Effect of new regulation on franchising performance: An exploratory study in Spain

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Abstract

The compulsory Spanish franchising regulation was introduced in 1998. Until then, franchising had no specific regulation and was regulated by general commercial laws. This paper examines the effect of the change from a general regulation to a specific legislation about franchising on survival rates and discontinuance rates in the Spanish market. We use a descriptive methodology and a comparison between survival curves. After controlling for time-in-market, results suggest that after regulation there is an increase in the organizational failure rates but a decrease in discontinuance rates. Furthermore, regulation affects foreign franchisors slightly more negatively than domestic ones and the reaction of growing firms is different to that of firms with negative growth.

Keywords: legislation, registration, failure, franchise discontinuance

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1. Introduction

The importance of franchising in the US and European economies in recent decades (Price Waterhouse and IFA, 2006; European Franchise Federation, 2008) has led to franchising becoming a major topic in business research. In the franchising literature, the kind of regulatory framework in which franchising should operate is a much-debated topic (Fulop and Forward 1997).

Local regulation is an important aspect that international franchisors have to take into account (Hacket 1976). The lack of awareness about the different legal requirements in each country has resulted in many franchisors making mistakes in format extensions (Hoy and Hoy Echegaray 1994). Government policies and regulations may increase business uncertainty for international firms (Miller 1992). Different countries may have different requirements. For example, the Franchise Disclosure Document (FDD), previously known as Uniform Franchise Offering Circular (UFOC), is based on the US franchise laws. Other countries, such as the UK and Spain, have elaborated specific franchise regulations. Many other countries have not introduced specific franchise regulations but franchise associations have adopted Codes of Ethics to regulate the conduct of their members (Terry, 2003). A legal environment that lacks clarity is one of the main impediments to the development of franchising (Anntonen *et al.*, 2005).

Despite the importance of the legal environment, very few empirical studies are dedicated to it in the literature. Studies have been carried out on the Australian market

(Lim and Frazer, 2002; Spencer, 2008) and on the US market (Beales and Muris, 1995; Shane and Foo, 1999), but there is lack of research about European markets.

The main objective of this paper is to analyze the effect of a change in the legal environment of franchising on performance. Our performance measure is network survival, which has been the focus of much of the extant research on franchise performance (Bates 1998, Shane and Foo, 1999; Shane, 2001; Holmberg and Morgan, 2003). Additionally, we analyze the moderating effect of origin and growth on the effect of regulation on survival.

We use data about the franchise chains in Spain between 1986 and 2004. In this country, until 1998, there was no specific regulation of franchising and this activity was regulated by the general retailing laws. This situation makes this country a suitable context for our study.

Our study examines two types of market exits: organizational failure and the fact that franchisors discontinue franchising but continue operating in the market. We distinguish them because in the literature there is evidence of the differences between the two types of exits (Stanworth et al., 2001). This allows us to contribute to the franchising literature providing new evidences and more knowledge about the decision of discontinuance franchising. About this issue, there is little empirical research.

Our results suggest that regulation increases failure rates. The number of bankruptcies is greater among the networks created with a specific legal environment.

This paper is structured as follows. The next section examines the positive and negative aspects of franchise regulation. Section 3 presents the data and the empirical analysis and Section 4 the results. Finally, we discuss the main results and their implications.

2. Aspects and effects of franchise regulation

In this section, we examine the theoretical background of the positive and negative aspects of franchising regulation. An explanation and description of the law and registration requirements in Spain is found in the appendix.

2.1. Positive aspects of regulation

A high quality franchisor-franchisee relationship is a factor that encourages network performance (Grünhagen and Dorsch 2003, Frazer and Winzar, 2005). These relationships are characterized by trust and commitment, which are key variables for a successful relationship between the parties (Fernandez-Monroy and Melián-Alzola, 2005).

In the franchise contract, the main problem is that there is an important information asymmetry that creates uncertainty. Franchisees may suffer from a lack of information about the quality of new franchise businesses (Shane and Foo 1999). Some franchisors may use this situation to opportunistically misrepresent their quality to franchisees. Franchisors have to provide franchisees with economic and internal information to reduce the information asymmetry and uncertainty. How can they reduce this uncertainty?

One way is to have an external certification about the quality of the franchisor. This certification is mainly supported by franchise associations, what requires their members to adhere to codes of ethics (e.g. the European Code of Ethics of the European Franchise Federation). So, besides fulfilling their responsibilities appropriately, both franchisors and franchisees must treat each other fairly.

