

# A Closer Look

An expert reveals the secrets to investigating a franchise.

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There are two faces of franchising. One face offers the glittering smile of enormous financial rewards and conjures up visions of Ray Kroc (McDonald's) and Colonel Sanders (KFC) and the thousands of millionaires they've helped into business. These pioneers made franchising a household term with their motto: "Get in early, build multiple stores fast and make a million."

The other face is the darker side of the franchising story. The early years of franchising growth culminated in a "60 Minutes" TV report titled "From Burgers to Bankruptcy," which aired in December 1978. The show told the story of a couple of slick guys in rented Rolls-Royce automobiles and gaudy jewelry who sold the empty promise of phony fast-food success on the strength of their outrageous claims of instant wealth. The motto of this face of franchising: "Fast-buck artists selling hot air on the promise of success."

Understanding the dual nature of franchising is an essential step in the task of finding the right investment for your interests and resources. Go to a franchise trade show, and notice the pace of the sale. It's fast. It's a hard sell. And, all too often, it is accompanied by exaggerated claims of earnings potential. The other face of franchising can be difficult to uncover, but there is good news: The law is on your side, and you will be prepared for the process if you do your homework and bring diligence to your task.

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## The Informed Investor

Since the 1970s, a number of states and the Federal Trade Commission (FTC) have seen to it that burgers don't lead to bankruptcy, at least not because the expensive cars are rented and the dazzling jewelry is fake. Every franchise buyer in the United States is protected by the receipt of a comprehensive disclosure prospectus, dubbed the Uniform Franchise Offering Circular (UFOC), at least 10 days before the purchasing commitment is made.

The UFOC contains a mind-boggling amount of information about the franchisor, its key people, its litigation and bankruptcy history, the fees to be paid to the company, the total investment, purchasing restrictions, basic information about trademarks, the key terms of the franchise agreement, the addresses of franchise owners, a list of franchisees who have left the system, and more. Attached to the document are copies of all contracts to be signed by the franchisee as well as the franchisor's audited financial statements. Armed with this key information, the investor will be in a position to make an informed decision about the franchise. At least in theory, the true face of the franchise will be revealed.

## Doing Your Part

It would be easy if receiving the UFOC was the end of the effort to protect yourself, but it's not. An additional effort must be made to be sure the franchise you're considering doesn't have a darker side.

How can you protect yourself? Take these five steps to success in choosing a franchise:

**1. Research the market.** Before you jump into the idea of franchising, carefully research the business potential of the town where you plan to locate. Start by driving around and observing where the growth is in your community, where new businesses are being built and what businesses are clearly prospering. Head to the library, and check the statistics relating to the town's business growth. Skip this vital step, and you will be flying blind-and vulnerable-once you begin the process of evaluating franchise opportunities.

**2. Read the UFOC.** The disclosure document is vital to your investigation,

but it is little more than a paperweight if you don't read it.

The UFOC recently underwent a renovation. The new-format UFOC, after a two-year phase-in period, becomes mandatory for all franchisors as of January 1. Much improved over the previous format, which had been used for more than 20 years, the "new and improved" UFOC is written in plain English and is considerably shorter than it used to be.

The first parts of the UFOC contain a general description of the franchisor, a list of the people running the company and general information about the franchise offering. Here you will find litigation and bankruptcy history if there is any to reveal.

Items 5 through 7 detail information about the initial and continuing fees to be paid to the franchisor and the company's estimate of your total investment in the franchised business.

Later sections summarize purchasing restrictions, discuss financing available from the company, and spell out the services the franchisor promises to provide to you. You'll find key information about any relevant trademarks, patents or copyrights, and whether you are required to be personally involved in the business's management.

If the franchisor provides information about earnings among franchisees in the system, it will appear in Item 19. Franchisors are not required to give potential franchisees earnings information, but if they do, the law requires them to put it in writing in the disclosure document.

Item 20 contains your best leads for further research-the list of current franchise owners and those who have left the system in the past year. Take advantage of the list, and select a random sampling to contact.

Attached to the UFOC are two essential documents. First, franchisors must include up to three years of audited financial statements. An audited statement means an independent CPA has certified that the statements were prepared according to the industry standard Generally Accepted Accounting Principles.

You are planning to make a major investment that could last for 20 years or more, so do not pass "Go" without an independent evaluation of the

company's financial standing. Read the statement carefully; if you are at all uncertain about how to read it, seek out a competent accountant.

The other attachment is a sample copy of the standard franchise agreement and any related contracts you will sign with the franchisor. Unlike the UFOC, the typical franchise agreement is not written in plain English and is often difficult to read and fully understand, so proceed with caution. Best approach: Find a good lawyer who can review the contracts, discuss them with you and answer your questions.

**3. Talk to franchisees.** Who else is closer to the real story? The biggest mistake you can make is to let the seller handpick a few franchise owners for you to interview-by phone. Instead, take the list in Item 20, and do your own research-in person. Get in the car, and visit the franchisees you have picked from the list. Watch their businesses in operation, do a rough customer count, and quietly confirm to yourself that you would enjoy working in this business.

