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Conflicts in the Franchise Industry: How to Forge a Win-Win Partnership

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"Korea's franchise market is wavering. Amid the heavy concentration of food service businesses and the high number of inexperienced franchisors, franchisees have had little opportunity to grow. Moreover, the terms and conditions of franchise agreements have become a source of contention due to their contradicting impact on the performances of franchisors and franchisees. Accordingly, government efforts are needed to overhaul information disclosure documents so that they accurately reflect the information and data on, for example, the franchisor's experience and background, and the franchise store's average sales figures, etc. At the same time, the fixed-percentage royalty should be promoted through discussions with respective industries and guidelines established for essential items. Actions must include exploring temporary measures to strengthen the qualifications for franchise businesses, particularly in sectors that show a high concentration of certain businesses."

I. Issues

Korea's franchise market is undergoing quantitative growth, with the number of franchisors and brands increasing by an annual average of 9% and that of franchise stores by 5% in 2014-2016 (Figure 1).[1)] In 2016, franchisors and franchisees together raked in 114 trillion won in sales, up 22 trillion won from 2014. And, given the expansion strategies, uncomplicated store setup processes, and consumers' preference for brand stores, this growth trend is expected to continue.

Korea's franchise market is growing rapidly, not only in size but also in terms of the number of franchisors, brands and franchisees.

* Lee, Jinkook, *Study on Franchise Contract and Franchise Market System*, Policy Study 2018-04, Korea Development Institute, 2018 (in Korean).

1) A higher number of franchisors than brands by approx. 1,000 means that franchisors tend to develop and operate several brands of similar business items. Having multiple brands can be seen as a management strategy to sensitively respond to changing market demands and to disperse the risk of failure.

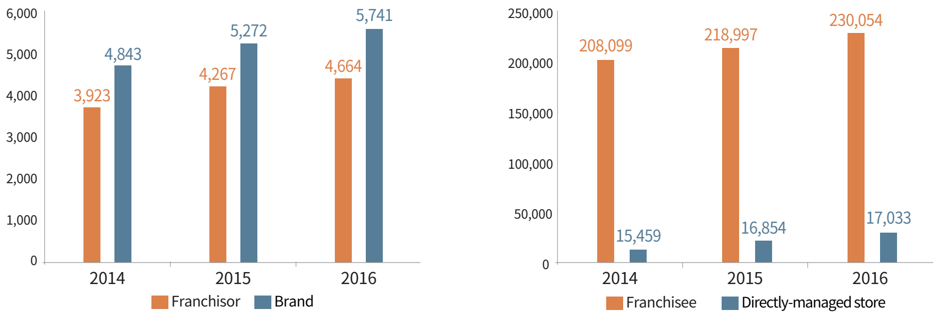
The growth has come with increasing conflict over issues such as information asymmetry and imbalances in bargaining power.

At the same time, however, there have also been serious growing pains. The number of appeals submitted to the Dispute Resolution Committee shot up from 357 in 2008 to 779 in 2017. About 30% pertain to conflicts arising from information asymmetry including a failure to submit disclosure documents[2] and providing false or exaggerated information. Additionally, there has also been a steady rise in dispute cases related to the imbalance of bargaining power, for example, unfair liability for damages, unjustified termination of contracts, and territorial encroachment (Korea Fair Trade Mediation Agency, 2013; 2018).

This study micro-analyzes how the franchise market has grown and what the causes of conflict are.

With internal conflict exacerbating disproportionately to the external growth, this study presents win-win measures for the industry, using microdata on disclosure documents and by analyzing the growth patterns and sources of conflict.

[Figure 1] Number of Franchisors and Brands (left), Number of Franchise Stores and Directly-managed Stores (right)



Source: Calculated by author using microdata on disclosure documents (2014-2016).

II. Three Facets of the Franchise Market

1. Disappearance of Brands, and the Birth of Even More

The franchise market is seeing an increase in brands as entries outpace exits.

<Table 1> shows the rise and fall of franchise brands and their very short life-spans. In 2015 alone, 2,224 new brands (①+②) were launched and a staggering 47% (1,046) failed to last for more than a year—mainly due to a failure to recruit new franchisees and to maintain sufficient sales.

Of the 5,741 brands operating (②~⑤) in 2016, only half were older than three years while the remaining were fairly new (maximum of two years). That is, the market supply of brands was growing in net terms as new entrants outpaced the exiters.

