

# EVALUATING FRANCHISE OPPORTUNITIES

*Management and Planning Series*

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## TABLE OF CONTENTS

### INTRODUCTION

### WHAT IS FRANCHISING?

### BENEFITS OF A FRANCHISE

### INVESTIGATE YOUR OPTIONS

What is the Business?

Who is the Franchiser?

What is the Franchise Package?

The Disclosure Document

### PERSONAL ASSESSMENT

### OBTAINING PROFESSIONAL ADVICE

### APPENDIX: INFORMATION RESOURCES

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### INTRODUCTION

The success rate for franchise-owned businesses is very high. According to studies conducted by the U.S. Department of Commerce from 1971 to 1987, less than 5 percent of franchised businesses failed or were discontinued in each of those years. However, success is not guaranteed. One of the biggest mistakes that you can make is to be in a hurry to get into business. If you take shortcuts on your evaluation of a potential business, you might neglect to consider other

franchises that are more suitable for you. Don't be pressured into a franchise that is not right for you. Although most franchise operations are managed by reputable individuals, as in all industries, some are not. Also, some franchised businesses are poorly managed and financially weak. Resist pressure to purchase before you complete a thorough investigation.

This publication is designed to assist you in investigating your options. It includes the questions you should ask to adequately evaluate the business, the franchiser, the franchise package and yourself as a franchise owner.

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## **WHAT IS FRANCHISING?**

A franchise is a legal and commercial relationship between the owner of a trademark, service mark, trade name or advertising symbol and an individual or group seeking the right to use that identification in a business. The franchise agreement governs the method for conducting business between the two parties. Although forms of franchising have been in use since the Civil War, enormous growth has occurred more recently. By the end of 1990, more than 500,000 franchised establishments in 60 industries achieved gross sales of over \$700 billion dollars and employed 7 million full- and part-time workers. Industries that rely on franchised businesses to distribute their products and services touch every aspect of life, from automobile sales and real estate to fast foods and tax preparation.

In its simplest form, a franchiser owns the right to a name or trademark and sells that right to a franchisee. This is known as product/trade name franchising. In the more complex form, known as business format franchising, a broader and ongoing relationship exists between the two parties. Business format franchises often provide a full range of services, including

- Site selection.
- Training.
- Product supply.
- Marketing plans.
- Financing.

Generally, a franchisee sells goods or services that are supplied by the franchiser or that meet the franchiser's quality standards.

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## **BENEFITS OF A FRANCHISE**

There are a number of aspects to the franchising method that appeal to prospective business owners. For example, easy access to an established product and a proven method of operating a business reduces the many risks of opening a business. In fact, U.S. Small Business

Administration and U.S. Department of Commerce statistics show a significantly lower failure rate for franchised businesses than for other business start-ups. The franchisee purchases not only a trademark, but also the experience and expertise of the franchiser's organization. However, a franchise does not ensure easy success. If you are not prepared for the total commitment of time, energy and financial resources that any business requires, you should stop and reconsider your decision to enter the franchise business.

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## **INVESTIGATE YOUR OPTIONS**

As in all major business decisions, nothing substitutes for thorough investigation, planning and analysis of your options. This publication is designed to help you systematically review the possibilities and pitfalls of the franchised business you are considering. Use the questions below to guide your research and cover all the bases. Read the entire publication before you begin to gather information.

### **What Is the Business?**

Determine whether the business opportunity would be a successful venture on its own, apart from the benefits offered by the franchiser.

- Is the product or service being offered new or established? Does the business require special skills or aptitudes that you may lack? Do you feel strong motivation for producing the product or providing the service?
- Does the product meet a local demand? Is there a proven market?
- Who is the competition?
- If the product requires servicing, who bears the responsibilities covered by warranties and guarantees? The franchisee? The franchiser? If neither, are service options available?
- What kind of reputation does the product or service enjoy?
- Are suppliers available? What reputation do they enjoy?

### **Who Is the Franchiser?**

Visit at least one of the firm's franchises. Ask for a list of all of the firm's current franchises and make sure that you select the one to visit. Avoid calling those names recommended by the franchiser. At the very least, the franchiser must provide you with the names of 10 franchises in your prospective market area.

When you meet with the franchisees, observe their operation, discuss expenses and ask how well the franchiser supports the franchise units. Does the franchiser actively promote and market the

products or services of the franchise? You should determine the reputation, stability and financial strength of the franchiser.

- How long has the franchiser been in the industry? How long has the firm granted franchises?
- How many franchises are there? How many in your area?
- Examine the attitude of the franchiser toward you. Is the firm concerned about your qualifications? Are you being rushed to sign the agreement? Does the firm seem interested in a long-term relationship, or does that interest end with the initial fee?
- What is the current financial condition of the franchiser? Check the franchiser's financial statements in the disclosure document (see page 3). If the franchisees are paying their upfront fees but not their royalties, this may indicate that franchise units are being sold to investors but that they fail to open or perform too poorly to pay royalties.
- Who are the principal officers, owners and management staff? What is each person's background? How much experience in franchising do they have?
- Compare sales promises with existing documentation. Be certain that the sales presentation is realistic and that major promises are clearly written into the contract. Be alert for exaggerated claims and pressure tactics.
- For newly established franchises, make sure the franchiser has registered the company's trademark. If not, the company's name and logo may have to be altered, forcing you to change your market identity after you have established yourself.
- Verify earnings claims and compare them with other business opportunities. Investigate all earnings claims carefully. Earnings claims must (1) be in writing; (2) describe the basis and assumptions for the claim; (3) state the number and percentage of other units whose actual experience equals or exceeds the claim; (4) be accompanied by an offer to show substantiating material for the claim; and (5) include certain cautionary language. Treat this opportunity like any other investment. Does the franchise offer the return you require? If not, you may want to look at a different business.
- What is the legal history of the franchiser? Have any of the executives been involved in criminal or civil actions? Is any litigation pending, particularly involving any restrictions on trade that may affect the franchise?
- Is the franchise a member of the International Franchise Association (IFA)? If not, why not? The IFA has a strict code of ethics that must be met before a company can become a member.