Another way is registration (Shane and Foo, 1999). Registration shows that the franchisor will comply with and adhere to the highest quality standards for franchising.

This provides a quality check on the system and will reduce the likelihood of franchisor and franchisee opportunism as well as increasing new franchise survival (Shane and Spell 1998).

The franchise laws guide the new franchisors about how to create a franchise chain registered nationally or regionally. Both the Register and the codes of ethics force the franchisors to disclose information to new franchisees. Recently, it has been suggested that the information disclosed is not enough and that registration should improve the quality of the information (Spencer, 2008).

2.2. Negative aspects of regulation

There is evidence in the literature of the harmful effects of franchising registration and the disclosure of information (Price, 2000 Bricley, 2002). Compulsory registration will mean some additional costs for the franchisee and the franchisor. Brickley (2002) found that franchisee’s outcome is lower in states with termination laws. So, franchisees appear to pay a higher price for their businesses in states with these specific regulations. The increase in the prices of the contractual payments will cover the increased cost of legal requirements (Stadfeld, 1992). The disclosure of information will also mean some economic losses for franchisors because the information is available (to competitors (Price, 2000).

Regulation and requirements will increase the number of franchisors ceasing their activity (Stadfeld, 1992). The Spanish Franchise regulation forces the franchisors to provide the governmental register with information about the number of new outlets opened and closed every year. As this information is public and available to all the potential franchisees, the franchisors are reluctant to provide negative information. Before this law, potential franchisees did not know how many outlets failed every year as the franchisors avoided giving this information. Now, the availability of this information may reduce the number of franchisees interested in the less profitable businesses.

2.3 Moderating effect of origin and growth

Franchise regulation is especially important, not only for domestic firms, but also for international franchise firms. Domestic firms have the advantage of knowing the legal aspects of the local environment. Foreign networks have to change their requirements and even their business format to comply with the local regulations. In countries with no specific regulation, foreign franchisors have fewer problems than in those with a specific regulation. Foreign franchisors have to adapt their business to the new environment. So, the effect on performance will be stronger for foreign franchisors than for domestic franchise networks (Miller 1992).

In Spain the fact that there is a public register and all the information is publicly available, may affect growing and declining firms differently. Franchisors with a greater number of newly opened outlets every year or, at least, a positive growth in the total network will be more attractive to potential investors. Legislation may be more harmful to chains with problems. It may eliminate unsuccessful firms and benefit growing franchise networks to a greater extent.

3. Data and empirical analysis

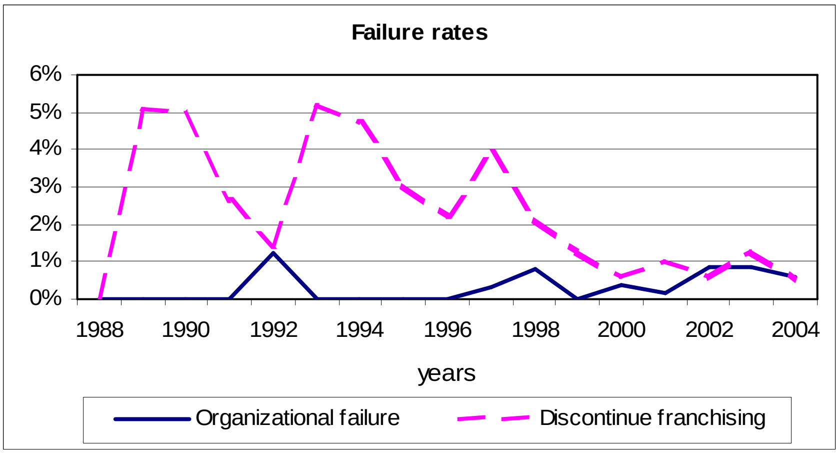
The empirical analysis examines the market exit of franchise systems operating in the catering (fast-food, restaurants, pubs, cafeterias, etc.) and fashion retailing sectors in Spain. Data covers the years between 1986 and 2004 and 384 franchise systems. Of these franchisors, 190 were created before the new legislation started. Information was obtained from different Spanish Franchise Annuals (Franchise Annuals of Tormo and Associates, Franchise Annuals of Barbadillo & Associates, Franchise Annuals of the Spanish Association for Franchisors and Franchise Annuals of Franchisa) and from the National Franchisor Register. In the annuals, we found information about the year each firm started to franchise, the number of company-owned and franchised outlets and the origin.

