VETBIZ RESOURCE CENTER

Buying a Franchise

An important step in the small business startup process is deciding whether or not to go into business at all. Each year, thousands of potential entrepreneurs are faced with this difficult decision; because of the risk and work involved in starting a new business, many new entrepreneurs choose franchising as an alternative to starting a new, independent business from scratch.

One of the biggest mistakes you can make is to hurry into business, so it's important to understand your reasons for going into business, and determine if owning a business is right for you.

If you are concerned about the risk involved in a new independent business venture, then franchising may be the best business option for you. But remember that hard work, dedication, and sacrifice are essential to the success of any business venture, including franchising.

What is Franchising?

A franchise is a legal and commercial relationship between the owner of a trademark, service mark, trade name, or advertising symbol and an individual or group wishing to use that identification in a business. The franchise governs the method of conducting business between the two parties. Generally, a franchisee sells goods or services supplied by the franchiser or that meet the franchiser's quality standards.

Franchising is based on mutual trust between the franchiser and franchisee. The franchiser provides the business expertise (marketing plans, management guidance, financing assistance, site location, training, etc.) that otherwise would not be available to the franchisee. The franchisee brings the entrepreneurial spirit and drive necessary to make the franchise a success.

There are primarily two forms of franchising:

- Product/trade name franchising
- Business format franchising

In the simplest form, a franchiser owns the right to the name or trademark and sells that right to a franchisee. This is known as product/trade name franchising. The more complex form, business format franchising, involves a broader ongoing relationship between the two parties. Business format franchises often provide a full range of services, including site selection, training, product supply, marketing plans, and even assistance in obtaining financing.

Shopping at a Franchise Exposition

Attending a franchise exposition allows you to view and compare a variety of franchise possibilities. Keep in mind that exhibitors at the exposition primarily want to sell their franchise systems. Be cautious of salespersons who are interested in selling a franchise that you are not interested in.

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Before you attend, research what type of franchise best suits your investment limitations, experience, and goals. When you attend, comparison shop for the opportunity that best suits your needs and ask questions.

Know how much you can invest: an exhibitor may tell you how much you can afford to invest or that you can't afford to pass up this opportunity. Before beginning to explore investment options, consider the amount you feel comfortable investing and the maximum amount you can afford.

Know what type of business is right for you: an exhibitor may attempt to convince you that an opportunity is perfect for you. Only you can make that determination. Consider the industry that interests you before selecting a specific franchise system. Ask yourself the following questions:

- Have you considered working in that industry before?
- Can you see yourself engaged in that line of work for the next twenty years?
- Do you have the necessary background or skills?

If the industry does not appeal to you or you are not suited to work in that industry, do not allow an exhibitor to convince you otherwise. Spend your time focusing on those industries that offer a more realistic opportunity.

Comparison shop: Visit several franchise exhibitors engaged in the type of industry that appeals to you. Listen to the exhibitors' presentations and discussions with other interested consumers. Get answers to the following questions:

- How long has the franchiser been in business?
- How many franchised outlets currently exist?
- Where are they located?
- How much is the initial franchise fee and any additional startup costs? Are there any continuing royalty payments? How much?
- What management, technical, and ongoing assistance does the franchiser offer?
- What controls does the franchiser impose?

Exhibitors may offer you prizes, free samples, or free dinners if you attend a promotional meeting later that day or over the next week to discuss the franchise in greater detail. Do not feel compelled to attend; rather, consider these meetings as one way to acquire more information and ask additional questions. Be prepared to walk away from any promotion if the franchise does not suit your needs.

Get substantiation for any earnings representations: Some franchisers may tell you how much you can earn if you invest in their franchise system or how current franchisees in their system are performing. Be careful. The FTC requires that franchisers who make such claims provide you with written substantiation. This is explained in more detail in the section "Investigating Franchise Offers." Make sure you ask for and obtain written substantiation for any income projections or income or profit claims. If the franchiser does not have the required substantiation or refuses to provide it to you, consider its claims to be suspect.

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Take notes: It may be difficult to remember each franchise exhibit. Bring a pad and pen to take notes. Get promotional literature that you can review. Take the exhibitors' business cards so you can contact them later with any additional questions.

Avoid high pressure sales tactics: You may be told that the franchiser's offering is limited, that there is only one territory left, or that this is a one-time reduced franchise sales price. Do not feel pressured to make any commitment. Legitimate franchisers expect you to comparison shop and investigate their offering. A good deal today should be available tomorrow.

