

## Buying A Franchise Shouldn't Be An Uphill Battle

**E**very entrepreneur knows the conventional wisdom: A new business should be run according to a carefully written business plan. When you buy a franchise, however, it is often tempting to forgo the business planning stage. After all, franchisors provide a tremendous amount of information, a smooth sales process, a reassuring program of business development, and a source of continuing assistance. What's to plan?

launch of any business. Doing so requires investigation, self-assessment, professional consultation and, finally, a written plan with detailed projections of estimated revenues and expenses.

Purchasing and developing a franchise, however, adds another dimension to the typical business planning process. Not only must you research the potential of the business, you must also investigate the franchisor. Self-assessment must include whether you will enjoy the franchised business (you can't change the format if you're unhappy) and the long hours that will more than likely be necessary to operate it.

Are you willing to exchange a measure of your independence for the "security" of a franchise? Many people find they are too headstrong for a franchise relationship. Professional consultation for a franchised business should include seeking specialized legal advice regarding the complex franchise agreement; and estimating the expenses and revenues of the franchise must take

# Quest For Knowledge

Plenty. The franchise sales process and the disclosures required by state and federal law are no substitute for diligent planning and extensive questioning on your part. As a prospective franchisee, you must ask questions and more questions.

Planning the success of your franchise is much like planning for the

into account the experiences of existing franchise owners.

### ... That Is The Question

As a potential franchisee, one of your biggest challenges is simply figuring out which people to see, which information sources to use and what questions to ask. It's very tempting to just let the franchise sales representative spoon-feed you selected information. This process is all the more seductive because you receive an impressive-looking offering prospectus from the franchisor. This document,

**Don't be overwhelmed by franchise jargon and paperwork. Take the time to do your research now so you'll make a smart decision later.**

BY ANDREW A. CAFFEY

the Uniform Franchise Offering Circular (UFOC), contains 23 items of information apparently designed to give you all the information you need.

If only it were that easy. The information the franchisor gives you is a good starting point, but don't stop there. There are numerous areas you need to investigate on your own, both inside and outside the UFOC. You must force yourself to ask tough, sometimes uncomfortable questions to gather the information

vital to smart decision-making.

Rule one in reading a franchise offering circular: *Never assume it tells you everything you need to know.* When writing these documents, franchisors follow a detailed list of required disclosures, and their attorneys prepare careful statements in response to general disclosure guidelines, but generally, they do not go beyond what is strictly required by the disclosure format. (This doesn't necessarily mean they have something to hide; going beyond

the required disclosures can be confusing and misleading, so franchisors tend to walk a narrow path.)

The first few items of the offering circular introduce the reader to the franchisor, its principals, and its litigation and bankruptcy history, if any. Additional areas to ask about include the names and business experience of field or area representatives assigned to your territory. Ask about the annual evaluation process by which the company assesses a franchisee's compliance with the system. Request a copy of the evaluation form, and review it carefully with the company. You may also want to ask existing franchisees about the evaluation process. Is it fair? Constructive? A waste of time?

The UFOC also addresses a subject of core importance to the investor: money. It details initial fee requirements and monthly royalties payable to the franchisor, and estimates the franchisee's total initial expenses. Franchisors often underestimate these initial expenses, or allow their estimates to become out of date. Question the franchisor, and especially existing franchisees, about whether the figures are realistic.

Be particularly careful about suggested levels of working capital. "Too many franchisors show zero working capital or an unrealistically low figure," says Arthur L. Pressman, a franchise litigation specialist with Abraham, Pressman & Bauer, P.C., in Philadelphia. "[Working capital] should allow for a reasonable financial base until the business is self-supporting and the owner can draw a salary. Prospective franchisees should ask whether the working capital figure in Item 7 of the UFOC includes living expenses until the business turns a profit. Ask other franchisees what they consider an adequate level of working capital for the first year of operation."

Arlington, Virginia, Mail Boxes Etc. franchisee Gene Swanzy agrees. "We were told our working capital needs would be in the \$10,000 to \$15,000 range, and our operating losses are 10 times that range. I think this is a large problem in franchise disclosures. Franchisors should do all they can to keep their franchisees from making the mistake of being undercapitalized."

The detailed operations of a franchisor's advertising fund may not appear in the document, since this is

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not a required disclosure. Ask about it anyway. Where will your advertising royalties go? Do existing franchisees believe the company's advertising is effective and is money well spent?

One of the largest sources of franchise controversy these days is the degree of control franchisors exercise over the products and supplies offered to franchisees through the franchise system. "Genuinely competitive sourcing is indispensable to controlling costs in a franchise," says Andrew C. Selden, a franchise attorney with Briggs and Morgan in Minneapolis. "Ask questions exploring any approved supplier program, restrictions on suppliers becoming 'approved,' the rights of franchise owners to form their own purchasing cooperatives, and the pricing policies of the franchisor or other designated suppliers. Many franchisees get into business only to find their franchisor is the sole product supplier for their business and charges a premium on the product, making it difficult for the franchise to make a profit."