2. Concentration in Food Service

Compared to other countries, the share of Korea's self-employed sector is significant, and it is especially dense in the area of accommodation and food services. The same inclination can be

2) Franchise disclosure documents are designed to provide general information on the franchisor's business performance, potential risks and business operating conditions. Prior to entering a franchise agreement, franchisors must submit and register the documents at the Korea Fair Trade Mediation Agency.

observed in the franchise market, which continues to expand its presence in the self-employed sector (Lee, 2017).

Just as in the self-employed sector, food service accounts for a huge percentage of the franchise market.

<Table 1> Rise and Fall of Franchise Brands

No. of brands		2014	2015	2016	Life-span
①	1,046		↔		1 year
②	1,178		↔	↔	2 years
③	1,497			↔	1 year
④	17	↔		↔	-
⑤	3,049	→	→	→	3+ years
⑥	1,778	↔			-

Source: Ibid.

When brand distribution is examined, food service accounts for 75.6% as of 2016, followed by services and wholesale and retail trade at 18.7% and 5.6%, respectively.[3)] Of the increment in brands between 2015 and 2016, 70% was concentrated in food service, maintaining the bias towards such businesses. In terms of the distribution of franchise stores (Figure 2), a staggering 113,000 (48.9%) from a total of 230,000 are engaged in food service while 68,000 (29.6%) are in services and 49,000 (21.5%) are in wholesale and retail trade (left panel, Figure 2).

On the other hand, the opposite is true for the number of franchise stores per brand, with wholesale and retail trade (229) eclipsing services and food service by a significant margin. This can be explained by the fact that in the wholesale and retail trade industry, a few large/corporate franchises have the majority of stores while in the food service industry, there are a large number of small franchises.[4)]

More than half of food service franchise stores sell fried chicken, traditional Korean food (*hansik*) and coffee.

Upon a closer examination of the specific businesses in the food service industry, fried chicken (22%), traditional Korean food (*hansik,* 18%) and coffee (11%) franchise stores take up over 50% of the food franchise market, most likely owing to the steady consumer demand and relatively low setup costs. However, the degree of concentration is so intense that it has become a running joke that "all roads lead to the fried chicken business." And, due to the fierce competition between the top five types of franchises in food service i.e. fried chicken, *hansik*, coffee, drinking establishments and Korean snack food (*bunsik*), their average sales (250 million won) account for only 60% of that of other food service businesses.

3. Franchisors' Limited Experience in Operating Directly-managed Stores

About 60% of franchisors have no experience in operating directly-managed stores and rely solely on their franchisees.

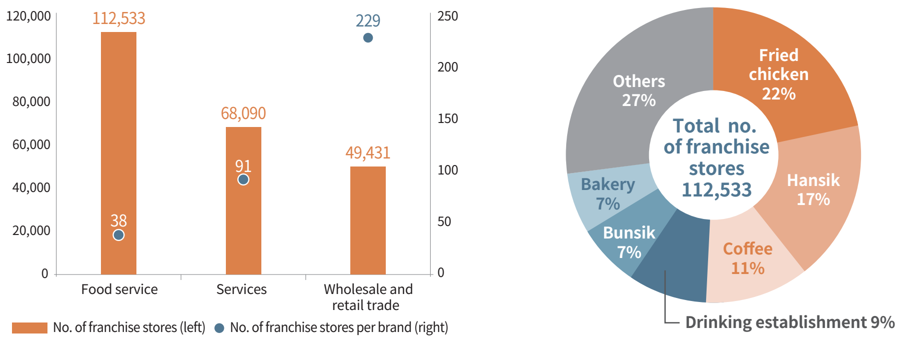
What also makes the franchise market so noteworthy is the fact that the majority of franchisors have little or no experience in directly managing stores, implying that they lack first-hand knowledge of consumers and the market. <Table 2> shows that almost 60% of brands do not have directly-managed stores, and rely solely on franchise stores—60.8% in food service,

3) Based on the high classification level specified in the franchise disclosure documents.

4) In the wholesale and retail trade industry, the convenience store business has the largest number of franchisees per brand—particularly the top three brands e.g. CU (10,746), GS25 (10,604), and 7-Eleven (8,206)—which is contrary to the food service business with *hansik* having 24 brands, fried chicken 80 brands and coffee 50 brands.

