opportunities and avoid exhausting themselves and their organisation by chasing after every option, being ruthlessly disciplined
- They focus on execution- specifically adaptive execution, exploiting real opportunities
- They engage the energies of everyone in their domain, relationship management in pursuit of their opportunities

Additional studies linking franchising and entrepreneurship have been investigated by Maritz (2005; 2005a). These included a link between GEM entrepreneurs and the franchise system, with the entrepreneurial link to small business facilitated by franchising. Findings were also indicative of franchise system entrepreneurs being significantly prone to ecommerce capability. Both studies identified an entrepreneurial orientation within the franchised system; together with franchising being an entrepreneurial option towards creating and developing ventures.

What follows is an empirical study conducted on the EO of franchisees Lindsay and McStay (2004), specifically on the entrepreneurial constructs of innovation, creativity and risk-taking.

3.4.2 Franchisee entrepreneurial orientation: an empirical review

Lindsay and McStay (2004: 3) relate that from the franchise system perspective, benefits in maintaining system integrity may be achieved by constraining franchisee entrepreneurial behaviour. However, they advise that this will be costly to both franchisor and franchisee from a performance perspective. Those organisations demonstrating entrepreneurial activities, contingent upon environmental and organisational factors, experience improved performance (Covin & Slevin, 1989: 77; Lumpkin & Dess, 1996:

434). EO is furthermore an essential feature of high performance organisations (Lumpkin & Dess: 1996). Various authors concur on OE measures. Morris and Kuratko (2002); Miller (1983); Lumpkin and Dess (1996); Covin and Slevin (1989) and Wiklund (1999) regard EO measures as including proactiveness, innovativeness and risk-taking.

3.4.2.1 Proactiveness

Seen as an opportunity-seeking and forward-looking perspective in anticipating future demand (Morris & Kuratko: 2002). Whilst not necessarily meaning ‘first to market’ (Lumpkin & Dess: 1996), proactivity represents an aggressive competitive orientation (Covin & Dess: 1997). Morris and Kuratko consider proactiveness as being concerned with implementation, with taking responsibility and doing whatever is necessary to bring an entrepreneurial concept to fruition. It is manifested as acting on rather than reacting (Miller: 1983) from a corporate entrepreneurship perspective. The essence of proactiveness is captured in the well known Nike slogan “just do it”. The author is however of the opinion that proactiveness would better be described as “just did it”.

3.4.2.2 Innovativeness

Viewed as the basic willingness to venture beyond current paradigms or state of the art; departing from existing technologies or practices (Lumpkin & Dess, 1996: 142). Often associated with creativity, Nieman *et al* (2003) add that something new and different is required. Seven perspectives of creation and innovation are identified by Morris (1998): creation of wealth; creation of enterprise; creation of innovation; creation of change; creation of employment; creation of value and creation of growth. Morris and Kuratko (2002) inform that innovation is concerned with combinations of resources that make existing methods or products obsolete.

3.4.2.3 Risk-taking

A tendency to unfold bold, yet calculated dynamism to achieve goals. Such activities include venturing into new and unknown markets and entering ventures with uncertain outcomes (Lumpkin & Dess: 1996). Nieman *et al* (2003) identify risk as involving personal and financial sacrifice. Morris and Kuratko (2002) consider risk-taking as involving anything new, or some likelihood that actual results will differ from

expectations. They advise that emphasis is usually placed on risks that are moderate and calculated.

A combination of these three dimensions makes unique contributions to an organisation's entrepreneurial orientation (Miller: 1983; Covin & Slavin: 1989). In evaluating these three dimensions within the franchise system, Lindsay and McStay (2004) developed hypotheses to research EO within the system. They inform that franchisees will need to be proactive in scanning the environment to highlight opportunity areas for franchisor approval or implementation. Franchisors are protective of their intellectual property, not allowing franchisees opportunity to innovate franchisor capital. Although innovations may originate from the franchisee, Lindsay and McStay (2004) believe innovation will only be implemented with franchisor approval. Despite the risk reduction elements of the franchise system (Mendelsohn: 1992), franchisees will still need to engage in risk taking activities within their environments in the pursuit of profits (Lindsay & McStay, 2004: 4).

Lindsay and McStay (2004: 6) inform that results demonstrate that franchisee organisations are capable of demonstrating an EO, in spite of the constraints of the franchise system. Depending on specific surrounds and context, the entrepreneurial dimensions can vary independently. The results provided support that proactiveness and risk taking are inherent dimensions within the franchise system (Mendelsohn: 2003), whilst innovation is primarily at the hand of the franchisor. Both proactiveness and risk-taking were found to drive franchisee performance.

Managerial implications highlight the need for entrepreneurial freedom so that franchisees may respond to uncertainty, change and complexity. The research examined the EO construct and EO- performance relationship with respect to franchisees. Research findings are indicative that franchisees may not be dissimilar to entrepreneurs (Lindsay & McStay, 2004: 7; Freel & Deakins, 2003: 69).

Section 3.4 concludes two chapters on entrepreneurship and franchising, identifying the causal relationship between the two disciplines. The seven perspectives on the nature of entrepreneurship (Morris & Kuratko: 2002) are by implication applicable to the entrepreneur, intrapreneur and franchisee. These are identified as:

- Creation of wealth
- Creation of enterprise
- Creation of innovation
- Creation of change
- Creation of employment
- Creation of value
- Creation of growth.

The seven perspectives (Morris & Kuratko: 2002) are identified in Section 3.4, and in Tables 3.4 and 3.5. Predominant literature (franchise system specific) identifying the causal relationship revolves around Mendelsohn (2003); Nieman (1998); Nieman *et al* (2003); Bygrave (1997); Michael (2003); Lindsay & McStay (2004); Spinelli (1997); Schaper and Volery (2004); Hisrich *et al* (2004); Deakins and Freel (2003); Amos and James (2003) and Johnson (2003). Empirical analysis will identify the strength of the relationship in a pre-determined franchise system; albeit the opinion of the author that such a relationship in fact exists.

3.5 CONCLUSION

Franchising is a market initiative facilitating entrepreneurial new venture development, primarily reducing associated risk. It is seen as an entrepreneurial option towards creating and developing ventures, and is seen as a relatively low-cost means of creating new ventures.

The nature and development of franchising is examined, together with a link of franchising and entrepreneurship. Franchise rationale is analysed, consisting of franchise agreements, franchise manuals and disclosure documents. Challenges to growth are analysed, highlighting franchisor and franchisee interaction.

Franchise system relationships are the driving force of franchise activity, highlighting merits and demerits of the franchise system. Entrepreneurial orientation has been analysed within the franchise system. An entrepreneurial orientation of the franchisee is evaluated by means of a literature review on the disciplines. Whilst there is evidence of entrepreneurial orientation on behalf of the franchisor, such evidence is scant regarding the franchisee. The literature review is indicative of an entrepreneurial orientation

amongst the entrepreneur, intrapreneur and franchisee. An empirical study will however validate the opinion of the author. Research is indicative of proactive and risk taking dimensions on franchisee performance; whereas innovation is the prime responsibility of the franchisor.

In Chapter 4, the service profit chain is discussed within the context of the franchise system. The service profit chain primarily includes customer and employee satisfaction, loyalty and value; identifying strategic initiatives of referrals, retention and related sales. Customer loyalty is introduced as experiencing a positive relationship with profit, highlighting determinants, relationships, and methods of enhancing loyalty. The chapter concludes with an entrepreneurial spirit of service profit chain enhancement, identifying strategies to facilitate service profit chain implementation.

CHAPTER 4: PUTTING THE SERVICE PROFIT CHAIN TO WORK

“The service profit chain unveils a great model that managers can use to maximize both customer loyalty and profit. It links an action plan for managing all elements of a business with a thorough process for measuring results”.

John B. McCoy, Chairman and CEO, Bank One Corporation, USA.

4.1 INTRODUCTION

The service profit chain is a well-received model to explain the sustainable competitiveness of many service organisations (Lau, 2000: 422). The model attributes a service organisation’s financial and market performance to its relationships with its customers and employees (Heskett: 2002). Internal service quality serves the foundation of the model, igniting a chain effect to an organisation’s growth and profit (Silvestro: 2002).

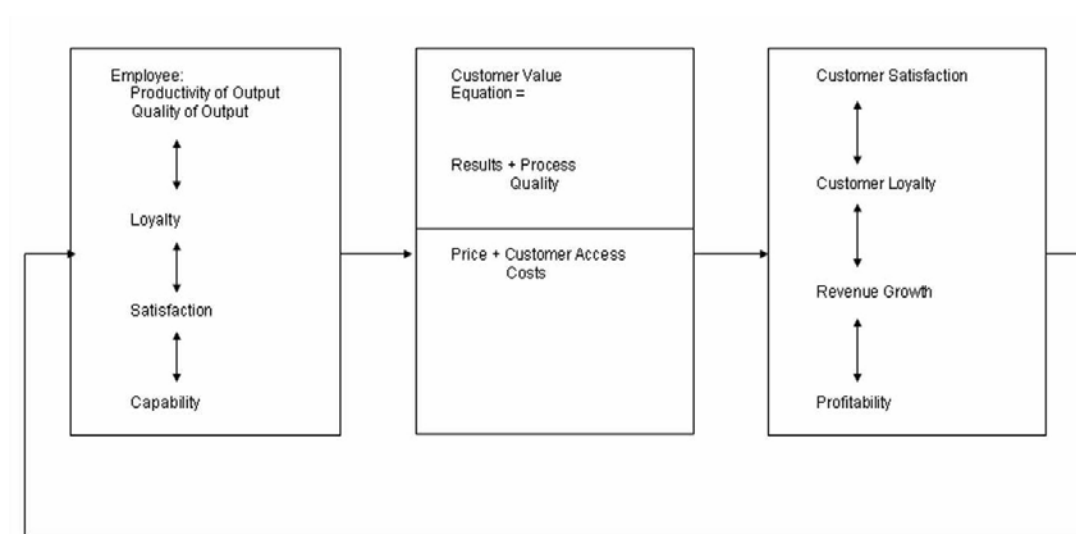
The Service Profit Chain is a strategic service vision, whereby there is a strong and direct relationship between customer satisfaction (Andreassen: 1994), customer loyalty (de Ruyter & Bloemer: 1999) and the value (Silvestro & Cross: 2000) of goods and services delivered to customers. Furthermore, there is a strong link between these elements and overall profit and growth of an organisation (Heskett, Sasser & Schlesinger, 1997: 11). Organisational profit and growth are linked to customer loyalty, satisfaction and value via the strategic implementation of referral, related sales and retention strategies (Heskett, Jones, Loveman, Sasser & Schlesinger: 1994).

In contrast to economic market forces (Porter: 1998), whereby competitors believe a high correlation between profitability and market share prevail, many management authors (Reichheld & Sasser: 1990) are of the opinion that it is quality of market share which is important (Andreassen: 1994), and a high correlation actually occurs between service value and profitability (Maranto & Reynoso: 2003; Ho & Cheng: 1999). This correlation was evident in Southwest Airlines (USA), who never made the top five largest in its industry, but has over the years been the most consistently profitable (Herbert D. Kelleher, Chairman, President and CEO of Southwest Airline Company). The Service profit chain identifies direct and strong relationships between profit, customer satisfaction, employee satisfaction and capability (Heskett *et al*: 1994).

The customer value equation is pivotal to the other two elements of the service profit chain, with the employee at one end, and the customer at the other (Ho & Cheng: 1999). The employee links productivity and quality of output with employee loyalty, satisfaction and capability (Andreassen: 1994; Sivestro: 2002). The customer value equation equates results plus process quality against price plus customer access costs, linking profitability and growth with customer satisfaction and customer loyalty (Ruyter & Bloemen (1999). In service settings, these relationships are self-reinforcing; whereby satisfied customers contribute to employee satisfaction and *vice versa* (Reichheld: 2001).

Figure 4.1 identifies the elements of the service profit chain, depicting the centralisation of the customer value equation. Internal service quality serves the foundation of the model (Lau, 2000: 422), represented by employee loyalty, satisfaction and capability (Silvestro: 2002). The output is depicted on the lateral flank, represented by customer satisfaction and loyalty; resulting in organisational revenue growth and profitability (Heskett *et al*: 1997).

FIGURE 4.1 Elements of the service profit chain



Source: Heskett, Sasser and Schlesinger (1997:12)

4.2 PROFIT AND LONG TERM GROWTH

Walker, Boyd and Larrache (1999), highlight that marketing is ultimately the art of attracting and keeping profitable customers. Kotler (2000: 55) further identifies a profitable customer as, "a person, household, or company that over time yields a revenue

stream that exceeds by an acceptable amount the company's cost stream of attracting, selling, and servicing that customer." The emphasis is not on the profit from a particular transaction, but from the lifetime stream of revenue and cost (Sherden: 1994).

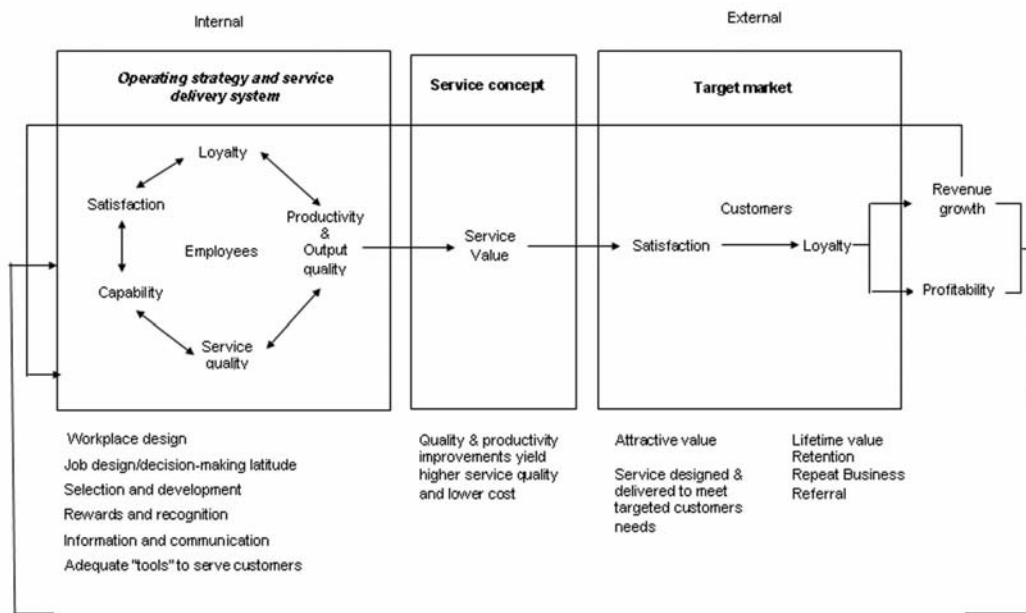
Hayes (1993) highlighted the Taco Bell (a leading Mexican take-out chain in USA) retention strategy, whereby their managers help employees understand the value of keeping customers satisfied. Although tacos cost less than a dollar each, one wouldn't think they would fret over lost customers. Yet, executives at Taco Bell have determined that a repeat customer is worth as much as \$ 11,000. Service Profit Chain implementation is seen as a means towards achieving long-term profit and growth (Heskett *et al*: 1997).

