BARRIERS TO FRANCHISE INITIATION FOR GENERAL CONTRACTORS IN US REMODELING INDUSTRY: A NON-FRANCHISOR PERSPECTIVE

Benjamin Murray[1] and Hedley Smyth

Construction and Project Management, Bartlett School of Graduate Studies, UCL, 1-19 Torrington Place, London, WC1E 7HB, UK

As the US homebuilding industry moves toward greater consolidation and concentration, residential remodelers remain highly fragmented and becoming increasingly more disaggregated into specialty trades and sectors. The result is remodelers have a diminished bargaining position against more consolidated segments and are susceptible to market risk since they traditionally service geographically specific markets. Theory would suggest that franchising may be a useful competitive business strategy to parallel consolidation in other segments. Research conducted in 2008 shows a small population of remodeling franchises listed in the US. The vast majority of these franchises were in specialty trades and only one general remodeling franchise was represented. This paper investigates the barriers to franchising in practice for general contractors in the US remodeling industry. The applicability of economic theories used to describe why firms franchise is evaluated against secondary quantitative data and extant literature. Interviews were conducted amongst non-franchising, general remodelers who conceptually are classified as 'potential franchisors'. Two principal findings emerge. Human capital requirements are found to be a primary perceptual barrier to franchise initiation. A second and somewhat unexpected finding is the perceptual barrier amongst key decision-makers in founder-controlled firms. The analysis reflects upon this finding by introducing upper-echelon theory and ultimately suggests that as the profile of company owner's change, the perceptual barrier to franchising may be of lesser significance.

Keywords: barriers of entry, franchising, general contractor, and remodeling.

INTRODUCTION

Management theories do not always translate into construction easily or at all. Franchising would appear to be a case in point. This paper explores the conceptual and practical opportunities and constraints for franchising in what would appear to be a fruitful market – general contractors in the residential remodeling sector.

Extant literature on franchising does not adequately address the difficulties with employing franchising across industries (Michael, 1996). While some progress has been made regarding the construction industry (Watson and Kirby, 2000), there is no research into franchising in remodeling and little research on franchise initiation in general (Combs *et al.*, 2004). Research that is available on franchise initiation is retrospective and therefore possibly biased. In addition, businesses that do not initiate franchises (non-franchisors) are excluded from research samples.

[1] h.smyth@ucl.ac.uk

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The following study addresses franchising as a business strategy for general remodelers by identifying the primary barriers to franchise initiation for firms (potential franchisors). It is expected that by locating the dominant constraints progress may be made toward explaining why only one full-service franchise is currently operating. This is significant given the current industry and market environment, which suggests franchising may be a useful strategy.

REMODELING INDUSTRY

Residential remodelers are primarily responsible for projects such as additions, alterations, reconstruction, maintenance and repair work on single-family and multifamily dwellings. More specifically, the term ‘general remodeling contractor’ refers to the industry of residential remodelers as defined by the 2002 North American Industry Classification System (NAICS), 236118. Recent economic reports in the US depict an industry dominated by small remodelers who account for a disproportionately small share of the industry’s overall receipts (Will and Baker, 2007). The impact of a polarised industry saturated by sole-proprietorships is difficult to gauge and is encouraged by low financial and regulatory barriers to market entry. The small scale of average remodeling projects and diversity of national building codes and regulatory requirements creates an environment suited to small firms.

The prevalence of small firms suggests a healthy competitive market, easily adapting to changes in demand. Large numbers of businesses enter the remodeling market during an upturn and exit during decline. This variability of industry capacity may not best serve consumers. Fluctuations may translate to losses in reliability and service quality. The loss of capacity is illustrated by the business dissolution rate, which is often considered a proxy of industry risk levels (Michael, 1996). In 2003, general remodelers had a dissolution rate of approximately 13 percent compared to 11 percent for the entire construction sector (U.S. Census Bureau, 2003). Arditi *et al.* (2000) explains that the high dissolution rates are primarily due to budgetary reasons, or administrative systems and procedures under the control of management. General remodelers entering the industry are often unprepared for the business and management requirements of operating a company. Construction firms are established predominantly by experienced craftsmen with limited formal education, the requisite knowledge capital and experience for operating a construction firm being largely unavailable outside the industry (Bates, 1995).

