Ask the Insiders

What franchisors want, common mistakes and the skinny on multiunit options: Our panel of experts tells all.

Andrew A. Caffey | January 1, 2006

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Wondering where to start on your franchise journey? Well, you've come to the right place. Our resident expert, franchise attorney Andrew A. Caffey, assembled a panel of some of the most esteemed insiders in the business to help you buy the right kind of franchise--and be the right kind of franchisee. Meet Linda Burzynski, president and CEO of Liberty Fitness, who has previously served as the head of successful franchises CMIT Solutions and Molly Maid; Don Fertman, who, as director of development for Subway, sets the tone for how franchisees will be accepted into the number-one franchise system in the nation; and Andrew C. Selden, a franchise attorney with Briggs & Morgan in Minneapolis and former chair of the American Bar Association Forum on Franchising. These experts' opinions and insights can help you navigate your way to a fruitful franchise future.

Andrew Caffey: What do you look for when evaluating a prospective franchisee?

Linda Burzynski: Financial qualifications come first, I suppose, but I'm really looking for candidates with people skills, because I've never been in a franchise business that didn't require getting along with people. In addition, and equally important, I look for a track record of high integrity and character. A track record of leadership tells me a person can build rela-tionships. Getting results with people, getting along with others--these are strong indicators of success.

Caffey: I imagine you would evalu-ate leadership skills and integrity in an *interview process?*

Burzynski: Absolutely. I firmly believe in spending a lot of time with candidates. We also review personal and professional references--not just one or two, and not just pro forma. We ask the references to provide more in-depth information about the character, leader-ship and integrity of our candidates.

Don Fertman: I agree with Linda's comments about integrity, communication skills and the ability to interact with the public. We evaluate candidates in two different phases: One is basic skills. We give people math, English and basic communication skills tests, just to get a sense of what they can do when dealing with people face to face. Then on a more complex, subjective level, do these folks have the ability to think outside the box? Being a successful franchisee is a balancing act. You have to be able to stay within the box, so to speak-work within the operations manual and follow the system, have the characteristics of somebody who will follow a system-but at the same time have enough ability to think outside the box so you can run a successful business and troubleshoot when necessary. We're always looking for hands-on owner-operators. Will the folks be involved in the business on a day-to-day basis? Will they get behind the counter? Will they put their hands in the tuna fish? Will they really get to know the business inside out? Because that's how they're ultimately going to be successful. We're not looking for absentee investors who want to plunk down some money and make a quick buck, because that isn't what franchising is all about.

Caffey: Andrew, you've represented numerous franchisors and numerous franchisee associations. What sort of guidance do you give to a prospective franchisee who comes to you?

Andrew Selden: It's almost impossible to get too much information before you make your first investment in a franchise. You have to wade through the Uniform Franchise Offering Circular line by line to begin the information-gathering process, but I would counsel a pro-spective investor to look at a couple of issues you aren't going to find in the UFOC. The first is the soundness of the underlying business proposition. You could have a UFOC that describes a perfectly structured, perfectly financed, well-managed vacuum tube dealership--even if the franchise is perfect, if the underlying business is weak, that's not a good investment proposition. Second, talk to existing franchisees in that system to determine whether the franchisees have an active and meaningful participation in system decision making, or if the system is more dic-tatorial. There are many large, successful, market-dominant franchise systems in different industries that have taken the partnership rhetoric to heart. They've said, "Look, we've got a lot of equity investors in this system--let's learn from their experience and their entrepreneurialism."

Caffey: Are franchisors using psychological testing or profiling in the evaluation process when they look at prospective franchisees?

Fertman: We use something called a "predictive index test." We don't necessarily use it for every prospect; in some international markets, we find a different mind-set that limits the test's usefulness. The predictive index test gives us a sense of how people behave in certain situations: Are they outgoing? Are they go-getters? Are they motivated? Do they have a strong sense of urgency? Those indicators can help the evaluation process.

Burzynski: We use a DiSC personality profile [which tests a person's domi-nance, influence, steadiness and conscientiousness; see www.inspiring solutions.com]. We use the test once a candidate becomes a franchise owner so we have a good idea of how to work with them and coach them. We are now considering administering that test as part of our application process.

Common Mistakes, Negotiations and More

Caffey: What are the most common mistakes made by franchisees and franchisors?

Selden: From a franchisee perspective, a common mistake is not getting a good understanding of the franchise system, its track record or the financial performance that you can reasonably expect to get out of the system.