Figure 4.2 (overleaf) identifies internal and external components of the service profit chain, further segmented into four core sections:

- Operating strategy and service delivery system; consisting of internal employee's loyalty, productivity, service quality, capability and satisfaction. Inputs include workplace design, job design/decision making latitude, selection and development, rewards and recognition, information and communication, and adequate 'tools' to serve customers (Lau: 2000; Silvestro: 2002)
- The service concept; consisting of service value, identifying quality and productivity improvements that yield higher service quality and lower cost (Ho & Cheng: 1999)
- The target market; consisting of external customer satisfaction and loyalty (de Ruyter & Bloemer: 1999). Inputs include attractive value, designed service, lifetime value (McDougal, Wyner & Vazdauskas: 1997), retention (Ahmad & Buttle: 2002), repeat business and referrals (Helm: 2003)
- Profitability represented by organisational revenue growth (Bowen & Chen: 2001).

Figure 4.2 is represented on the following page.

FIGURE 4.2 The service profit chain



Source: Heskett, Sasser and Schlesinger (1997: 19)

4.3 CAPITALISING ON THE SERVICE PROFIT CHAIN

Heskett *et al* (1997) identify issues linking profit and growth, stating that when companies put employees and customers first; a radical shift occurs in the way they manage and measure success. Heskett *et al* (1994) identify the links in the service profit chain, commencing with the primary stimulation of customer loyalty. A closer analysis of each link reveals how the service profit chain functions as a whole.

4.3.1 Profit and growth link to customer loyalty

The principle of market share equals profit is replaced by the opinion of Reichheld and Sasser (1990), concluding that customer loyalty is a more important determinant of profit than market share in a wide range of industries. As such, they believed that quality of market share, measured in terms of customer loyalty, deserves as much attention as quantity of market share. Loyal customers are customers who hold favourable attitudes toward the company, commit to repurchase the product/service, and recommend the product to others (Bowen & Chen: 2001). It has been regarded as the *sine qua non* of an effective business strategy (Heskett: 2002). Hallowell (1996) identifies loyalty from a

cognitive (attitudinal) and behavioural point of view. Customer loyalty is purchase behaviour, unlike customer satisfaction, which is an attitude (Griffin: 1996). Duffy (1998) identifies loyalty marketing as more than just a program, being a state of mind and a business strategy. Southwest Airlines, the leading budget 'no frills' American airline, implement loyalty programmes, primarily by keeping in touch with their customers at the front-line. As Colleen Barrett, Executive Vice President at Southwest, puts it, "Once customers fly on us three times they're hooked". This contributes to Southwest's record of being the only U.S. airline to report twenty-four straight years of profitability. When properly embraced, developed and implemented, loyalty marketing strategies become integrally linked to the product (Duffy: 1998).

Reichheld and Sasser (1990) found that when a company retains just five per cent more of its customers, profits increase by twenty-five per cent to one hundred and twenty-five per cent. Gould (1995) consolidated the interest in loyalty through his research that supported Reichheld and Sasser's work. The increased profit from loyalty comes from reduced marketing costs, increased sales and reduced operational costs (Bowen & Chen: 2001). Loyal customers are less likely to switch because of price and they make more purchases than similar non-loyal customers (Reichheld: 2001; Reichheld & Sasser: 1990). Loyal customers will also provide strong word-of-mouth, create referrals, provide references and portray a positive image of the organisation (Bowen & Chen: 2001). Finally, loyal customers cost less to serve, in part because they know the product/service and require less information (Heskett *et al*: 1994). The results of the Bowen and Chen (2001) study supported the contentions that there is a positive correlation between loyal customers and profitability.

Hallowell's (1996) regression analysis also supports the inference of a relationship between customer loyalty and profitability. Heskett (2002) believes there is a real opportunity to build loyalty from a core of apostles and owners who have extraordinary lifetime value for the provider of goods and services. Marketers use loyalty-building strategies to help increase customer retention and boost share of customer (Mulhern & Duffy: 2004). Loyalty behaviour such as increased scale or scope of relationship, relationship continuance, and word-of-mouth (recommendation) result from customers' beliefs that the quantity of value received from one supplier is greater than that available from other suppliers (Hallowell: 1996). Duffy (2003) identifies benefits of loyalty to

include cost savings, referrals, complain rather than defect, channel migration, unaided awareness and greater awareness of brand assets.

The financial performance and customer loyalty link demonstrates strong correlation, indicating that retailers with loyal customers are more profitable than those with less loyal customers (Silvestro & Cross: 2000). Heskett *et al* (1997) emphasized the importance of evaluating the lifetime value of the customer. Service providers need to consider retaining customers in a continuing relationship through consumer orientated initiatives of retention, related sales and referrals (Lau: 2000).

4.3.2 Customer loyalty link to customer satisfaction

Leading companies quantify customer satisfaction; often revealing that there is no constant link between customer satisfaction and loyalty (Soderlund: 1998). Based on recent research, this link has been found to be the least reliable in the service profit chain (Heskett *et al*: 1997). Customer satisfaction (or dissatisfaction) results from experiencing a service quality encounter and comparing that encounter with what was expected (Caruana, Money & Berthon: 2000). Reichheld (1996) expressed the suspicion that those things satisfying customers may not be the same things that enhance loyalty to the provider. He further informs of short-term tactics, such as price discounting, which may entice satisfied customers to migrate to competitors. Hallowell's (1996) regression results support the inference of customer satisfaction and customer loyalty relationship. Results are however ambiguous regarding the role of price satisfaction in predicting customer loyalty. Support for a view that the effects of customer satisfaction on loyalty are different depending on the level of satisfaction is offered by Jones and Sasser (1995). They argue that the relationship is non-linear, being subject to different patterns depending on the product/service. Soderlund (1998) concludes that the relationship between customer satisfaction and loyalty is different at different levels of satisfaction.

Van der Wiele, Boselie and Hesselink (2002) relayed empirical data finding evidence that there is a positive relationship between customer satisfaction and organisational performance indicators (albeit not very strong), and that there is a significant time-lag effect on the relationship. Considerable research has focussed on service quality dimensions as the primary determinants of customer satisfaction (Parasuraman *et al*: 1998; Ziethaml & Bittner: 2003). There is a correlation between satisfaction and service

quality, emphasized by cross-tabulation analysis (Sureshchander, Rajendran & Anantharaman: 2002). The two constructs do however exhibit independence, and are different constructs from the customer's point of view. McDougall and Levesque (2000) empirically identified a strong relationship between loyalty and satisfaction, suggesting the importance of perceived value to loyalty and, in turn, to profitability. It is further well understood that increasing customer loyalty is positively correlated with increasing profitability (Heskett *et al*: 1997; Reichheld: 1996). Andreassen (1994), in agreement with Soderlund (1998) identifies the satisfaction and loyalty link dependent on the nature of the product/service. Silvestro and Cross (2000) do not suggest a significant relationship between customer satisfaction and loyalty, except for the link between satisfaction and a customer's propensity to recommend services to friends and relatives.

Due to the link between customer service and loyalty being the weakest in the chain, the relationship between them is not constant, with varying relationships dependent on complexities of the situation (Heskett, *et al*: 1997). The service profit chain however reflects the behavioural side of customer loyalty, as opposed to attitudinal loyalty (Hallowell: 1996); which can only be reinforced by increased customer satisfaction (Lau: 2000).

4.3.3 Customer satisfaction link to service value

The value-orientation of customers is emphasized as a driver of customer satisfaction (Andreassen: 1994; Heskett *et al*: 1994). Value is seen as the primary motivator, again evidenced at Southwest Airlines, where customer perceptions of value are very high, even though the airline does not offer all the services and amenities provided by its competition. Similarly, value at American Express (AMEX) Travel Services is a combination of results produced for customers; such as quick and accurate ticketing (Heskett *et al*: 1997). Customers today are strongly value-oriented and they seek results and service process quality that far exceed the price and acquisition costs they incur for that service (Heskett *et al*: 1997). Winning value combinations comprise good results, superb process quality, reasonable pricing and product quality (Jones & Sasser: 1995).

Service value is the customer's overall assessment of the utility of a product based on perceptions of what is received and what is given (Zeithaml: 1988). The author identifies value as low price, whatever I want in a product, the quality I get for the price I pay, and

what I get for what I give. Empirical results from Caruana *et al* (2000) suggest that the effect of quality on satisfaction is not just direct but is also moderated by value. Value however does not have a strong independent effect on satisfaction. The negative coefficient for the interaction between service quality and value implies that this factor can have a negative impact on satisfaction. Ho and Cheng (1999) developed a new concept called the value mix, focussing on the customer's perception of the value of a product or service in terms of function, quality and price. Value is suggested as integral to strategy in pursuing customer satisfaction. Heinonen (2004) proposed and empirically investigated a conceptual model of customer perceived value, highlighting dimensions of location and time frame of service offerings. An important implication of this is that value dimensions can be used to target customers in a new way.

The connection between perceived value and customer satisfaction contends that value has a direct impact on satisfaction (Heskett *et al*: 1997). From an empirical perspective, perceived value should be recognized as a contributing factor to satisfaction and loyalty (McDougall & Levesque: 2000). They identify that the strong relationship between loyalty and satisfaction suggests the importance of perceived value to loyalty, and in turn, to profitability. McDougall *et al* (1997) reflect that customers differ widely in the long-term value they represent to a company, and the optimal customers are often many times more valuable than the average ones. They identify value components of acquisition cost, revenue stream, cost stream and length of relationships. In agreement with Heskett *et al* (1997), they too identify the service value link to the lifetime value of the customer.

Silvestro and Cross (2000) identified a strong positive correlation between customer satisfaction and perceived service value at the 95 per cent level. Customers appear to be strongly value-driven, suggesting a strategy of improving service value to customers. When customers perceive a high service value they are more likely to display loyal behaviour, including relationship continuance, word of mouth and recommendations (Hallowell: 1996).

4.3.4 Service value link to employee productivity

Highlighting the link between quality service and the productivity of employees (Lau: 2000), Southwest Airlines can board many more passengers per employee than any other major U.S. airline. Even pilots have been known to assist with baggage for late

departures. A recent study indicated that Southwest served 50% more passengers per employee than its closest competitor (Heskett *et al*: 1997). Similarly, at American Express Travel Services, productivity is defined in terms valued by customers (Heskett: 2002), for example, the speed and accuracy with which tickets are prepared. As such, quality of service and high productivity most often go hand in hand (Escover: 1993).

Through their long tenure serving specific groups of customers, loyal employees make it easier to create increased profit through enhanced services, reduced costs of acquiring customers, and lower customer-price sensitivity (Reicheld & Sasser: 1990). The result of enhanced communications and employee involvement is increased productivity and employee satisfaction. Escover (1993) regards the process as involving negotiating expectations, objectives, levels of performance and pay for performance. Gomez-Mejia (1990) developed a model highlighting performance appraisal and reward systems in enhancing employee performance. He further argued that feedback is a powerful instrument in performance enhancement. Honeycutt (1989) identified service value and employee productivity by providing open channels of communication, interpersonal trust and acceptance, which are the building blocks to construct motivation, productivity and commitment.

Schermerhorn (2002) identifies productivity as the quantity and quality of work performance, with performance effectiveness being an output measure of task/goal accomplishment. He applies the individual performance equation (Schermerhorn, 2002: 392), which includes individual ability, support and effort. Sivestro and Cross (2000: 249) identified a strong correlation ($r= 0.92$) between service value and productivity. Friendly service encounters were seen as determinants for efficient purchasing, enhancing service value.

4.3.5 Employee productivity link to loyalty

Employee loyalty is highlighted at Southwest Airlines, whereby the airline was voted one of the 10 best places to work in the United States. This was coupled with their high levels of employee productivity; and the highest staff retention in the industry (Heskett *et al*: 1997). A study by VSDA (2001), found that strong relationships and loyalty are developed between staff and customers through consistency of management and staff. Through their long tenure services, loyal employees tend to develop personal

relationships with their customers (Lau: 2000). These relationships serve as the foundation for a reinforcing cycle of positive interactions between the service employees and customers (Reichheld: 1993). Choosing the right employees is the first step in retaining productive employees (Lau: 2000). Traditional measures of losses incurred by high employee turnover related to cost of recruiting, hiring and training replacements. In most service positions, the real cost is the loss of productivity and decreased customer satisfaction (Heskett *et al*: 1994).

Reichheld (1996) deems that increasing employee loyalty, in terms of length of service, should reduce costs and improve profitability. Loveman (1998) found a positive link between employee tenure and financial performance. Loyalty is however a construct of two dimensions; length of service, and employees' stated willingness to refer the place of employment to friends and colleagues (Nel *et al*: 2004). Silvestro (2002) empirically tested the loyalty relationship, postulating that the only measure of employee loyalty which correlated significantly with hard measures of performance was length of service. There was a significant and negative correlation with profit and all the productivity measures. These conflicting results suggest that the link between employee loyalty and profit is more complex than originally stated by Heskett *et al* (1997). There appears to be a significant rift between employee loyalty and the rest of the service profit chain (Silvestro & Cross, 2000: 249).