58.3% in services and 45.7% in wholesale and retail trade.[5)]

[Figure 2] Number of Franchise Stores, Number of Franchise Stores per Brand (left), Number of Food Service Franchise Stores by Item (right)



Source: Calculated by author using microdata on disclosure documents (2016).

The percentage of brands with directly-managed stores is high in low-sales sectors such as fried chicken, drinking establishments and *hansik*.

The more franchisors are in contact with the market through direct management of stores, the more likely it is for franchisees to improve their sales.

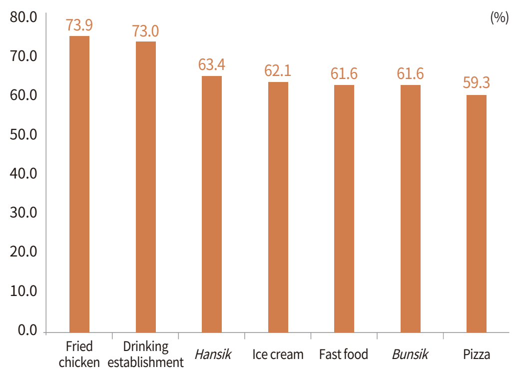
Such a practice presents concerns because by not having directly-managed stores, franchisors do not have the opportunity to gain insight into the competitiveness of their products and to learn from trial and error. This may, in turn, increase the business risks that are transferred to the franchisees,[6)] negatively impacting their sales. Indeed, the analysis results support these concerns, showing that brands without directly-managed stores are particularly prevalent among businesses with low sales records such as fried chicken and *hansik* restaurants and drinking establishments, etc. (Figure 3). A correlation analysis also reveals that sales are negatively correlated (-0.104) with the number of franchise stores, while they are positively correlated (+0.345) with the number of directly-managed stores. In other words, the more franchisors expose themselves to the market by operating directly-managed stores, the higher the probability will be of increasing franchisees' revenues.

<Table 2> Percentage of Brands without Directly-managed Stores

	Brands without directly-managed stores (%)
Total	59.5
Food service	60.8
Services	58.3
Wholesale and retail trade	45.7

Source: *Ibid.*

[Figure 3] Percentage of Brands without Directly-managed Stores (food service)



5) Franchisors who do not operate directly-managed stores include both those who have no experience and those who previously had directly-managed stores but not any longer. The analysis of franchise disclosure documents reveals that the former accounts for 82%.

6) In Korea, franchisors with no directly-managed stores or experience in its operation are eligible to recruit franchisees.

III. Analysis of Franchise Agreements

Under such circumstances, what are the terms of agreement between franchisors and franchisees? To answer this question, this study focuses on three factors that pertain to the conflicts between the two parties and that have significance for policy.

1. Setup costs (prior to opening)

In order to own a franchise store, prospective franchisees pay an average of 120 million won to franchisors—the payment includes the franchise fee (10.12 million won, 8.6%), training fee and deposit (7.63 million won, 6.5%), interior fit-out (53.39 million won, 45.4%) and other expenses (46.52 million won, 39.5%). By sector, food service demands the lowest at 100 million won, followed by wholesale and retail trade at 120 million won and services at 180 million won (right panel, Figure 4).[7)]

The setup cost that franchisees pay to franchisors is approximately 120 million won on average.

[Figure 4] Franchise Setup Cost Structure (left), Setup Cost Structure by Sector (right)

Source: Ibid.

Franchise fee is the price of a brand's accumulated reputational capital, and according to a micro-quantitative analysis, the amount is contingent on the number of directly-managed stores a brand has and the number of years it has been in the franchising business (both related to prestige). A one unit increase in the number of directly-managed stores and years of business raises the fee by 14,000 won and 33,000 won, respectively. Simply put, franchisors are reaping the rewards for transferring their accrued know-how and standing. From the franchisees' perspective, they are willing to pay more for a reputable brand. Accordingly, rather than criticizing the absolute amount of the franchise fee, it would be more logical to examine whether the high price is justified by the franchisor's level of experience and expertise.

Fanchise fee is the price of a brand's reputational capital and tends to rise as the brand adds more directly-managed stores or stays longer in business.

The interior fit-out of a franchise store takes up the biggest share of the initial costs. In regards to this, there has recently been backlash over the fact that some franchisees have been forced into contracts with interior design firms that have been designated by the franchisors or their affiliates to rake in additional revenue. Of course, franchisors should be able to provide interior blueprints and/or guidelines in order to maintain consistency. But, binding a franchisee

Costs for interior fit-outs account for the largest percentage in the setup cost.

