

Buying a Franchise

Introduction

Many people dream of being an entrepreneur. By purchasing a franchise, you often can sell goods and services that have instant name recognition and can obtain training and ongoing support to help you succeed. But be cautious. Like any investment, purchasing a franchise is not a guarantee of success.

The Benefits and Responsibilities of Franchise Ownership

This booklet will help you understand your obligations as a franchise owner, how to shop for franchise opportunities, and how to ask the right questions before you invest.

A franchise typically enables you, the investor or "franchisee," to operate a business. By paying a franchise fee, which may cost several thousand dollars, you are given a format or system developed by the company ("franchisor"), the right to use the franchisor's name for a limited time, and assistance. For example, the franchisor may help you find a location for your outlet; provide initial training and an operating manual; and advise you on management, marketing, or personnel. Some franchisors offer ongoing support such as monthly newsletters, a toll free 800 telephone number for technical assistance, and periodic workshops or seminars.

While buying a franchise may reduce your investment risk by enabling you to associate with an established company, it can be costly. You also may be required to relinquish significant control over your business, while taking on contractual obligations with the franchisor.

Below is an outline of several components of a typical franchise system. Consider each carefully.

The Cost

In exchange for obtaining the right to use the franchisor's name and its assistance, you may pay some or all of the following fees.

- **initial franchise fee and other expenses.** Your initial franchise fee, which may be non-refundable, may cost several thousand to several hundred thousand dollars. You may also incur significant costs to rent, build, and equip an outlet and to purchase initial inventory. Other costs include operating licenses and insurance. You also may be required to pay a "grand opening" fee to the franchisor to promote your new outlet.

- **continuing royalty payments.** You may have to pay the franchisor royalties based on a percentage of your weekly or monthly gross income. You often must pay royalties even if your outlet has not earned significant income during that time. In addition, royalties usually are paid for the right to use the franchisor's name. So even if the franchisor fails to provide promised support services, you still may have to pay royalties for the duration of your franchise agreement.
- **advertising fees.** You may have to pay into an advertising fund. Some portion of the advertising fees may go for national advertising or to attract new franchise owners, but not to target your particular outlet.

Controls

To ensure uniformity, franchisors typically control how franchisees conduct business. These controls may significantly restrict your ability to exercise your own business judgment. The following are typical examples of such controls.

- **site approval.** Many franchisors pre-approve sites for outlets. This may increase the likelihood that your outlet will attract customers. The franchisor, however, may not approve the site you want.
- **design or appearance standards.** Franchisors may impose design or appearance standards to ensure customers receive the same quality of goods and services in each outlet. Some franchisors require periodic renovations or seasonal design changes. Complying with these standards may increase your costs.
- **restrictions on goods and services offered for sale.** Franchisors may restrict the goods and services offered for sale. For example, as a restaurant franchise owner, you may not be able to add to your menu popular items or delete items that are unpopular. Similarly, as an automobile transmission repair franchise owner, you might not be able to perform other types of automotive work, such as brake or electrical system repairs.
- **restrictions on method of operation.** Franchisors may require you to operate in a particular manner. The franchisor might require you to operate during certain hours, use only pre-approved signs, employee uniforms, and advertisements, or abide by certain accounting or bookkeeping procedures. These restrictions may impede you from operating your outlet as you deem best. The franchisor also may require you to purchase supplies only from an approved supplier, even if you can buy similar goods elsewhere at a lower cost.
- **restrictions of sales area.** Franchisors may limit your business to a specific territory. While these territorial restrictions may ensure that other franchisees will not compete with you for the same customers, they could

impede your ability to open additional outlets or move to a more profitable location.

Terminations and Renewal

You can lose the right to your franchise if you breach the franchise contract. In addition, the franchise contract is for a limited time; there is no guarantee that you will be able to renew it.

- **franchise terminations.** A franchisor can end your franchise agreement if, for example, you fail to pay royalties or abide by performance standards and sales restrictions. If your franchise is terminated, you may lose your investment.
- **renewals.** Franchise agreements typically run for 15 to 20 years. After that time, the franchisor may decline to renew your contract. Also be aware that renewals need not provide the original terms and conditions. The franchisor may raise the royalty payments, or impose new design standards and sales restrictions. Your previous territory may be reduced, possibly resulting in more competition from company-owned outlets or other franchisees.