4.3.6 Employee loyalty link to employee satisfaction

This link raises the question of what employee satisfaction is linked to. Employee satisfaction levels at Southwest Airlines are high and cultivated by management. Many companies characterize themselves as big families; often seen in after-work activities such as involvement with charities, sports, events and the like. This tends towards satisfied employees, making them less vulnerable to leaving the employ of the company (Heskett *et al*: 1997). Schermerhorn (2002) identifies employee satisfaction as the degree to which an individual feels positively or negatively about their employment.

Bitner (1990) believes that inferior performance will lead to customer dissatisfaction, firm switching and negative word of mouth communication on the part of the customers about the employee and the firm. Rogers, Clow and Kash (1994) conceptualised a satisfaction model, highlighting the loyalty and profitability link. Constructs consisted of empathy;

job satisfaction; job tension; conflict and role clarity. Contrary to compelling evidence (Heskett *et al.*: 1997), the model conceptualised by Vilarés and Coelho (2003) does not consider the business climate; or more specifically, the cause and effect relationship between employee behaviour and customer satisfaction. They however incorporate satisfaction, loyalty and commitment as a construct, as they are perceived by customers (ECSI model). The effects of the positive encounter cycle correlate employee and customer attitudes (Heskett: 2002).

The retention of employees who develop continuing positive interactions with customers will become even more critical in the future (Rust & Stewart: 1996). They present a customer satisfaction measurement approach to evaluating employee satisfaction and retention, providing a foundation towards the ultimate link to profit and growth (Heskett *et al.*: 1994). A study by Schlesinger and Zornitsky (1991) showed that the potential turnover rate of dissatisfied employees is three times higher than that of satisfied employees. High employee turnover can be costly. Solomon (1998) reported that separation, replacement and training costs are up to two-and-a-half-times annual salary for each leaving employee.

Silvestro (2002) however revealed striking employee satisfaction results (albeit a small sample). Employee satisfaction was negatively and significantly correlated with profit margins, and with the productivity indicator. This however is applicable to a busy retail environment, indicative of employees being over-stretched in retail outlets. This notion does not accord with the assumption in management literature that empowered staff are better equipped to meet customer needs and more likely to find job satisfaction (Nel *et al.*: 2004; Heskett: 2002; Hisrich & Peters: 1998; Hamel & Prahalad: 1995; Lindsay & McStay: 2004; Ring & Van de Ven: 1994; Ziethaml & Bitner: 2003). In a separate study, Silvestro & Cross (2000) found no significant correlation between any of the measures of employee loyalty and overall staff satisfaction at retail level. They did however suggest that employee satisfaction and loyalty are linked, even though the correlation was not statistically significant.

4.3.7 Employee satisfaction link to internal quality of work life

Internal quality of work life is measured by the feelings that employees have toward their jobs, colleagues, and companies. This includes the attitudes that employees have towards each other. Many companies successfully implement teambuilding to enhance this link, which includes conferences, group sport events and social clubs. According to the service profit chain, internal service quality serves the foundation of the model and it ignites a chain effect leading to an organisation's growth and profitability (Lau: 2000). Heskett *et al* (1994) referred internal service quality to the quality of work environment that contributes to employee satisfaction, which has also been known as quality of work life (QWL).

Schermerhorn (2002) identifies quality of work life opportunities in the areas of career development, career planning, work-life balance, compensation and benefits, retention and turnover, and labour-management relations. Internal quality of work is most often identified with internal marketing (Kang, James & Alexandris: 2002). They propose that a critical component of internal marketing is the provision of internal service quality. Their study modified the SERVQUAL instrument (Parasuraman *et al*: 1988; Ziethaml & Bitner: 2003) for a service setting and empirically tested and confirmed that it is appropriate for measuring internal service quality. They identified distinct and conceptually clear dimensions of reliability, assurance, tangibles, empathy and responsiveness.

Internal marketing focuses on identifying and satisfying employees' needs as individuals and as service providers (Varey: 1995), just as external marketing focuses on identifying and satisfying the external customers' needs (Kang *et al*: 2002). Yoon, Beatty and Suh (2001) empirically indicated that in addition to job satisfaction, employees' work effort plays a strong, central role in determining customers' perception of employee service quality. Their study investigates two components for successful implementation of internal marketing, service climate and supportive management.

Common beliefs support the contention that quality of work life will positively nurture a more flexible, loyal and motivated workforce (Bassi & Vanburen: 1997; Meyer & Cooke: 1993). Lau (2000) empirically analysed the quality of work life (QWL) construct, and found that QWL companies indeed enjoy higher growth rates than those not portraying QWL, and their differences are statistically significant. With regards to profit, QWL

companies managed to have a higher average profit margin than their counterparts, however, the difference was not statistically significant ($p= 0.1977$). QWL is an important issue as it determines the ability of an organisation to attract and retain prospective employees (Lau: 2000).

These links highlight the interaction between the customer; value; and the employee-attributing towards the implementation of the service profit chain within leading organisations (Heskett *et al*: 1997). The connection between employee satisfaction and customer satisfaction is conceptually strong because of many active interactions between them (Lau: 2000). The threat is however that the ‘human resources trap’ may result in the belief that all good (and bad) things that happen to customers in a service business are caused by human resource policies, practices and procedures (Schneider & Bowen: 1995). It must however be that some of the concepts linked together in the chain are not single constructs which can be linked together in the simplistic way proposed by Heskett *et al*'s (1997) model (Silvestro & Cross: 2000). Bloemer and Kasper (1995) demonstrated that the relationship between some of these concepts could vary depending on the nature of the construct, as well as being contingent upon environmental and operational variables.

4.4 SERVICE PROFIT CHAIN MANAGEMENT IMPLICATIONS

Leadership underlies the success of the service profit chain, and leaders who understand the concept develop initiatives to develop and maintain a service culture around customers and employees (Heskett *et al*: 1997). Implications of the service profit chain vary according to situational factors (Bloemer & Kasper: 1995), but most often incorporate guidelines depicted by Heskett *et al* (1994). These include inter-organisational activities.

4.4.1 Measuring across operating units

System orientation (Perry: 2002) is particularly evident when an organisation has multiple outlets (Mendelsohn: 2001), an example being franchising. The objective is to maintain high levels of service across the franchise chain, linking satisfaction to consistency throughout the network (Heskett, Sasser & Hart: 1990). Such measurement is facilitated by implementing customer satisfaction surveys throughout the network, highlighting

correlations and variances. Similarly, employee satisfaction is usually obtained through direct periodic surveys (Kang *et al.*: 2002).

4.4.2 Developing a balanced scorecard

Kaplan and Norton (1993; 1996a; 1996b) recommend not only using financial measures, but also non-financial outcomes as innovation, human resources effectiveness, and customer satisfaction or loyalty. Although the service profit chain places emphasis on the overall link to growth and profitability (Heskett: 2002), other less tangible factors have to be monitored (Meyer & Cook: 1993). Such examples include strategic alliances for long-term benefit, whereby financial means are not readily available for analysis (Porter: 2001). Low, Siesfeld and Larcker (1999) place emphasis on new technologies and e-commerce, stating that corporate wealth is now being accumulated through non-financial measures by electronic webs formed through corporate alliances and joint ventures.

According to Brinker (1999) a company's competitive advantage is defined by the know-how, relationships, secrets and collective knowledge of its employees. The balanced scorecard (BSC) is a performance management indicator, whereby strategy-focused organisations thrive in new business environments (Kaplan: 2000). The balanced scorecard calls on managers to make a commitment to introduce an array of measures or scorecards that will guide their decisions away from narrowly focussed financial measures. In agreement with Heskett *et al.* (1997), Sim and Koh (2001) advise that the balanced scorecard serves to guide business into greater profitability as managers position themselves to better serve their customers, employees and shareholders at large. The rationale behind the balanced scorecard appeals to managers who face new challenges in the current business climate (Hasan & Tibbits: 2000). The scorecard views four business aspects, being management (financial), external (customers), operations (internal business) and organisational (innovation and learning) (Kaplan & Norton: 1996b).

The balanced scorecard and management by objectives are similar in nature, as both are based on the development of strategic measures, despite BSC being more explicit about the measures (Dinesh & Palmer: 1998). No organisation has made a more comprehensive effort to measure performance and relationships using BSC and the service profit chain than the fast-food company, Taco Bell (Heskett *et al.*: 1994). The integration of the BSC and service profit chain depends not only on placing hard values on soft measures, but

also on linking those individual measures together into a comprehensive service picture (Heskett *et al.*: 1997).

4.4.3 Communication of results

Satisfaction monitoring and results are communicated throughout the organisation, enabling management and employees to facilitate corrective measures, together with building upon opportunities (Heskett *et al.*: 1997). Many organisations provide a base for sharing information, triggering a best practice approach between operating units. This aspect correlates to internal marketing, an important approach for fostering a service and customer oriented culture in an organisation (Kang *et al.*: 2002). Schneider and Bowen (1985) suggested that employees would deliver excellent service to customers when the organisation provides them with the necessary resources, including logistical, administrative, equipment, and management support. Internal communication of results is communication within distinct organisational units or the people working in these departments, to other units or employees within the organisation (Stauss: 1995).

The provision of optimal communication and internal services to employees is crucial to the overall success of an organisation (Heskett: 2002; Schlesinger & Heskett: 1991; Schneider & Bowen: 1985). The link to the service profit chain is that satisfied employees are a critical prerequisite to the satisfaction of external customers (Kang *et al.*: 2002). Internal marketing includes those activities that improve internal communications and customer consciousness among employees, and the link between these activities and external market-place performance (Hogg, Carter & Dunne: 1998).

4.4.4 Performance management

Performance Management goes hand in hand with designing efforts to enhance performance (Kaplan & Norton: 1996b; Heskett *et al.*: 1997). Terminology such as business process re-engineering and paradigm shifts (Hamel & Prahalad: 1995); are often associated with improvements (Porter: 1996). Whilst service profit chain initiatives do not necessarily have to be of such a magnitude, implementation can be guided by simple training and development, change in policies and procedures, reorganisation and redesign of processes (Heskett: 2002). Methods of performance management also include management by objectives and the balanced scorecard approaches (Dinesh & Palmer:

1998). In the context of the service profit chain, performance management is about designing efforts to enhance performance (Heskett *et al.*: 1997). Performance management entails setting standards, assessing results, and planning for performance improvements (Nel *et al.*: 2004).

Performance appraisal is the process of evaluating performance and providing feedback to an employee (Schermerhorn: 2002). Service profit chain performance objectives may be centred on customer/employee satisfaction, loyalty and value (Heskett *et al.*: 1994), using techniques such as behaviourally anchored rating scales (Grote: 1999), critical-incident technique, a multiple comparison or 360 degree feedback (Edwards & Ewin: 1996). Kang *et al.* (2002) identified SERVQUAL as an appropriate performance management study regarding internal service quality. Yoon *et al.* (2001) identify performance issues centred on work effort; service climate; supportive management; job satisfaction and employee service quality. This equates to the service profit chain link of internal quality of work life.

Levering and Moskowitz (1999) identified five characteristics of performance management areas; more employee participation, more sensitivity to work/family issues, more two-way communication, more sharing of the wealth, and more fun. They also identify quality of work life performance around pay and benefits; opportunities; job security; pride in work and company; openness and fairness; and camaraderie and friendliness. Similarly, Lau (2000) identifies links in the service profit chain as integral to performance management. In agreement with Heskett *et al.* (1994), these include internal service quality, employee satisfaction, employee loyalty, employee productivity, service value, customer satisfaction and customer loyalty.

4.4.5 Encouraging internal best practice exchanges

This is particularly useful when dealing with geographically dispersed units or branches, such as the franchise system (Siegel: 2002). Managers are motivated to discuss issues with other business units, sharing success stories. Bank One, a leading retail bank in the U.S; purposely budget high travel and communication costs to encourage operating unit heads to talk frequently to discuss ways of improving their performance (Heskett *et al.*: 1994). Heskett *et al.* (1997: 37) state that, "it's this process of continual improvement

through internal best practice comparisons that utilizes the full competitive advantage of a large organisation with multiple operating sites".

A best practice perspective towards managing customer satisfaction is described by Zairi (2000) as a total concept which not only encapsulates the measurement aspects of customer satisfaction *per se* but also as a long-term pursuit of improvement; a culture change that can yield to competitive advantage in the higher order. To support the process of developing a customer-focused culture, Zairi (2000) believes there are some key drivers. These are based on best practice and used to measure business excellence at world-class level; identifying who the customer is; identifying and evaluating market dynamics, competition, opportunities, threats and environmental factors and identifying methods of creating customer focus.

Davies and Kochhar (2000) developed a structural framework of best practice, encouraged by their having a strong relationship with performance objectives, with no major adverse effects and having the necessary supporting practices in place for the desired practice to be implemented successfully. Their framework can be used to identify best practices with the strongest effect on the area to be improved, together with a sequence of desired practices. Also highlighted is the need to consider the dependency relationships that exist between the practices themselves.

Best practice is often associated with benchmarking, a concept whereby one learns from others (Heskett *et al*: 1990). Andersen, Fagerhaug, Randmoel and Prenninger (1999) identify this learning from others using terminology of measurement, comparison, learning and improvement. Benchmarking emphasizes attaining so-called breakthrough improvements, usually accomplished by introducing best practices that are new to an industry, through generic benchmarking (Andersen & Pettersen: 1995).

Andersen *et al* (1999) advise that the primary information from benchmarking activities are flow charts and process descriptions. In developing benchmarking, the following steps are identified (Andersen & Randmoel: 1997):

- Plan: critical success factors, select a process for benchmarking
- Search: find benchmarking partners

- Observe: understand and document the partners' process, both performance and practice
- Analyze: identify gaps in performance and find the root causes for the performance gaps
- Adapt: choose best practice, adapt to the company's conditions, and implement changes.

