

## Franchising Basics

*Adapted from content excerpted from the American Express® OPEN Small Business Network*

When you're considering starting your own business, you have a choice of either starting from scratch, buying an existing business, or looking at a business opportunity like a franchise. Owning and operating a franchise can be as much work as other options, and it can also be quite profitable.

There are thousands of franchised businesses, covering nearly every conceivable industry, from well-known national brands to smaller, local opportunities. The challenge is to decide on one that both interests you and is a good investment. Many franchising experts suggest that you comparison shop by looking at multiple franchise opportunities before deciding on the one that's right for you. Use the answers to the questions below to help you learn more about the concept.

- \* **What is a franchise? How does it work?**
- \* **What are the benefits of being a franchise over starting my own business?**
- \* **Is there a downside to being a franchisee?**
- \* **What franchising laws do I need to be aware of?**
- \* **What should I look for in the disclosure documents?**
- \* **What should I look for when selecting a franchise?**
- \* **Is there other research I can do to learn more about a particular franchise?**
- \* **What fees should I expect to pay for my franchise?**
- \* **Should I look into established franchises or rising stars?**

### **What is a franchise? How does it work?**

When you buy a franchise, you are buying the right to use a specific trademark or business concept. The business you run is essentially the same as all other business being run under the same name. In order to do this, you may have to buy things like products, tools, advertising assistance, and training from the franchisor (the company that owns the rights to the business).

While you own the business, its operation is governed by the terms of the franchise agreement. For many, this is the chief benefit of franchising -- you are able to capitalize on business format, trade name, and support system provided by the franchisor. The oft-quoted line is that franchising allows people to go into business for themselves, not by themselves.

### **What are the benefits of being a franchise over starting my own business?**

You get a number of advantages when you purchase a franchise:

- \* **Reduced risk** - Franchises traditionally have a much lower failure rate than other start-up businesses. The reason? You're buying a business concept where most of the kinks have

already been worked out by someone else.

\* **You get a complete package** - The guesswork usually associated with starting a business is taken care of. Your total package can include trademarks, easy access to an established product; a proven marketing method; equipment; inventory; etc.

\* **Strength in numbers** - When you've become a franchisee, you have the buying power of the entire network, which can help you get product and compete with larger national chains.

\* **Business processes** - Many franchisors provide their franchisees with various proven systems including financial and accounting systems; ongoing training and support; research and development; sales and marketing assistance; planning and forecasting; inventory management; etc. They'll show you the techniques that have made the business successful and help you utilize them in developing your own business.

\* **Financial and site selection assistance** - Some companies will help you finance your initial franchise, letting you get by with as little upfront cash as possible. They also may help with site selection, making sure that your business is located in an area where it can thrive.

\* **Advertising and promotion** - Not only will you benefit from any national or regional ad and promotional campaigns from the franchisor, but they may also help out in other areas -- from providing camera-ready copy for your own advertising efforts to developing in-store point-of-sale materials designed to drive customers through your business. It would cost you a great deal to develop these materials on your own.

### **Is there a downside to being a franchisee?**

Franchising is certainly not for everyone. Here are some of the potential disadvantages:

\* **Lack of control** - The essence of a franchise -- buying and operating a proven concept -- can make it seem like you're more of a manager than a boss. This may be difficult for some people, especially those that are more entrepreneurial. This type of person may find it hard to conform to someone else's system.

\* **Cost** - It can take a good deal of cash to open and operate a franchise. Upfront costs can be significant, and you may find that ongoing royalty fees will have a major impact on your cash flow.

\* **You're not alone** - Just as a franchisor's reputation can benefit your individual business, the franchisor's problems are also your problems. So if the parent company comes upon hard times, your individual franchise may also suffer because of how closely you're tied in.

\* **You're committed** - Your franchise agreement is a binding contract, and can be quite restrictive. You're locked in to certain business practices, fees, and even the look of your business. If you don't agree, you may have no recourse except to adhere to these guidelines.

## **What franchising laws do I need to be aware of?**

You should consider having your attorney, accountant or other advisor review the disclosure documents and proposed contracts before entering into any agreement. This advice, coupled with your own research, can help save you money and keep you from making a bad investment.

## **What should I look for in the disclosure documents?**

The disclosure document provided to you by the franchisor can serve as a window into the company's operations. It is important to review it completely (preferably with the assistance of an attorney, accountant or business advisor) to learn all you can about the franchisor.

### **Some things to look for:**

- \* **Does the franchisor have a track record of success?** - Learn all about the franchisor's personal and business names, its organization; its background; and its financial history. You'll also need to determine whether this success can be duplicated in your area.
- \* **What will it cost me?** - The circular should have complete list of fees that you will be required to pay both to start your franchise and operate it. It will also tell you other obligations, such as inventory or equipment that must be purchased from the franchisor.
- \* **Will my territory be exclusive?** - You will want to determine whether or not the franchisor can open other stores in your area, or even sell its product by mail order to customers in your region. You also might have to meet certain sales criteria to maintain your exclusivity.
- \* **What products can I sell and how can I sell them?** - You may only be allowed to sell certain products that are on the franchisor's approved list. And you may be limited in the ways you can sell them. For instance, you might be allowed to handle walk-in traffic to your store, but you may be prevented from selling outside your location.
- \* **What services will the franchisor provide to me?** - Look for what services will be provided to you prior to opening, and after you're open for business. You'll also want to read about what training is necessary, where it will take place, and what it will cost you. Also, check to see what trademarks and patents you will receive.
- \* **Is there any bad news I should know about?** - The documents must disclose any actions involving violation of franchise law, fraud, embezzlement, or unfair business practices. They also must disclose whether the franchisor, any predecessors, or any partners or officers have declared bankruptcy in the past 15 years. And be sure to read financial statements closely.
- \* **How much can I expect to make from this business?** - The circular contains hypothetical profit projections, along with the formula for how these figures were created. Be aware that

economic conditions vary from region to region, so these figures do not assure success of a particular outlet. Instead, use these figures combined with estimates of costs and expenses in your area.

