BUYING A FRANCHISE: SOME TIPS FOR THE UNWARY

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For many, the idea of owning your own business and being your own boss is alluring: you set your hours and you alone reap the rewards of your endeavors. Unfortunately, the road to success is often paved with many perils: employee costs continue to spiral as do the cost of goods; increased competition from other companies both here and abroad; more regulation from local, state and federal agencies; etc.

Though risk cannot be eliminated, it can be reduced. To lessen the risk of failing in this ever competitive environment, buying a franchise has become an attractive alternative to starting a business from scratch. Franchises are, in fact, one of the fastest growing segments of the business community. According to the International Franchise Association, it is estimated that a new franchise opens in the United States every 16 minutes.

Why are franchises such an attractive alternative for many. To understand this, you should understand just what a franchise is, what the concept can and cannot do for you, and what you should look out for if you are interested in investing in a franchise. This article will discuss these issues in an attempt to better equip you to determine whether or not a franchise is right for you.

What is a Franchise?

A franchise is essentially a license to use a product or marketing concept, or both. There are two parties to any franchise arrangement: the franchisor and the franchisee. The franchisor is generally one who, from experience, has developed a business to the point that it can be marketed by others.
Rather than expanding on their own and expending their own resources in such expansion, the franchisor offers to allow others, known as franchisees, to essentially open a similar business with the help of the franchisor. In exchange for the permission to use the franchisor's ideas, the franchisee pays a franchise fee, and a royalty, generally based upon a percentage of the gross income of the franchisee's business. In addition, the franchisee can expect to pay an additional sum to defray the franchisor's advertising expenses.

What a Franchise Should Do For You

A franchise differs from other business opportunities because, in theory, you should not have to start from square one to open your business. In starting a business, there are many factors to consider, such as what to name the business, where the business should be located, how will your business fare in relation to other similar businesses, how much product to buy, etc. In addition, unless you have extensive experience in running the type of business you intend to open, you will need to get training in management skills and in producing (if you intend to manufacture a particular product) or in obtaining the product you intend to sell (if you intend to open a retail establishment).

A good franchisor should be able to provide you with all of the basics you will need to open your business. It should be able to provide you with training in all aspects of your franchise operation, not just give you the right to use its name. This assistance should include, at minimum:

(1) a reputable name to use;

(2) how to make the franchisor's particular product to its specifications;

(3) basic management training, including how to order supplies, how to prepare basic financial reports, and how to hire and train employees;
(4) how to select the proper site for your operation;

(5) help with review of your lease, to get favorable terms and to assure that the lease complies with the franchisor's desires; and,

(6) how to develop your business, market and advertise effectively.

The franchisor should not only assist you when you initially purchase and open your franchise, but should also continue to help you with regular product updates, advertising ideas and the like. It should be a truly symbiotic relationship; the franchisor trains and supports the franchisee, while the franchisee pays a fair fee for this assistance.

What to Look for in a Franchise

There are many franchises available, both established (i.e., McDonald's, Postal Instant Press, etc.) and new, selling popular items and services. Naturally, the more established and successful the franchisor, the higher the franchise fee, with franchise fees ranging from $20,000.00 and up. Furthermore, you can expect to pay a monthly royalty of at least 3% of your gross income and an additional royalty of at least 2% of your gross income to help defray the franchisor's advertising costs.

As can be seen, the amounts to be paid to the franchisor are sizable. You should thus approach your investment in a franchise with great caution.

State law requires that prior to purchasing a franchise, the franchisor provide the prospective franchisee with a written prospectus outlining certain aspects of the franchise operation including the principals of the franchisor, an audited financial statement of the franchisor, whether the franchisor is involved in any legal actions, among other information. Though the state requires a prospectus to be provided, it does not pass on the truthfulness of the information contained in the prospectus.
State law also requires that the franchisor wait 36 hours between the time a prospectus is delivered and the franchise fee being paid. This is to allow a cooling off period for the prospective franchisee.

Although most franchisors are sincere in their marketing brochures and in the required prospectus, some take liberties in the information they include in these items, as well as in discussions with a prospective franchisee. Because of this, as well as the large sum of monies you can expect to pay to the franchisor, a thorough investigation of the franchisor is in order.

It is recommended that prior to investing in a franchise, you should:

1. Carefully read the prospectus. Are the representations consistent with the information contained in the franchisor's marketing brochures and in other oral representations made by the franchisor's representatives.

2. Carefully review the financial statement provided by the franchisor with your accountant or legal advisor. A financial statement should be provided within the prospectus. If it is not, be wary of the franchisor. Be sure the financial statement has

been prepared by a certified public account and is an audited statement. If it is not, be careful. The audit is a more stringent level of accounting review and, if accurately prepared, should give an accurate picture of the franchisor's financial strength. If the financial statement shows the franchisor is in ill health financially, go no further; do not have them use your money to get healthy, possibly at your expense.

3. Check to see how long the franchisor has been in business. If it is a new franchise opportunity, investigate the franchisor's existing business. The franchisor should have a successful track record in the type of enterprise it intends to franchise, if so go to their currently-operating businesses. Talk to their employees. Is the business doing well financially? Are they busy?

4. Talk to other franchisees. Are their businesses successful (i.e., do they have customers, are their businesses organized and employees knowledgeable about the products or services offered) Are they happy with the relationship? Are they getting training and support from the franchisor? Are they glad they invested in the franchise?

5. Ask the franchisor's representative tough questions. It is your money you are going to spend and you should have all questions answered to your satisfaction. Be sure that the answers are consistent with the written representations contained in the prospectus and what you have learned in your own investigation.

6. Be skeptical of glowing projections provided by the franchisor as to how well your particular franchise will do; very little in this world is a sure thing. If such projections are given, ask for audited financial statements which support the representations and review them with your accountant or legal counsel. Most projections are mere puffing given to promote a sale and should be given little weight.

7. Check with the California Department of Corporations (which regulates franchises in California) to see if the prospectus is registered. As mentioned above, although the contents of the prospectus is not checked for accuracy, they must be reviewed by the department and a copy must be on file with the state. The department will also be able to tell you if the franchisor is the subject of any complaints filed by franchisees as well as the basis for such complaints.

8. Check with the local Superior and Municipal court in the county in which the franchise is located to see if the franchisor is being sued by vendors or franchisees.

Most courts will provide you with a copy of any such suits, which may show that the franchisor is experiencing financial difficulties that could affect their ability to work with you, the franchisee.

9. Speak with your accountant and legal advisor. Have them review the written information provided by the franchisor and provide you with their comments and advice as to whether the opportunity is sound both financially and legally.
10. Ask yourself tough questions. Is the opportunity right for you? Is the product or service you intend to provide via the franchise one that you really need the help of a franchisor for.

An investment in any business is a time-consuming and expensive proposition. It requires much homework and hard work to be successful. The purchase of a franchise is an equally expensive proposition in terms of your time and of your hard-earned money. Remember, you will not only be paying the regular operating expenses involved in running your business, but will also be paying the franchise fee, royalty and advertising royalty, all of which may add up to a large amount you will be paying to the franchisor. Thus, it is imperative that you thoroughly investigate any potential in a franchise and, once you have completed your investigation, ask yourself if the franchise still seems to be a good investment to you.

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