The UFOC discloses the highlights of supply programs, but often the disclosures read like empty legal boilerplate. Ask franchisees to fill you in on how the program works in practice. Do they experience problems getting supplies? Are they paying competitive market prices reflecting their collective buying power?

One of the UFOC's strengths is it delivers three years of audited financial information about the franchisor. But not everyone can read a balance sheet or spot potential sources of financial difficulty that might be contained in the financial statements. Ask your accountant or attorney to assist you in reading the financial statements in Item 21 of the offering circular. It is well worth the modest expense.

One area where many UFOCs fall short is in Item 20, regarding franchisees in the system and franchisees who have left for various reasons. This item discloses the number of franchisees who were terminated or not renewed during the past three years, but it doesn't tell you the number of franchise owners who left for their own reasons or who sold their businesses.

"Prospective franchisees should listen carefully to how the franchisor describes the circumstances under which former franchisees left the system," says attorney Pressman. "Then

pursue the question with each franchisee. Getting both sides of the picture helps you evaluate how the company handles its franchise relationships." While the franchisor does not have to hand the names and addresses of former franchisees to you on a silver platter, Pressman says they do have to tell you where franchises that closed within the last year are located. Therefore, with a little research, you should be able to track down former franchisees to get the information you need.

All UFOCs contain a sample franchise agreement. At this point, there are two essential steps to the decision-making process: (1) read the contract yourself, and (2) have a lawyer review it with you before you sign anything. Be sure you have a working understanding of all the contract's provisions. For instance, do you understand the contractual restrictions on transferring the business? Many franchisors reserve a right of first refusal. Ask your lawyer



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to explain these and other terms.

Make sure you understand not only the terms of your contract but any applicable termination standards under the laws of your state. Post-termination provisions often impose a covenant not to compete with the franchisor, in which the franchisee agrees not to continue operating the business if the contract is terminated for any reason. It is vital you explore these concepts with your lawyer and understand them.

### Beyond The UFOC

Understanding the information in the UFOC is a first step, but there are still many more questions to ask. Franchise regulation has left at least one gaping hole in the information made available to prospective franchise buyers. It is the answer to the first question on any buyer's lips: "How much money can I make?"

Franchise regulations prohibit franchisors from making unfounded claims of profitability, and they strictly regulate virtually all information from a franchisor that might help a prospect answer that question. "Regulatory changes in the late 1980s, [which told franchisors how to present earnings information], encouraged more franchisors to provide this information, but still only 15 to 20 percent of franchisors include earnings claims in their disclosure documents," says attorney Selden.

"The current regulations are meant to encourage delivery of earnings information," Selden adds, "so if your prospective franchisor doesn't offer earnings claims information, find out why. It may be the company has nothing favorable to tell you."

How do you get the answer to the question of potential earnings? The advice to prospective franchisees is to ask existing franchise owners about their businesses' financial performance. This is an essential step, though in practice it is more difficult than it sounds. It's an uncomfortable subject, and many franchisees will be reluctant to discuss it with you.

Make the subject less awkward by asking the franchise owner about general franchise system topics first, then close in on more direct questions about his or her own experience. Be sure to cover the following questions:

• Are you pleased with your decision to buy the franchise? Knowing

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what you now know, would you want to do it again?

- If a second franchise became available in your market, would you buy it? Could you afford to buy it?

- Has the franchisor been responsive to your business needs?

- What did you think of the training program? Were you well-prepared for this business by the time you opened your doors?

- Were there any surprises in your first year of operation? Did you think the cost estimates provided by the company were realistic? Was your working capital sufficient? How much did you budget for your first year?

- Is there a franchise owners' association? Is the group's general attitude helpful? Do franchise owners pay their royalties? Are there any disputes that are the subject of discussion among franchisees?

- How long are your workdays? Do you take vacations? Does your family help you operate the business?

- Do franchisees who refer franchise sales leads or meet with prospective franchisees receive a referral fee, commission or bonus?

- Are sales patterns in this business seasonal? Describe the busy season. Is it difficult making ends meet in the off-season?

- What were your annual sales last year? Was it a good year for your business, or have you been hurt by the recession?

- Do you think this type of business has a strong future?

Meet with at least a few franchise owners, selected at random from a complete or partial list of franchisees (found in Item 20 of the UFOC) in the system. Don't let the franchisor choose the people you meet with.

When gathering the information you need for your business plan, take notes and carefully weigh the advantages and disadvantages of the investment. If any aspect of the franchise program is unclear, ask about it again. Only by asking questions will you get the facts you need to make a smart—and informed—decision. ■

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