Burzynski: I think a common mistake is that often, individuals buy franchises for the wrong reasons and with wrong assumptions about the business. They may have recently been downsized or disappointed, and they feel that by buying their own franchise, they are completely in control of their destiny and they'll never have to answer to anyone. I often see unrealistic expectations, no matter what we say in the application process. Some owners expect instant success as a result of the system, as if it will happen all by itself. Then, when they actually become accountable, they realize that it is all up to them, that there just isn't a magic bullet. They also realize they are account-able to their clients and their employees, as well as to fellow franchise partners. Too many investors underestimate what it takes to [build a] successful franchise.

Fertman: That's an important point. People can come in sometimes with expectations that are too high; they just don't understand how much work is involved or the commitment it takes. As Linda said, it's not going to happen by itself. The franchisor can be guilty of setting unrealistic expectations as well. Candidates have to talk to other franchisees and understand fully what they're getting into.

Selden: I think it's critical to ask existing franchisees, "If you had it to do over again from the start, would you invest in this franchise a second time?" If the answer is yes, they're sure going to tell you about it, because they're probably enthusiastic about the business, they like the brand, they like the system and they're OK with the hard work. If it hasn't worked out for them, for whatever reason, they'll tell you that, too.

Burzynski: Here's a great question to ask: As a franchisee, if you could do one thing over again to help make your business even more prosperous, what would it be? That's a won-derful question because it helps foster honesty about the lessons they have learned in the business.

Selden: You'd also want to ask existing franchisees if the support services from the franchisor contributed real value, and if the system's marketing support is effective.

Fertman: Another important question is, How much money can I make? Of course, you're going to get all kinds of answers to that, but the financial issue is always an interesting one.

Caffey: Don raises a good point. Andy, how does a franchisor legally answer the question, How much money can I make?

Selden: Well, the hurdles to franchisors making legal and proper financial disclosures today are so low that many companies with a favorable story to tell can-and I would argue should-tell that story in the UFOC. If they don't include financial performance information in their offering circulars, they are not able to legally provide performance information themselves. In that case, franchisors have to refer the candidate to other sources-existing operators, the library and business magazines, their bankers-to ask what similar businesses can do.

Fertman: If I were a new franchise investor looking for a franchise in a particular category, I'd investigate as many franchises within that category as I could find. I would want to get a sense of their average unit volumes and growth rates, and compare them.

Caffey: Should a franchisee expect to negotiate the terms of a franchise agreement? Is that common in franchising, or is it relatively rare? What's your experience in negotiating the terms of a franchise agreement, and what should a franchisee expect?

Burzynski: Franchisee candidates should anticipate that the franchise agreement is the franchise agreement, and it will not be fundamentally altered. I've got to assure every single franchise partner that they all have the same agreement. Now, we have taken steps to clarify some aspects of a franchise agreement by way of a letter of clarification, but material terms generally do not change. Every franchise partner of ours has the same agreement; no one has to guess whether someone negotiated a better deal.

Fertman: For us, the bottom line is: If it's outside the disclosure, we can't change it. Within the disclosure, we describe all the different scenarios that a franchisee will encounter. As we've grown, we've accommodated different situations where we're doing business with oil companies, for example, going into convenience stores and dealing with larger corporations. We changed our rules a bit and modified our franchise agreements somewhat to handle those types of situations.

Electronic Disclosure, Subfranchising and the Future

Caffey: Let's talk about electronic disclosure. Why don't franchisors provide *electronic disclosure of their offering circulars--or do they? If electronic disclosure is not common now, is it coming?*

Burzynski: I don't see it that often, and I choose not to use electronic documents. Maybe I'm old-fashioned, but I want to make sure our prospective franchise owners are taking the time to read that document. I'm concerned they will not take the time to print out an electric document and read it carefully. It is surprising, but I still find [people] who come to the table for a serious discussion, and it's clear from their questions that they haven't read the UFOC or the agreement.

Fertman: We still send out that big book to about 600 people every week. A printed version is an expense for the franchisor, but it's easy for people to read. A while back, we made the UFOC available on CD-ROM; we asked prospects if they had a preference for the old-fashioned book or the electronic CD-ROM, and virtually everybody took the book. Electronic disclosure is ultimately a useful tool, but it may take more time for people to get comfortable with it.

Caffey: In the past 20 years, we've seen some strong subfranchising systems arise, and I'm wondering what experience you've had with multi-unit franchising or subfranchising, and whether you think this is a strong direction franchising is taking.

Burzynski: It's definitely growing. Franchising is attracting very sophisticated investors looking to build empires. This is a growth tool that many franchisors will use. I approach multiunit arrangements very cautiously. With Liberty Fitness, we are embarking on a couple of multiunit franchise opportunities, but I'm going to watch it carefully. I want to ensure success for the system and, of course, for the developers.