7) Rental deposits and premium required for the store lease are excluded.

to a specific firm may be a violation of Article 12 (Prohibition on Unfair Trade Practices) of the Fair Transactions in Franchise Business Act.

When a franchisee independently hires an interior contractor, the franchisor charges a high supervision fee which cuts into the franchisee's cost savings.

Recognizing this, most franchisors accept the franchisee's choice of contractor. This, however, entails an exorbitant supervising fee. For example, Brand A (food service brand) charges 200,000 won in supervising fees for every 3.3㎡. For a standard store of 198㎡, this would total 6 million won—which can significantly lower the franchisee's incentive to choose their own contractor.

Accordingly, if the interior cost becomes a common source of revenue for franchisors, this will further incentivize them to open more stores, ultimately damaging the win-win relationship between franchisor and franchisee.

2. Royalty

Royalty is a monthly payment made by the franchisee to the franchisor after opening, and it is another form of remuneration for the franchisor's reputational capital and business know-how. According to the top panel of <Table 3>, the average adoption rate of royalties in the franchise industry is 68.3%, which is relatively high considering the ongoing argument within the industry that the concept of royalties has not fully taken root.

25.4% of brands adopted a fixed-percentage royalty while 41.8% use a fixed-sum royalty.

A closer look reveals that only 25.4% of brands adopted a fixed-percentage royalty. This approach best represents the nature of royalties and encourages mutual cooperation between both parties as the franchisor's profit—or rather, the amount of profit—is dependent on the performance of the franchisee. A fixed-sum royalty is more commonly used, with 41.8% of brands adopting this approach. Within such a contract, the royalty rate is fixed regardless of the franchisee's sales, and hence, franchisors are less inclined to support their "progenies" in improving their performance.

In the fixed-sum royalty contract, franchisors have less incentive to work to improve the sales of franchisees.

In terms of the royalty rate (both types), <Table 3> shows that the rate is low for food service businesses such as those for fried chicken, *hansik* and *bunsik.* This is because most of these stores are located in close proximity to each other and their sales and survival rates are low. As a result, franchisors tend to rely more on the initial payments from the store setup, or they retrieve a part or even the whole sum of the royalty by adding the amount to their raw materials and equipment prices.

In some cases, franchisees are given royalty discounts (70-100%) in return for purchasing raw materials and equipment from a supplier designated by the franchisor.

The purchase of raw materials and equipment is particularly notable because brands sometimes offer royalty discounts if franchisees buy their supplies directly from them or from a designated supplier. Cases such as this are most commonly found in the food service industry (26 drinking establishments, 18 *hansik* restaurants, 15 other types and 5 fried chicken restaurants, Figure 5), and the discount rate varies from 70% to 100%. An additional quantitative analysis found that the bigger the discount is in the purchase contract, the larger the royalty rate is initially. Indeed, royalty discounts can be used as a strategy to draw franchisees into a purchase contract, thus prospective franchisees must carefully examine their contracts to see whether there is an actual discount before signing.

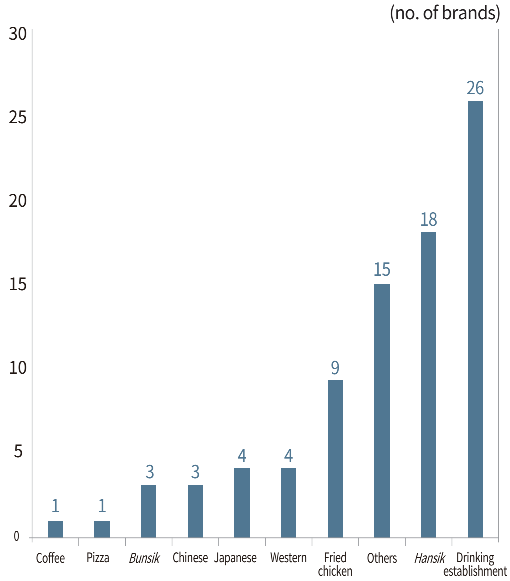
<Table 3> Type of Royalty/Adoption Rate (top), Royalty Rate (bottom)

(%)

		Total	Fixed %	Fixed sum	Other
Adoption Rate of Royalties (%)	Total	68.3	25.4	41.8	2.8
	Food service	67.5	27.5	40.6	0.8
	Services	76.0	20.3	48.6	10.6
	Wholesale and retail trade	52.0	14.6	36.2	3.5

		Fixed percentage (%)	Fixed sum (1,000 won)
Royalty Rate	Food service	2.5	285
	Bunsik	2.1	220
	Hansik	2.1	258
	Fried chicken	2.4	233
	Services	6.1	739
	Wholesales and retail trade	5.4	449

[Figure 5] Number of Brands (food service) Providing Royalty Discounts for Purchases of Raw Materials and Equipment



Note: Certain brands accept multiple royalty types and hence, the sum of the types does not equal the total.
Source: Microdata on disclosure documents (2016).