In our study, we examine market exit with two variables: organizational failure and franchise discontinuance. Previous studies suggest that the two types of exit are different (Stanworth et al., 2001). In our sample, 114 franchisors exit the market (30%), of which 24 systems failed (bankruptcy, liquidation or acquisition) and 90 systems decided to discontinue franchising.

Regulation was measured with two different variables. The Spanish law for franchising was created in 1998, which is our cut-off year. We have created two variables: a dummy variable (regulation) that takes value 1 for the year 1998 and the following years and 0 for years previous to 1998, and a dummy variable (franchise creation under regulation) that takes value 1 for firms that become franchisors under the new regulation and 0 for firms that started to franchise before 1998.

Figure 1 shows the evolution of the failure rates and the discontinuance rates during the time of the study. We can see that there is an increase of organizational failure rates after 1998, while the discontinuance rate decreases.

Figure 1. Market exits.



Source: Own elaboration

4. Results

Tables 1 and 2 show the effect of regulation on each type of failure after controlling for experience in franchising. As can be seen in table 1, the risk of failure was higher after 1998 than before that year. However, after 1998, with compulsory registration, the number of discontinuances was lower. So, the effect of regulation depends on the type of failure analyzed.

Table 1. Failure rates by regulation and year of creation of the franchise system (before or after 1998)

		Organizational failure	Franchise discontinuance
Regulation	= 0	0.0011	**0.0305**
	= 1	**0.0115**	0.0133
Franchise creation	before 1998	0.0063	**0.0276**
	after 1998	**0.0076**	0.0038

Before drawing any conclusions about the effects of regulation and mandatory registration, we examine the effect of the change in regulation on franchise systems depending on their period of creation. Franchise firms created before 1998 show the highest failure rate (0.0163) and the highest discontinuance rate (0.0409) after the establishment of the new regulation (Table 2). The change in franchise regulation and legislation hurts incumbent franchise firms as it increases the exit rate. The lowest rate is found for firms created under regulation. As they follow strict regulation and requirements for becoming franchisors, the risk of not finding franchisees and the probability of discontinuing the franchising activity decrease.

Table 2. Failure rate of franchise systems depending on the interaction between their period of creation and the regulation.

	Organizational failure		Franchise discontinuance	
	Regulation=0	Regulation=1	Regulation=0	Regulation=1
Franchise creation before 1998	0.0011	**0.0163**	0.0257	**0.0409**
Franchise creation after 1998	n.a.	0.0076	n.a.	0.0133

Comparing the survival curves for the two types of exits, the results suggest that regulation changes the franchisor failure and discontinuance function (Table 3). If we only analyse the franchise networks affected by the change in legislation and compare the survival curves before and after the implementation of the new law, we find that regulation has a negative effect on the rates of organizational failure and discontinuance.

Table 3. Comparing the effect of regulation for franchisors created before the new legal environment.

	Organizational failure			Franchise discontinuance		
	Relative hazard (Cox)	Events observed (Wilcoxon)	Events expected (Wilcoxon)	Relative hazard (Cox)	Events observed (Wilcoxon)	Events expected (Wilcoxon)
Regulation=0	0.3640	2	8.69	0.8485	42	50.20
Regulation=1	3.3205	14	7.31	1.3604	35	26.80
LR chi2(1)	12.99**	10.19**		3.92**	2.30	

*** significant at 1% , ** significant at 5% * significant at 10%.

However, comparing the survival curve for the franchisors that were created before the new legislation with those created afterwards, findings are different (Table 4). In this case, the results suggest that franchisors created in the new legal environment suffer a lower relative discontinuance rate (the number of observed discontinuances are lower than expected). The findings suggest that franchisors created in the new legal environment suffer a lower failure rate than incumbents, although this difference is not significant.

Table 4. Test of equality of survival curves for franchisors created before and after the new legal environment in the period 1998-2004.