The unique characteristics of remodeling work help explain the high business failure rate. Since remodeling work concerns existing structures, labour activity is restricted to the spatial dimensions of buildings, which complicates the estimating of labour requirements (Egbu, 1999). Also, the unknown existing condition of buildings creates high levels of uncertainty, and project estimates are typically based on ‘best guesses’ of conditions (Egbu, 1999). The nature of remodeling customers is also unique. Customers are traditionally private home-owners undertaking one-off projects and lack familiarity with construction processes. They typically inhabit dwellings during remodeling. Production, therefore, takes place at the point of consumption and levels of client interaction and management are elevated to levels associated with more service-based industries (Holm, 2000). Overall, contractors generally consider remodeling jobs more difficult to manage than new construction and cite that forecasting and planning, analysis of risk and uncertainty, and competitive tendering are the items most difficult to control (Egbu, 1999).

Remodeling firms, therefore, are currently focusing more on specialisation to control the high levels of uncertainty and complexity that characterise the sector. According to the 2002 Economic Census, the industry is increasingly disaggregating into specialty trades and niche markets. Contractors traditionally served multiple sectors yet are now focusing more on the home improvement market and specialising in specific remodel project types, sizes and clients, possibly subjecting remodelers to higher levels of market volatility. Indeed, specialist firms exhibit higher levels of variability in revenue growth compared to full-service firms (Will and Baker, 2007).

However, as remodelers specialise, the remainder of the home building industry is progressing toward greater consolidation and concentration. For example, the top fifty wood manufacturers which are traditionally one of the most fragmented segments in the building industry account for over 35 percent of the industry's total receipts while the top fifty remodelers account for less than 5 percent. Consolidated industries often experience greater efficiencies by reducing the share of resources required for overhead functions such as human resources and budget controls. In addition, by increasing market share, companies benefit from improved bargaining positions with suppliers and are better able to protect against challenges from competitors. These benefits are presumably passed on to consumers through cost savings and confidence in expected service and product quality.

In addition to increased business risk, remodelers may face a challenge of operating small business-oriented enterprises in a market favouring larger entrants. Recent movements by manufacturers and retailers differentiating into remodeling services suggest that at least a segment of the remodeling market may require greater consolidation. At present, remodeling activity is being nationalised via licensing schemes and installation programs which could potentially reduce the market power of general remodelers.

However, within the industry, a small population of contractors is achieving consolidation through business format franchising, where franchising is an agreement between two independent businesses. One firm (franchisor) provides the rights to a product or service trademark, an entire business format, and continuing two-way communication to another firm (franchisee). In return, a franchisee pays an initial franchise fee plus annual royalty payments to the franchisor. Unlike licensing programs, franchising is subject to securities law and as such is more difficult to initiate. It requires greater investment by a franchisor. However, franchisors have comparatively more control over franchisees.

Conceptually, both the market and industry are suited to franchising. Franchising offers businesses (franchisors) rapid growth, increased consolidation, and the spread of business risk across geographical markets. In addition, franchising may add stability to the industry by reducing the high failure rates of small firms and increase standards of service by helping maintain market capacity. As franchisees, small remodelers are provided support, established management systems, and immediate access to customers through an externally managed brand. Consumers are expected to benefit from the cost savings of a consolidated industry and increased confidence in service and product quality from brand reputation.

Existing franchises in remodeling are broadly grouped into four business areas, namely full-service, handyman, insurance restoration and single-line specialty (Will and Baker, 2007). *Entrepreneur* publishes an annual list of the top 500 franchises in the US, providing an adequate representation of major national franchises currently operating. Available remodeling franchises culled from the lists published during the period 2004 to 2008 suggest that the vast majority of firms are franchised in single-line specialties (28 franchises) such as plumbing and kitchen remodels. This is followed by handyman (7 franchises) and insurance restoration (7 franchises). Only one firm currently franchises as a full-service operation.

