FRANCHISEE CONSIDERATIONS IN EVALUATING A FRANCHISE

ADVANTAGES AND DISADVANTAGES OF A FRANCHISE

The "turn key" nature of many franchise offers can be quite alluring to a prospective investor.

Franchise industry propaganda paints a rosy picture of franchise investment opportunities. A franchise program may provide the franchisee with potentially significant advantages compared to the start-up of an independent small business. That said, there are also several distinct disadvantages and risks in owning a franchised business. There is no business sector in which a person must buy a franchise in order to start a business. If one chooses to cook hamburgers for a living, one need not pay substantial amounts of money to one of the recognized national hamburger restaurant franchisors to do so. Still, many well-informed and intelligent investors line up for the opportunity to do so based on their perception that there is a *quid pro quo* – a true trade-off of values to be derived from the franchise that justifies the fees and other burdens involved. This section summarizes some of those advantages and disadvantages from the prospective franchisee's perspective.

Advantages

By investing in a franchise of an established chain, a franchisee acquires access to the ***distinctive trade identification*** of the franchisor in the form of the licensed trademark or other commercial identification used by the franchised business. In

most circumstances, this provides an advantageous head start on acquiring goodwill in the marketplace (*i.e.*, trade recognition by potential customers). In many cases, however, especially when dealing with franchisors who are themselves in a start-up mode or perhaps just newly entering the Minnesota marketplace, the shared trade identification will be of limited value (at least until that particular brand establishes itself in the marketplace).

Trade identification, however, is a two-edged sword. In rare cases, a brand identification carries negative goodwill in the marketplace, which actually can be a strong disadvantage to the franchise. A new franchise may thus be in trouble from day one if the brand is declining through age or mismanagement, or it has acquired a justified bad reputation in a particular market based on bad performance by the franchisor or by earlier franchisees. Prospective investors should always engage in careful pre-purchase investigation of a franchise offering in their intended market area, as well as generally.

The synergism that results from ***being part of a larger chain*** of merchants carrying common trade identification can sometimes provide an additional competitive edge for the investor that is not obtainable from an independent small business. But chains can pull in two directions. As such, if public recognition of the chain turns unfavorable, the chain identification and synergism can work to the franchisee's detriment.

Most franchise programs provide the franchisee with the ***developed expertise*** of the franchisor. This occurs both in the business being franchised and in some of the areas of common support services described later. At its best, this expertise will provide the franchise investor with a roadmap for getting the franchised business up and running. This will help the investor avoid many of the trial-and-error mistakes that an independent, small business operator might otherwise commit due to the learning curve associated with starting up a new business.

An advantage promised by most franchisors and delivered by some is ***expert site evaluation*** and site selection assistance. Many first-time business investors lack real estate and marketing expertise sufficient to enable informed selection of suitable site locations for a new business. A capable franchisor may be able to provide that assistance, in some cases going so far as assisting in the negotiation of acquisition terms or lease terms. A small minority of franchisors will go further still, providing financial assistance relative to site selection by agreeing to acquire or lease the site for the franchised business.

A major value of many franchises is a ***proven operating system*** shared with the franchisee, presumably mastered by the franchisor through its own or its franchisees' efforts and experience. The operating system is usually conveyed to the investor in a pre-opening training program, an operations manual and other communications from the franchisor. Operating systems in franchised businesses vary significantly from one franchisor to another in their sophistication, scope and value.

Most franchise programs also offer ongoing ***operational support*** from the franchisor. Support may include pooled purchasing of inventory, supplies, insurance, or other inputs into the franchised business, as well as various research and development functions. Operating support almost always includes various forms of advertising and marketing assistance. As with many other features of a franchise, the composition and quality of operating support services varies greatly from one franchisor to another. This occurs even within a single industry sector and certainly between different industry sectors. Again, careful investigation and aggressive shopping are both required for a prospective franchisee to identify a suitable franchise program offered by a franchisor with a successful track record. Not every franchisor consistently delivers what it promises, and not every support service is worth its cost to the franchisee.

A franchised start-up business may be ***more "bankable"*** than an independent business start-up. A growing number of banks and other financing sources are showing greater willingness to finance franchised businesses. When a franchisee sells the franchised business, a prospective buyer may be more willing to buy a business that is part of a recognized and successful franchise organization than an independent operation (which may be highly dependent upon the personality and public recognition of its individual owner for its success).

