Get Franchise Fit

Buying a franchise biz can be a real workout. This research routine will put some muscle on your franchise future.

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You finally resolve to get back in shape, so you hire a personal trainer to help you achieve your goals. At your first meeting, the fitness trainer asks you a series of questions and measures you, weighs you and pinches around to determine your level of body fat. You're at the beginning of a long road. It is vital not only that you know where you're starting from, but also that you head down the right path for you.

It's a lot like the process of buying a franchise business--you cannot afford to make a mistake on such a large financial investment. Like working out at the gym, you can get hurt if you're not careful and well-informed about the process. To locate and evaluate a franchise that will be a good fit for your needs, and to do it right, you have some research and work to do. You'll also be using investigative muscles you've never used before.

Answering the Tough Questions

Focus your attention on the type of business that interests you. If you plunge into the franchise marketplace without giving some thought early on to the type of business for you, you'll be in trouble. Like walking cold into a gymnasium full of complicated, intimidating workout equipment, you won't know where to start.

Are you intrigued by a conventional retail business, or do you see yourself working from home? Do you live for food? Do you like serving the public, or do you want to sell to corporate customers? Do you want to run the business full time or part time?

Obviously, these questions must be answered in the context of your interests, your resources and your particular level of financial fitness. Assess the capital you have immediately available to you and other likely sources of funds. If you're about to sell your $100,000 baseball-card collection or liquidate your priceless stockpile of Batman paraphernalia, by all means include the proceeds in your calculations. You may want to talk to a local banker about loan programs for which you could qualify (ask about small-business loans backed by the SBA), talk to an accountant, even visit with your rich Uncle Ned. This personal self-assessment will tell you whether you should be looking at a $700,000 retail franchise or a $40,000 homebased franchise.

Working the Trade-Show Circuit

The internet will throw a lot of options and hype at you; a franchise trade show will let you try out the equipment. Most cities have one or two franchise and business opportunity trade shows in a given year. If one comes to your town, take the time to attend. A trade show is a terrific opportunity to see what the market is offering and speak with knowledgeable franchise representatives.

Let your key research begin here: Ask the right questions of the representatives. You know from your personal assessment what type of business you're seeking, how much cash you have on hand to invest and how much you qualify to borrow from a lender. So be sure to ask a few initial qualifying questions: Does the company require prospects to have a certain amount of cash on hand? What is the total investment range for the franchise? (They should know the range, since this information appears in the franchise's disclosure document, which we'll discuss later.) Are there business-experience qualifications required of prospective franchisees? If the answers to these questions pull you out of your range, don't waste your time--move on down the line. Make the effort to find the program that interests you and hits your investment sweet spot.

Plan your time at the show carefully. Expect to pick up a ton of general brochures and application forms--carrying these around for a few hours will tone your shoulder muscles. Make sure you have a full collection from any franchise booth that interests you, and leave them your complete contact information. A personal business card makes the best impression.

Pumping Iron: Lifting the UFOC

Not many franchisors will deliver a disclosure document to you when you walk up to the trade-show booth. If you attend a sales presentation or a "discovery session," or speak one-on-one with a sales representative at a hospitality suite or some other off-site location, most companies will hand you a franchise disclosure document at that time. So just what is this document?

All franchising companies in the United States are required to deliver a complete disclosure document known as the Uniform Franchise Offering Circular, or UFOC, to a prospective franchisee a couple of weeks before money changes hands or the prospect signs a binding legal obligation. For anyone researching a franchise investment, this is an indispensable document. As soon as you become at all serious about a particular franchise, it's time to get a copy of the company's UFOC. Franchisors are not required by law to give you a UFOC until fairly near the close of the transaction, so it's your responsibility to request one earlier. Some companies wait until you come through headquarters on a visit; others allow you to view the document online. Either way, your goal is to get your hands on the UFOC so you can obtain a full picture of the program as early as possible.

Once you have the company's UFOC, read it carefully. If you're an old hand at corporate investing, the document will be vaguely familiar to you--it's based on similar disclosures required under corporate securities laws. If you're new to these documents or if it's been awhile since you cracked open a securities offering prospectus, you're in for a pleasant surprise: All UFOCs are written in plain English and organized along the same detailed outline.

Resistance Training: Crunching Numbers

A UFOC is basically broken into three parts: 1) a descriptive narrative describing 22 various important aspects of the franchise offering, 2) a copy of the contracts you sign when you become a franchisee, and 3) a set of the franchisor's audited financial statements (or those of the company guaranteeing the obligations of the franchisor).

Start at the back. An experienced accountant can tell you a lot about the financial health of the franchising company by reviewing its audited financial statement. Does it have the financial muscle to survive long enough to continue servicing your franchise business, or is it teetering on the edge of a financial abyss? How many franchisees paid royalties last year, and what was the rough annual average payment? Did the company make money from its operations last year, and how do the numbers compare to the previous two years? Are any disturbing trends buried in the numbers? If you're not conversant in number-speak, seriously consider getting professional assistance. You'll probably need an accountant to help with the establishment of your business anyway, so find one now, and have the UFOC's financials reviewed.