Overall, the description and analysis of the remodeling industry and market raise the question as to the extent the theories of franchising align with the current shape of the market. The following regards extant literature on franchising in order to appraise the potential barriers to franchising for general remodelers in the remodeling industry.

THEORETICAL FRAMEWORK

Two tools are generally used to explain why firms choose to franchise, namely resource scarcity (Oxenfeldt and Kelly, 1969) and agency theories (Caves and Murphy, 1976). The following discussion uses these two theories to regard the theoretical barriers to franchising for general remodelers.

Resource scarcity theory suggests that companies choose franchising as a method of company growth when financial capital, managerial skill, or local market knowledge is required (Oxenfeldt and Kelly, 1969). In other words, firms sell franchises as a method of growth in order to raise capital. However, this alone does not explain why franchising is employed to varying degrees across industries, and why some industries with different levels of associated business risk and varying costs of capital choose to raise capital through franchising instead of financial markets (Michael, 1996). Presumably, businesses requiring higher start-up costs would necessitate additional capital which may adversely affect franchisee recruitment by creating higher initial franchisee fees. However, Price (1997) used average franchisee rates to illustrate the different levels of capitalisation between retail and construction industries and found that franchising is perhaps favoured in industries with higher levels of capitalisation.

Regarding the construction industry, data is generally unavailable to determine the varying degrees of capitalisation for its subsectors, specifically remodeling. Indeed, in terms of capital requirements, the multiple subsectors of the construction industry often share more differences than similarities (Ive and Gruneberg, 2000). The characteristics of remodeling work limit the use of equipment and plant which could otherwise increase productivity. Production is therefore expected to rely heavily on human capital and thus require lower levels of capitalisation relative to other subsectors. From a purely financial capital perspective, raising capital through franchising would not be necessary as capital requirements are already low. Yet, the sheer diversity of building codes and regulatory requirements across states and localities increases the barriers for business expansion across geographic markets. Arguably, the requirement of specific local market capital creates a barrier to business expansion through company-owned outlets for general remodelers. According to resource scarcity, a remodeling firm could use franchising as a rapid means to expand into other geographic markets and acquire necessary local knowledge capital.

Agency theory posits that firms choose franchising when the transaction costs of monitoring a company-owned outlet exceed that of a franchised firm (Caves and Murphy, 1976). Since franchisees invest capital in a franchise and are residual claimants, their success is directly linked to that of the franchise. The motivations of franchisees are therefore better aligned with franchisors than a salaried manager of a company-owned subsidiary.

Issues of moral hazard in sectors where workers have higher value added may render monitoring more difficult, increasing related transaction costs (Michael, 1996). For example, in remodeling work, production occurs 'off-site' from the main office. In addition, using median industry wage rates as a proxy for worker value added, the average output of a worker in construction ($17.76 per hour) is more valuable than those in heavily franchised industries such as accommodation and food services ($8.28 per hour) (US Bureau of Labor Statistics, 2007). While wage rates specific to general remodelers are not available, remodeling work is comparatively more reliant on human capital than other subsectors. Therefore, the cost of monitoring in remodeling is expected to be high and favourable for franchising. Indeed, from an agency perspective, one would expect franchising to be favoured over full vertical integration in construction (Watson and Kirby, 2000; Smyth, forthcoming). However, the high value added of workers in remodeling relative to heavily franchised industries suggests that work practices are unroutinised and operatives require greater levels of training. Indeed, Michael (1996) argues that a franchise does not fully utilise the potential of human capital because of the standardisation inherent in systems. Therefore, the more an industry relies on human capital for production, the less likely franchising will be employed.

