

How to determine if a franchisor is financially stable?

By: Michael H. Seid and Kay Marie Ainsley, Managing Directors, Michael H. Seid & Associates, LLC.

Question: I am thinking about buying a franchise and there are several franchisors to choose from. How do I tell if a franchisor is financially stable and able to meet its commitments?

One of the dangers of investing in a franchise is getting caught up in the hype – the sizzle of the opportunity. You simply need to step back and spend the time looking to see if there is any steak. Investing your life savings based upon a glossy brochure, a great web site and your new instant buddy – the franchise salesperson or franchise broker isn't smart and it certainly isn't necessary.

Understand the franchise sales process. Great franchise salespeople can make you feel like there is an urgency to buy. The best of breed can make you feel reluctant to ask the hard and important questions – even while they are creating the illusion of pressuring you to do just that. The process calls for you to provide reams of information on yourself but doesn't always get the questions you ask answered in the depth or with the speed you need. Sometimes you find that the person working with you doesn't even work for the franchisor you are interested in. They're brokers and they only get paid when you buy a franchise from one of their clients. To them, the amount you have to spend, the speed at which you are willing to spend it and the size of the commission check they get from the franchisor are more important than how correct that investment is for you.

There are probably no more important questions to ask than whether a franchisor has the financial ability and a track record of meeting its commitment to its franchisees. Take a step back from the hype and pressure of the sale and look for the answers.

Finding out about a franchisor's financial capabilities is not a complicated process but it often requires some investigation outside of the disclosure documents they provide you.

Begin by examining the financial statements provided in their disclosure document – the Uniform Franchise Offering Circular in Item 21. Franchisors are required to provide their audited financial statements for the past three years or for a shorter period if the company has not been in business that long.

- Does the franchisor have a history of profitable operations?
- Does its Balance Sheet reflect a company that has financial stability?

It is essential that you discover whether the franchisor can afford to meet the commitments they are making to you. You are relying not only on the initial services

of getting you trained and open for customers, you are relying on them being in business for a long time and growing.

Is it sufficient that they are making money? It certainly a good sign but that's not enough. Many franchisors do not disclose the sources of where their income comes from and depending on how long they have been in business and the size of their franchise system, the answer to that question can be critical.

When franchise systems are new they often rely to a great extent on the initial franchise fees they collect from franchisees. That's understandable because the system is growing and there are not a lot of franchisees yet open. But, as the franchise system matures, more and more of its daily operating income needs to come from more sustainable sources – the continuing royalties paid by its franchisees. No matter how profitable a franchisor is, if it is relying on initial fees to support the system – and franchise sales slow or stop – the franchise system is going to be in jeopardy and that will impact its franchisees.

While some franchisors may provide a detailed breakdown of revenue, others that do not may provide you with a supplemental disclosure of this information if you ask. Sometimes if the information is not broken down in the income statement it may be contained in notes to the financial statements. Often though you will have to estimate initial fee revenue based upon clues in the disclosure document that may simply be multiplying the initial franchise fee times the number of new franchises in the system. Remember though that is not an exact science because area fees, deferrals, etc. will impact your calculation. However, by making your analysis over a few years you will begin to get an understanding of where the system is deriving its income and how much of that income is coming from continuing sources. Your accountant and attorney will be able to help you pull the clues out of the documents.

It is exciting to be part of a growing system. The brand recognition is improved, buying power increases and it just seems that customers have an easier time finding you. But, growth can be a double edge sword if the franchisor is placing too much of its resources into growing internationally or if domestic growth is not in areas that benefit you. If resources are placed into growing the system and little is left over for research and development, system improvements, headquarters and field support you are going to have problems since system growth is not going to provide you with much if any benefit. You need to cut through the hype that accompanies system growth and focus on what the franchisor is doing for its franchisees continuing operations.

Look at the trade literature for the industry the franchisor is in. Many trade publications or business publications often include articles that evaluate system performance. Remember though that if the magazine is the publication of a trade association, the information may be considerably more flattering than it is realistic. If the company is public, look at its SEC filings. Public information can often be accessed directly off of the web for free.

Don't forget the folks that are already in the trenches – the existing franchisees. They are the most knowledgeable people as they experience the franchisor on a day-to-day basis. They know and can tell you if the franchisor is meeting its commitments on a routine and regular basis and often can provide you with information about the franchisor that outsiders would have no way of determining.

Speak with members of the franchisor's staff. Ask the hard questions. Follow up the bits of information you learned from talking to the other franchisees. Press for details and learn as much as you can about the reality of the franchise system. Focus on how the franchise system is going to benefit you – individually. Make certain that what you rely upon in making your decision to buy is actually an obligation of the franchisor to provide to you. If promises of the franchisor is important to you, make certain that your attorney has it included in the franchise agreement.

It's your responsibility to do your own homework on any investment opportunity. The great thing about franchising is that much of the information is readily available and can be easily verified.