Investigating Franchise Offers

Before investing in any franchise system, be sure to get a copy of the franchiser's disclosure document. Sometimes this document is called a Franchise Offering Circular. Under the FTC's Franchise Rule, you must receive the document at least 10 business days before you are asked to sign any contract or pay any money to the franchiser. You should read the entire disclosure document; make sure you understand all of the provisions. The following outline will help you to understand key provisions of typical disclosure document as well as ask questions about the disclosures. Get a clarification or answer to your concerns before you invest.

Business background: The disclosure document identifies the executives of the franchise system and describes their prior experience. Consider not only their general business background, but their experience in managing a franchise system. Also consider how long they have been with the company. Investing with an inexperienced franchiser may be riskier than investing with an experienced one.

Litigation history: The disclosure document helps you assess the background of the franchiser and its executives by requiring the disclosure of prior litigation. The disclosure document tells you if the franchiser or any of its executive officers have been convicted of felonies involving, for example, fraud, any violation of franchise law, unfair or deceptive practices law, or are subject to any state or federal injunctions involving similar misconduct. It also will tell you if the franchiser or any of its executives have been held liable or settled a civil action involving the franchise relationship. A number of claims against the franchiser may indicate that it has not performed according to its agreements, or, at the very least, that franchisees have been dissatisfied with the franchiser's performance. Be aware that some franchisers may try to conceal an executive's litigation history by removing the individual's name from their disclosure documents.

Bankruptcy: The disclosure document tells you if the franchiser or any of its executives have recently been involved in a bankruptcy. This will help you to assess the franchiser's financial stability and general business acumen as well as predict if the company is financially capable of delivering promised support services.

Costs: The disclosure document tells you the costs involved to start one of the company's franchises. It will describe any initial deposit or franchise fee, which may be nonrefundable, and costs for initial inventory, signs, equipment, leases, or rentals. Be aware that there may be other undisclosed costs.

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The following checklist will help you ask about potential costs to you as a franchisee.

- Continuing royalty payments
- Advertising payments, both to local and national advertising funds
- Grand opening or other initial business promotions
- Business or operating licenses
- Product or service supply costs
- Real estate and leasehold improvements
- Discretionary equipment such as a computer system or business alarm system
- Training
- Legal fees
- Financial and accounting advice
- Insurance
- Compliance with local ordinances, such as zoning, waste removal, and fire and other safety codes
- Health insurance
- Employee salaries and benefits

It may take several months or longer to get your business started. Consider in your total cost estimate operating expenses for the first year and personal living expenses for up to two years. Compare your estimates with what other franchisees have paid and competing franchise systems; perhaps you can get a better deal with another franchiser. An accountant can help you to evaluate this information.

Restrictions: Your franchiser may restrict how you operate your outlet. The disclosure document tells you if the franchiser limits:

- The supplier of goods from whom you may purchase
- The goods or services you may offer for sale
- The customers to whom you can offer goods or services
- The territory in which you can sell goods or services
- Understand that restrictions such as these may significantly limit your ability to exercise your own business judgment in operating your outlet

Terminations: The disclosure document tells you the conditions under which the franchiser may terminate your franchise and your obligations to the franchiser after termination. It also tells you the conditions under which you can renew, sell, or assign your franchise to other parties.

Training and other assistance: The disclosure document will explain the franchiser's training and assistance program. Make sure you understand the level of training offered. The following checklist will help you ask the right questions.

- How many employees are eligible for training?
- Can new employees receive training and, if so, is there any additional cost?

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- How long are the training sessions?
- How much time is spent on technical training, business management training, and marketing?
- Who teaches the training courses and what are their qualifications?
- What type of ongoing training does the company offer and at what cost?
- To Whom can you speak if problems arise?
- How many support personnel are assigned to your area?
- How many franchisees will the support personnel service?
- Will someone be available to come to your franchised outlet to provide more individual assistance?

The level of training you need depends on your own business experience and knowledge of the franchiser's goods and services. Keep in mind that a primary reason for investing in the franchise, as opposed to starting your own business, is training and assistance. If you have doubts that the training might be insufficient to handle day-to-day business operations, consider another franchise opportunity more suited to your background.

Advertising: You often must contribute a percentage of your income to an advertising fund even if you disagree with how these funds are used. The disclosure document provides information on advertising costs. The following checklist will help you assess whether the franchiser's advertising will benefit you.

- How much of the advertising fund is spent on administrative costs?
- Are there other expenses paid from the advertising fund?
- Do franchisees have any control over how the advertising dollars are spent?
- What advertising promotions has the company already engaged in?
- What advertising developments are expected in the near future?
- How much of the fund is spent on national advertising?
- How much of the fund is spent on advertising in your area?
- How much of the fund is spent on selling more franchises?
- Do all franchisees contribute equally to the advertising fund?
- Do you need the franchiser's consent to conduct your own advertising?
- Are there rebates or advertising contribution discounts if you conduct your own advertising?
- Does the franchiser receive any commissions or rebates when it places advertisements? Do franchisees benefit from such commissions or rebates, or does the franchiser profit from them?