That brings us to the franchise contracts--everybody's favorite mental workout! A word of caution here: Your franchise agreement is not required to be written in plain English. It's typically quite long (30 pages of single-spaced verbiage is not at all unusual), and it will strike you as remarkably one-sided, seeming to favor the franchisor at every turn. Let a good lawyer help you review it. Find one who has experience working with small businesses, and let the lawyer explain how it affects your interests. If your lawyer finds 27 ways she would like to change the contract before you sign it, arrange a discussion with your franchisor representative to find out how the company handles negotiated-change requests. Some franchisors insist on their standard contract; others will negotiate. Generally, in my experience, the younger the franchise program, the more willing the franchisor is to negotiate. In any case, it's always better to have a lawyer on your team to help you assess the legal situation.

Shaping Up, One Item at a Time

Now that you have professionals working on the more complicated aspects of the UFOC, turn to the plain-English narrative description. The first few items (Items 1 through 4) tell you all about the franchise program and the franchisor, its identification, address, range of business activity, history, involvement in other franchise programs, its managers' business experience, and its litigation and bankruptcy background. This is key information for checking out the depth of the company's experience and the nature of any serious legal problems. Don't be surprised if you find a few civil cases or arbitration cases against franchisees disclosed in Item 3--running to court or arbitration to resolve a dispute is an inescapable part of modern business life, and franchises are certainly no different from other businesses. In fact, the franchise sector is more litigious than most business sectors.

The next few items in the UFOC (Items 5 through 10) lay out the fees and estimates of the new franchisee's total expenses and disclose whether the franchisor provides financing for any aspect of the investment. Item 7 is most useful among these items; it's a chart summarizing all the expenses you're likely to incur when you establish a new franchise business. Make sure your accountant sees this information--it will be useful in your financial planning.

Items 11 through 14 detail the services and rights the franchisor provides you as a franchisee--everything from assistance with your grand opening to training to the granting of trademark and patent rights. Territorial protection, an issue close to the hearts of most franchise investors, is described in Item 12.

Other items worth noting are Item 19 ("Earnings Claims") and Item 20 ("List of Outlets"). An earnings claim is any statement that conveys how your franchise will perform financially or how existing franchisees are performing. A franchisor cannot say, "These businesses generate at least $450,000 a year" (even if it's true) without making the statement in Item 19 and disclosing the reasonable basis for the statement and the assumptions that underlie the claim. Item 19 disclosures, which appear in an estimated 30 percent of all UFOCs, are therefore eagerly read by prospective franchisees. If the UFOC has no Item 19 statement, you must rely on the performance information provided by existing franchisees.

Item 20 lays out a statistical picture of the entire franchise system over the past three years. It includes a list of current franchisees as well as people who left the franchise system for any reason in the past fiscal year. Use this vital contact information when looking to interview franchisees about their experiences with the program.

Just as it takes a little sweat to get in shape, it also takes some hard work to find a franchise business that meets all your needs--but the rewards can be well worth it.

The Real McCoy?

The question prospective franchisees ask me most frequently is, "How can I find out if the franchisor is legitimate?" Some people imagine there's some sort of national clearinghouse that can confirm legitimacy on the telephone. There is no such place, but there are clues ripe for the picking. Here are five likely sources of information to help you answer that all-important question.

1. Even though it may not tell a complete story, the UFOC will tell you volumes about the franchisor and its background. What sort of business experience do the company's key executives have (Item 2)? What does it say about the company's history of litigation (Item 3) and bankruptcy (Item 4)? Is the trademark registered with the federal Patent and Trademark Office (Item 13)? What do the system numbers (Item 20) say about the number of franchises that have opened for business in the past three years?

2. Another great source of information: existing and former franchisees. Call them (they're listed in Item 20 of the UFOC), and set up interviews. Ask them about their experiences with the franchise, the training, the investment and how their business is performing. And ask the ultimate litmus-test question: Would you make the same investment knowing what you know now? If the franchise offering is new and there are no existing franchisees to call, you have no comparable source of information.

3. State agencies can be most useful in your evaluation, particularly if you're in a state that regulates franchise sales. The franchise registration states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. Each of these states requires a franchisor to register to offer franchises. Find out if the franchise you're interested in is registered before getting too serious.

4. The Better Business Bureau provides reports of customer complaints received. For more information, go to www.bbb.org.

5. The FTC brings legal enforcement actions, large and small, against

franchising companies. Look over its recent activity at www.ftc.gov.

Franchise Fitness Checklist

Muscled up and fit to buy:

- The franchisor is financially strong; your accountant is satisfied.
- Franchisees in the system give their investment decision the thumbs up. Some systems make their franchisee "grades" available online for a modest price (see www.fransurvey.com).
- The business offers a good fit with your interests, and you're excited to jump into the business. Even better, you have experience in this type of business.
- The revenue potential looks strong.
- Market trends are in favor of this business.
- A good location or good customer base is available in your home market.
- The franchise system shows steady growth.

Still flabby and needs to step up its regimen:

- There is a load of litigation reported in the UFOC, revealing a rough franchisor dispute-resolution style.
- Franchisees in the system say they feel trapped and would not make the same investment again.
- Franchisees in the system say the training is inadequate.
- Your lawyer says the contract is heavy-handed and poorly prepared, and your accountant wonders whether the franchisor will be around in 12 months.
- Your state franchise or consumer-protection agency says the franchisor is not registered (if required) or that numerous complaints are on file.
- The franchisor provides you no UFOC, or the UFOC they give you is out of date, incomplete or not registered (if required).

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