Before Selecting a Franchise System

Before investing in a particular franchise system, carefully consider how much money you have to invest, your abilities, and your goals. The following checklist may help you make your decision.

Your Investment

- How much money do you have to invest?
- How much money can you afford to lose?
- Will you purchase the franchise by yourself or with partners?
- Will you need financing and, if so, where can you obtain it?
- Do you have a favorable credit rating?
- Do you have savings or additional income to live on while starting your franchise?

Your Abilities

- Does the franchise require technical experience or relevant education, such as auto repair, home and office decorating, or tax preparation?

- What skills do you have? Do you have computer, bookkeeping, or other technical skills?
- What specialized knowledge or talents can you bring to a business?
- Have you ever owned or managed a business?

Your Goals

- What are your goals?
- Do you require a specific level of annual income?
- Are you interested in pursuing a particular field?
- Are you interested in retail sales or performing a service?
- How many hours are you willing to work?
- Do you want to operate the business yourself or hire a manager?
- Will franchise ownership be your primary source of income or will it supplement your current income?
- Would you be happy operating the business for the next 20 years?
- Would you like to own several outlets or only one?

Selecting a Franchise

Like any other investment, purchasing a franchise is a risk. When selecting a franchise, carefully consider a number of factors, such as the demand for the products or services, likely competition, the franchisor's background, and the level of support you will receive.

Demand

Is there a demand for the franchisor's products or services in your community? Is the demand seasonal? For example, lawn and garden care or swimming pool maintenance may be profitable only in the spring or summer. Is there likely to be a continuing demand for the products or services in the future? Is the demand likely to be temporary, such as selling a fad food item? Does the product or service generate repeat business?

Competition

What is the level of competition, nationally and in your community? How many franchised and company-owned outlets does the franchisor have in your area? How many competing companies sell the same or similar products or services? Are these competing companies well established, with wide name recognition in

your community? Do they offer the same goods and services at the same or lower price?

Your Ability to Operate the Business

Sometimes, franchise systems fail. Will you be able to operate your outlet even if the franchisor goes out of business? Will you need the franchisor's ongoing training, advertising, or other assistance to succeed? Will you have access to the same or other suppliers? Could you conduct the business alone if you must lay off personnel to cut costs?

Name Recognition

A primary reason for purchasing a franchise is the right to associate with the company's name. The more widely recognized the name, the more likely it will draw customers who know its products or services. Therefore, before purchasing a franchise, consider:

- The company's name and how widely recognized it is. -- If it has a registered trademark.
- How long the franchisor has been in operation.
- If the company has a reputation for quality products or services.
- If consumers have filed complaints against the franchise with the Better Business Bureau or a local consumer protection agency.

Training and Support Services

Another reason for purchasing a franchise is to obtain support from the franchisor. Ask these questions:

- What training and ongoing support does the franchisor provide?
- How does their training compare with the training for typical workers in the industry?
- Could you compete with others who have more formal training?
- What backgrounds do the current franchise owners have?
- Do they have prior technical backgrounds or special training that helps them succeed?
- Do you have a similar background?

Franchisor's Experience

Many franchisors operate well-established companies with years of experience both in selling goods or services and in managing a franchise system. Some franchisors started by operating their own business. There is no guarantee, however, that a successful entrepreneur can successfully manage a franchise system.

Carefully consider how long the franchisor has managed a franchise system. Do you feel comfortable with the franchisor's expertise? If franchisors have little experience in managing a chain of franchises, their promises of guidance, training, and other support may be unreliable.

Growth

A growing franchise system increases the franchisor's name recognition and may enable you to attract customers. Growth alone does not ensure successful franchisees; a company that grows too quickly may not be able to support its franchisees with all the promised support services. Make sure the franchisor has sufficient financial assets and staff to support the franchisees.

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.

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 franchisor been in business?
- How many franchised outlets currently exist? Where are they located?
- How much is the initial franchise fee and any additional start-up costs? Are there any continuing royalty payments? How much?
- What management, technical, and ongoing assistance does the franchisor offer?
- What controls does the franchisor 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 to 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 franchisors 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 franchisors 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 franchisor does not have the required substantiation, or refuses to provide it to you, consider its claims to be suspect.

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 franchisor'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 franchisors expect you to comparison shop and to investigate their offering. A good deal today should be available tomorrow.