Disadvantages

In spite of the many advantages a franchise promises its owner, almost every franchise also has a number of features that are disadvantageous to the franchisee as compared to the independent small business owner. These include the following factors.

Every franchise is ***part of a controlled group***. Many of the entrepreneurial management decisions that would be within the discretion of the independent business owner, in a franchise are reserved and exercised by the franchisor. The franchisee is part of a team, not an entirely independent business. While the capital investment, managerial effort, and the ultimate risk or reward of the investment still lie with the franchisee, many of the important decisions at both a strategic and tactical level will be made by someone else. That creates a potentially substantial vulnerability on the part of the franchisee to the insight, research, wisdom and judgment of the franchisor.

Investors who can't function well as team players generally do not make successful franchisees. Individuals who depend upon others to make decisions are generally better off working as employees in a traditional corporation, while individuals who are so independent or free-spirited that they cannot accept important decision-making by others are probably better advised to seek out their own independent business opportunities.

A growing proportion of franchise organizations afford member franchisees an institutionalized ***role in system governance***. Such a role entails participating in decisions regarding the franchise system which can affect the outcome of the franchisee's investment in the system. These mechanisms are highly beneficial to the franchisee and the system as a whole. The prospective franchisee should inquire about the existence of an independent franchisee association within the system and how it interacts with the franchisor. Inquiry should also be made regarding the existence of independent purchasing or advertising cooperatives, which may be available to system franchisees. The FDD may or may not report information concerning co-ops or independent franchisee associations.

Cost is another disadvantage to franchising. Franchises almost always entail substantial fees, which constitute both an ongoing cost burden and often a structural competitive disadvantage. No one is under any legal obligation to pay fees to a franchisor in order to start up an independent business in any particular line of business. Before committing to pay substantial fees to a franchisor, a prospective franchise investor should satisfy himself that the value to be derived from the franchise offering is commensurate with the fees to be paid over the life of the franchise.

A franchise is also a relatively ***immobile business***. Because the franchisor has a legitimate interest in controlling where its retail outlets will be located and in what markets they will operate, definition of the site or market boundaries of the franchised business is rarely left to the discretion of the franchisee. This can become an especially acute problem if the franchisee decides that the business should be relocated for any reason. Relocation may or may not be possible in a franchise system, or may be allowed only with burdensome conditions.

The ***ability to resell*** the franchise also may be impaired by the terms of the franchise agreement. A proposed transfer of the franchise or of its business assets ordinarily draws close scrutiny

by the franchisor before the business may be sold to another. The facility may have to be upgraded to current system standards. Franchisors also have a legitimate interest in regulating who their franchisees will be, and usually reserve the right to require that their consent be granted before a transfer may occur. Consent may depend on subjective factors such as the experience or financial qualifications of the proposed transferee. Transfer fees, sometimes sizeable, are imposed in many franchise offerings. Franchisors also frequently reserve a right of first refusal to match an offer by a third party to acquire the franchised business. This can be a significant impediment or deterrent to some prospective purchasers. Some franchise contracts do not allow the seller even to assign his or her own franchise, but require the buyer to sign a new, different, and possibly less advantageous franchise contract.

A franchisee suffers from ***vulnerability to factors beyond his or her control*** in areas that can have a profound impact on the success of the business or the satisfaction or profit the franchisee derives from it. These areas include vulnerability to the other franchisees' performance and the quality and value of the franchisor's operational performance. This factor is often missed altogether or downplayed by inexperienced prospective franchisees.

The *shared brand identification* of the franchisee's business can have negative implications. If others in the system in the same or nearby markets do a poor job, the public ill will that ordinarily attaches to such performance may be transferred to the franchisee despite his or her own good efforts in running his or her own business. Bad publicity from another franchisee's breakdown (or the franchisor's), such as a food contamination issue, can severely injure the business of an innocent franchisee in the same brand.

Many franchise agreements allow for ***competitive encroachment*** by the franchisor or its affiliates through new nearby outlets, or distribution of competitive products through other channels of distribution under the same brand identification used by the franchisee. This can be a very severe risk to a franchisee because

its own franchisor can become a primary competitive threat to the franchised business. For the most part, courts have not protected franchisees against this very serious problem.

In the long run, every franchisee is extremely vulnerable to the overall commercial performance of their franchisor. If the franchisor fails financially, the consequences can be catastrophic for system franchisees.