Jarrar and Zairi (2000) refer to best practice as those practices that have been shown to produce superior results; selected by a systematic process and judged as exemplary, good or successfully demonstrated. They identify a six stage process for the effective transfer of best practice, somewhat similar to the Andersen and Randmoel (1997) process: searching, evaluating, validating, implementing (transfer and enabling), review and routinising.

They identify internal transfer of best practices as arguably the most difficult stage. Transfer is identifying and learning from best practice and applying them in the new setting/location (O'Dell & Grayson: 1997). In addition to removing obstacles and barriers, organisations must create enabling structures for the effective transfer of best practices (Jarrar & Zairi: 2000). Best practice is further studied in chapter 5.

4.5 MANAGING CUSTOMER SATISFACTION

One in four customers has a problem with products purchased. If the item purchased is relatively low in price, only one in five will register a complaint. Research indicates that thirty-five per cent of customers will return and purchase the product/service if they are not actually satisfied with the service they have received (Eccles & Durand: 1998). In theory, this suggests that if customers are dissatisfied, two-thirds will not return. When a successful service recovery process is in place, the statistics somewhat change; eighty per cent of customers will return if satisfied with the response to a complaint (Plymire: 1992).

Kotler (2000: 36) identifies satisfaction as, "a person's feelings of pleasure or disappointment resulting from comparing a product's perceived performance (or outcome) in relation to his or her expectations". Zeithaml and Bitner (2003) review satisfaction as the customer's evaluation of a product or service in terms of meeting needs and expectations. Oliver (1997) identifies customer satisfaction as the consumer's fulfilment

response. Customer satisfaction is the leading criterion for determining the quality that is actually delivered to customers through the product/service and by the accompanying servicing (Vavra: 1997). Vavra's (1997: 4) outcome definition of customer service characterises satisfaction as the end-state resulting from the experience of consumption. Customer satisfaction is influenced by specific product or service features and by perceptions of quality (Parasuraman *et al*: 1998). Satisfaction is also influenced by customers' emotional responses, attributions and perceptions of equity (Zeithaml & Bitner: 2003). Sureshchandar *et al* (2002) further identify five factors of customer satisfaction as core services or service product; human element of service delivery; systematization of service delivery (non-human element); tangibles of service (servicescapes) and social responsibility.

Zairi (2000) believes organisations need to indicate that they are truly focussed on their customers through deeds and actions. He places emphasis on a customer-focused culture, highlighting the following guidelines:

- Customer focus is not necessarily a written statement
- The focus intention will have to be examined in terms of appropriateness and degree of seriousness to instigate a culture of customer focus
- Customer focus is a statement of intent, enabling the intent of a company to challenge existing operations, and adopt new innovations
- Creating new systems, benchmarking, best practices, and by doing the right things right first time and on time
- An evolutionary rather than revolutionary process
- A state of mind rather than an absolute concept which indicates optimised performance and reaching the pinnacle of success.

Zairi (2000) believes being customer focussed means having a clear service strategy which is deployed with vision, purpose and goals. He further identified benchmarking and best practice guidelines, depicted in Section 4.4.5.

In order to track customer satisfaction, companies need to monitor their competitors' performance in similar areas. For example, a company cannot be content when it receives an 80% satisfaction vote in a survey; when compared to a direct competitor, who receives a 90% satisfaction vote, notwithstanding that the competitor was aiming for a 95%

satisfaction score (Heskett *et al*: 1997). The dialogue created with customers has to be based on a strong system, constantly seeking views, feedback, future needs, putting action plans into place, monitoring satisfaction levels and drivers; enhancing loyalty and retention (Zairi: 2000). Hallowell (1996) in agreement with Duffy (1998; 2003), Helm (2003), Heskett (2002), Zairi (2000) and Bitner (1990) reflect on the many studies whereby customer satisfaction influences purchase intentions as well as post-purchase attitude. Various other studies also identified that customer satisfaction is strongly correlated to repurchase intentions, the willingness to recommend the company and to improve cross buying (Reichheld: 1996; van der Wiele *et al*: 2002; Parasuraman *et al*: 1998; Yu & Dean: 2001). The relationship and link of customer satisfaction to customer loyalty and value are represented in Sections 4.3.2 and 4.3.3 respectively. At the opposite end, researchers have also found that there is a strong link between dissatisfaction and disloyalty or defection (Anderson & Mittal: 2000).

Van der Wiele *et al* (2002) focused on the analysis of empirical data on customer satisfaction and the relationship with organisational performance data, finding evidence of a positive relationship between the two constructs. Hallowel (1996) identified that higher customer satisfaction translates into higher than normal market share growth, the ability to charge higher prices, improved customer loyalty with a strong link to improved profitability, and lower transaction costs.

For customer-oriented companies, customer satisfaction is both an objective and a marketing tool (Ziethaml & Bitner: 2003). Companies with high customer satisfaction rankings make sure their target market knows it (Kotler: 2000). Cognisance must be taken that striving for superior customer service must be in synergy with the strategy of the company, as maximizing customer satisfaction may have a negative effect on profit, should the company offer substantial discounts (Porter: 1996). The opposite rings true, in that issues such as enhanced research and development, or improvements in manufacturing processes may also lead to improved profits, emphasizing company wide initiatives to increase profits; not customer satisfaction on its own (Heskett: 2002). Kotler (2000) identifies the total resource approach, whereby the company must ultimately operate on the philosophy of achieving high levels of customer satisfaction, subject to delivering acceptable levels of satisfaction to the stakeholders within the constraints of its total resources.

The Dell Computer Corporation's direct-to-customer business model has resulted in high levels of customer satisfaction due to quick response levels, coupled with their business ethic of being accessible, fast and effective. Zairi (2000) summarizes the impact of customer satisfaction on repeat purchase, loyalty and retention:

- Satisfied customers are more likely to share their experiences with other people to the order of five or six people, as opposed to dissatisfied customers to the order of ten people
- Many customers do not complain, either accepting poor service, or migrating to competitors
- Whilst dealing with customer satisfaction/complaint is costly, it costs as much as 25 per cent more to recruit new customers.

Another point of view is that of Williams and Visser (2002), who inform that, customers are more and more being rewarded for being dissatisfied. Research has indicated that the most loyal customers are those who complain and report, subsequently, that their complaints have been well attended to by the company concerned (Goodman, Broetzmann & Ward: 1993). Yu and Dean (2001) believe that the emotional component of satisfaction serves as a better predictor of loyalty than the cognitive component. They postulate that negative emotions are negatively related to positive word of mouth and willingness to pay more, and positively associated with switching behaviour. Organisations use many methods to track customer satisfaction (Heskett *et al*: 1997). An overview of such methods follows.

4.5.1 Customer feedback, complaint and suggestion systems

Such systems make it easy for customers to deliver suggestions and complaints. Zeithaml and Bitner (2003: 128) identify complaint solicitation as identifying and attending to dissatisfied customers and common service failure points. The data is qualitative in nature, relatively low cost in value and time, and of continuous frequency. The feedback can take many forms, including on-site customer complaints, calls to toll-free customer-response phone numbers, and customer comment cards; most often facilitating two way communications. In each of these forms, the feedback information is either unsolicited or passively solicited (Sampson: 1998). Customers generally appeal to passive solicitation as focus is not directed on any specific customer. Sampson (1998) identifies the internet as

an effective means of gathering customer feedback. Complaints provide crucial information feedback which organisations should respond to positively (Andreassen: 1997). There is a distinct need for employee training in handling information feedback, to provide people with the skills, encourage positive attitudes and so bring about the behavioural change that will ensure converted, loyal customers (Bitner: 1990).

Organisations are seen to be paying lip service to customers and their complaints, while the lack of customer focus in design of systems and procedures is a cause for the complaint in itself (Heinonen: 2004). Ironically, the front line of many organisations faces as many battles internally as hassles from external customers. Additionally, some reward systems actively discourage effective complaint handling (Schlesinger & Heskett: 1991). Plymire (1992) advises that the complaints-generation process results in a customer-focused culture in which complaints are viewed as a source of opportunities.

4.5.2 Lost customer analysis

Organisations contact customers who no longer portray patronage, to discover with their reasons for defection (Heskett: 2002). Zeithaml & Berry (2003) identify lost customer analysis as identifying reasons for customer defections, being qualitative in nature, low monetary and time congruence, and continuous frequency. Bolting (1989) proposes ways of managing customer complaints of harmful types of dissatisfaction and for maximizing opportunities to develop loyal customer bases through effective handling of problems. Focussing on customer defections and service failures can assist organisations in improving service quality and improving long-term retention (Mack, Mueller, Crotts & Broderick: 2000). Keaveney (1995) empirically analysed (critical incident) service customers to study defections, finding eight general categories for switching: price; inconvenience; core service failures; service encounter failures; competitive issues; failed employee response to service failures; ethical problems and involuntary factors.

Fifty-five per cent of the respondents in the Keaveney (1995) study reported complex switching incidents due to more than one category, which were often interactive. Keaveney (1995) pointed out that six of the eight factors are controllable by the firm, and he identified suggested actions to prevent switching. High levels of successful recovery are positively associated with high levels of customer satisfaction (Bitner: 1990; Heskett: 1994). Sundaram, Jurovski and Webster (1997) used hypothetical service failure

recovery efforts to identify the positive association with quality and satisfaction. Banwari and Walfred (1998) suggest that unsatisfied customers may not wish to defect, however, satisfied customers may look for other suppliers because they can get an even better service level elsewhere (Trubik & Smith: 2000). It is estimated that 35 per cent of defecting customers defect as a result of uncontrollable external factors (Varney: 1996), with controllable factors including those identified by Keaveney (1995). Database management is a crucial method of analysing defections, together with studying retention strategies (Trubik & Smith: 2000). Zairi (2000a) believes effective management of defection strategies may turn around into customer loyalty and retention.

4.5.3 Customer satisfaction surveys

Surveys are conducted with emphasis on service related issues of importance to customers, representative of the entire customer base (Parasuraman *et al.*: 1998). The qualitative and quantitative measurement of customer perceptions about the quality of a product or service are important element of conducting a business (Hayes: 1997). Active solicitation is accomplished at moderate cost (such as mail surveys) to high cost (such as personal interviews) (Churchill: 1995). Zeithaml and Bitner (2003: 128) identify relationship surveys and SERVQUAL surveys as identifying customer requirements in various settings:

- As input for quantitative research (qualitative and periodic frequency)
- Monitoring and tracking service performance (quantitative and infrequent)
- Assessing overall company performance (quantitative and infrequent)
- Compared with that of competition (triangulation and situational)
- Determination of links between satisfaction and behaviour intentions
- To assess gaps between customer expectations and perceptions.

4.5.4 Ghost shopping

Often referred to as mystery shoppers, the company ascertains the degree of service in a real life shopping experience, together with gauging the level of employee competence (Heskett *et al.*: 1997). The mystery shopper evaluation is a formal observation method, gathering primary data by physically recording a designated aspect of behaviour. Grove and Fiske (1992) identify this form of research as unique to services, whereby

experienced researchers evaluate service as though they were customers. Mystery shoppers deliver objective assessment about service performance by completing questionnaires about service standards (Zeithaml & Berry: 2003). Mystery shopping is a technique used to measure individual employee performance for evaluation, recognition and rewards; and to identify systematic strengths and weaknesses in customer-contact-service (Zeithaml & Berry: 2003). Data is most often quantitative, relatively low in time and value, and optimally, quarterly in frequency. Au Bon Pain, a take out convenience food outlet sends mystery shoppers to their stores to evaluate service and the servicescape (Heskett *et al*: 1997). Servers are evaluated on standards including the following (Zeithaml & Bitner, 2003: 142):

- Acknowledged pleasantly
- Acknowledged within three seconds after reaching first place in line
- Server suggested additional items
- Server requested payment prior to delivering order
- Received receipt and received correct change
- Correct order received.

The mystery shopper is also used by Au Bon Pain as a key element in its compensation and reward system (Heskett *et al*: 1997). Mystery shopping can be a very effective way of reinforcing service standards (Zeithaml & Bitner: 2003); however, when more than one mystery shopper is involved, steps need to be taken to ensure that the measurements being taken are uniform for all observers - this is otherwise known as inter-rater reliability (Page & Meyer: 2003).

Measuring customer satisfaction can be tracked by means of 'listening posts' such as formal marketing research; customer surveys; feedback from customers; frontline reports; and most importantly, by the actual customer involvement in certain organisational issues (Heskett *et al*: 1997). The importance however rests on the interpretation and analysis of these mechanisms, coupled with the appropriate corrective measures to be implemented (Page & Meyer: 2003). Becoming customer oriented does not mean achieving high scores on ratings, but gaining an awareness of the needs of customers (van der Wiele *et al*: 2002). Pizam and Ellis (1999) empirically evaluated customer satisfaction in hospitality enterprises, concluding that, if properly administered and analyzed, the process of

monitoring customer satisfaction can be beneficial to any enterprise and make the difference between offering a mediocre product and an excellent quality product.

4.6 THE CUSTOMER VALUE EQUATION

A central link to the service profit chain is that of customer value, representing the results created for the customer, together with the quality of the process to deliver the results (Heskett *et al.*: 1997). This is in relation to the price and acquisition of the service offered. Value defined in this way is related to customer satisfaction, identifying the customer satisfaction link to service value (McDougall & Levesque: 2000). This link was depicted in section 4.2.3, evaluating the research of Heskett *et al.* (1997), Caruana *et al.* (2000), Ho and Cheng (1999), Andreassen (1994), Heinonen (2004) and McDougall and Levesque (2000). Zeithaml and Bitner (2003) believe consumer value is a component of a myriad of attributes, appearing to be highly personal and idiosyncratic. They attribute four customer meanings to value:

- Value is low price; indicating that what consumers have to give up in terms of money is most salient in their perception of value
- Value is whatever I want in a product or service; negating money, but incorporating the benefits they receive from a product/service as the most important component of value
- Value is quality I get for the price I pay; whereby other consumers see value as a trade-off between money they give up and the quality they receive
- Value is what I get for what I give; indicating that some consumers consider all benefits they receive as well as all sacrifice components (money, time, effort) when describing value.