3. Closed Territory

Closed territory refers to the geographic and administrative boundaries within which franchisees can operate as the sole representative of a brand. Accordingly, franchisors must designate a territory for each franchisee and avoid opening another store (directly-managed or another franchise store) within it (Article 5 of Fair Transactions in Franchise Business Act). Despite concerns that the practice hinders competition, it is the obligation of franchisors and a right of franchisees according to the legislation promoting the management stability of franchise stores.

Closed territory is an exclusive geographic and administrative area where a franchisee may conduct its business. 80% of closed territories are established based on distance.

<Table 4> Distribution of Closed Territories by Type

	Distance (radius/walking)		Population/ households	Administrative area (*eup/myeon/dong*)	Other
		Territorial range			
Total	79.7	0.73km	8.6	16.0	3.5
Food service	87.0	0.69km	7.1	11.2	2.3
Services	52.2	1.04km	15.0	33.8	7.8
Wholesale and retail trade	72.0	0.75km	7.5	20.9	4.7

Note: A few brands use multiple territorial types.
Source: Calculated by author using microdata on franchise disclosure documents (2016).

<Table 4> shows that the type and range of closed territories vary by brand and that approximately 80% establish territories based on distance (radius or walking). Food service businesses account for the highest percentage at 87% in distance-based territories which are based on the shortest range (0.69km).

IV. Effects of Contract Conditions on Franchisees' Management Performance

High franchise fees tend to entail significantly high sales gains.

The sections below review what impact contract conditions have on the management performance of both franchisor and franchisee and analyze the correlation between contract conditions and industry disputes. The following outlines the results of a quantitative analysis which combines data on the information and management details of franchisors and franchisees from microdata on franchise disclosure documents.[8)]

The number or percentage of direct stores can be a useful metric to measure the stability of sales.

Firstly, the first row in <Table 5> shows that the higher the franchise fee, the more significant the increase is in the franchisee's sales. This can be interpreted to mean that because franchise fees are proportional to the number of directly-managed stores and years of business and reflect the size of a brand's reputational capital, the transferred reputation and know-how help franchisees to attract customers. This finding is consistent with the aforementioned phenomenon that franchise stores in sectors wherein brands have little experience in operating directly-managed stores have low sales. This also implies that prospective franchisees can use the number or percentage of directly-managed stores as a metric when choosing a brand that has relatively stable sales.

The sales increase from the fixed-percentage royalty implies that franchisors are more motivated to improve franchisees' sales if their profits are aligned.

Royalty fees show varying effects depending on the type. It was found that fixed-sum royalties, the most common type, had no significant impact on franchisees' sales while a 1%p increase in fixed-percentage royalties raised sales by 4.40 million won. This supports the hypothesis that when royalty earnings are closely linked to the sales of franchise stores, franchisors may be more inclined to help bolster their franchisees' performance. Thus, the use of fixed-percentage royalties must be expanded to achieve win-win partnerships and enhance franchisees' business stability and growth.

Analysis of the royalty discount (based on a proportion of raw materials and equipment purchases) revealed striking declines in franchisees' sales. This type of contract earmarks a percentage of the payment for raw materials and equipment for the royalty, and is often found in the food service industry. It can also be a source of revenue for brands that have failed to accumulate reputational capital and to settle on a satisfactory royalty rate and franchise fee with the franchisees. However, the weaker reputational capital may make it more difficult to achieve a meaningful increase in demand.[9)]

Increases in franchise fees and royalties erode the operating profit of franchisees.

Although, from the franchisee's perspective, an increase in sales resulting from the franchise fee and fixed-percentage royalty can look promising, high fees and royalty rates are not always beneficial as they are still costs that the franchisee must bear. In fact, according to estimations on the impact of contract conditions on franchisees' operating profits (second row, Table 5), an increase in franchise fees and royalties has a negative effect on franchisees' operating profits—

8) Based on the Wholesale and Retail Trade/Service Industry Survey MDIS from Statistics Korea.

