

Check It Out

How to be a crack gumshoe when investigating a franchise.

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They say that real detective work, unlike the glamorous world portrayed in the movies, is mostly mind-numbing routine and tedious research. Truth be told, private investigators are glorified information gatherers. The good ones know where the information is, how to get at it and what to take back to their clients. They also have a nose for valuable information. They are good listeners, and they are relentless in their pursuit of information that pertains to their case.

Investigating a franchise involves similar work. Sure, there is some glamour. Those trade shows are exciting. You were welcomed into company headquarters and met the charming president of the franchise. You could get used to this attention, right? Well, before you get too comfortable . . .

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On The Case

Your work is just beginning. Now that you've identified a few programs you find exciting, it's time to assess what information you'll need to make the right decision and how you'll go about gathering those nuggets.

The tasks ahead look something like this:

- self-assessment
- franchisor and business system evaluation

- site location and market study
- investment projections and financing
- legal assessment and negotiation

And the basic information sources to help you complete those tasks are:

- the franchisor representative and promotional materials
- the Uniform Franchise Offering Circular (UFOC)
- libraries and other public demographic information sources
- current franchise owners
- government agencies
- professional advisors
- personal advisors, family and friends

It helps to create separate files for these subjects. Your investigations can generate a lot of paper, and you'll want to have it well-organized.

An Eyewitness Account

It's so easy to skip the self-assessment process, but it's a vital step in avoiding a huge investment mistake. Confirm in advance that you will enjoy the business you're researching--not making money at the business but the daily activity of the business: the customer service, the management of employees, the salesmanship, the details, the hours, the hard work. Keep those thoughts in mind as you proceed with your investigation. You will discover the nitty-gritty of the franchise as you dig deeper.

The franchisor will be your first and most convenient source of information. You'll receive a glossy brochure that stimulates the imagination but is usually light on information. Take the tour of the company's headquarters, make the rounds of company-owned or franchised stores in the area as part of the tour, and be inquisitive. Ask questions and take notes. Talk to all the people you meet. Ask them what they like about the organization.

Like any good detective, you should listen for clues about the company's style. What's the general attitude toward franchisees? Ask for details about the training program, and check out any training facilities at the headquarters. What system has the company set up for field support for franchises?

The Paper Trail

The best document for investigation purposes--and it is head and shoulders above any other single source--is the Uniform Franchise Offering Circular (also known as the UFOC, the disclosure document or the prospectus). For a detective, it is the smoking gun, the name written in lipstick next to the body, and the Maltese Falcon all rolled into one. It is an information find that will be unparalleled in your investigation.

The UFOC is designed by lawmakers to provide prospective franchisees with all the information that is considered important in making an investment decision. It consists of 23 items describing various aspects of the program, copies of up to three years of the franchisor's audited financial statements, and a copy of the franchise agreement and each related contract you will be asked to sign.

A remarkable number of prospective franchisees don't bother to read the UFOC. Don't make that mistake. Sure, it's imposing: A comprehensive UFOC can run a few hundred pages in length. If you have no experience reading a balance sheet or a complex legal contract, put those sections aside for professional review later. You should read the narrative items and flag anything you don't understand. Pay particular attention to the following sections:

- Item 1 offers a concise description of the franchisor and the franchise offering.
- Item 2 gives the five-year business experience of the franchisor's key executives.
- Item 3 is a list of material litigation against the franchisor over the past 10 years.
- Item 4 notes whether the franchisor or any of the individuals described in Item 2 have been through a bankruptcy.
- Items 5 through 7 list in table form the initial franchise fees, ongoing royalty fees, advertising contributions and an estimate of the franchisee's total investment.
- Item 8 notes the restrictions placed on the supplier sources for any of the franchisee's purchases.
- Item 11 details the franchisor's contractual obligations, advertising requirements and training program.

- Item 19 contains information about the financial performance of the franchise, if the company elects to provide this information. If there is no information about performance in Item 19 (and only about 20 percent of franchisors provide this information), ask why. It may be that the performance story doesn't paint an attractive picture of the franchise.
- Item 20 lists statistics about the growth or shrinkage of the franchise system and the names, addresses and telephone numbers of existing franchisees. You will also find the names and last known addresses and phone numbers of franchise owners who left the system in the prior fiscal year.

What warning signs in the UFOC does the investigator look for? There are several areas where problems may be revealed. If the company has a long track record of litigation involving claims made by franchisees or if there is a significant bankruptcy described, inquire further. If the franchisor has a small net worth, it should tell you that it may not have long-term financial stability. Compare the company's current assets to its current liabilities for a quick ratio of its financial health. If the ratio is less than 2:1, look deeper and talk to your accountant about it.

