

Buying a Franchise

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It is impossible to drive down any Main Street in America today without passing a franchised business. Franchising has grown so rapidly since the end of World War II that by the end of this decade over 50 percent of every retail dollar spent in the United States will be from an automobile, beverage, hamburger, dry cleaning or one of the other 65 industries which make up the franchised marketplace.

Internationally, franchising has become one of the great intangible exports for the United States. Franchisors have penetrated the iron curtain with a long list of industries including restaurants, retail and service providers. The markets in unified Europe, the Pacific Rim, Mexico, the Middle East, Asia, South America, and even Africa are absorbing American style franchising at an ever increasing rate. This export of business technology to the emerging markets is one of the great stabilizing social forces as jobs, services and the supporting resources are created for those markets.

When a business licenses its tradename and operating systems to a third party in exchange for a payment, and exercises some control over the operation of the third party's retail unit, the business generally is defined as a franchise.

It is important to understanding franchising to recognize that McDonald's does not "franchise" hamburgers nor does Midas "franchise" mufflers. What they both franchise is a business system - and it is that system that delivers the products or services. It is the entire method of doing business, the name, the product, decor and methodology of delivery that is franchised.

While sophisticated investors are becoming a major force in franchise ownership, it has been the individual, investing in a franchise opportunity, that has fueled franchising's growth. These franchisees typically express their reason for buying a franchise as a desire to achieve the Great American Dream of financial security and independence. They see themselves as entrepreneurs.

Truly though, an entrepreneur or an independent person should never buy a franchise. If they want independence and the ability to be innovative, they should start their own business. For a franchise system to be successful, it is the responsibility of the franchisor to control the system and - - - It is the responsibility of the franchisee to follow the methods laid down by the system.

The principal reason for the franchisor to exercise control is to protect the public's ability to rely on the franchisor's trademark as an indicator of the systems products or services, delivered consistently from location to location. Another reason is to protect the franchisees, who rely on the franchisor to ensure that other franchisees do not diminish the value of the trademark, and by extension the value of their franchises, and to keep the franchisor financially sound.

Your decision to purchase a franchise should be based upon two broad understandings:

First: You should have an understanding of the advantages and disadvantages of franchising and **Second:** You should have an understanding of the franchise you want, and how to evaluate it.

The public has become accustomed to a certain level of quality and consistency from brand name franchised locations. The established franchisor, through the trademark, provides the franchise with a customer base accustomed to shopping under the marks. It is this brand identification which makes it easier for new franchisees to compete with the well established independent operators and against well established chain operations.

Franchisors, having survived their mistakes while developing the franchise and operating their prototype locations, can guide their franchisees to not make the same mistakes. Upon joining an established franchisor, franchisees receive comprehensive initial training in the operation of the franchise system, its product, services and methodologies. The franchisee benefits from the operations manuals, site selection, store design, construction programs and continuing system support which would not be available had they started independently. They not only have their franchisor as a seasoned partner from whom they can get answers, they also have the network of other franchisees who can provide added assistance in the continuing operation of their business.

In essence, many of the major stumbling blocks which could lead to failure are removed by the good franchisor. These franchisors prepare their franchisees for the business and then continue to support them.

A statistic often cited about small business failure is from The Department of Commerce, which estimated that over 80% of independent small businesses fail in the first five years. The International Franchise Association estimates that during the same five years only 5% of all franchisees fail.

"Failure", as commonly used in franchising, must be carefully understood by the prospective franchisee.

Business failure refers to the closing of the location's doors, on a permanent basis. In a franchise system, statistics on failures do not include franchised locations which are repurchased by the franchisor, and continue in operation as a company owned location, or as a location resold and operated by a new franchisee, at times with a financial return to the original franchisee.

Franchisors will often acquire locations for strategic reasons, which may include a desire to operate more company owned locations or because a franchisee is not performing to standards. Instead of terminating the relationship through litigation, the repurchase of a franchise may be the most attractive route. On the other hand,

franchisees often sell or abandon their businesses because they have not received the rewards they expected, or for other reasons including retirement or the desire to change their life patterns.

