

How To Determine Profitability

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The one burning question of every person looking to make an investment is, “How much money can I make?” Stockbrokers will give you historical trend data, other research and opinions before you make any market investment. Companies, in their private offering memorandum or prospectus, will provide you with reams of historical financial data, management’s opinions on future events and projected financial results. In this information age, data on current and projected financial performance is so readily available that most investors don’t think twice before asking about profitability. They just expect that information is available. Besides, who would even consider making an investment without that knowledge?

The great surprise for prospective franchisees is that most franchisors won’t answer the question for you. It’s not that they can’t. Item 19 of the UFOC (Uniform Franchise Offering Circular—the disclosure document used in franchising) provides franchisors with an opportunity to give historic and prospective information. It’s that they choose not to.

Franchisors give numerous reasons for not providing this information: potential legal liability; the possibility of compiling an inaccurate or incomplete disclosure based on the information provided by franchisees; the belief that their locations may be so diverse in size, maturity and markets that a compilation of information would be misleading; the protection of trade secrets that might be revealed in the disclosure, and the cost of accumulating the information are just a few. For some franchisors the reason is even more basic—their system’s numbers are so bad that if they disclosed them, no one would ever considering buying a franchise.

Get To Know Your Ufoc

So, do you fly blind into a franchise investment and simply hope for the best? Hardly. Information is available, but you need to do some work to find it.

The UFOC is your starting place. Item 20 provides you with the names and contact information of existing franchisees and franchisees who have left the system in the past year. These are the folks in the trenches who can tell you how much they’re making, whether the franchise system has been a good investment for them and whether they would make the investment today, knowing what they know now about the franchise system. Former franchisees can give you insight as to why they left the system and whether they made a return on their investment. Call them. While they’re not obligated to answer your questions or might be too busy running their business to spend any length of time with you, they have the most direct and relevant information available.

The UFOC has other “hidden” resources that, when combined with other research, can provide you with insight to profitability.

Look at the company’s audited financial information and the accompanying notes for information on company-owned unit performance. Check out Items 5 and 6 (the sections that discuss fees) to see whether the fees are based upon some performance formula. Review Item 7 (the initial investment)—especially the notes. The notes often describe the size and type of locations required (this can give you a handle on rent), discuss staff sizes and organizational structure (which give you a handle on staff costs), and reveal how the company has determined working capital requirements. Item 7 may also cover inventory and inventory turns. When you couple this with the disclosures in Item 8 about required purchases, you begin to develop a fairly strong cost-of-goods model. A franchise consultant or accountant can guide you to a lot of information about the potential rewards or risks of a franchise opportunity via the data in a UFOC.

Tools For Digging Up The Info

Outside of the UFOC, three other tools may be available to you:

1. If the franchisor is a public company, the SEC (Securities and Exchange Commission) requires them to distribute reports to their shareholders. These reports contain information not provided in the franchisor’s UFOC. They’re available from your broker and can usually be found on the company’s Web site.
2. Conduct an online search of the franchisor’s press releases and other news reports on the company (especially within industry trade journals). Often profitability information is clearly provided. You’ll likely learn a lot about the franchisor’s industry segment and may even discover information on competitors that might better fit your needs.
3. Robert Bond has published a collection of earnings claims by franchisors in his book, actually titled *How Much Can I Make?* It may have financial information on your franchisor and/or its competitors. www.worldfranchising.com

Getting the information you need to determine the financial potential of your franchise investment may not be as easy or straightforward as it would be if it were contained in the franchisor’s UFOC. But, with a little work, a clear understanding of the dynamics of a franchise system, a grasp of the UFOC and possibly the assistance of a knowledgeable professional, you can build a fairly accurate profitability picture to help with your franchise decision.