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Is It Time to Buy a Franchise?

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John Tozzi--BusinessWeek

Think buying a franchise means you get the benefits of owning a business without the risk of business failure? Think again. Without proper due diligence, franchisees can find themselves stuck in bad business models, chained to unfavorable contracts, or victims of fraud. Although the industry's reputation has improved in recent years, franchising isn't necessarily safer than starting a new business.

Economic slumps tend to boost the industry, as unemployed workers seek to start businesses with the perceived safety of established systems. The International Franchise Assn., the industry's largest trade group, estimates there are about 3,000 franchise systems in the U.S. today. The concepts range well beyond fast food, with franchises in industries as diverse as pet care and tutoring services. In 2005, franchised businesses employed 11 million people -- more than 8% of private sector workers -- and generated 4.4% of U.S. economic output, according to a report by PricewaterhouseCoopers commissioned by the IFA. John Reynolds, president of the IFA's research arm, expected growth in franchising output and employment to continue at least through the middle of 2007.

Think Like An Investor

Where should you start if you're new to franchising? Aspiring franchisees need to think more like investors than entrepreneurs to thoroughly vet any opportunity before buying, franchise experts say. "The franchising industry represents that franchising is a safe and secure path to business ownership," says Robert Purvin Jr., head of trade group American Association of Franchisees & Dealers and the author of Franchise Fraud: How to Protect Yourself Before and After You Invest. "But in today's marketplace, franchising is almost never business ownership, and it is very often not a safe and secure path." He explains that buying a franchise means buying a license to operate someone else's business for the period of the contract.

Purvin says prospective franchisees should first check whether a system has an independent franchisee association [BusinessWeek.com, 1/29/07] that the company recognizes. These organizations let franchisees share information, negotiating power, and legal resources. If a franchisor doesn't recognize an independent association, Purvin says buyers should keep looking. "I would limit my search to companies that have an established collaborative culture so that I know if problems come up there's going to be a process in which we can air those problems and resolve them," he says.

Although state governments and the Federal Trade Commission [the FTC offers a guide] require franchisors to disclose information about their offerings, franchisors do not have to register with any federal agency the way publicly traded companies must with the Securities and Exchange Commission. You can get disclosure documents from franchisors after you express interest and get initial approval. You can also buy them from companies like FRANdata. The disclosures, known as Uniform Franchise Offering Circulars or Uniform Franchise Disclosure Documents, require franchisors to reveal information on 23 items, from numbers of lawsuits and bankruptcies to fees and other estimated costs. [Note that the FTC introduced an amended document in January, 2007, called a Franchise Disclosure Document that will replace both the UFOC and the FTC's original disclosure document and become mandatory on July 1, 2008.]

Disclosure documents also must contain information on other franchisees, including those who have left the system. Talking to these franchisees is an essential part of due diligence, says Tom Pitegoff, a franchise attorney in White Plains, N.Y. "If you talk to nobody else, talk to the ones who left the system and find out why. Does it have something to do with the franchisor and something you should be looking out for?" While ex-franchisees may have sound reasons for leaving the system -- retirement, for example -- you should find out if they have complaints about the franchisor.

Look At The Bottom Line

You should also make sure that the company you're buying into is financially strong and able to sustain its growth. The franchisor's financial statements must be in the offering documents, and Pitegoff says you should get an accountant to review them. Even if you run your franchise well, it will be difficult to prosper if the franchisor is struggling, because brand reputations can suffer and unprofitable corporations may squeeze their franchisees for money. Also evaluate how strong the business model is. Just because a concept is being franchised does not mean it is proven, as eBay resellers discovered [BusinessWeek.com, 8/31/07].

Choosing an established franchise like McDonald's (MCD) can reduce your risk, though it will cost more than an unproven one. But don't mistake a brand name for a sound investment. Prominent brands falter, sometimes because they expand too quickly. Many franchisees for Boston Market, Krispy Kreme (KKD), and Quiznos bought in as the companies rode waves of popularity. Krispy Kreme weathered an accounting scandal and years of losses, Boston Market went bankrupt and is now owned by a private equity group, and Quiznos [BusinessWeek.com, 1/29/07] and other systems faced lawsuits from franchisees.

You should hire a lawyer who specializes in franchising to help you steer clear of a bad investment or a harmful contract, according to Les Stewart, a franchise consultant and industry watchdog who once lost his personal savings on a failed lawn-care franchise. Aspiring franchisees should expect to take six months to vet the opportunity and to spend 5% to 10% of their investment on legal fees, Stewart says. "If you're not, then you're unnecessarily gambling," he says. Lawyers should review the franchise offering, contract, and loan documents. For married franchisees, Stewart says both spouses need independent counsel, because both can be on the hook for debt if a venture fails.

Get It In Writing

Above all beware of hard-sell tactics and promises that franchisors refuse to put in writing. "If any promise is made, you should have it in writing, and if you put it in writing and it isn't included in a franchise agreement, you should assume you are dealing with a liar and a scoundrel," says Stewart. He says it's difficult to estimate how many franchises are bad bets because there is no comprehensive tracking of franchise failures. But he suggests that a majority of the new offerings being marketed are "non-sustainable," and that the number is greater than in the past. "These fly-by-night systems come in to the market because people allow them. They buy them and they think it's just like McDonald's."

For more advice on franchising, including an explanation of franchising fees, an interactive case study on a new franchisor, a round-up of suggestions from industry veterans, and more, read the rest of this special report.