	Organizational failure			Franchise discontinuance		
	Relative hazard (Cox)	Events observed (Wilcoxon)	Events expected (Wilcoxon)	Relative hazard (Cox)	Events observed (Wilcoxon)	Events expected (Wilcoxon)
Franchise creation before 1998	0.8845	16	18.30	1.263	77	65.39
Franchise creation after 1998	1.483	8	5.70	0.5504	14	25.26
LR chi2(1)	1.23	1.79		9.02***	7.13***	

*** significant at 1% , ** significant at 5% * significant at 10%.

The effect of regulation for domestic and foreign franchise networks is shown in Tables 5 and 6. We find that regulation increases the hazard rate for the two types of networks, foreign and domestic, but it has no effect on the discontinuance rate. In the two groups of franchise networks, regulation has a negative effect, increasing the failure rate. The effect of regulation on failure curves is only slightly higher for foreign (chi(2)=6.81) than for domestic franchise networks (chi(2)= 6.45).

Table 5. Test of equality of failure curves for foreign franchisors created before the new legal environment.

	Organizational failure			Franchise discontinuance		
	Relative hazard (Cox)	Events observed (Wilcoxon)	Events expected (Wilcoxon)	Relative hazard (Cox)	Events observed (Wilcoxon)	Events expected (Wilcoxon)
Regulation=0	0	0	2.01	0.90	15	16.7
Regulation =1	1.447	3	0.99	1.31	8	6.30
LR chi2(1)	6.81***	5.79**		0.66	0.42	

*** significant at 1% , ** significant at 5% * significant at 10%.

Table 6. Test of equality of survival curves for domestic franchisors created before the new legal environment.

	Organizational failure			Franchise discontinuance		
	Relative hazard (Cox)	Events observed (Wilcoxon)	Events expected (Wilcoxon)	Relative hazard (Cox)	Events observed (Wilcoxon)	Events expected (Wilcoxon)
Regulation=0	0.3924	2	6.02	1.265	27	21.81
Regulation =1	2.242	11	6.98	0.85	27	32.1
LR chi2(1)	6.45**	5.39**		2.06	1.71	

*** significant at 1% , ** significant at 5% * significant at 10%.

Looking at the effect of regulation for firms that have negative growth rates (Table 7), we find that regulation has no effect on the hazard rate of organizational failure, but the new law helps to reduce the number of expected discontinuances. However, regulation has an unexpected effect on growing firms. Comparing the hazard rate before and after regulation for growing firms (Table 8), results suggest that, with the new legal environment, the number of exits observed is higher than the expected. So, the new regulation did not benefit them.

Table 7. Test of equality of failure curves for negative growth franchisors created before the new legal environment.

	Organizational failure			Franchise discontinuance		
	Relative hazard (Cox)	Events observed (Wilcoxon)	Events expected (Wilcoxon)	Relative hazard (Cox)	Events observed (Wilcoxon)	Events expected (Wilcoxon)
Regulation=0	1.00	**1**	**1**	**1.640**	12	8.58
Regulation=1	0.998	3	3	0.689	8	11.42
LR chi2(1)	0	0.05		2.96*	4.07**	

*** significant at 1% , ** significant at 5% * significant at 10%.

Table 8. Test of equality of survival curves for growing franchisors created before the new legal environment.

	Organizational failure			Franchise discontinuance		
	Relative hazard (Cox)	Events observed (Wilcoxon)	Events expected (Wilcoxon)	Relative hazard (Cox)	Events observed (Wilcoxon)	Events expected (Wilcoxon)
Regulation=0	0.324	**1**	**5.79**	**0.738**	6	9.24
Regulation=1	4.715	9	4.21	2.76	6	2.76
LR chi2(1)	11.14***	8.52***		4.51**	6.77***	

*** significant at 1% , ** significant at 5% * significant at 10%.

5. Discussion

The aim of this research is to examine the effect of a specific franchise regulation and mandatory registration on franchise survival. Although regulation is important for surviving, it has received little attention (Shane and Foo, 1999). Our research analyzes the failure rates and the survival curve of existing franchise firms before and after regulation and those of firms created after regulation.

Our results suggest that regulation seems to increase failure rates but to decrease the number of discontinuances. They confirm the negative effect of regulation on survival found in other studies (Marvel, 1995). As the new regulation defines what a franchise business is and the basic requirements for the franchising activity, we expected a higher number of discontinuances. Businesses that were not really a franchise would disappear from the franchise market and the franchise annuals. In the new legal environment, the lowest failure and discontinuance rates are for the new franchise chains. This change in the legal environment implies new costs, so some existing firms decided to discontinue franchising. Our results suggest that incumbents and new franchise systems show different survival patterns.