Fertman: Subway is actually doing more multiunit franchising. We've put together an exclusive area agreement program where we grant a particular territory to a franchisee-or a partnership or consortium of franchisees-and they have an opportunity to develop that area over a period of time. They retain exclusivity as long as they build the business as scheduled. I agree with Andy that multiunit franchising is something we're going to see more of in the future. As our system matures, our franchisees mature and more multiunit operations become available to the owners. They start becoming business-builders as opposed to individual franchisees.

Caffey: What does the state of franchising look like down the road?

Burzynski: The state of franchising is extremely strong. I believe there is a realization not only in our country, but in many countries throughout the world, that franchising is definitely a strong way to expand business. People's desire to own their own businesses and to grow and prosper is growing, not weakening. Baby boomers are consistently disappointed in the corporate culture, so I feel that franchising is going to grow as a strong alternative.

Fertman: I would certainly agree with that. Franchising is indeed a growing proposition. It really is a terrific business model.

Selden: I see a trend-I don't think it's an avalanche, but a trend. Independent economic research and aca-demic literature about franchise systems are telling us that systems following what I'll call a 1950s or 1960s top-down, vertical hierarchy are the ones that never really flourish. Systems that embrace a more holistic, collaborative, internal-governance arrangement are the ones that realize their full potential, and we see more and more of this in big systems and small systems alike. They understand that franchisors and franchisees both have a lot at stake, that they're all rowing the same boat, so to speak, and to the extent they can genuinely work together on system issues, they're all going to come out ahead.

Raise the Red Flag Does your gut tell you something isn't quite right with that franchise investment? Check out this list of 7 warning signs.

1. No uniform franchise offering circular: Franchisors are required by federal law (and often state laws) to give you a UFOC at least 10 business days before you pay any money or sign a franchise agreement. If you don't receive one, don't even consider investing.

2. The hustle: If the seller tells you the window of opportunity is closing or uses any other hard-sell tactics, be prepared to walk away.

3. Product price squeeze: If you're buying a business that sells the franchisor's product line, make sure its pricing allows you to be competitive in the marketplace. Ask franchisees how the pricing structure works for them. If the product is supplied by third parties, or by the franchisor itself, make sure the supply program runs smoothly. Have the franchisees established a buying co-operative? Do franchisees have input about supply arrangements?

4. High turnover rates: Check Item 20 of the UFOC to confirm how many franchisees have left the system in the past three years. If anything looks suspicious, ask the franchisor about it.

5. Earnings-claim mumbo-jumbo: When you ask how much money you can make with the franchise, listen carefully to the answer. Although a franchisor is legally allowed to provide an answer with either a projection, pro forma or statement about how its franchisees have performed, it must also include the claim in its UFOC (Item 19). If the information isn't in the UFOC, the company must decline to answer the question. If no performance information is given (only about 25 percent of franchisors provide earnings claims), it may be because the true picture isn't pretty. Ask the same question of the franchisees you interview. They are legally free to tell you.

6. Too many lawsuits: Item 3 of the UFOC shows the 10-year history of lawsuits filed against the company. A heavy litigation history may mean franchisees are unhappy, so find out what's going on.

7. Weak financial statements: The UFOC contains three years' worth of the franchisor's audited financial statements. Review them carefully, and take them to a CPA. The poor financial condition of a franchisor magnifies your own risk.

Any of these warning signs should prompt you to ask more questions. If you don't like the answers and your gut (or professional advisor) tells you to be wary, this may not be the right program for you.

Digging for dollars The biggest challenge most people face when purchasing a franchise is finding the money necessary to build the business. Here are some starting points:

- **SBA-backed loans:** The SBA's lending program has launched more franchises than any other in history. Talk to your bankers about whether you qualify for an SBA-backed loan for your franchise.

- **Family equity:** Even if you locate financing, you'll have to inject a slug of equity into the business. Check your own resources. What do you need to pay your bills every month? Do you have friends and family willing to invest in the venture?

- **Venture capital:** If you approach a venture capitalist, be prepared to provide every last detail of your proposed business and business plan, and be willing to give up as much as 50 percent of your business in return for the investment.

- **Angels:** An angel investor is a wealthy individual who is not a professional venture capitalist.

He or she has investment money in hand and is looking for a financial home run, or at least a better return than can be expected from the stock market. Angel investors look for annual returns of at least 25 percent. They're often patient, long-term investors who have witnessed the birth of plenty of entrepreneurial ventures.

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