Therefore, it is important when discussing failure rates with any franchisor that you ask about reacquisitions and transfers. New UFOC requirements in Item XX will provide for this information. Request the names of those franchisees involved in the transactions and determine for yourself why the businesses were sold.

This difference in failure rates is an impressive reason to consider in favor of buying a franchise. However, the Small Business Administration revealed in a recent study that the success rate for independent start-ups is similar to that of franchisees when the new business had adequate capital to support the business.

Independent businesses do not fail solely because of poor quality products or services. They often fail because they could not anticipate their capital requirements, and do not have the experience or resources to fully analyze the risks they face.

Capital adequacy is a function of business uncertainty and is the primary risk for new enterprises. Will the location they selected provide them with sufficient customers? Is the size of the location too large or too small? Is the rent too high? How many staff are required at what times of the day and how much should they be paid? Is the equipment selected the best for the operation and is the price for the equipment fair? These and hundreds of other issues must be considered and answered.

Well developed franchisors have experience in starting and operating the business the franchisee are going to operate. They can guide their franchisees in making these critical determinations. That experience lessens the franchisees risk of mistakes, helps them to avoid underestimating their capital needs, and therefore lessens their risk of failure.

Franchising is not a perfect vehicle and has disadvantages. It is important for new franchisees to recognize that many of the disadvantages inherent in franchising may also be advantages. One that is often perceived as a disadvantage is the public's perception of the system as a chain. When they receive great service at one location they assume they will get great service at all locations. The reverse is also true. You will be judged not only by your performance but by the performance of all of the other franchisees.

Therefore, when evaluating a franchise make certain that the franchisor has the right in the agreement to enforce the systems standards and has strongly exercised those rights. You need assurance that performance standards will be enforced and enforced uniformly. The franchisor's standards on product and services are restrictive, but they provide the public with assurance on the meaning of the trademark.

The limitations on territorial rights may constrain your market and income, but it allows for other franchisees to contribute with you to the market's advertising fund and provides the critical mass needed for the system to compete effectively against the competition. The possibility of being terminated for failure to follow the system, or the franchisor having the right to approve the person to whom you may want to sell your business, protects you from those other franchisees who may not perform as well as you and to whom your success is tied.

Therefore, many restriction placed on a franchisee can also be viewed as an advantage for the franchise system. But, for those franchisees who see the loss of independence and the other restrictions as a disadvantage, the proverbial cup will always be half full, and the advantages of the system will always be unbearable personal disadvantages.

Finally, have realistic financial expectations. Should you find the franchise with the \$30,000 investment and the 2 percent royalty that provides you with a six figure income in the first year and returns your investment in six months, please give me a call. I will immediately leave my consulting practice and join you in that investment. Unrealistic expectations is the greatest disadvantage of every new business, not just franchising. Financial realism is important.

Select an industry which meets your personal needs and likes. If you will be embarrassed to tell your friends that you own a drycleaning business, even it is highly lucrative, don't buy one. If working twelve hour days, seven days a week is not your idea of fun, make certain the franchise industry you select from has better hours. If you need \$100,000 a year to support your family, make certain that the other franchisees in the system you select make that type of return.

Your answers will come from two main sources. The personal meetings with the franchisor at their headquarters and your contact with other franchisees already operating in the system.

Begin your examination of the offerings in the industry that meets your needs. The obvious choice may be the well established company with hundreds of franchisees, but keep in mind, many of the newer opportunities have entered the market with innovations that may not be possible for older systems to incorporate.

Also, older established systems may be less flexible should you want to negotiate any terms of the franchise agreement. Newer systems may be willing to consider certain points as negotiable.

Here again, this may be a double-edged sword. Franchising's strength is its consistency. Should the franchisor be willing to negotiate with any franchisee on significant issues, they are likely to be willing to do so with others.