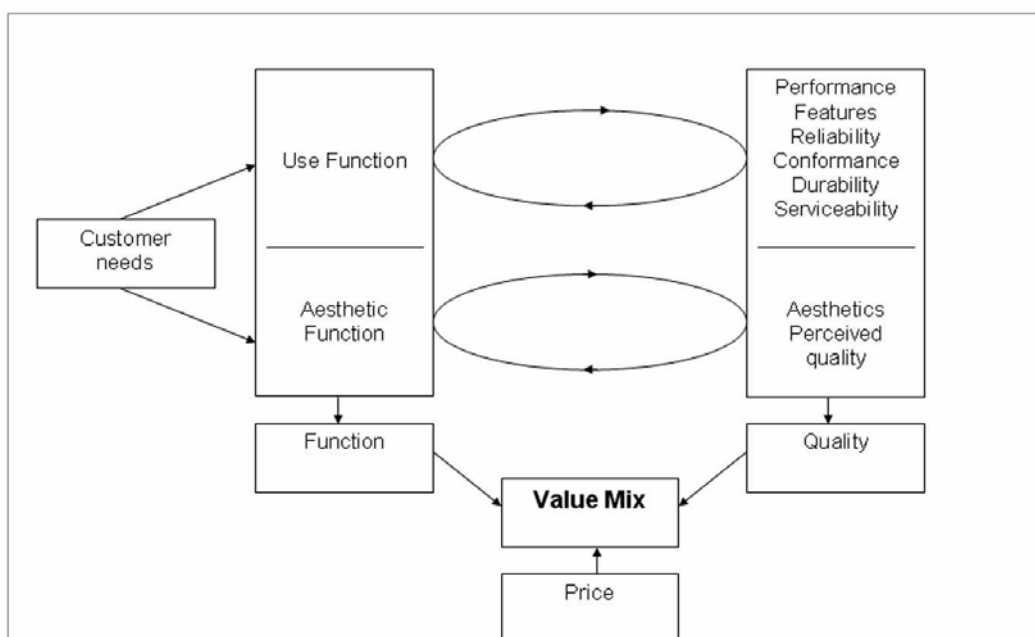
These four components may be captured in a single definition, consistent with the concept of utility. Utility theory (Lancaster: 1971) provides the theoretical underpinning for the value construct. Zeithaml and Bitner (2003: 491) define perceived value as, “the consumer’s overall assessment of the utility of a service based on perceptions of what is received and what is given”. In other words, value has been seen as the trade-off between benefit and the sacrifice in an offering (Heinonen: 2004). Customers will derive value according to the utility provided by the combination of attributes less the disutility represented by the final price (Heskett *et al.*: 1994; Caruana *et al.*: 2000). In a study

conducted by Caruana *et al* (2000), a negative regression coefficient for the interaction between service quality and value implied that value can have a negative impact on satisfaction.

Ho and Cheng (1999) evaluated the quest for the value mix, embracing the essence of the traditional approaches to value and quality. As Cooper and Slagmulder (1997) suggested, quality and function are considered as two separate but closely related characteristics. Components of the value mix (Ho & Cheng: 1999) include price; function; customer needs (use function and aesthetic function); and quality (performance, features, reliability, conformance, durability, serviceability, aesthetics and perceived quality). The interaction is depicted in Figure 4.3.

Dimensions that affect service quality indirectly affect perceived value and quality dimensions may thus be used to define perceived value (Heinonen: 2004). Lanning (1998) identifies delivering profitable value as the sum of developing a competitively superior value proposition and a superior value-delivery system. As such, the brand must represent a promise about the total experience that customers can expect. A similar theme emphasized by Knox and Maklan (1998), is that too many companies create a value gap by failing to align brand value with customer value.

FIGURE 4.3 Components of the value mix



Source: adapted from Ho and Cheng (1999: 205).

The value concept is achieved with maximum benefit for customers, employees, partners, and investors through an operating strategy that seeks to leverage results over costs by means of such factors as organisation; policies; processes; practices; measures; controls and incentives (Heskett *et al*: 1994). The strongest predictors of customer satisfaction are those conditions that support process value (Brooks: 2000). He sees internal process value as a product of the organisation's tools; information systems; policies and procedures' collaboration among departments; management support; goal alignment, training; communication and appropriate recognition and reward for delivering value.

Ultimately, the higher the company's value-creation ability; the more efficient internal operations activity, and the greater its competitive advantage, the higher the profits will be (Heskett *et al*: 1997). This is all viewed from the perspective of the customer, and is incorporated in the customer value equation.

4.6.1 The components of the customer value equation

Customers don't simply purchase products and services, but purchase the results they wish to achieve (Ho & Cheng: 1999). As such, in the case of home entertainment, they are purchasing home relaxation, satisfaction, enjoyment and entertainment (Maritz: 2003a,b). Heskett *et al* (1997) conceptualised the value equation, placing emphasis on the conceptual link between strategic service vision and service profit chain. In line with the principles of the service profit chain, viewed from the perspective of the customer, the value equation may be depicted as follows:

$$\text{Value} = \frac{\text{Results produced for the customer} + \text{Process Quality}}{\text{Price to the customer} + \text{Costs of Acquiring the Service}}$$

The four integral dimensions of the value chain as identified by Heskett *et al* (1997) are central to the service profit chain. The value chain suggests that the value of goods and services delivered to customers is equivalent to the results created for them (Caruana *et al*: 2000) as well as the quality of the processes used to deliver the results (Ho & Cheng: 2004), all in relation to the price of a service (Zeithaml & Bitner: 2003) to the customer

and other costs incurred by the customer in acquiring the service (Cooper & Slagmulder: 1997). The four integral dimensions are now detailed (Heskett *et al*: 1997).

4.6.1.1 Results produced for customers

Customers buy results, not products (McDougall & Levesque: 2000). As such, it is the benefit of the transaction which is of importance, not the product itself. An example is the purchase of petrol for a vehicle, the desired result being transportation, not the petrol itself. The value attached to results varies with the size of the service task, together with its importance to the customer (Ho & Cheng: 1999). This again highlights the value trade-off between benefit and sacrifice (Heinonen: 2004). Utility is of importance, dating back to economic theory postulated by Lancaster (1971). Caruana *et al* (2000) also added to derived value as a product of utility provided by the combination of attributes.

4.6.1.2 Service process quality

Placing emphasis on the way in which the service is delivered, is often being as important as results (Zeithaml & Bitner: 2003). Five universal dimensions of service process quality (SERVQUAL) were identified by Parasuraman *et al* (1988):

- Dependability/Reliability; did the service provider do as promised?
- Responsiveness; was the service provided in a timely manner?
- Authority/Assurance; did the service provider elicit a feeling of confidence in the customer during the service process?
- Empathy; was the service provider able to take the customer's point of view?
- Tangible evidence; was evidence left that the service was indeed performed?

Other research (Lau: 2000), Heskett (2002), Silvestro and Cross (2000), Maranto and Reynoso (2003) is indicative of the profound implications for service providers, including the following findings:

- Process quality is abstract, not absolute (Kang *et al*: 2002)
- Process quality is determined by the customer, not the service provider (Zairi: 2000)
- Process quality varies from one customer to another (Yu & Dean: 2000)

- Process quality can be enhanced by action to control expectations; or by meeting or exceeding customer expectations (Andreassen: 1994).

Process quality and customer satisfaction are the key to competitive advantage (Sureschandar *et al*: 2002). Building upon SERVQUAL, Sureschandar *et al* (2002) identified five factors of service process quality as critical from the customers' point of view. These included the core service or product; human element of delivery; systemization of service delivery (non-human element); tangibles of service (servicescape) and social responsibility.

From a best value perspective, the measurement of process quality should take into account customer expectations of service as well as perceptions of service (Wisniewski: 2001). It is generally agreed that process quality is an attitude or global judgement about the superiority of a process, although the exact nature of this attitude is not agreed (Robinson: 1999). Some suggest that it stems from a comparison of expectations with performance perceptions (disconfirmation) (Parasuraman *et al*: 1988), whilst others argue that it is derived from a comparison of performance with the ideal processes (Teas: 1993) or from perceptions of performance alone (Cronin & Taylor: 1992). This is made evident by the variety of models for process quality measurement (Kang *et al*: 2002; Zairi: 2000; Yu & Dean: 2000; Andreassen: 1994; Lau: 2000; Silvestro & Cross: 2000).

Cronin and Taylor (1992) believe literature lends more support to performance measures of process quality, as opposed to the notion of the expectations-performance gap, as identified by Parasuraman *et al* (1998). They believe the adequacy-importance attitude model is the most appropriate if the main objective is to predict behaviour (Mazis, Ahtola & Klipel: 1975). In this model performance is weighted by importance to define an individual's attitude, and expectations are not considered. Not all studies however reach the conclusion that performance-only measures provide the greatest predictive power (Robinson: 1999).

Using SERVQUAL as a measurement of process quality has been empirically tested (Parasuraman *et al*: 1998; McDougall *et al*: 2000; Heinonen: 2004); however, cognisance must be taken of areas of debate. These include diagnostic or predictive purpose, the nature of attitude, measuring expectations or not, and whether the five dimension model is correct for its original context (Robinson: 1999). As a concluding remark on process

quality, there is no value in a product or service until it is in the hands of its customers (Li, Tan & Xie: 2003). Process quality is determined by the interaction of all those factors that affect the process of making products/services available to the customer (Christopher: 1998).

4.6.1.3 Price and acquisition costs

Whilst many customers and service providers measure their costs only in terms of price, the costs of acquiring a service may in some cases outweigh the price. Added value, such as range extensions; convenience; adaptability and portability often allow the service provider to negate price as the only measure of cost (Palmer; 2001). Service providers however need to convince customers of the value of such efforts (Caruana *et al.*: 2000). Managing by the customer value equation is a way of life in outstanding service organisations (Heskett *et al.*: 1997). The customer value equation suggests that service value to customers can be enhanced by increasing either (or both) results delivered or process quality, while reducing either (or both) prices or service acquisition costs.

Regarding price, British Airways do not seek to charge the lowest airfares, but have won many awards for superior service (Heskett *et al.*: 1997). Their ‘putting people first’ campaign went a long way to enhancing customer value, via the increase in customer satisfaction levels. This was however a long process, involving a reduction in service acquisition costs, together with an enhancement of results delivered. Organisational influence on pricing incorporates a wide variation in the objectives they seek to achieve. Palmer (2001) identifies the following objectives for price decisions: profit maximisation; market share maximization; survival and social considerations.

In practice, organisations work to a number of objectives simultaneously (Kotler: 2000). Rather than seeing each customer transaction in isolation, the development of ongoing buyer-seller relationships is becoming a much more important part of business strategy (McDougall *et al.*: 1997). Customer lifetime pricing may be an accepted strategy to develop lifetime value customers over the long term (Palmer: 2001; Heskett: 2002; Reichheld: 2001).

4.6.2 Requirements to add value

Heskett *et al* (1997) identify various requirements which facilitate the implementation and adoption of the customer value equation. Whilst not limited to these requirements only, organisations implement the following as groundwork essentials:

- Understanding customer needs. Although customer needs can be gauged by traditional forms of marketing research, modern business practices actually involve customers in the design and ways in which services are delivered (Kotler: 2000). British Airways place emphasis on more traditional research methods, including on-board customer service surveys, together with focus groups. Of paramount importance, however, is the interpretation and analysis thereof. Customers are also encouraged to register complaints with the airline, via numerous listening posts. Moral and ethical development in business has been integral to the development of global consumerism (Boone & Kurts: 2000), and forms an important part of the marketing concept (Chaston: 2000). Meeting the needs and wants of the consumer, together with a societal responsibility (Kotler: 2000), are key inputs into the marketing strategy. Nieman *et al* (2004) mention the importance of product leadership, differentiation and market domination toward managing growth
- Influencing attitudes towards the value equation. Company wide initiatives involve a customer service orientation throughout the organisation, whereby even the lowest ranking employees are trained regarding handling of customer queries (Vilares & Coelho: 2003). The Sheraton Hotel chain regularly develops such skills with their cleaning and maintenance staff; as these employees come face to face with most customer complaints. Of importance is the recording of complaints registered by customers, along with potential root causes, providing a basis for establishing priorities for timeous corrective action (Brooks: 2000). Influencing attitudes consists of communication within and outside the organisation (Boone & Kurts: 2000), and consists primarily of empowering employees in the form of sharing information, sharing decision-making authority and linking rewards to company performance (Nel *et al*: 2004)
- Establishing a return on value-enhancing initiatives. This relates primarily to service quality improvements (Zeithaml & Bitner: 2003), and measurement of root causes of complaints (Heskett *et al*: 1997). British Airways (BA), for example,

received complaints from 30% of customers regarding seat allocations and overbooking. These customers indicated that they would seek alternative airlines that do not continually have these problems (Heskett *et al.*: 1997). Measuring these problems, resulted in an anticipated loss of over eight million pounds sterling in revenue, should these problems not be rectified. As a result of such measurement, BA estimated that for every pound spent on customer retention, the Airline would net two pounds in revenue

- Developing different value packages for various market segments. Different sectors of the market demand different service offerings at varied prices (Walker *et al.*: 1999). The airline industry discriminates on value and price with regards their first, business and economy modes of flying. Although it is said that the real profits on airlines are made from those flying up front (business and first class), all other passengers contribute to the vast overheads. Customers travelling in the different classes have distinctively different needs, together with value expectations. Problems can however arise when companies have multiple offerings, for example, when passengers compare the different options while travelling in adjacent seats. In differentiated marketing, the firm operates in several market segments and develops different programs for each segment (Chaston: 2000), and differentiated marketing typically creates more total sales than undifferentiated marketing (Kotler, 2000: 276)
- Establishing that value can be provided at a profit. Little margin for error exists in establishing value (Caruana *et al.*: 2000), as once a customer defects, the cost of re-acquiring their patronage comes at a huge cost, relative to retaining current customers (Brooks: 2000). To deliver value at a profit, it is necessary to link the value equation to the strategic service vision (Heinonen: 2004). Customer value and loyalty is a prime determinant of long-term financial performance of firms (McDougall & Levesque: 2000).