Is the company's principal trademark effectively registered with the U.S. Patent & Trademark Office? If it isn't, the system could face the risk that another user of the same or similar mark will create legal problems for the company. If the mark application is pending or the franchisor claims that its state trademark registration is completed and tells you that's sufficient, consult your lawyer about it.

Another red flag: the statistical charts in Item 20. What do they tell you about the number of franchisees who left the system in the past year? Be careful here--the numbers can lie. All franchise systems have turnover in ownership, and a departure from the system does not necessarily mean there was a business failure. If the turnover seems high, ask more questions of the franchisor. Find out the real story. The lists in Item 20 will be most useful when you begin interviewing franchisees in the system.

Carefully study the company's initial and ongoing fees; these will tax your operation, so make sure you understand how they work. Most franchise fees will be assessed according to the gross sales of your operation,

without regard to the profits the business makes. This means even if you're losing money in the business, you're still expected to pay royalties.

Hit The Bricks

Your next stop on the evaluation trail is to meet as many franchise owners as you possibly can. Drive to their businesses and observe for a while. Find a quiet time of the day and interview each owner. He or she will tell you the inside story on the franchisor, so ask tough questions. Ask about the training, the value of the program, the style of the franchisor, the mood among franchise owners. Don't shy away from asking questions about the business's revenue. What were gross sales last year? Did they meet the owner's expectations?

Ask about the franchisee's first few years in business. Did the owner have enough start-up capital? Ask if the estimates of first-year capital requirements in the UFOC are accurate.

Get The Facts

As useful as the UFOC and current owners may be, they don't tell the entire story, and it is certainly not the end of your investigation. Now you must answer a few fundamental business questions: Will the concept be successful in your marketplace? What will your competition be, and has the competition been successful in this market? Is there a site available that will make the business a success?

These questions are vital to your decision-making process. Even if the franchise is homebased, you must still assess how the business will be received in your market. Most market evaluations begin with a "walk-about," a drive around town observing local businesses and talking to their owners. What businesses are newly opened, and what looks like it's going downhill or is recently boarded up? This will tell you a lot about the business trends in your area. Talk to merchants whose businesses are similar to the one you're planning.

You should also stop at the public library and check the demographic information available. Is the town growing? Where are the new neighborhoods being built?

The last two steps in your investigation are to consult a good accountant and retain a savvy lawyer.

Investigating the purchase of a franchise is not all glamour and glitz, but it must be done if you want to open your new business knowing in your heart you made the right decision.

On The Lookout

While investigating a franchise, keep in mind these indications that the franchise may be right for you:

- You have investigated the type of business and find you have a sustained, compelling interest in it. You take a temporary position in the same type of company and love it.
- When you interview existing owners, they tell you that the help of the franchisor has been instrumental to their success.
- You get mixed reports from franchise owners because they all have different reactions, experiences and feelings about their franchise ownership. (Worry if you get the same rosy story from everyone.)
- The franchisor is on solid financial footing, and the Item 20 statistics in the UFOC show ownership stability.
- You find there is a low level of competition in your market area but that you will not be the first one in the market with this business. Being a pioneer presents a relatively high risk.
- Your accountant tells you that the projections indicate you will be able to afford the purchase and have sufficient capital to weather the start-up phase of the business.

Here are some indications that the franchise may not be right for you:

- You find that the franchisor has a lengthy history of suing franchisees, Item 20 indicates a high level of franchisee turnover, and existing owners tell you there is trouble in the system.
- The trademark is not federally registered because the franchisor filed with its home state and thinks that is sufficient.
- The franchise fees, especially the monthly royalty, are too high for you to make money at the business. Also, your accountant's projections do not paint a pretty picture.
- The franchisor's financial statements show a minimal net worth, and

- other financial indications suggest it is on a downward slide.
- Item 19 (Earnings Claims) of the UFOC is blank, and franchisees tell you it's because no one has figured out how to make money at this business yet.
 - The franchise concept is largely untried in the marketplace, and you can't afford to put your life savings at serious risk.

Read The Fine Print

Can you negotiate the terms of a franchise agreement? Of course: You can propose any number of changes in the terms of the contract, and franchisors are generally free to make changes in response to your requests. Some state franchise laws make it difficult for a franchisor to alter the terms of its standard contract, but where the law permits, such changes can be made by a willing franchisor.

For More Information

- The *Federal Trade Commission (FTC)* provides a free package of information about the FTC Franchise and Business Opportunity Rule. Write to the Federal Trade Commission, Public Reference Branch, 600 Pennsylvania Ave. N.W., Washington, DC 20580, or call them at (202) 326-3128. The FTC also has an informative and useful Web site at <http://www.ftc.gov>