Here are some key questions to pose to the owners you visit:

- Knowing what you know now, would you buy this franchise again?
- What is the toughest and what's the most pleasant part of this business?
- How was the quality of the franchisor's training program? Did you feel well equipped to start the business?
- What were your gross sales last year? What was your pretax net? Is the franchise living up to your financial expectations?
- Does the franchisor provide useful assistance when you have problems? Is it responsive and prompt?
- Did you have enough money to capitalize your start-up? Are the company's estimates of the total investment in Item 7 realistic?

Complete your research by tracking down a few franchisees who left the system in the past year. Find out why they left and how the franchisor handled their departure. Was there a dispute? Litigation? Did the company have effective dispute resolution (arbitration, mediation or other) programs in place to head off any legal dispute?

**4. Throw some really tough questions at the seller.** Be prepared to ask the franchisor's representatives many of the same questions you ask the franchisees-and then some. Put a few of these in your notebook:

For companies with no earnings claim in Item 19: Why is there no earnings information listed in the UFOC? Is it because the numbers are not very attractive?

For companies with an earnings claim in Item 19: Can you provide any more specific earnings information about other franchisees in my market? (The law allows a franchisor to provide such "Supplemental Earnings Information" outside of the UFOC. For instance, if you find in Item 19 a statement of the national average gross sales of the franchisees in the system, the company can lawfully tell you the gross sales of franchises in the town where you will be starting. Press for this information; it could be extremely useful.)

- What is the main reason franchise owners fail at this business?
- Tell me about the culture of your franchise system. What is your philosophy regarding the franchise relationship?
- What are the company's plans for franchise expansion?
- What procedures are in place for resolving disputes between the company and its franchisees?
- Is there a franchise owners' council or association? What role does it play in the company's decision-making?

**5. Get professional help.** This is no time to pinch pennies on good advice. You are considering entering into a complex legal relationship, complete with all the financial challenges small-business ownership can throw at you. Find an experienced attorney familiar with franchising and representing small-business owners, and pay for a review of the UFOC. Be sure you understand the franchise agreement and the other contracts that accompany it.

You may also want to seek the assistance of an experienced accountant to help you put together your numbers. Like every entrepreneur planning to start a business, you need to develop a detailed business plan in which you project your revenues and expenses. You cannot afford to wing it.

Franchising adds a unique dimension to your efforts to start a business. And finding the right franchise requires a lot of hard work-doing independent research, interviewing other owners and carefully evaluating complex legal documents. Like it or not, there is no other way to see past the two faces of franchising.

# Watch Your Step

*As you investigate franchises, be sure to avoid these common mistakes franchise buyers make:*

**1. Losing sight of what you want.** You're looking for a part-time, homebased business, but you end up with a fast-food operation that demands 90-hour workweeks. What happened?

It's easy to lose sight of your original goals when hit with the franchise hard sell. Know what you want before you go shopping, and avoid franchises that don't meet your criteria.

**2. Getting in over your head financially.** Franchises are expensive. There are upfront fees, equipment and training costs, royalties and more.

As with any business, know how much you can afford to spend on start-up. Write out a business plan showing financial projections, and stick to it.

**3. Not getting feedback.** It's easy to feel isolated when buying a franchise, but you can end up making a big mistake if you don't get outside advice.

Seek people who can help you evaluate a company objectively. Visit existing franchisees, as well as some who have left the system. Ask them what they like and don't like about the franchise.

**4. Failing to read the fine print.** Yes, the Uniform Franchise Offering Circular (UFOC) is a hefty and intimidating document. But you are making a sizable investment that will affect your daily life for years to come. You can't afford to ignore any information that will help you make the right decision.

It's essential to read the UFOC and related documents carefully. Bonus: This year, all franchisors are required to use the new format, "plain English" UFOC, which is far easier to read than the old format's mind-boggling legalese.

**5. Being penny-wise and pound-foolish.** Paying to have a qualified lawyer and accountant read the UFOC with a fine-toothed comb is an

investment well worth making. Scrimping on professional fees now could cost you thousands later.

**6. Buying in too early.** Buying into a new franchise system can be a great way to get in on the ground floor. Unfortunately, some new franchisors haven't yet worked out all the bugs; moreover, they may not have the name recognition that's such an important part of the franchise formula.

Move extra cautiously if you are considering a new franchise. Meet other franchisees if there are any, and pay particular attention to founders' previous business experience. One plus: It may be easier to negotiate flexible terms when dealing with a new company.

**7. Falling for exaggerated earnings claims.** If the franchisor's claims of profit potential sound too good to be true, they probably are. Take any such claims with a grain of salt.

By law, any earnings claims a franchisor makes must be backed by hard data. Again, talking to franchisees will give you a better sense of the validity of these claims.

**8. Not checking the warranty.** For whatever reason, the franchise doesn't work out as you'd hoped. Now what do you do?

Know your options before you buy. The franchise agreement will specify your alternatives for getting out of a franchise. Review them carefully with your lawyer before signing on the dotted line.

## For More Information . . .

- The *Federal Trade Commission* (FTC) provides a package of information about the FTC Franchise and Business Opportunity Rule free of charge. Contact Public Reference Branch, Federal Trade Commission, Washington, DC 20580, (202) 326-3128.