In construction, Watson and Kirby (2000) argue the primary operational difficulty with existing construction franchises is finding 'quality' franchisees. They suggest an inverse relationship between human capital requirements and industry propensity to employ franchising. However, problems with franchisee recruitment are experienced across industries (Knight, 1986). Watson and Kirby (2002) found few operational difficulties with franchising in construction. Difficulties in remodeling relate to management systems, such as planning and forecasting. Research suggests that while remodeling work is non-repetitive and reliant on human capital, greater emphasis is needed on standardisation for non-production routines (Egbu, 1999).

The industry risk may influence a potential business owner's decision to become a franchisee. Agency theory suggests that franchisees are residual claimants as their profitability is tied to the franchise. While franchisors spread business risk across multiple markets, franchisees are subject to local market conditions, thus higher volatility. Franchisees may require a certain return on their investment and if the risk associated with an industry is high, potential franchisees are unlikely to risk capital (Michael, 1996). The lower the associated industry risk, the more likely franchising will be employed. Using business dissolution rates as a proxy for industry risk, the relatively high risk level (13 percent) suggests franchising would be an unfavourable remodeling strategy. Yet, potential franchisees are entrepreneurs and would not likely give up autonomy to a franchisor if an industry is low risk (Dant and Grundlach, 1999). When the risk of entering an industry is low, a potential franchisee may venture into the market on their own instead of giving up profits to a franchise. There is a direct relationship between the risk level of an industry and the propensity for a potential business owner to desire the systems and support of a franchise. It is expected franchising would be favoured in industries such as remodeling where industry risk is relatively high (Watson and Kirby, 2000).

While both resource scarcity and agency theories may explain why franchising is used more in certain industries, the theories are generally production-oriented and therefore inward focused. An outward or customer-oriented view centres on the needs of consumers by providing 'added value'. 'Added value' is considered as any increase in service or product quality that would not otherwise be obtained (Smyth, 2000). This suggests firms serving their customers best will receive referrals and repeat business. Firms may seek a customer-oriented approach in industries or markets where customers have considerable market power and desire 'added value'. Those businesses best serving their customers, experimenters in franchising being one option, will get referrals and repeat business. However, poor customer knowledge would be a constraint to this market as well as the current low levels of experimentation with franchising. For franchising to operate as a customer-oriented approach, the primary difficulty would be properly locating consumers with adequate market power and identifying their needs.

Remodeling clients may require better assurances of service and product quality. Indeed, construction is traditionally inward focused (Smyth, 2000). Construction clients have considerable market power even in strong markets primarily due to the fragmented supply side of the market, which normally competes on price (Smyth, 2000). For franchising to be viable, the costs associated with building and maintaining a brand would need to be cheaper, in relation to return, for the franchisor than directly delivering service satisfaction. Essentially, this is a resource scarcity perspective which regards franchising as a cost effective method of growth. For a franchise to work however, the service delivery would need to be difficult for a single operator to complete. For example, creating and maintaining a brand would be difficult for a single operator. Yet, as a franchisee, a single operator would benefit from not having to develop a brand - the franchisor's primary asset. To limit franchisee shirking and thus moral hazard, the systems for service delivery and quality assurance would need to be simple yet labour intensive. Financial penalties for noncompliance would be needed to discourage 'free riding' behaviour by franchisees which would negatively impact system quality. In sum, a customer-oriented approach to franchising appears an employable strategy.

Overall, the theories of franchising and data from the remodeling industry do not suggest definitive barriers to franchising for general remodelers – at least not to the degree which explains the existence of only one general remodeling franchise. Indeed, there are few operational difficulties with franchising in construction (Watson and Kirby, 2000).

METHOD

To explore these issues in the field, a qualitative approach was used given the exploratory nature of the study and the general lack of quantifiable data. To better understand and identify the potential barriers to franchising, the research looked at the problem from the perspective of general remodelers seemingly well positioned to franchise ('potential franchisors'). It is believed that there is a direct relationship between a firm's level of experience, business system and brand development and its propensity to franchise. The proposed 'top down' approach was expected to provide a richer source of data than assessing potential barriers to franchising at the project level or from the perspective of potential franchisees. In addition, firm owners are assumed to provide the most useful insight into perceived barriers to franchising by virtue of being key decision-makers.