4.6.3 Linking the strategic service vision and the service profit chain

The margin between the cost of providing the service, and the provision itself, is deemed necessary for the long-term survival of the business (Duffy: 1998). It is the margin between value and cost that represents a profit opportunity to the service provider. Heskett *et al.* (1997) suggest that the value equation serves as a conceptual link between the service profit chain and the strategic service vision. The strategic service vision

incorporates all activities of the organisation, and their overall objectives towards the realization of superior service and value (Waker *et al*: 1999). This includes the service delivery system, operating strategy, service concept, and target market; linking profit, value to the customer, and overall organisational growth (Heskett: 2002).

4.7 CUSTOMER LOYALTY

Previous mention was made of leading service organisations' link of profitability and quality of customer service (Maranto & Reynoso: 2003; Ho & Cheng: 1999), together with not equating profitability only with market share (Andreassen: 1994). It is an objective to have true and faithful customers (Bowen & Chen: 2001), however, this is only possible upon the implementation of superior service and value initiatives (Duffy: 1998). Sections 4.2.1 and 4.2.2 identify the profit and growth link to loyalty; and the loyalty link to satisfaction.

Peck *et al* (1999) identified the customer loyalty ladder, depicting two extremes of customer loyalty. The bottom extreme, with emphasis on one-off transactions is represented by the prospector, through purchaser, through client. The upper extreme, with emphasis on long-term loyalty, is represented by the supporter, advocate and ultimately partner. It is generally held that there are three distinctive approaches to measuring loyalty; being behavioural, attitudinal and composite measurements (Bowen & Chen: 2001).

From a composite point of view, loyal customers are those who hold favourable attitudes toward the company, commit to repurchase the product/service, and recommend the product to others (Bowen & Chen: 2001). Customer loyalty is purchase behaviour, unlike customer satisfaction, which is an attitude (Griffin: 1996). Customer loyalty, a key mediating variable in explaining customer retention (Pritchard & Howard: 1997), is concerned with the likelihood of a customer returning, making business referrals, providing strong word-of-mouth, as well as providing reference and publicity (Bowen & Shoemaker: 1998). Loyal customers are less likely to switch to a competitor due to a given price inducement, and these customers make more purchases compared to less loyal customers (Baldinger & Robinson: 1996).

Duffy (2003) identifies benefits of loyalty as cost savings, referrals complain rather than defect, channel migration, unaided awareness, greater awareness of brand assets, and turn left rather than turn right. The latter represents the subtle, psychological reluctance to defect created by a loyalty strategy. Duffy (1998) sees building customer loyalty as a business strategy, not just a marketing programme. He states that all businesses should seek to boost loyalty and maximize share of customer. A service organisation's long term success in a market is essentially determined by its ability to expand and maintain a large and loyal customer base (Wong & Sohal: 2003). They found that the most significant predictor of customer loyalty at a company level is tangibles, while the most significant predictor of customer loyalty at an interpersonal level is empathy.

4.7.1 Determinants of customer loyalty

Adopting the belief of processing the ability to relate to customers, latitude of front-line judgment, together with the rewards for doing so (Caruana *et al*: 2000). This was implemented in Au Bon Pain restaurants, resulting in reduced employee turnover, and increased customer satisfaction. The link between employee and customer loyalty is highlighted in this example (Reichheld: 1996).

4.7.2 The relationship between customer loyalty and profit and growth

As emphasized in the Service Profit Chain, once again highlighting leading service organisations' approach of negating the profit and market share relationship, with that of customer loyalty (Heskett: 2002).

4.7.3 Customer loyalty and customer satisfaction

Also linked in the Service Profit Chain, however of all the links, this is the least reliable. Competitive prices, locality marketing and other competitive initiatives have made satisfied customers migrate/defect to opposition outlets, somewhat questioning the loyalty/satisfaction relationship (Silvestro & Cross: 2000).

4.7.4 Enhancing loyalty

This includes learning opportunities from those customers defecting to opposition service providers (Sundaram *et al.*: 1997). The reasons for defecting may be lengthy; however, root causes have to be identified. In addition, incentivising front-line staff, not only for signing up new customers, but retaining existing clientele, requires continual analysis (Heskett *et al.*: 1994). This again emphasizes the link between employee and customer loyalty (Rogers *et al.*: 1994).

The satisfaction/loyalty relationship advocates how an organisation approaches the competitive environment with particular reference to defectors. Heskett (2002) identifies the fruits of loyalty through three customer behaviours; commitment, apostle-like behaviour and ownership. Committed customers are not only loyal, but tell others of their satisfaction (Helm: 2003). Apostles are not only viral, but convincing. They possess credibility and a certain degree of authority in the eyes of others (Heskett *et al.*: 1997). ‘Owners’ are defined as those loyal customers that take responsibility for the continuing success of a product or service offering. Gremler and Brown (1999) identified the loyalty ripple effect, highlighting the behaviours and effects they have on margins and profitability.

Heskett (2001) also identified how a committed customer as an apostle or owner can generate the same lifetime value of as many as one hundred customers who are merely loyal but who do not recruit other customers or provide ideas for product or service improvement. Heskett (2002) informs that explicit efforts can be made to develop ‘owners’. They involve a hierarchy of initiatives to fast-track customer loyalty, one that complements in some ways the hierarchy of customer behaviours. First level strategy to develop extraordinary loyalty is transactional, involving product warranties and service guarantees. Higher-order strategy (strategic) involves repositioning the business to deliver solutions rather than products or services. A third level, reflected as cultural, involves the linking of operational functions, such as product development and improvement, to customers or suppliers, often regarded as partners.

The top of the hierarchy is represented by organic strategies designed to develop customers who regard themselves as owners. At such levels, efforts are made to identify such customers as well as ensure they are treated in a manner that leads them to believe

they are part of a community of preferred customers who are able to influence company strategies. An example of this is the input loyal customers have in selecting cabin assistants at Southwest Airlines. Heskett (2002) further postulates that the potential payoff from building commitment, apostle-like behaviour, and ownership among customers is so great that it often outweighs the potential costs. He concludes that mere loyalty is not enough; and that there is a real opportunity to build loyalty from a core of apostles and owners who have extraordinary lifetime values for the provider of goods and services.

The extreme on the other end of the scale are referred to as 'terrorists', indicative of very dissatisfied customers with low loyalty and low retention behaviour. This is in contrast to apostles indicating a zone of affection, with highly satisfied and loyal customers. Upon evaluating terrorist motives, particularly those with reasonable and pertinent service issues, effort must be made to conform them from an area of defection; through the zone of indifference, to that of apostles in the zone of affection (Heskett *et al.*: 1997). To this end, Xerox (USA) found that a high rating on customer satisfaction led to a higher probability of repurchase from Xerox.

4.7.5 Recognition and rewards

This construct involves a double barrel approach, incorporating both customers and employees, aligning the customer and employee performance link to long term profitability (Lau 2000). Employee Recognition and Rewards include implementation of performance appraisals, profit share, incentives, training and development, participation in decision-making, involvement, towards the achievement of overall organisational objectives (Bassi & Vanburen: 1997). Customer recognition and rewards include enhancement of the current loyalty programme, birthday and special event cards, frequent viewer initiatives, and most of all, superior service at the point of rental, for example, thanking the customer for using the services of the particular service provider (Heskett: 2001).

Kotler (2000) places emphasis on customer satisfaction as a method of strengthening customer retention. The task of creating enhanced customer loyalty is referred to as relationship marketing; embracing all those steps that companies undertake to understand their valued customers better. Relationship marketing centres on developing more loyal

customers, thereby increasing revenues (Heskett: 2002). The introduction of loyalty programmes facilitates this element of retention, however, if not administered correctly, could actually have adverse effects. South African Airways employ a loyalty programme known as Voyager, whereby commuters are rewarded for flights on the airline. The redemption of award certificates is, however, cumbersome, together with continual non-availability of free seats on selected flights. This negates the entire programme, resulting in passengers migrating to opposition airlines.

Adding financial benefits facilitates additional usage, together with retention (Heskett *et al.*: 1997). Frequency marketing programmes are produced to reward loyal customers who use a company's services in substantial amounts. This is an acknowledgement of the fact that eighty per cent of the company's business is done by twenty per cent of its customers (pareto-analysis). Typically, the first company to introduce such programmes in an industry stands to gain the most benefit; however, after competitors respond, the frequency programmes may become a financial burden to all the offering companies. Another form of loyalty programme includes club membership, which is aimed at bonding customers closer to the company. Such affinity clubs also have the advantage of developing a customer database. Harley-Davidson, the world famous motorcycle company, sponsors the Harley Owners Group (HOG), being in the region of half a million members. First time Harley Davidson buyers receive a free one-year membership, which includes free magazines, handbooks, insurance, discount hotel rates, and other related services. And, of course, the 'stigma' attached to being a 'HOG' member. In relation to recognition and rewards, three constructs are developed.

4.7.5.1 Empowering employees

The positive relationship between quality of work life (QWL) and growth and profitability is emphasised by Lau (2000). QWL will positively nurture a more flexible, loyal and motivated workforce, which is essential in determining the company's competitiveness (Meyer & Cooke: 1993). Positive associations have also been found between progressive human resources practices, such as training, staffing selectivity, empowering employees and common firm performance measures (Nel *et al.*: 2004).

Empowerment refers to the educational, training and developmental activities of employees towards the achievement of objectives (Nel *et al.*: 2004), with particular

emphasis on training and employee development in this context. Towards the successful implementation of internal marketing, service climate and supportive management are two pre-requisites (Yoon *et al.*: 2001). They identify employee empowerment as one of the key constructs. Employee perception of work climate not only influences organisational variables such as work effort and job satisfaction, but also affects service evaluation by customers. Yoon *et al.* (2001) believe it necessary to explicitly design and establish various organisational policies such as employee empowerment, detailed service codes, service performance reward/award, and employee education/training, in order to develop a system that will facilitate service-oriented environment and supportive management.

Empowerment is when management promotes this goal by giving employees authority and responsibility to make decisions about their work without traditional managerial approval and control. Managers empower employees by sharing company information, delegating decision-making authority and rewarding employees based on company performance (Boone & Kurtz: 2000). The concept of empowerment is truly implemented when employees have the power to make decisions that influence their work procedures in ways that are linked to organisational strategy, not only in suggesting improvements, but allowing employees to turn ideas into actions (Boon & Kurtz: 2000). Wal-Mart's computer and communications technology puts information in the hands of employees. Every employee knows the price of the products, their mark-ups, and how many are sold. Sharing information results in high-quality communication among employees and between Wal-Mart and its customers.

4.7.5.2 Relationship marketing

Whilst the discipline of relationship marketing is worthy of its own chapter, relevance to loyalty will be emphasized. From this point of view, relationship marketing is viewed as a philosophy of doing business that focuses on keeping and improving (retaining) current customers rather than on acquiring new customers (Zeithaml & Bitner: 2003). Relationship marketing has evolved from an acquisition and transaction focus toward a retention focus (Webster: 1992). The primary goal of relationship marketing is to build and maintain a base of committed customers who are profitable for the organisation, and to achieve this, organisations will use attraction, retention and enhancement strategies (Berry: 1983).

Benefits of effective relationship management revolve around value, where consumers evaluate the trade off between receiving and giving. Apart from receiving service value, other customer benefits include confidence benefits (trust and confidence in the provider), social benefits (familiarity, social support system), and special treatment benefits (benefit of doubt, preference) (Gwinner, Gremler & Bitner: 1998). Benefits to the organisation are that relationship-oriented service firms achieve higher overall returns on their investment than do transaction-oriented firms (Kumar: 1999). Other benefits include increased customer purchases over time (Reichheld: 2001), lower costs (Zeithaml & Bitner: 2003), free advertising through word of mouth (Helm: 2003) and the indirect effect of employee retention (Lau: 2000). Relationship marketing is further evaluated in Chapter 5.

4.7.5.3 Customer loyalty strategies

Specific application is geared towards loyalty marketing and programmes in the context of the service profit chain (Heskett *et al*: 1997). The aim of loyalty programmes is to extend the customer's life with a company so that their lifetime profitability is increased (Palmer: 1998). Loyalty programmes create communities of customers that are organized and initiated by companies (Butscher & Muller: 1999; Diller (1997). The current customers are approached for a potential membership to enable a steady direct communication and to intensify the relationship during the total time of business relationship (Tomzcek & Dittrich: 1999). A loyalty programme is regarded as a suitable platform to increase the interaction frequency between company and customer (customer interaction effect) by creating contact and feedback opportunities (Diller: 1997). The customer's willingness for membership depends on the distinct advantage to them (customer benefit effect), and most often only if the cost-benefit-calculation leads to a positive result (Strauss, Chojnacki, Decker & Hoffmann: 2001).

Building customer loyalty is a business strategy, not just a program. Structuring customer loyalty strategies centres on share of the customer. Customers from whom you get twenty per cent to eighty per cent share represent the best opportunity for growth (Duffy: 1998). He informs that the effort to boost share of customer in the middle is considerably less than at the low end and high end of the share-of-customer scale. Loyalty programmes commercially started in the airline industry in 1978, due to airlines struggling for a point of differentiation. Remarkably, it has been said that frequent flyer programs have played a significant role in the demise of many post-deregulation airline start-ups (GAO Report:

1996). A characteristic of airline loyalty marketing is the term promotional currency, being miles or points earned as the member spends. The promotional currency is redeemed for something of value- in this case free travel, accommodation and related services. When effectively developed and implemented, loyalty marketing strategies become integrally linked to the product/service (Reichheld: 2001).

