Business in a Box

Is Franchising Risk Worth the Potential Payoff?

By TODD C. RATNER

Frustrated middle managers, executives looking for a career change, and blue-collar workers seeking financial independence are all enticed by the idea of starting their own enterprise by purchasing a franchise.

Notwithstanding the persuasive glossy brochures supplied by the franchisors, purchasing a franchise is a risky endeavor. However, with the proper due diligence and professional advice, owning a franchise may prove profitable and enhance one's quality of life.

Collectively, franchising is an economic giant. In the U.S. alone, nearly $1 trillion a year in sales is accrued at franchised stores. Despite these numbers, the median size of a franchise operation is approximately 25 units. Moreover, fewer than 20 companies have franchised as many as 5,000 units. And, powerful brands like McDonald's stores carry hefty price tags.

According to Griffith University, the overall average price one can expect to pay for a new franchise territory is $120,000. Specifically, the average franchise costs $35,000 up front with a five-year term. This up-front amount typically entitles the franchisee to a territory, training, advice on location, a brand name and trademark, business systems, software support, the benefits of bulk buying, guidance, initial stock and an operating manual.

Then, there is also a monthly fee, usually a proportion of sales. The average monthly fee is 6% but it can be as high as 15%. Moreover, on average, another 3% of sales are paid to the franchisor for brand marketing and advertising. Again, this $120,000 fee is for an average franchise. On the other hand, a McDonald's store averages $540,000 for a new territory.

For some, purchasing a franchise is a very appealing and well-suited opportunity. A franchisee can achieve levels of brand awareness, market penetration and purchasing power not readily achieved by individual business owners. Furthermore, some franchisees find securing financing easier because the franchisor typically has an established trademark and goodwill, as well as marketplace experience.

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For others, purchasing a franchise represents all the financial exposure, headaches, and stress of business ownership without the full reward, as the franchisor is entitled to royalties on sales. The franchisor will dictate most everything that a franchisee can do including what types of signs you can put up, how you price your items, and who will be your suppliers. As such, a franchise business is often referred to as a 'business in a box.' Also, it is much more perilous endeavor than most people realize.

In the early 1970s, states commenced franchise-disclosure and registration laws. This action led to the Federal Trade Commission's Franchise Rule in 1979, which required all franchisors to furnish potential fees together with information concerning the franchisor, the franchised business, and the franchise relationship. The Uniform Franchise Offering Circular (UFOC) now satisfies the FTC's disclosure requirements and must be presented to each prospective franchisee at their first face-to-face meeting.

The UFOC is a contract between the franchisor and the franchisee that provides:

- A written disclosure statement that sets forth certain information about the business to be franchised, and
- A proposed franchise agreement or contract.

A third document, an 'earnings-claim' statement of the franchisor, may or may not be provided at the choice of the franchisor. While the franchisor is not required to provide the prospective franchisee an earnings claim statement, its failure to do so should raise a red flag.

Eric Karp, a professor of graduate courses at Babson College states that "the typical UFOC is about the size of a telephone book, and it is enormously complex because it's so multifaceted. Everything related to the business – construction, brand management, employee training, etc.— is all rolled into on vast document … the irony is, you can say there should be more information, but the more information is laid out for people, the more we risk overwhelming them, so that they don't read at all."

The franchise agreement is a legally binding contract outlining the franchisee and franchisor relationship. More often than not, companies that sell franchises are so much more sophisticated than the buyers that the franchisors hold most of the cards. This is evident in the initial draft of the franchise agreement composed by the franchisor, which is provided to the franchisee.

There is no standard form of franchise agreement because the terms, conditions, and the methods of operations of various franchises differ greatly depending on the type of business venture. Despite the above, there are terms within almost every franchise agreement that can be negotiated. For example, the following items may be negotiable: price, timing of payments, duration of the franchise, the number of people the franchisor will train, and the exclusive territory given to the franchisee.

A purchase of a franchise is a substantial commitment of a franchisee's money, time, and reputation. It is critical that the prospective franchisee base his or her financial assumptions on many sources: the information available from the franchisor, information obtained through their discussions with existing franchisees, information obtained from articles about the franchisor and the industry, and the prospective franchisee's visits and observations at several franchised locations.

In addition, the prospective franchisee should always review the UFOC and refer other questions to an experienced franchise lawyer and an accountant.❖

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