Their reasons for negotiating may be based upon their need to sell you a franchise to meet next weeks payroll. Even if this isn't the reason, another word for flexibility is inconsistency, and inconsistency is not what you or the public wants from a franchise system.

Contact each franchisor in the industry and obtain each information package. Read them carefully and begin to write down your questions about the company. Remember, a glossy brochure and a great franchise salesman are not a good reason to select any company.

Try to understand the philosophy of the company and identify their customers. Compare their services as well as their fees with others in the same industry group.

Lower fees should be the least important reason to select one company over another. If the fees are high but the services provided by the franchisor are the best available, the high fees are a bargain. If the fees are low and the services are inconsistent or leave you to operating independently, why buy the franchise in the first place.

Once you have received and reviewed the information about the companies you contacted, select those which meet your criteria and arrange to visit their headquarters and meet management and the staff.

Allow the franchisor the opportunity to introduce you to the system, the services and the key personnel. Ask questions when you visit the headquarters and do not accept superficial answers. Remember, the franchisor has been through this process many times before, but it is likely your first time.

Come prepared, with your questions written down and do not be embarrassed to ask them. Be satisfied by the answers and do not be reluctant to probe for further information. Buying your franchise is likely to be one of the most important personal business decisions you will ever make - be sure.

At your first meeting with the franchisor to discuss the purchase of a franchise you will receive a copy of the franchise disclosure documents. The disclosure document will provide you with a wealth of information on the franchisor and the system.

Among the areas included in the disclosure documents are: the management and the key staff's experience in managing the franchise business; its litigation and bankruptcy history; the cost of opening a franchise as well as the initial and continuing fees. It includes an explanation of the relationship and responsibilities of the franchisor and franchisee together with financial information on the franchisor. It also provides information on the number of franchises opened, closed and most importantly a list of franchisees.

Regardless of how much you want to invest in the franchise after meeting with the franchisor, you should always review the offering circular with a qualified franchise attorney and possibly your accountant. Good franchisors respect that this is a very important decision you will be making. They will not pressure you for an answer on buying their franchise until you are satisfied that the franchise is right for you. Besides, the law requires a cooling off period of 10 days from the date you are given the disclosure document until you can buy the franchise. Use the ten days wisely and seek outside counsel and advise.

Call as many franchisees as you feel necessary for you to make an educated decision before buying any franchise. Also, visit as many of the franchisees as possible. Just because a franchisee is unhappy in the system, it is not always a solid indication that the entire system is bad. In every franchise system there may be at least one, or maybe several, unhappy franchisees. Probe their unhappiness to determine if it is a wide spread concern.

One piece of critical information which you may expect may not be in the disclosure document. This is an earnings claim or projection of unit profitability.

For a host of reasons, the majority of franchisors still do not include this information. In recent years there have been changes in the legal requirements for disclosing an earning claim which have made it easier and less expensive to provide. More and more franchisors are providing this information. The majority, probably in excess of 75

percent, still do not do so though. While I would prefer to see this information in every franchisor's disclosure document, I understand the reasons that many do not do so and a failure to find this type of information is not an indication that the franchise system is a poor investment. Regulators are now considering formats under which franchisors will be required to include earnings information in future years.

Therefore, it is critical that you base your financial assumptions on many sources: the information available from the franchisor, information obtained through your discussions with existing franchisees, information from articles about the franchisor and the industry, your visits and observations at the franchised locations.

My final piece of advice in making your franchise selection is to suppress your emotions. Never buy a franchise based upon the sizzle of the brochure or the salesmanship of the franchisor. Base your decision on the quality of the investment and on the available facts. Make certain before you invest in a franchise that it will benefit you both personally and financially.

This book will be your guide as it provides you with a thorough examination of the franchise arena from the buyer's perspective. Now, it is up to you to select from the over 3,000 opportunities available. Purchasing a franchise is an exciting decision to make. Take your time, complete your examination, ask thorough questions, do not be intimidated select carefully.