Although some studies suggest that a risk to international franchise networks is to understand local regulations (Stanworth et al., 2001), we have not found significant differences between domestic and foreign franchisors. Our results about the effect of the origin of the franchise system suggest that regulation increases organizational failure for foreign and for domestic firms. As was expected, the negative impact is slightly higher for foreign than for domestic firms.

Our research suggests that regulation has a different impact on the survival of growing systems and of systems with negative growth. Contrary to our expectations, the new regulation had a negative impact on successful firms and a positive impact on unsuccessful firms. Incumbent firms with negative growth rates do not suffer any change in their survival curves, and regulation and registration reduce the level of discontinuance. We expected that the mandatory disclosure of information will cause declining firms to fail or cease franchising because no franchisees would be interested in investing in these systems. Regulation had a strong harmful impact on incumbent firms with positive growth rates, increasing the hazard rate and the number of firms that discontinued their franchising activity

Our findings provide some important contributions to franchising research. Our research expands the franchising survival literature, providing some descriptive results on the crucial, but infrequently discussed, effect of the introduction of specific franchise legislation and mandatory registration on survival. Furthermore, it contributes to the franchising literature with some guidance about the reaction of the incumbents when there is a change in the legal environment. It also provides evidence on how origin and growth moderate the effect of regulation. Our findings show that growing firms are the most damaged by the introduction of the new law and that both foreign and domestic firms are damaged by the introduction of the new legal requirements.

Managers will find our results useful. They suggest that franchisors should adapt their business to the legal situation. This adaptation is needed for operating in the Spanish market, but it implies additional costs, which could affect franchise survival. The stable legal environment will reduce the number of discontinuances because requirements for becoming a franchise system are clearer and, therefore, uncertainty and information asymmetry is reduced. This situation helps to attract potential franchisees.

Our research has some important implications for policy makers. It seems that registration decreases the number of discontinuances, but it does not have the same effect on survival. These contradictory and unexpected results may suggest that registration is not enough to encourage survival. Regulators should adapt the legislation to include appropriate disclosure information to increase franchisee's satisfaction (Hing, 1999; Fulop, 2000). The information provided to franchisees should be accessible, usable and suitable to help franchisees to make their decision about the best franchise systems to invest (Lim and Frazer 2002; Spencer 2008).

This research is not without its limitations. First, the methodology used is descriptive, looking at only the change in the survival curves. It would be interesting to continue analyzing this issue using an econometric model such as a Cox model or a clog-log estimation. Additionally, we have focused only on two sectors. The effect of regulation may vary for other types of services. With respect to performance measurement, we have only examined market exit. It would be interesting to analyze the effect of the new regulation on other measures like profitability, or on subjective measures such as trust or the quality of the franchisor-franchisee relationship. We hope this paper will spur further research into the factors that affect the success of firms.

Appendix: The Spanish Franchise legislation.

The specific franchise legislation came into effect in 1998 (Real Decreto 2485/1998, BOE, nº 283[2]). It establishes the basic conditions of the franchising activity and the creation of the Franchisor Register.

The new regulation creates new duties for the franchisor in relation to the pre-contractual information given to the potential franchisee. It is based on information disclosure. The franchisees are given a 20-day cooling-off period. The disclosure of documents forces franchisors to provide a clear picture of their franchises in terms of experience, sales forecast, assistance and financial capability. This brings honesty and trust to the relationship and aids franchisees to take an informed decision. But, before contacting the franchisor, the potential franchisees have another source of information: the franchisor register.

The regulation stipulates that all businesses that want to operate as a franchise system in Spain have to be registered in this specific Franchisor Register. It also predetermines the type of information that the franchisors have to provide annually, generating a new duty for them. Apart from general information about the franchisor (such as activity, number of outlets or experience in franchising), franchisors have to provide information about the number of outlets opened and closed with the reasons for the closure of the outlet. They also have to inform of the disruption of the franchising activity within a maximum of three months. The objective of the Franchisor Register is to have a source of information that brings transparency into the market.

[2] BOE, nº 283, pp. 38859-38862. I Disposiciones Generales. Ministerio de Economía y Hacienda. www.boe.es

This regulation tries to help the franchisee to take a decision about the best franchise system to invest and it balances the power between the two parties, reducing information asymmetry and uncertainty.

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