Non-random purposive sampling was used to select a sample of 'potential franchisor' firms. Firms were selected from *Qualified Remodeler's* annual list of top 500 US residential remodelers spanning the years 2003 to 2007. Franchising is considered feasible for firms having high gross margins and easily implementable business concepts (Weinrauch, 1986). While disclosure of gross margins is not compulsory for privately-owned firms, the *Qualified Remodeler* lists the self-reported annual turnover of firms which is used as a proxy. In addition, potential franchisors should possess two strategic assets, namely operating routines and brand reputation (Caves and Murphy, 1976). Firms listed as one of the top firms nationally are likely to have well developed and systematised business practices compared to others. Firms applying for repeated inclusion in the annual list are interested in establishing national brand awareness. Will and Baker (2007) used a technique of only sampling firms from *Qualified Remodeler* that routinely reported information since these firms were expected to provide more accurate data than those responding occasionally. This study adopted the same qualification. Firms were selected reporting data four out of five years, 2003 to 2007.

For comparative purposes, the sample was limited to firms operating in the same geographic location: the San Francisco Bay Area of California is one of the top five metropolitan areas in the US for remodeling projects (Will and Baker, 2007). In addition, California has relatively high barriers to entry for general remodelers with regard to licensing requirements, building codes and construction methods when compared to other states. As such, top firms in the San Francisco Bay Area have greater experience and probably more developed operating routines compared to similar firms in other US markets. The final sample consisted of ten general remodelers; eight of which participated in this study in June of 2008.

Face-to-face, semi-structured interviews were used to obtain data from ‘potential franchisors’. The study sought the perspective of company owners regarding barriers to franchising. Semi-structured interviews permit reasonable freedom to explore emergent themes and the ability to ascertain unanticipated responses.

Leather and Rolfe (1997) employed a similar sampling technique for assessing small scale repair and maintenance firms in the UK within specific geographic confines. They also employed a method of consulting national trade organisations to verify that data represented broader conditions. This study adopted the same approach and consulted two national trade organisations on data collected.

FINDINGS

The remodeling firms interviewed ranged in age from 14 to 30 years with 23 years being the average time since founding. Seven company owners have artisan backgrounds with one owner having a background outside the industry. The vintage of these firms suggests some time is required to develop the skills and knowledge to be a large general remodeler. Seven respondents were male, artisan-founders, which confirms the majority of construction firms are founded by craftsmen (Bates, 1995).

Seven respondents emphasised the non-repetitive nature of remodeling work. Although respondents felt human capital is important, they thought its value is often overemphasised. One respondent stated that the focus on human capital is hindering the industry: “The value of the human element in the industry is often overrated. A remodeling company sells a service or an experience and there needs to be more focus on the experience than on the people.”

Six respondents felt the process of locating qualified franchisees with the appropriate combination of technical knowledge and social savvy necessary for service delivery and client management would be difficult. This perceived difficulty may suggest that individuals with the requisite skills do not turn to a franchise for support.

All respondents thought the primary impediment would be the mentality of most small remodelers, a culture of self-employment, characterised as a male dominated, 'Wild West' mentality that encourages 'maverick' behaviour. Phrases such as "cowboy builder" and "lone wolf" were repeatedly used with one respondent stating: "The 'maverick' image and philosophies that encumber most contractor, developer personalities would prevent them from taking the advice of others. As most are self-made men with no other skills, their possibilities and paths are narrowed and they take themselves and their worth to a business structure too seriously."

Respondents said small remodelers would not be interested in giving up their freedom and autonomy to a franchise, especially when the barriers to market entry are already low. Additionally, franchisors would require franchisees capable of operating a firm as a business and not from an artisan mindset. Since most small remodelers are from craft backgrounds, respondents thought this would cause problems as most remodelers have poor management habits and normally do not seek business training.