This vulnerability extends both to the conduct of the business that is being franchised and to the franchisor's skills in administering its franchise relationships. These are two entirely separate but closely linked areas of concern. Franchisees have no assurance that personnel shifts will not occur in the franchisor, which can result in the loss of people upon whom the franchisee relied in making the investment commitment.

Ownership of a franchisor also can transfer unexpectedly. A founder may decide to sell out, perhaps by making a public offering of stock or by selling out to a larger conglomerate organization. A publicly traded franchisor may be taken over by another business. It is not unheard of for a franchisor to be acquired by one of its key competitors. These types of change in control may result in significant changes in level or quality of service support, levels of capital appropriated to the business, competence of the personnel assigned to franchisee service functions, or redefinition or redirection of the business. It may result in diverted or nonexistent loyalty if the new franchisor already owns a competitive business (whether franchised or not).

In some franchise systems, franchisors have been unresponsive to ***changes in market circumstances,*** or have created contractual arrangements that do not enable the system as a whole to change in response to changing market circumstances. This may result in inflexibility to changing competitive, technological, or regulatory circumstances that can harm the success of the franchisee's business.

The franchisee's ***purchasing discretion*** is likely to be restricted in most franchise systems. If this power is abused or used opportunistically by the franchisor, a material adverse impact on the franchisee's financial results can occur. Franchisors have a legitimate interest in controlling the nature and quality of goods and services provided under the franchisor's brand identification. Most systems express this by means of restrictions as to the type, brand, or origin of products and services purchased by the franchisee for use in the franchised business. Some franchises go beyond this to control the sources from which franchisees obtain equipment and supplies for the franchised business. This may deprive the franchisee of the benefits of shopping aggressively for various types of equipment and supplies used in the franchised business. This concern is alleviated in systems that have purchasing cooperatives, especially co-ops controlled by the franchisees, which allow franchisees to obtain equipment, fixtures, ingredients, supplies and other inputs to the business which meet the franchisor's standards and specifications, but to procure them from independent, competitive sources.

Covenants against involvement in other businesses are a feature of many franchises. These contract clauses restrict or prohibit involvement by the franchisee in outside or competitive businesses during and for some period after the term of the franchise. This can become an especially burdensome restriction if growth opportunities within the franchise system are not generally available, leaving the franchisee with few choices for reinvestment and growth.

Franchises are often promoted as a means of reducing the financial risks of business ownership. A small but persuasive body of academic research shows that franchised small businesses often have ***lower profitability, higher costs and a greater risk of business failure*** in their first five years of operation when compared to similar but non-franchised small businesses. This is not necessarily true of all franchise offerings. Still, it underscores the need for the investor to be diligent in investigating a franchise

offering both as to the franchise program itself and as to the soundness of the underlying business that is the subject of the franchise offering.

HOW TO EVALUATE A FRANCHISE OFFERING

Balancing all of the theoretical advantages and disadvantages of franchises – plus whatever other considerations may arise in respect to a given product or geographic market, the idiosyncrasies of a particular franchisee-investor, and the characteristics of a given industry sector or franchisor – is a challenging task for each prospective franchisee. The franchisee must evaluate his or her own suitability to function as a franchisee and must assess the merits of each franchise offering he or she considers. There is no such thing as too much due diligence for a prospective franchisee.

The franchisee-investor must make a thorough and careful assessment of the price-value relationship between the franchise fees charged by a franchisor and the package of services offered. The prospective franchisee should carefully compare other franchise offerings in the same industry sector as well as offerings in other industry sectors involving comparable levels of investment. This will help the investor assess whether the particular features of a given franchise offering are representative or whether a particular offering may be above or below the norm being offered in that industry, or in franchising generally.

Other sources of information available to a prospective franchisee (beyond the franchisor's FDD) were discussed earlier. These sources include the FDDs of competing franchisors and franchisors in other industry sectors, the annual report of a publicly traded franchisor, interviews with other franchisees in the system, inquiry of public agencies, and even basic economic research in the public library. This type of information can be obtained from other franchisees, the investor's own professional advisors, attendance at trade shows, asking the Better Business

Bureau for a business experience rating of the franchisor or its local franchisees, and trade associations – either in the particular industry sector involved or the International Franchise Association in Washington, D.C., the American Franchisee Association in Chicago, or the American Association of Franchisees and Dealers in San Diego. "A Consumer's Guide to Buying a Franchise" is available from the FTC. The FTC can be contacted at 1-877-FTC-HELP or 600 Pennsylvania Avenue, NW, Washington, D.C., 20580. Additional information is available at www.ftc.gov.