9) Moreover, in a fixed-percentage royalty contract, a decrease in franchise sales could lead to a decline in the franchisor's profit. So, it is impossible to completely exclude the possibility that franchisors may raise the royalty rate in order to make up for the decline.

probably because the increase in costs outweighs the increase in sales. Even if sales increase, the increment would be significantly limited by the intensifying concentration of businesses and competition. Of the factors (franchise fee and royalty) driving down operating profits, the fixed-percentage royalty was found to be the least aggressive.

A future issue of contention will be whether royalties and franchise fees are set too high compared to the brand's accumulated reputational capital and in cases where there is a decline in profit, the franchisee could feel that the current fees are excessive.

Of the franchise agreement conditions, what actually improved franchisees' sales and operating profits was the protection of closed territories.

Among the contract conditions, the one that actually increased both sales and operating profit was the protection of closed territories. This is because, compared to the increase in exclusive demand that accompanies an expansion of a territory, the entailing costs are low. Although further analysis is needed on the effects of closed territories on market growth and consumer welfare, the establishment of closed territories certainly seems to meet some degree of the purpose of the legislation to protect franchisees.

<Table 5> Impact of Contract Conditions on the Management Performance of Franchisors and Franchisees

Terms and conditions		Franchisee		Franchisor	
		Sales	Operating profit	Sales	Operating profit
Franchise fee		(+)	(-)	(+)	(+)
Royalty	Fixed sum	n.s.	(-)	(+)	(+)
	Fixed percentage	(+)	(-)	(+)	(+)
	Discounted rate	(-)	(-)	(+)	(+)
Territory	Radius	n.s.	(+)	(-)	n.s.
	Walking distance	(+)	(+)	(-)	(-)
	Population	(+)	(+)	(+)	n.s.
	Administrative area	n.s.	(+)	(-)	(-)

Note: 1) (+) denotes a meaningful increase, (-) a meaningful decrease and n.s. no statistical significance.
2) The type of royalty is categorized into fixed sum, fixed percentage and discounted rate.
3) All coefficient estimates and significance levels are specified in Lee (2018).

Source: Microdata on franchise disclosure documents (2014, 2016), Wholesale and Retail Trade Survey MDIS (2014, 2016), Service Industry Survey MDIS (2014,2016).

V. Effects of Contract Conditions on Franchisors' Management Performance

Lastly, with respect to the impact on franchisors' management performance,[10] the third row in <Table 5> shows that franchise fees and royalties generate a certain increase in franchisors' sales—although they are a cost to franchisees, they are a source of revenue to franchisors.

Franchise fees and royalties generate certain increases in franchisors' sales.

Specifically, an increase of 1 million won in the franchise fee raises the franchisor's sales by 440 million won, and a one unit increase in all three types of royalties raises it by 1.22 billion won (fixed sum), 0.59 billion won (discount rate) and 0.09 million won (fixed percentage), respectively.[11] It is clear from these estimates why the fixed-sum royalty is most commonly used

10) Franchisors' sales are largely composed of payments secured from setup costs, including the franchise fee, training fee and other expenses, royalties and sales from directly-managed stores.

11) A one unit increase in the respective royalties means that the fixed-sum royalty rises by 280,000 won per month while the fixed-percentage royalty and discount royalty both rise by 1%p. Increments in the respective types are set identical for analytical purpose.

in the industry.

Increases in the franchise fee and royalty also incur an increase in franchisors' operating profits.

As can be seen in the fourth row of <Table 5>, increases in the franchise fee and royalty lead to an increase in franchisors' operating profits. In order to raise the fee and royalty, franchisors need to secure reputational capital which entails significant investments in product and service development; advertising and promotion and; monitoring the management of franchise stores. Regardless, if there are increments in franchisors' operating profits, this indicates that the increase in the revenue from royalties and franchise fees exceeds the increase in input costs. This is contrary to the above finding that higher franchise fees and royalties diminish the operating profits of franchisees, sowing the seeds of conflict in regards to the distribution of value added.