Six respondents thought 'potential franchisees' are unwilling or incapable of adapting themselves and their businesses to accommodate a franchise. While the majority opined that the human capital requirements are overemphasised, they did feel that the requirements of a remodeling business owner are unique which would make recruiting franchisees difficult.

Overall, the interviews suggest that the human capital requirements of remodeling are a potential barrier to franchise development and the requisite skills are not necessarily found outside the industry. This outcome generally supports the findings of Watson and Kirby (2000) suggesting that the human capital requirement is both a barrier to franchise initiation and operation.

The most surprising discovery of the study was the impact of a founder's perception on a firm's propensity to franchise. While all respondents regarded franchising as a viable growth strategy for general remodelers, they felt it would not be a useful strategy for their firms. The business risk was perceived as too high, respondents being content to pursue traditional and potentially more risky growth strategies of differentiation and specialisation. Such comments were made with familiarity of franchising as a concept and business strategy. They appreciated the value of company brands and business models as transferable assets, yet did not mitigate the perceived high business risk of franchises. The respondents were unable to say why this was high risk and riskier than traditional approaches.

Penrose (1959) asserted that the capacity of management is often a key constraint to a firm's expansion. The self-image of a founder is central to a firm's development and ultimately determines its growth. Upper-echelon theory suggests that a manager's decisions are influenced by their personal characteristics, education and prior experiences (Hambrick and Mason, 1984). Livesay (1989) suggests that the characteristics and preferences of a founder acutely impact firms. While upper-echelon theory has not been applied to franchising, Combs *et al.* (2004) suggest that it may be useful for understanding why firms do or do not choose to initiate a franchise. Specifically, the theory may explain why, in the absence of dramatic changes to business systems and markets, businesses operate for years as non-franchisors before deciding to franchise. Hambrick and Mason (1984) suggest that managers with less tenure at a firm are often not as psychologically tied to the existing strategies and are therefore more prone to take risks such as employing non-traditional strategies. Older managers, on the other hand, may seek fewer risks and place greater value on financial stability and career certainty – they are psychologically committed to existing strategies (Combs *et al.*, 2004).

Upper-echelon theory appears a useful tool for explaining the barrier to franchise initiation for founder-controlled firms of the particular vintage in the study sample. Company founders may be risk averse or psychologically beholden to existing business strategies or industry norms. Founder-controlled firms are seemingly well positioned to employ non-traditional strategies, yet are constrained by their perceptions, established norms and values within their industry. Conformity to institutional norms grants a firm legitimacy, and conformance to social expectations occurs even when it is inefficient (Roberts and Greenwood, 1997). Upper-echelon theory explains how the perceptions of founders can influence and potentially hinder growth in founder-controlled firms.

Yet, the practices of highly visible and successful competitors are often observed and copied. As new practices are adopted they gradually become legitimised within an industry. In the context of franchising in remodeling, this may be initiated by new industry competitors (e.g. retailers and manufacturers) who are attempting to nationalise remodeling activity or by a general remodeler with a successful model in practice. As older founders leave the industry, younger more business oriented managers, may adopt non-traditional industry strategies such as franchising.

CONCLUSIONS

The most significant outcome was the perceptual barriers to franchise initiation by key decision-makers, specifically company founders. While respondents felt franchising was feasible, they were uninterested in exploring it as a business strategy. This is significant in the current market and, using upper-echelon theory, of general significance for franchise theory. Younger firms and managers, coupled with non-industry entrants may change perceptions in and structure of this sector.

Resource scarcity and agency theory were found to be of some explanatory value, human capital for example being a barrier, but the evidence suggests too much emphasis can be placed upon such factors. Future studies of non-franchisors in remodeling should focus upon younger founder-controlled businesses. Such research may identify scarcity and agency factors and other barriers to franchise initiation. This will help develop a discourse on the culture of small remodelers and address difficulties of franchisee recruitment in the construction industry overall.

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