### **What should I look for when selecting a franchise?**

Here are some of the things you should look at when evaluating a franchise:

**Profitability** - Make sure that both the franchisor and individual franchisees are healthy. A track record of success - Is this concept viable? Has it succeeded elsewhere?

### **Does the franchisor have a good credit rating?**

\* **A strong USP** - You'll want a business that stands apart from the competition, since you don't want to be perceived as selling the same old thing.

\* **Effective financial management and other controls** - A strong monitoring system will help you identify your problems and deal with them more effectively.

\* **A good image** - It's important that the public has a positive image of the franchisor, since you're basing your business on its reputation. Also, look for a concept that can expand nationally so your business can grow locally.

\* **Integrity and commitment** - You actually want the franchisor to spend a lot of time checking you out, because you want to make sure it has strong requirements for all its franchisees, since your success is intertwined with its.

\* **A successful industry** - Look for opportunities in industries that are growing.

### **Is there other research I can do to learn more about a particular franchise?**

It's important to learn as much as you can before purchasing any kind of business so you can make an informed decision. There are a wide variety of sources you can approach to learn about a franchise opportunity. Here are some things you can do:

\* **Interview the franchisor** - Make sure that you feel comfortable with the franchisor, and that all your questions can be answered to your satisfaction.

\* **Interview existing franchisees** - Speak with current franchisees to see how they feel about the business. Are they happy with their investment? Are they making as much money as the expected?

\* **Read the business and trade press** - Spend some time in the library or on the Internet looking through the media. Often, you'll learn a lot more about the company than they volunteer in disclosure documents.

\* **Check references** - Don't just speak to franchisees. Call bank and other business references supplied by the franchisor.

\* **Go to independent agencies** - Find out whether any complaints have been lodged against the company.

\* **Get a credit report** - Get a report on the franchisor from Dun & Bradstreet, TRW/Experian, or one of the other credit reporting agencies. You'll learn a lot about how the company conducts business.

### **What fees should I expect to pay for my franchise?**

There are basically two types of fees you should expect to pay for your franchise -- upfront fees and ongoing fees.

The first is the initial upfront fee, which is what you pay the franchisor for the rights open your franchise. Essentially, you are purchasing the rights to use the franchisor's trademarks, business methods, and distribution rights. This licensing charge can be significant, especially for a well-known, established franchise -- it's not unusual for it to be in the tens of thousands of dollars. Often, it is also based on the value of the territory or trading area, so the larger your market, the more you could end up paying.

Be aware that this upfront fee may be in addition to any other start-up costs you will have to incur. The initial franchise fee may or may not include things like training costs; start-up promotional fees; inventory; build-outs (some franchisors require your space to have specific architectural elements); equipment/fixtures (you may be required to purchase or lease specific equipment and fixtures from the franchisor); and any other costs that are necessary to open your business.

You will also have to pay ongoing fees to maintain the rights to your franchise. Most franchisors charge a royalty fee, typically a percent of your gross sales, not your profits. This royalty fee can range from 1 percent to as much as 15 percent, although 5 percent is typical. Remember, you are paying this royalty on gross sales (your total receipts, less sales tax, returns and refunds), so it can potentially take a significant bite out of your profits.

Some franchisors charge a regular fee (payable weekly, monthly or quarterly) in lieu of royalty payments. This type of fee may also be part of the mark-up you are charged for goods or services you are required to purchase.

It is also common for franchises to pay a portion of the franchisor's local, regional and national advertising and promotional costs. These fees are usually put into a cooperative advertising fund that ultimately benefits all franchises through increased exposure to your trade name.

### **Should I look into established franchises or rising stars?**

This is one of the key decisions you will need to make if you decide to go the franchise route. There's a trade-off you will need to evaluate in terms of risk and ultimate pay-off.

A franchise with an established track record has many benefits -- significant name recognition; proven marketing methods; entrenched business plans and training systems; strong management; and a history that is easy for you to investigate. On the downside, you might find that the franchisor has already saturated your market (so good locations may not be available, or other outlets may encroach on your area); fees may be higher; and you may find that the larger the company, the harder it is for you to be heard should any disagreements arise.

An emerging franchise gives you the chance to get in on the ground floor of what could be a highly profitable growth opportunity. Newer franchises also tend to have lower upfront and royalty fees, and they may be more willing to negotiate and accommodate individual franchisees. On the other hand, smaller franchise opportunities may lack name recognition; they may not have enough experience to make their system work; you may find yourself being a test-case for their procedures; and the chance of franchisor failure could be much greater.