Loyalty strategies seek to enhance customer relationships, which in turn facilitate customers to have a point of contact for product/service concerns; rather than quietly defecting (Duffy: 1998). As a result, this may result in customers becoming advocates or disciples (Heskett *et al*: 1997). Duffy (1998) postulates that loyalty strategies can create a reluctance to defect, particularly when the customer may associate loss of a benefit in so doing. Duffy (1998) further explores and recommends typical loyalty strategy initiatives:

- Name the promotional currency. This may be referred to as miles or points, rule of thumb being simplicity
- Select an appropriate unit of measure. Not too large and not too small
- Select an appropriate tier structure. The first approach is tiers based on spending (the more you spend the more you earn, motivates spending); the second approach is tiers based on balance (the more you save the more it's worth, motivates spending and saving)
- Require redemption in fixed units. Guarantees members will mostly have a balance remaining after redemption, and be reluctant to defect
- Use redemption to drive sales. Mechanisms must be built in to ensure that loyalty programs build business, being incremental sales
- Program accounting. Contrary to being a database only, the system requires full accounting capability.

Strauss *et al* (2001) confirm that the essential result of their study is the fact that a loyalty programme cannot only obtain an indirect retention effect for an organisation because of the use of an improved customer data base, but that a direct retention effect actually can be achieved with regard to higher relationship satisfaction and customer retention. Loyalty club members definitely show a higher degree of relationship satisfaction and customer retention than non-members, once again highlighting the customer satisfaction and loyalty link to long term growth and profit (Heskett: 2002).

4.7.6 Lifetime value

The discussion on customer value in section 4.4.1 revolves around the customer value equation, whereas the lifetime value reflects the equation over a strategic period, with long-term implications for the organisation (Heskett *et al*: 1997). Customer equity is the total of the discounted lifetime values summed over all of the organisation's customers, and is the most important determinant of the long term value of the firm (Zeithaml & Bitner: 2003).

Towards lifetime values, McDougall, Wyner and Vazdauskas (1997) indicate four basic components to customer value:

- Acquisition costs. The sum of sales, advertising and communications mix elements spent in acquiring the customer
- Revenue stream. The total revenue generated by the customer through the purchase of products and services
- Cost stream. The cost to provide these products and services to the customer (including customer service costs)
- Length of relationship. How long the customer remains a customer of the organisation.

McDougall *et al* (1997) identify three essential steps in performing customer valuation, consisting of defining the relevant customer universe, collecting data (based on relevant behavioural and economic components of lifetime value), and determining overall value (integrating these components into overall measures of value). TeleCheck, a large cheque acceptance company in USA calculated a 33 per cent increase in profit with a 5 per cent increase in their retention rate (Heskett *et al*, 1997: 200-201). Value based customer segments can be used in aspects of strategic planning, share goals (retention, win-back, acquisitions), new product development (needs and behaviours of most valuable customer segment/s), brand management (most appropriate communications strategy, competitive differentiation, brand repositioning) and customer service (depending on expected lifetime value to the company) (McDougall *et al*: 1997).

Reichheld (2002) links loyalty to profitability via the lifetime value of the customer. McDougall *et al* (1997) argue that by understanding and managing lifetime customer

value, a company not only allocates resources to its customers more effectively, but also becomes better able to focus on developing long-term customer relationships. Heskett *et al* (1997) identify the strategies of retention, related sales and referrals towards achieving the lifetime value objective.

4.7.6.1 Retention strategies

Retention can be defined as a commitment by customers to do business or exchange with a particular company on an ongoing basis (Zineldin: 2000). Customer retention brings with it benefits such as employee retention and satisfaction, better service, lower costs (Reichheld: 1996), lower price sensitivity, positive word-of-mouth, higher market share, higher efficiency and higher productivity (Zineldin: 2000). Retention of current customers refers to the ability of organisations to maintain active relationships with their current customer base (Ruyter & Bloemer: 1999). In return, the revenue received becomes increasingly profitable, due to less effort required to analyse their needs (Andreassen: 1994). The key to retaining customers is relationship marketing, highlighted in the previous section. MBNA (USA), a large insurance company, had one of the lowest defection rates in the industry, and as a result, achieved phenomenal profits, despite no acquisitions or mergers.

The higher the employee and customer retention rates (loyalty) the higher the profit (Brooks: 2000). Not paying attention to all major stakeholders' results in a hidden cost to cash flow resulting from the churn in fickle customers, disinterested employees and short-term owners. While satisfaction may be an important retention driver, trust and brand switching barriers are also likely to influence retention, both independently and in tandem (Ranaweera & Prabhu: 2003). In their empirical investigation on the effect of these constructs on retention, the following was highlighted:

- In a low customer contact, mass service setting, satisfaction is the strongest driver of customer retention
- Results confirm the expected positive effect of trust on retention
- No evidence that trust, as a direct determinant of retention, is more important than satisfaction, not even in a continuous purchasing setting more suited to trust relationships

- Trust can be lost in the event of service failure, despite a satisfying service recovery experience
- Customers appear to be willing to accept the apology and compensation offered by the service provider to offer a trouble free service in the future
- The main and the interaction effects of switching barriers on retention were highly significant. The suggestion is that, in an industry with switching barriers, service providers are likely to be able to retain even those customers who are less than satisfied
- Customers could become resentful to switching barriers especially if these barriers lead to a scenario of complete entrapment
- While switching barriers could be thought of as an alternative means of retaining customers, they could also be a complementary source of satisfaction through the provision of added value to the service bundle.

In an empirical study conducted by Hansemark and Albinsson (2004), they found the strongest connections between satisfaction and retention pertaining to the experiences of relationships and confidence, and frequent contact accompanied by open dialogue. Complaint handling was also strongly connected to both concepts. Appiah-Adu (1999) finds that the most critical element in retaining customers is the company's customer philosophy. He also stresses that there is a difference between satisfaction and complete satisfaction, the goal being to achieve the latter. Ranaweera & Neely (2003) empirically showed that increasing service quality perceptions strengthen the rate of retention of even those who are unhappy about price. They do however inform that there are price ceiling which negate perceived service quality.

Many studies have revealed that attracting new customers is at least five times more expensive than retaining existing ones (Bowen & Chen: 2001; Mulhern & Duffy: 2004; Wong & Sohal: 2003). To this end, even though incentives should be put in place to procure new customers at the point of purchase and to increase usage, companies should also implement retention incentives to frontline and support personnel.

Kotler (2000) identifies the tendency of most companies to concentrate on attracting new customers rather than on retaining existing ones. Many companies, however, have always cared passionately about customer retention, and are determined not to lose customers. To this end, Sherden (1994) identifies key questions regarding customer defections. The

analysis commences with internal records, followed by extending defection research to outside sources. Key questions include:

- Do customers defect at different rates during the year?
- What is the relationship between defection rates and changes in price?
- What are retention and defection norms of the industry?
- Which Competitor in the industry enjoys the highest retention rates?
- Where do defection customers go?
- Does defection vary by outlet or location?

Heskett *et al* (1997) identify the use of listening posts, facilitating retention via open communication channels between companies and customers. Such listening posts are not only implemented for customer complaints, but also for recommendations, ideas, requests and the like. Albrecht and Zemke (1985: 67) emphasized that listening is not enough; but that companies must respond quickly and constructively to complaints and requests. They also link retention with referrals as, “of the customers who register a complaint, between 54 and 70 per cent will do business again with the organisation if their complaint is resolved. The figure goes up to a staggering 95 per cent if the customer feels that the complaint was resolved quickly. Customers who have complained to an organisation and had their complaints satisfactorily resolved tell an average of five people about the good treatment they received”.

As loyal customers account for a substantial amount of company profits (Heskett: 2002), a company should not risk losing a customer by ignoring grievances and queries. However, a small per centage of customers will never be content with service offerings, no matter when and where they shop. Wal-Mart actually have a strategy where they 'fire' customers, yet only as a last resort. In such cases, and only upon confirmation from management, the customer is requested to use the services of another retailer, who might be able to satisfy their needs (Heskett *et al*: 1997).

Reichheld (1996) identifies some interesting facts bearing on customer retention:

- The average company loses 10 per cent of its customers per annum
- Acquiring new customers can cost at least five times more than retaining existing ones

- Profits can increase by twenty-five to eighty-five per cent (industry dependent) by having a five per cent reduction in the customer defection rate
- The customer profit rate tends to increase over the life-cycle of existing customers.

Computing the cost of lost customers identifies eight steps in attempting to reduce the defection rate. These include (Reichheld: 1996):

- The organisation must define and measure its retention rate
- The organisation must distinguish causes of defection, and identify those causes that can be managed better
- The organisation needs to estimate loss in profits per defection, which involves the lifetime value, being the present value of the profit stream that the company would have realized, had the customer not defected prematurely
- Changing channels of distribution
- Minimising adverse selection of customers through creative filtering
- Rewarding the sales force for retaining customers, not just winning new customers
- Designing special programmes to attract and hold the most valuable customers
- Finally, the company needs to ascertain the costs involved to reduce the defection rate. As long as the cost is less than the loss in profit from defections, the company should expend that amount to reduce the defection rate.

Reichheld (1996) places emphasis on retaining the right employees, suggesting measures such as designing career paths for maximum productivity, adopting a concept of partnership that aligns the company's interests with the employees, making a proactive effort to keep its best employees, and recruiting staff carefully; staff that will maintain and improve the character and integrity of the firm. Reichheld (1996) identifies the third tier of involvement as attracting and keeping investors. In this regard, he advises as follows: educating current investors, and attracting the right kind of core owner, that is, those that have a long term view. Those organisations that implement competitive advantage and succeed; deliver high customer value and satisfaction, which leads to high repeat purchasers, and, therefore, higher profitability (Heskett: 2002).

4.7.6.2 Related sales of new products and services

It is more profitable to sell new products and services to the existing customer base than to new customers (Reichheld: 2001). Given the existence of a loyal customer base, there is a strong incentive to exploitation, by developing related products and services that appeal to it (Heskett *et al*: 1997). Many companies have diversified to accommodate related sales, thus enhancing their product offering, in turn improving profitability (Gibson: 1998). Whilst Ster-Kinekor theatres are in the business of movie exhibition, their related services include the sale of confectionery items, which account for twenty-seven per cent of their profits. Whilst related sales are directed at the lifetime customer, organisations may be in the position to leverage their core product (Porter: 1985), whereby additional revenue streams may be introduced. These streams are not always directed at the customer. Such leverage occurs at Ster-Kinekor theatres, where substantial revenues are a result of advertising opportunities within theatres and theatre foyers (CineMark). Similarly, Exclusive Books have introduced coffee shops in all their outlets; affording their customers the opportunity of reading books in a friendly and convenient location.

From a strategic marketing perspective, related sales may be aligned to extending volume growth via extended usage in current markets (Walker *et al*: 1999). The aim is to get current customers to spend more, either by increasing consumption on current products or services, or introducing new products or services (Kotler: 2000). Implementation may centre on affordability, convenience, needs, complementarity, notwithstanding impulse purchases. Whilst related sales are aimed at an existing customer base (lifetime value), increased penetration and market expansion are not relevant in this case. A study of purchase intentions in the home entertainment industry (Maritz: 2002; 2003a,b) found that customers had idle cash on hand once receiving change from transactions. The objective was to convince the customer to spend that change in-store; via related sales of confectionery, phone cards, movie paraphernalia and accessory items.

4.7.6.3 Referrals

Referral is used to describe communications (either positive or negative) between groups such as the product provider, independent experts, family and friends and the actual or potential consumer. Word-of-mouth is a similar concept, except that it constitutes verbal

communication (Hel & Schlei: 1998). Referrals from existing customers to other consumers rate amongst the highest form of positive communication (Stokes & Lomax: 2002). This necessitates efforts to enhance customer satisfaction, not only for repeat business, but also for the high value of referrals (Soderlund: 1998). Reichheld & Sasser (1990) found that recommendations from friends and acquaintances carry twice the impact of paid advertising when consumers make purchasing decisions. The U.S. Office of Consumer Affairs identified that dissatisfied customers tell at least eleven other people of their dissatisfaction, whereas satisfied customers only tell five other people of their satisfaction (Heskett *et al*: 1997). Reichheld (2001) reported that research indicates that people only tell eight friends about a truly satisfying experience, whilst a bad experience may be communicated to twelve people. Soderlund (1998) is of the opinion that the explanation is due to the theory of asymmetrical effects of positive and negative events. Word-of-mouth (WOM) is regarded as the primary referral medium (Ennew, Banerjee & Li: 2000).

Zeithaml and Bitner (2003) believe that people regularly turn to others for information rather than to traditional marketing channels; which may be due to services often being high in experience and credence properties. Referrals from satisfied customers go a long way in developing the trust needed for a new customer to purchase a service that may appear risky (Heskett: 2002). Word-of-mouth is considered more credible than other sources of information, and satisfied, loyal customers are likely to provide an organisation with strong word-of-mouth endorsements (Zeithaml & Bitner: 2003). Palmer (1998) recommends that opinion leaders be used to convey positive word-of-mouth, as this is seen as credible to the consumer.

Haywood (1989) examined the importance of the verbal exchange of positive and negative information about an organisation's products and services. He further presented suggestions for learning what is said and how to gain systematic control over the word-of-mouth process. This was depicted in a model of interpersonal communication among a variety of stakeholder groups. Stokes and Lomax (2002) builds upon this model, highlighting that marketing in entrepreneurial contexts relies heavily on WOM recommendations for customer acquisition. Their research identified two sets of dissonance, one between input WOM types and sources, the other between output WOM content and targets. They conclude that WOM effectiveness can be improved through a

variety of interventions, thus demonstrating that WOM can be an effective part of a marketing strategy.

Ennew *et al* (2000) inform that positive WOM from satisfied customers can increase purchases; while negative comments from dissatisfied customers can decrease purchases. They believe dissatisfaction can serve as an antecedent to negative WOM, relating to customer loyalty being a WOM antecedent. They further provide insights into why consumers use WOM (risk reduction), and why they might engage in WOM (satisfaction, loyalty). Customer referral campaigns (CRC's) are identified as one of the most direct forms of managing WOM and promoting acquisitions, identified by organisations incentivising existing customers to introduce new customers (Ennew *et al*: 2000). Haywood (1989) identified a plan for the management of WOM directly through acquisition and indirectly through retention. Constructs included: listen and question effectively, interact with customers on a personal level, consumer orientation, deliver on promises, targeting of opinion leaders, working with suppliers, joint advertising campaigns, helping potential customers with information, competitor analysis and development programmes.

