Red-Flag Franchises

Getting a weird feeling about that franchise investment? Check this list of warning signs to see if the company has some strikes against it.

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Buying a franchise is exciting-but like any big purchase, it requires exercising caution. While no investment is 100-percent certain, you can improve your odds by watching for these warning signs:

1. No UFOC. Franchisors are required by federal law (and, in many cases, by state laws) to give you a Uniform Franchise Offering Circular at least 10 business days before you pay any money for the franchise or sign a franchise agreement. This document is an essential part of evaluating the franchise opportunity. If you don't receive one, don't even think about making the investment.

2. The hustle. Buying a franchise is a substantial investment. If the seller is hurrying you along, or telling you that the window of opportunity is closing, or using any other hard-sell technique, be prepared to walk away from the deal. The decision to buy a franchise should not be rushed.

3. Product price squeeze. Product supply is the ticklish underbelly of franchise relationships. If you're buying a business that sells the franchisor's product line, make sure the product's pricing allows you to be competitive in the marketplace. Ask other franchisees how the pricing structure works for them. If you're considering purchasing a franchise where the product is supplied by third parties specified by the franchisor, or by the franchisor itself, make sure the supply program runs smoothly. Have the franchisees established a buying cooperative? Do franchisees have input about supply arrangements? Make sure this key aspect of the business will not frustrate you.

4. High turnover rates. Check Item 20 of the UFOC to confirm how many franchisees have left the system in the past three years. There's no rule of thumb to determine when this number is too high; it depends largely on the type of business. Lower investment franchises generally have a higher turnover rate than more expensive businesses. If anything looks suspicious to you, ask the franchisor about it.

5. Earnings claims mumbo-jumbo. When you innocently ask the seller's representative,"How much money can I make with this franchise?" listen carefully to the answer. Although franchisors are legally allowed to provide an answer to that question with either a projection, a pro forma or a statement about how their system owners have performed, the company 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 they say, "We're prohibited by federal law from answering that question," realize that although that may be true, it reflects a choice made by the company. If no performance information is provided (only about 20 percent of franchisors provide earnings claims), it may be because the true picture isn't a pretty one. Plan to 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 "material" lawsuits filed against the company. If you see a heavy litigation history, do a little digging to find out what's going on. It could mean franchisees are unhappy with the business.

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 knowledgeable CPA. The poor financial condition of a franchisor, no matter how wonderful its franchise program, magnifies your own risk.

Any of these warning signs should prompt you to ask more questions. If you don't like the answers you receive, and your gut (or your professional advisor) tells you to be careful, this may not be the program for you. With a decision as important as this one, you owe it to yourself to be confident you're making the right choice.