No Experience REQUIRED

Buying a franchise as an investment has its risks and advantages. Here's a guide to the pitfalls and potential that lay ahead.

BY ANDREW A. CAFFEY

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PURCHASING a franchise is about much more than buying a job. With the right franchise program and the right approach to the purchase, it can also be a healthy financial investment, a solid place to invest your funds for years of equity growth.

For some franchise owners, buying a franchise doesn't mean tying on an apron and standing behind a counter. For them, it's not a job at all; it's purely an investment. In fact, some of the most exciting franchise offerings are simply investments, requiring only minimal involvement in the business and allowing passive investors the opportunity to buy into a franchise program without leaving their current professions.

CASH FLOW IS KING

According to Roger Heymann, a CPA with Heymann, Smith & Suissa PC in Rockville, Maryland, whether you're buying an existing business or developing a new location—and whether or not you'll be involved in the daily operations—the crucial ingredient in any franchise purchase is cash flow.

"We've evaluated many franchise investments for our clients, and we look at whether the business will generate sufficient cash flow to pay the owner a fair salary and generate enough [money] to cover the debt that results from the purchase," says Heymann. "If the projections show the cash flow will support those two financial goals, the business is worth buying. If not, the new owner will either have to reduce or forego a salary entirely and even then may quickly go out of business. If the cash flow won't support the investment, it's time to renegotiate the terms of the purchase or pass it up entirely."

Business ownership accumulates value over time, riding the tides of inflation, community development and increased property values. For this reason, according to Heymann, investors don't need to insist on a specific return on investment, or ROI, even if it could be accurately measured before a business is purchased. "The owner will acquire equity in the business as debt is paid off," he says. "It's a lot like the benefits of home ownership."

And just like owning a home, if your income doesn't allow you to make your monthly payments, no promise of future appreciation will help you pay off your present-day debts. It's the cash flow—the revenue that the business consistently generates from one month to the next—that makes the investment possible.

PASSIVE VOICE

The passive franchise investor has many investment goals. That investor must plan on salaries for managers who will run the business, allow for debt service on the loans used to buy the business and still receive income as a return on the investment. How much of an ROI? "We generally look for a 10 percent cumulative annual return after debt service on the money invested," says Heymann. "That may seem high, but buying a business is a relatively risky investment compared to putting the money in a money-market account. That sort of risk should generate a high return for the investor."

Passive investors generally plan to build the business toward a specific value, usually expressed as a multiple of annual earnings. A common goal is to decrease the expenses of an operation and build revenue so the business is valued according to the highest possible multiple of earnings, often as high as five to one. For example, if the "recasted earnings" of the business (meaning without owner benefits such as a retirement plan) after salaries, taxes and debt service are taken out is $60,000, the purchase value of the business is about $300,000.

A Cut Above

For nearly a decade, entrepreneurs Greg Regian and Julie Wilson have amassed profits by creating publicity campaigns for franchises in the Fort Worth, Texas, area. Over the years, many Regian & Wilson advertising clients had urged the duo to put their money where their mouths were. Since they specialized in franchises, what better way than to experience franchising firsthand?

Becoming a passive franchise investor is a route many opt to take. For Regian and Wilson, the opportunity not only proved that they believed in their own abilities, but it also offered a fringe benefit: a sound investment for the future.

Fortunately, the pair didn't have to look far for the right venture. One of their primary clients, haircut shops franchisor Hawkins Pro-Cuts, was selling some existing locations, so they purchased one in 1995.

"It was more time-consuming than we'd bargained for," says Wilson. "So we decided it would make sense to buy

Franchising presents a natural opportunity to bring those important views of life to a business endeavor. "Franchising is a good vehicle for the passive investor, even if the investor doesn't own the franchise itself," says Justis. "I know of one fellow here in the South who loaned $50,000 to a multiple restaurant development franchisee and was guaranteed a 23 percent annual return for the next 10 years. That's not bad. All passive investors have to understand that in franchising, they're investing in the team of people who bring the operational skills to the business. A national trademark is just not enough, by itself, to support the investment."

Do all franchise systems allow passive ownership? Absolutely not. "In fact," says Justis, "it is expressly prohibited in many systems. That's because of the [documented] higher performance of many retail businesses when an owner is on the premises. Local ownership is part of the magic of the franchise formula, and many franchisors don't want that operational edge lost to passive ownership."

In many industries, the return on an investment may not be realized very quickly. "[Some] franchised businesses don't even break even, let alone give a return on an investment, for three or four years," says Justis. "And that can certainly discourage investors."