The effects of closed territories also reveal contradicting results. The closed territory in terms of radius, walking distance and administrative area causes an overall decrease in the sales and operating profit of franchisors. Indeed, while it helps franchisees to maintain stability in terms of management performance, it diminishes that of the franchisor by limiting the opening of additional stores. This is how the economic motives of the two parties collide, and disputes over territory infringement will likely continue in the future.

VI. Conclusion and Policy Recommendations

Franchise disclosure documents should contain more specific information particularly about the franchisor's experience with directly-managed stores to enable prospective franchisees to make prudent decisions about the business item and brand.

Micro-analysis found that the domestic franchise market is heavily slanted towards the food service business, and franchisors' lack of direct management experience seems to have significantly limited the growth of franchisees. Under the circumstances, the terms and conditions of franchise agreements affect the management performance of franchisors and franchisees differently, becoming a source of conflict. Thus, this study suggests the following policy directions to support the healthy growth of the franchise market and to establish an advanced and fair contract culture.

Firstly, the contents of franchise disclosure documents should be enriched to enable prospective franchisees to make informed decisions on a business or brand. In particular, documents need to be revised to provide more detailed information on the franchisor's experience in operating directly-managed stores. Despite current disclosure documents asking for the 'Start date of directly-managed stores'—as a sub-item to 'Start date of the franchise business'—many franchisors choose not to provide such information, even those who have directly-managed stores. Given that this information is critical to prospective franchisees when judging a brand's reputational capital and the adequacy of contract terms, documents must contain clear and precise information on the franchisor's experience in operating directly-managed stores; the start date of the business and; the period from operating a directly-managed store to opening franchises. Additionally, this information should be given the same weight as that for the 'Start date of the franchise business.'

Franchisors should strive to establish IT infrastructure to transparently examine franchisees' sales.

Second, franchisors should strive to establish an IT infrastructure to transparently examine franchisees' sales records. Although the latter may find the transparency uncomfortable, it is needed in order to promote the healthy and long-term growth of the market in two ways. Above all, the transparency will form a trust between franchisor and franchisee which in turn will help the royalty culture take root. The use of fixed-percentage royalties, in particular, needs to be promoted as it has the least negative affect on stores' operating profit; increases their sales and; restricts franchisors from thoughtlessly opening more stores. For this to happen, it is critical that the sales records of each franchise store are examined. Another reason why the fixed-sum royalty is more commonly used is because franchisors are unable to accurately assess the sales performance of their franchise stores.

Meanwhile, these examinations will enable franchisors to provide accurate data on the actual average sales records of franchisees. This will be significantly helpful to prospective franchisees since the data currently provided is mostly estimates based on the payments franchisors receive from franchisees for raw materials and equipment, and hence, inconsistent with the actual sales and difficult to verify. Taking this into account, as part of small-business supporting policies, measures should be considered to introduce a point of sale (POS) system—which enables users to check sales and manage inventory and orders—to franchise systems that meet a certain criteria.

Guidelines should be drawn up for essential items through discussions between the government and industry, and franchisors should be encouraged to include the distribution margin for raw materials and equipment in the royalty.

Third, in regards to the raw materials and equipment purchase contract, guidelines for essential items should be drawn up for each sector to specify which items are needed for brand consistency so that the purchase of irrelevant materials are not forced into the contract. Additionally, excluding the minimum logistical costs from the distribution margin for raw materials and equipment, the remaining amount should be included in the royalty. The supply process itself may be a reflection of franchisors' business know-how to some degree. Nevertheless, reflecting it into the royalty would help enhance the transparency of contracts and also ease disputes with respect to the distribution of profit.

Actions should be taken to temporarily impose stricter requirements for franchise businesses in sectors with a heavy concentration in a few items.

Lastly, in order to limit the risks that are transferred to franchisees from franchisors who have little or no experience in operating a directly-managed store, efforts should be made to partially/temporarily impose stronger requirements for franchise businesses. For such businesses with a high concentration of establishments, an institutional mechanism should be considered in which only those franchisors who have the necessary experience are eligible to recruit franchisees.[12)]

12) In China, only franchisors that have at least two directly-managed stores and have maintained the business for over one year are eligible to recruit franchisees (Chapter 2, Article 2 of Regulations on the Administration of Commercial Franchises). In Japan, franchisors hoping to recruit franchisees must provide information on their past experiences and performance concerning its goods, services and business know-how (supplied with a fee). Considering that this information is not available without experience, the regulation serves to restrict franchisors without directly-managed stores from recruiting franchisees (Japan Franchise Association Code of Ethics).

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