Study the Franchisor's Offering

Do not sign any contract or make any payment until you have the opportunity to investigate the franchisor's offering thoroughly. As will be explained further in the next section, the FTC's Franchise Rule requires the franchisor to provide you with a disclosure document containing important information about the franchise system. Study the disclosure document. Take time to speak with current and former franchisees about their experiences. Because investing in a franchise can entail a significant investment, you should have an attorney review the disclosure document and franchise contract and have an accountant review the company's financial disclosures.

Investigating Franchise Offerings

Before investing in any franchise system, be sure to get a copy of the franchisor'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 franchisor. 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 documents. It also will help you 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 franchisor may be riskier than investing with an experienced one.

Litigation History

The disclosure document helps you assess the background of the franchisor and its executives by requiring the disclosure of prior litigation. The disclosure document tells you if the franchisor, or any of its executive officers, has been convicted of felonies involving, for example, fraud, any violation of franchise law or unfair or deceptive practices law, or are subject to any state or federal injunctions involving similar misconduct. It also will tell you if the franchisor, or any of its executives, has been held liable or settled a civil action involving the franchise relationship. A number of claims against the franchisor may indicate that it has not performed according to its agreements, or, at the very least, that franchisees have been dissatisfied with the franchisor's performance. Be aware that some franchisors 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 franchisor or any of its executives have recently been involved in a bankruptcy. This will help you to assess the franchisor's financial stability and general business acumen and 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 non-refundable, and costs for initial inventory, signs, equipment, leases, or rentals. Be aware that there may be other undisclosed costs. 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 with competing franchise systems. Perhaps you can get a better deal with another franchisor. An accountant can help you to evaluate this information.

Restrictions

Your franchisor may restrict how you operate your outlet. The disclosure document tells you if the franchisor 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 franchisor may terminate your franchise and your obligations to the franchisor 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 franchisor'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?

- 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?
- Whom can you speak to 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 franchisor'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 franchisor'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 franchisor's consent to conduct your own advertising?

- Are there rebates or advertising contribution discounts if you conduct your own advertising?
- Does the franchisor receive any commissions or rebates when it places advertisements? Do franchisees benefit from such commissions or rebates, or does the franchisor 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, cancelled, 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 franchisor 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 franchisor has not supported that outlet with promised services.

The disclosure document gives you the names and addresses of current franchisees and 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 franchisor'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 franchisor's training adequate?
- What ongoing assistance does the franchisor provide?
- Are they satisfied with the franchisor's advertising program?

- Does the franchisor 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 franchisors may give you a separate reference list of selected franchisees to contact. Be careful. Those on the list may be individuals who are paid by the franchisor 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.

Franchisors are not required to make earnings claims, but if they do, the FTC's Franchise Rule requires franchisors 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 franchisor 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 franchisor 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 franchisors 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

Franchisors often do not have data on 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 franchisor 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 franchisor'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 franchisor have steady growth?
- Does the franchisor have a growth plan?
- Does the franchisor make most of its income from the sale of franchises or from continuing royalties?
- Does the franchisor devote sufficient funds to support its franchise system?

Additional Sources of Information

Before you invest in a franchise system, investigate the franchisor thoroughly. In addition to reading the company's disclosure document and speaking with current and former franchisees, you should speak with the following:

Lawyer and Accountant

Investing in a franchise is costly. An accountant can help you understand the company's financial statements, develop a business plan, and assess any earnings projections and the assumptions upon which they are based. An accountant can help you pick a franchise system that is best suited to your investment resources and your goals.

Franchise contracts are usually long and complex. A contract problem that arises after you have signed the contract may be impossible or very expensive to fix. A lawyer will help you to understand your obligations under the contract, so you will not be surprised later. Choose a lawyer who is experienced in franchise matters. It is best to rely upon your own lawyer or accountant, rather than those of the franchisor.

Banks and Other Financial Institutions

These organizations may provide an unbiased view of the franchise opportunity you are considering. Your banker should be able to get a Dun and Bradstreet report or similar reports on the franchisor.

Better Business Bureau

Check with the local Better Business Bureau (BBB) in the cities where the franchisor has its headquarters. Ask if any consumers have complained about the company's products, services, or personnel.

Government Departments

Several states regulate the sale of franchises. Check with your state Division of Securities or Office of Attorney General for more information about your rights as a franchise owner in your state.