The assistance of an *experienced*, professional franchise advisor – whether a lawyer, CPA or trusted business advisor – is indispensable for the evaluation of any franchise offering.

Risk Factors

Certain external risk factors not covered by most FDDs should be taken into account before making a franchise investment. The prospective franchisee should consider that franchise offerings involve a range of risk that runs from blue chip offerings, to competent but not nationally prominent franchisors, to high risk but honest startups and very small franchisors. A few offerings also descend into very dangerous areas populated by severely undercapitalized franchisors, marginally qualified franchisors, and the occasional outright crook who appears with a "franchise" deal.

The recent track record of the franchisor and its franchisees (especially new franchisees) is probably the most reliable single indicator of the near-term prospects of the franchise offering. A track record, however, does not by itself provide assurance as to the franchisor's long-term prospects. The franchisor may suffer a simple reversal in competitive fortunes or might be taken over by an incompetent, competitive or disinterested new owner.

Industry trends and experience are also important. One would be reluctant to acquire a franchise, however well capitalized and competently managed the franchisor might be, in an industry sector suffering rapid decline in consumer popularity. Tales of well-structured "buggy whip" franchises abound.

Another risk factor often overlooked by an enthusiastic prospective franchisee is the absolute level of investment required. The FDD's disclosure of the investment commitment necessary to open the franchised business is never the end of the spending. Significant additional investment in facilities may be required to deal with Minnesota's climate or local zoning or permit requirements. Substantial further outlays are necessary simply to operate the franchised business. Business assets also wear out and will need to be replaced, requiring still further investment obligation. Some franchisors are also significantly more aggressive than others in requiring reinvestment by their franchisees through remodeling or even relocation requirements. Franchisees should guard against becoming overextended financially.

Like any business, franchises are rarely profitable in their first few months or year of operation. Allowance must be made for the costs necessary to support the business during its start-up phase, including personal living expenses of the investor.

A prospective franchisee should carefully evaluate the other types of change that inevitably occur that could significantly impact a particular line of business. Rapidly evolving technological change, vulnerability to significant regulatory change (as has happened in some industries which have become deregulated in the last decade) and businesses that may be vulnerable to being cloned by aggressive competitive organizations may provide unusually high and unacceptable levels of risk to an investor.

Similarly, franchises that are vulnerable to a single source of supply for a key product or ingredient will present a much

higher level of risk than some other types of franchised businesses which are not dependent upon single sources of supply for critical products.

A person considering the acquisition of a franchise should also consider buying an established franchised business from an existing franchisee. Access to these opportunities is frequently possible through real estate brokers, the franchisor itself, or local business journals. In such a case, the franchisee will be paying the going concern value for an existing business with a known performance at a given location, but will avoid the uncertainties and delays inherent in starting up a new franchised business.

Upside Opportunity

In addition to considering a franchise opportunity's risks and downside, a franchisee should also consider the upside opportunity value. Various means are available to provide some growth opportunity within a franchise organization. These include such vehicles as acquisition of area franchise rights or multiple unit development rights within a prescribed market area. Investors will find that franchisors in a start-up mode, or just entering a geographic market, will be much more interested in granting such developmental opportunities than will established franchisors with mature systems. Franchisees are often successful in negotiating options for additional franchises or other forms of additional development rights – either in conjunction with the acquisition of the original franchise or after the franchisee has established its own track record in successful operation of the franchised business.

A franchisee should examine the FDD and Franchise Agreement to determine:

- whether the franchise is vulnerable to encroachment by other franchised or franchisor-owned outlets;

- whether the franchisor or its affiliate is distributing - or may come to distribute - identical goods, or goods identified by the same brand, through other channels of distribution; and
- whether the franchise agreement entitles or may compel the franchisee to expand or contract the menu of goods and services the franchisee is to offer periodically.

A franchisee may wish to bargain for rights of access to such expanded or innovative distribution programs.

Franchisees should pay especially close heed to the duration of the franchise and whether any extension or renewal rights are granted in the franchise agreement. If renewal rights are granted, on what terms may they be exercised? A "renewal" right that requires execution of a new franchise agreement on such terms and conditions as the franchisor offers in the future may be no more than a blind "put" to the franchisee and constitute more of a risk than a benefit.