Wilson (1994) considers the referral system as an interpersonal network and is one of the most important business communication mediums. She recommends a methodology of stimulating referrals: identify sources of referrals, offer reciprocation where appropriate, compile a centralised list of referrers, keep referrers informed of progress, and establish reasons for referral. Helm (2003) identifies different approaches to the calculation (value) of positive WOM, leading to a monetary referral value of an organisation's customers. She however concludes that the cost of monetizing referral value will probably outweigh the positive potential of WOM in a lot of cases, and that lifetime values are more pertinent. The effect of referral strategies on lifetime values and overall organisational long term and growth indicates a positive relationship between the constructs, facilitated by the focus on developing long-term relationships (McDougall *et al*: 1997). Furthermore, the positive association between WOM, customer and employee satisfaction and loyalty are emphasised (Ennew *et al*: 2000).

The objective of retaining the customer, enhancing referrals and providing related sales, leads to an increase in profitability which is threefold to base profits (Heskett: 2002). This is in agreement with Reichheld (1996: 2001), whereby he analysed the lifetime

profitability of customers. Managing the lifetime value requires management of retention, related sales and referrals (Heskett *et al*: 1997). Such initiatives, most of which have been identified in some context within this chapter, include:

- Creating listening posts. This involves the creation, identification and enhancement of listening posts. Listening posts include any form of medium which facilitates the handling of queries, for example, toll-free help lines, service counters, satisfaction surveys, salespeople, reception areas, point of purchase, and data base management (Bolting: 1989). One of the most effective ways of creating listening posts is loyalty programmes, such as frequent-flyer models by the airlines (Duffy: 1998). In return for communicating special offers, discounts and promotions, the airlines create information processing from their customer details. In addition, special training of staff to identify problems and opportunities has been installed at many leading organisations, including the Ritz-Carlton chain of luxury hotels. This listening mode forms a central part of the hotel's strategy (Ahmad & Buttle: 2002). Sampson (1998) identifies active solicitation and passive solicitation as means of creating listening posts. He sees e commerce capability as great opportunity for the use of feedback in quality monitoring and improvement processes. The digital nature of the medium lends itself to the establishment of automatic customer feedback collection and response database systems, or what one might call customer feedback information systems. Plymire (1992) regards the creation of listening posts as a sure way to a customer-focused culture. Zairi (2000) demonstrates that the effective management of listening posts can deliver customer loyalty and satisfaction
- Measuring and communicating lifetime values. The key is to highlight lifetime values as opposed to transaction based revenues (McDougall *et al*: 1997). The reality is to think of customers in terms of their present value over a lifetime, which places emphasis on the importance of retaining customers (Brooks: 2000). This excludes the effect of referrals from satisfied customers, which will increase lifetime values substantially (Ennew *et al*: 2000). Phil Bressler, one of Dominos Pizza's most successful franchisees in the Baltimore area, calculated the lifetime value of a loyal Pizza buyer in the region of \$4000. Employees were encouraged to have this figure in mind when serving customers, leading to policies of trusting customer's judgement on delivery-time, for which they received guarantees. McDougall *et al* (1997) argues that by understanding and managing lifetime

customer value, a company not only allocates resources to its customers more effectively, but also becomes better able to focus on developing long-term customer relationships. Employees should be motivated to enhance lifetime relationships with customers, by understanding the benefits of repeat business and making customers less likely to shop around for the best deals than non-loyal customers (Bowen & Chen: 2001)

- Customer defections as learning opportunities. Vital information can be provided by customers leaving an organisation, including how to get them back. Bolting (1989) proposes ways of managing customer complaints, and for controlling the more harmful types of dissatisfaction experienced from customers that have defected. Mack *et al* (2000) inform that focusing on service failures and defections can assist organisations in improving service quality and improving long-term customer retention. They identify potential failure points in the service process (from defectors) and identify methods to prevent, as well as recover, these failures to prevent negative customer perceptions and the ensuing customer loss and potential negative word of mouth. Trubik and Smith (2000) identified implications for organisations of the costs of retaining customer rather than acquiring them as new, and the resulting increased profitability of customers the longer they are with the organisation. The objective is to identify root causes for defections, enabling management to implement corrective action, instead of basing initiatives on management intuition
- Incentives to enhance customer loyalty. This reflects not only on business generated, but also on the ability to maintain and develop loyal customers. At MBNA, incentives are in place to reduce customer defection rates. Contributing towards a bonus pool for predetermined standards of performance are common practice in many leading service organisations, which also link customer loyalty to employee loyalty (Lau: 2000). Eccles and Durand (1998) consider factors such as the reason for complaints; reciprocity and complaint handling and ways to instil a service recover strategy, for enhancing customer retention and satisfaction. Mack *et al* (2000) postulate that focusing on service failures can improve service quality and improve long-term customer loyalty. Carr (1994: 13) identifies database marketing ('talking directly to our listening clients') as an integral connection to customer loyalty. Zairi (2000) sees the issue of complaints handling and management as essential for achieving retention and loyalty. A retail study (Wong & Sohal: 2003) empirically evaluated the connection between incentivizing staff

and associated customer loyalty, and a positive association was found. The link of employee satisfaction, loyalty and internal quality of worklife to customer loyalty is emphasized with the introduction of incentives to employees; towards retaining current customers (Lau: 2000)

- Relationship marketing. In essence, relationship marketing is based on building customer loyalty (Zeithaml & Bitner: 2003). It is a strategy, which advocates actions to seek lifetime relationships with loyal customers, rather than merely transacting with them (Peck *et al*: 1999). Loyalty programmes and clubs form an integral part of relationship marketing, as highlighted in the section on recognition and rewards (Section 4.7.5)
- Potential-based marketing. This combines measures of loyalty with data describing potential levels of usage (Walker *et al*: 1999). Its goals are to increase penetration and increase purchases by customers who have the greatest need, or exhibit strong loyalty to the service provider. In turn, such organisations attempt to extend the relationship through increased sales, lengthen the relationship, and increase profitability at each opportunity (Reichheld: 2001). Section 4.7.2.2 identifies related sales as an opportune strategy towards increasing customer share in mature markets (Maritz: 2002; 2003a).

Attracting customers and customer acquisitions are paramount to any company wishing to grow their revenues and profits (Kotler: 2000). Customer acquisitions require substantial skills in lead generations, whereby the company places adverts/promotions in the media to reach new prospects. The chain continues to lead qualification; whereby a prospective customer is introduced to the company, followed by account conversion, whereby the prospective customer becomes an active customer of the company (Palmer: 1998).

The cost of attracting a new customer is estimated to be five times the cost of keeping an existing customer happy (Heskett: 2002). The challenge, however, is not to produce satisfied customers, as several organisations can do this (Reichheld: 2001). The challenge is to produce loyal customers who will contribute to lifetime value (McDougall *et al*: 1997).

4.8 ENHANCING SERVICE PROFIT CHAIN INITIATIVES

Customers should no longer be satisfied, they must be delighted (Kotler: 2000). This is in agreement with Heskett *et al.* (1997), whereby loyalty, satisfaction and value are linked with long term organisational profit and growth. Total customer value is enhanced when benefits expected are met or exceeded, complementing satisfaction; which is the reaction towards the actual satisfaction derived, as compared to the perceived or expected satisfaction (Caruana *et al.*: 2000).

Heskett *et al.* (1997) identified beliefs of leading service organisations such as Wal-Mart, Southwest Airlines, Taco Bell and British Airways. These organisations have a common belief in the values relating to:

- Customers buy results (Ho & Cheng: 1999)
- Employees with the right attitude, the right incentives, the right training, and the right amount of latitude who will listen to customers are the key to designing and providing services that create such results (Lau: 2000)
- Because financial performance is the result of past performance, measurement and incentives must concentrate on determinants of future performance, customer and employee satisfaction and loyalty (Reichheld: 2001)
- The real payoff from listening to customers is not just results-driven service design and delivery that produces outstanding current performance, it is maintenance of a strong, adaptive organisation culture that insures continued excellence (Zairi: 2000).

These; and other leading service organisations believe in communicating the basics, and to this end, eight core strategies are identified, all of which facilitate service profit chain implementation (Heskett *et al.*: 1997). This is concluded with communication of the initiatives.

4.8.1 Spending time on the front line

Executives should periodically circulate and be involved at the point of purchase. Much too often management do not have a hands on approach, and therefore are not in touch with their customers (Rogers, Clow & Kash: 1994). Chairman William Pollard and his

colleagues at Service Master clean customers' hospital operating rooms at least one day a year. Pollard states that it reminds them of what their business is about.

4.8.2 Putting employees first

The links identified between loyal employees and loyal customers (Silvestro: 2002, Lau: 2000, Vilares & Coelho: 2001) necessitate careful attention and recognition of employees. Putting employees first necessitates management to spend unusually large amounts of time at the front line with employees, personally attending to customers, and making front-liners more successful at what they do (Rogers *et al*: 1994).

4.8.3 Leading personal development

Service Masters leaders invest personally in the development of a core of promising managers. This is in tandem with spending time on the front line and developing employees to the limits of their capabilities. Personal development is aligned to quality of work life, supporting the contention that quality of work life will positively nurture a more flexible, loyal and motivated workforce, which is essential in determining an organisation's competitiveness (Lau: 2000; Bassi & Vanburen: 1997).

4.8.4 Supporting greater job latitude

Employees are encouraged to portray greater latitude, together with employers facilitating training and developmental programmes to implement such latitude (Nel *et al*: 2004). Southwest Airlines have mastered the enhancement of greater job latitude, resulting in productivity levels twenty per cent higher than the average in the industry. They have achieved this by broadly defined jobs, whereby employees are trained in multi-functioning across the organisation (Heskett *et al*: 1997). Section 4.6.1 refers, relating to empowerment of employees (Lau: 2000; Nel *et al*: 2004). Boon and Kurtz (2000) identify the importance of empowerment of employees on quality of work life (Lau: 2000), whereby employees turn ideas into action.

4.8.5 Reducing labour costs by paying higher wages

This is usually achieved by eliminating unnecessary jobs, and providing technological support to enhance productivity. Heskett *et al* (1997) identify efforts which make employees more successful at what they do and increase their continuity on the job are regarded as the primary means to insure that customers will be served well. The employee satisfaction link to customer satisfaction is again highlighted (Silvestro: 2002).

4.8.6 Investing in customers

The value equation places emphasis on identifying and understanding customers' needs. Another objective is to retain customers, realizing the lifetime value (Reichheld: 2001). Customer needs are identified in terms of results sought by customers, process quality, product/service package price and access costs (Heinonen: 2004); along dimensions suggested by the value equation. Ensuring customer retention is implemented by Taco Bell, where they are called 'safety nets', periodic surveys of customer satisfaction are conducted and acted upon. At Service Master, there are annual customer reviews. At Wal-Mart, they include greeting senior citizens at the door, and low-price guarantees for the organisation's retail customers (Heskett *et al*: 1997).

4.8.7 Maintaining measures and rewards that influence behaviour

These measures are regarded as drivers of growth and profitability, directed at employees and customers (Lau: 2000; Yoon, Beatty & Suh: 2001). The financial results may take time to fruition; however, leading service organisations believe that profits will follow good performance on the non-financial measures (Heskett: 2002; Reichheld: 2001), and that the result is worth waiting for.

4.8.8 Communicating the message

Role models are important in any organisation (Stokes & Lomax: 2002), and related hereto, is the communication of superior customer service to employees and customers (Zeithaml & Bitner: 2003). Of importance is the effective communication of the service strategy of the organisation, and underlying reasons for the implementation thereof. The

communication process is that of a combination of external and internal, placing emphasis on the service profit chain links (Heskett *et al.*: 1997).

4.9 CONCLUSION

The service profit chain is a strategic service vision, whereby organisational profit and growth are linked to customer value, satisfaction and loyalty. Implementation is via the strategic initiatives of retention, related sales and referrals. Capitalising on the service profit chain entails analysing the links in the chain. The construct of long term profit and growth is linked to customer loyalty, satisfaction and service value. The construct of the employee is analysed in context of employee productivity, loyalty, satisfaction and quality of work-life; as a determinant of long term organisational profit.

Service profit chain management implications include measuring across operating units, developing a balanced scorecard, communication of results, performance management and encouraging internal best practice. The management of customer satisfaction incorporates customer feedback and suggestion systems, lost customer analysis, satisfaction surveys and mystery shoppers. Central to the service profit chain; the customer value equation is a factor of results produced for customers, process quality and price and acquisition costs. Requirements adding to value are introduced as understanding customer needs, influencing attitudes, and return on value enhancing initiatives, developing differentiation amongst market segments, and establishing value at a profit.

Customer loyalty is introduced as experiencing a positive relationship with profit, highlighting determinants, relationships, and methods of enhancing loyalty. The lifetime value of the customer is identified, together with links to satisfaction, value and loyalty. Strategic initiatives of retention, related-sales and referral strategies are evaluated. Management of lifetime value includes creating listening posts, communicating lifetime values, customer defection reasons, loyalty enhancement, relationship marketing and potential-based initiatives.

The chapter concludes with an entrepreneurial spirit of service profit chain enhancement; identifying strategies to facilitate service profit chain implementation.

In Chapter 5, service quality, relationship marketing and best practice is discussed. Service quality is studied from an integrated gaps model perspective; identifying dimensions of tangibility, reliability, assurance, empathy and responsiveness. Relationship management is studied from a six model framework, consisting of customer, internal, referral, influence, recruitment and supplier/alliance markets. Benchmarking for best practice is evaluated from a cross-industry perspective, culminating in a home entertainment industry best practice initiative from an international context. The objective of the chapter is to synergize and link service quality, relationship management and best practice with entrepreneurial orientation, the franchise system and the service profit chain.