CONSULTING YOUR CRYSTAL BALL

The crystal ball by which you can determine whether a business purchase will be a good investment is an accountant's projection. A projection by a competent accountant is a detailed, time-consuming, fairly expensive undertaking, but it's an essential step in your decision-making process. You and the bankers who would lend you money to buy the business

Hands Off

All investments pose risk—even when you're betting your savings on a reputable franchise system. The stakes get especially high for passive franchise investors, who typically entrust the success of the business to a full-time manager.

"I think my biggest issue [has always been] the risk involved," says Corey McClelland, a passive franchisee for three UniShippers franchises in Southern California. But that didn't stop him from joining forces with Dan Lockwood and Mike Dimase, two friends he met while working as a lifeguard years before, to buy the franchises. "I had a lot of trust in the people who were going to be running [the franchises] on a daily basis," he says.

Lockwood quit his job in 1991 to run the partners' first franchised location—and ultimately all three—full time with help from Dimase. McClelland only commits about an hour each month to the businesses when he can spare time from his job as a computer scientist for a large corporation. So far, so good: 1997 sales were $3.2 million, and 1998 projections were $4 million.

tion available to prospective investors. Earnings claims are heavily regulated by state and federal franchise laws because of historic abuse. Franchisors are not required to produce performance data, but if they do, it must be displayed in Item 19 of the company's Uniform Franchise Offering Circular (UFOC).

Although you may find useful investment data there, the odds are, you'll have to develop your own projections. The next best source of performance data is other owners. You'll find a list of franchise owners in Item 20 of the UFOC; get in the car and visit them, armed with financial questions. What were their gross sales for the year? What was their net income for the year? Have they drawn a fair salary out of the business and were they happy with its performance? And the key question: If they had the decision to make again, would they invest in this franchise?

Once you actually decide to buy the franchise and you sign the franchise agreement, the franchisor will be in a position to help you develop a complete business plan and won't be restricted by law from providing you with whatever system information is available. The law is designed to protect *prospective* franchisees from inappropriate inducements to buy into the franchise; once you commit to the purchase, the restrictions no longer apply.

What The Passive Investor Looks For:

✓A franchise agreement that allows passive ownership. If you want to be a passive franchise owner, make sure the franchisor allows it. Many don't.
✓A strong franchise program, which reduces the risks inherent in new franchise offerings
✓Return on Investment (ROI) in the neighborhood of 10 to 20 percent cumulative annual return after debt service
✓Accountant's projections that show the business can support management salaries, carry debt service and still hit a healthy ROI
✓Strong earnings information in the UFOC (Item 19)
✓The right team of operators or unit managers —*A.A.C.*

BEWARE OF TRANSFER RESTRICTIONS

If you're planning to purchase an existing franchise, check out the restrictions placed on the transfer of the franchise rights. Virtually all franchise contracts impose conditions on the sale of the franchised business. These usually include the franchisor's review and approval of the terms of the proposed transaction, your qualifications (financial and otherwise) as the prospective buyer, your signing a franchise agreement that may be substantially different from the contract held by the seller, and payment of a transfer fee to the franchisor. Make sure you or your attorney investigates these requirements early in the purchase process. Transfer fees and other expenses may affect the value of the business you want to buy. Expect the franchisor to ask you to submit application materials for its review and consideration.

Many franchise contracts also give the franchisor a right of first refusal, allowing it to buy a franchise in the event the owner receives a genuine purchase offer from another party. Once an offer is received, the contract might require the franchisee to pass it along to the franchisor, which has a specified period of time, usually 30 days, in which to exercise its right. You may do your homework, secure your accountant's projections, arrange financing and make a formal purchase offer only to find that the franchisor decided to exercise the right to buy the business on the same terms as your offer.

What The Active Investor Looks For:

✓Accountant's projections that show the business can support a fair salary and carry debt service
✓Equity that will be built over time as debt is reduced
✓Minimal transfer restrictions in the franchise agreement. Consult with a competent legal advisor on this point.
✓Reports of satisfaction from other owners about the financial success of their businesses
✓Accountant's projections that show you can afford the transaction —*A.A.C.*

THE FUTURE OF FRANCHISING

In its earlier years, franchise success was built on the courage, determination and hard work of the individual owner/operator. While there are still many great opportunities geared to the individual purchaser, the franchise market is decidedly different now. The new sophistication and maturity of the franchise concept, fierce competition in the marketplace, and the sheer size of the total investment required by most retail franchises have combined to create exciting investment opportunities for passive investors.

The future of franchising remains bright, whether you want to be involved behind the counter—or not.

For more information about researching a franchise, see "Now You're Cooking" on page 162. Ⓔ

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