Current and former franchisees: The disclosure document provides important information about current and former franchisees. Determine how many franchises are currently operating; a large number of franchisees in your area may mean increased competition. Pay attention to the number of terminated franchisees; a large number of terminated, canceled, or non-renewed franchises may indicate problems. Be aware that some companies may try to conceal the number of failed franchisees by repurchasing failed outlets and then listing them as company-owned outlets. If you buy an existing outlet, ask the franchiser how many owners operated that outlet and over what period of time. A number of different owners over a short period of time may indicate that the location is not a profitable one or that the franchiser has not supported that outlet with promised services.

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The disclosure document gives you the names and addresses of current franchisees who have left the system within the last year. Speaking with current and former franchisees is probably the most reliable way to verify the franchiser's claims. Visit or phone as many of the current and former franchisees as possible; ask them about their experiences. See for yourself the volume and type of business being done.

The following checklist will help you ask current and former franchisees such questions as:

- How long has the franchisee operated the franchise?
- Where is the franchise located?
- What was their total investment?
- Were there any hidden or unexpected costs?
- How long did it take them to cover operating costs and earn a reasonable income?
- Are they satisfied with the cost, delivery, and quality of the goods or services sold?
- What were their backgrounds prior to becoming a franchisee?
- Was the franchiser's training adequate?
- What ongoing assistance does the franchiser provide?
- Are they satisfied with the franchiser's advertising program?
- Does the franchiser fulfill its contractual obligations?
- Would the franchisee invest in another outlet?
- Would the franchisee recommend the investment to someone with your goals, income requirements, and background?

Be aware that some franchisers may give you a separate reference list of selected franchisees to contact. Those on the list may be individuals who are paid by the franchiser to give a good opinion of the company.

Earnings potential: you may want to know how much money you can make if you invest in a particular franchise system. Be careful; earnings projections can be misleading. Insist upon written substantiation for any earnings projections or suggestions about your potential income or sales.

Franchisers are not required to make earnings claims, but if they do, the FTC's Franchise Rule requires franchisers to have a reasonable basis for these claims and to provide you with a document that substantiates them. This substantiation includes the bases and assumptions upon which these claims are made. Make sure you get and review the earnings claims document. Consider the following in reviewing any earnings claims.

- **Sample size:** A franchiser may claim that franchisees in its system earned, for example, $50,000 last year. This claim may be deceptive, however, if only a few franchisees earned that income and it does not represent the typical earnings of franchisees. Ask how many franchisees were included in the number.
- **Average incomes:** A franchiser may claim that the franchisees in its system earn an average income of, for example, $75,000 a year. Average figures like this tell you very little about how

each individual franchisee performs. Remember, a few very successful franchisees can inflate the average. An average figure may make the overall franchise system look more successful than it actually is.

- **Gross sales:** Some franchisers provide figures for the gross sales revenues of their franchisees. These figures, however, do not tell you anything about the franchisees' actual costs or profits. An outlet with a high gross sales revenue on paper actually may be losing money because of high overhead, rent, and other expenses.
- **Net profits:** Franchisers often do not have data on the net profits of their franchisees. If you do receive net profit statements, ask whether they provide information about company-owned outlets. Company-owned outlets might have lower costs because they can buy equipment, inventory, and other items in larger quantities, or may own, rather than lease, their property.
- **Geographic relevance:** Earnings may vary in different parts of the country. An ice cream store franchise in a southern state, such as Florida, may expect to earn more income than a similar franchise in a northern state, such as Minnesota. If you hear that a franchisee earned a particular income, ask where that franchisee is located.
- **Franchisee's background:** Keep in mind that franchisees have varying levels of skills and educational backgrounds. Franchisees with advanced technical or business backgrounds can succeed in instances where more typical franchisees cannot. The success of some franchisees is no guarantee that you will be equally successful.

Financial history: The disclosure document provides you with important information about the company's financial status, including audited financial statements. Be aware that investing in a financially unstable franchiser is a significant risk; the company may go out of business or into bankruptcy after you have invested your money.

Hire a lawyer or an accountant to review the franchiser's financial statements. Do not attempt to extract this important information from the disclosure document unless you have considerable background in these matters. Your lawyer or accountant can help you understand the following.

- Does the franchiser have steady growth?
- Does the franchiser have a growth plan?
- Does the franchiser make most of its income from the sale of franchises or from continuing royalties?
- Does the franchiser devote sufficient funds to support its franchise system?

Taken from http://www.sba.gov