## What Is the Franchise Package?

Bring all your information and resources together as you examine the contract. Think carefully about the level of independence you will maintain as a franchisee. How comprehensive are the operating controls? Be very clear about the full costs of purchasing the franchise. Involve your attorney, accountant and/or business advisor as you examine these questions.

- What is the full initial cost? What does it cover?
  - Licensing fee?
  - Land purchase or lease?
  - Building construction or renovation?
  - Equipment?
  - Training?
  - Starting inventory?
  - Promotional fees?
  - Use of operations manuals?
- What ongoing costs are paid to the franchiser?
  - Royalties?
  - Ongoing training?
  - Cooperative advertising fees?
  - Insurance?
  - Interest or financing?
- Are you required to purchase supplies from the franchiser or a designated supplier?  
Are the prices competitive with other suppliers?
- What, if any, restrictions apply to competition with other franchises?
- What are the terms covering renewal rights? Reselling the franchise?

## The Disclosure Document

The Federal Trade Commission (FTC) requires sellers of franchises and other business opportunity ventures to provide prospective investors with the information they need to make an informed investment decision. It also requires that all earnings claims be documented, that the information investors receive be complete and accurate and that investors have adequate time to consider and evaluate the disclosures before making any final purchase commitment. All required information is given to prospective investors in the form of a franchise disclosure document, which must be furnished at least 10 business days before any purchase may occur. This document includes 20 important items of information, such as

- Names, addresses and telephone numbers of other franchisees.
- A fully audited financial statement of the seller.
- The cost required to start and maintain the business.
- The responsibilities you and the seller will share once you buy a franchise.
- Litigation involving the company or its officers, if any.

Again, use your professional support to examine all of these issues. Some of the contract terms may be negotiable. Find out before you sign; otherwise, it will be too late.

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## **PERSONAL ASSESSMENT**

Perhaps your most important step in evaluating a franchise opportunity is examining your own skills, abilities and experience. The ideal franchisee is a creative, outgoing person who is eager to succeed, but not so independent that he or she resents other people's advice. You must be able to balance your entrepreneurial initiative with a willingness to comply with the business formulas used by the franchiser. Remember, a successful partnership between a franchisee and franchiser involves a mutual understanding of each other's values and achievements.

Determine exactly what you want out of life and what you are willing to sacrifice to achieve your goals. Be honest, rigorous and specific. Ask yourself: Am I qualified for this field

- Physically?
- By experience?
- By education?
- By learning capacity?
- Financially?

Ask yourself how this decision will affect your family. Do they understand the risks and sacrifices required, and will they support your efforts? Beginning a franchise business is a major decision that does not ensure easy success. However, an informed commitment of time, energy and money by you and your family can lead to an exciting and profitable venture.

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## **OBTAINING PROFESSIONAL ADVICE**

You should consult a franchise attorney, an accountant and/or a business advisor to counsel you and go over the disclosure document and proposed contract. Their advice will help you make a realistic and sound decision. Remember, the money and time you spend may save you from a major loss on a bad investment. Also, see the information resources in the appendix.

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## **APPENDIX: INFORMATION RESOURCES**

### **U.S. Small Business Administration (SBA)**

The SBA offers an extensive selection of information on most business management topics, from how to start a business to exporting your products.

This information is listed in The Small Business Directory. For a free copy contact your nearest SBA office.

SBA has offices throughout the country. Consult the U.S. Government section in your telephone directory for the office nearest you. SBA offers a number of programs and services, including training and educational programs, counseling services, financial programs and contract assistance. Ask about

- **Service Corps of Retired Executives (SCORE)**, a national organization sponsored by SBA of over 13,000 volunteer business executives who provide free counseling, workshops and seminars to prospective and existing small business people.
- **Small Business Development Centers (SBDCs)**, sponsored by the SBA in partnership with state and local governments, the educational community and the private sector. They provide assistance, counseling and training to prospective and existing business people.
- **Small Business Institutes (SBIs)**, organized through SBA on more than 500 college campuses nationwide. The institutes provide counseling by students and faculty to small business clients.

For more information about SBA business development programs and services call the SBA Small Business Answer Desk at 1-800-U-ASK-SBA (827-5722).

## **Other U.S. Government Resources**

Many publications on business management and other related topics are available from the Government Printing Office (GPO). GPO bookstores are located in 24 major cities and are listed in the Yellow Pages under the bookstore heading. You can request a Subject Bibliography by writing to Government Printing Office, Superintendent of Documents, Washington, DC 20402-9328.

Many federal agencies offer publications of interest to small businesses. There is a nominal fee for some, but most are free. Below is a selected list of government agencies that provide publications and other services targeted to small businesses. To get their publications, contact the regional offices listed in the telephone directory or write to the addresses below:

### **Consumer Information Center (CIA)**

P.O. Box 100  
Pueblo, CO 81002

The CIA offers a consumer information catalog of federal publications.

### **Consumer Product Safety Commission (CPSC)**

Publications Request  
Washington, DC 20207

The CPSC offers guidelines for product safety requirements.

### **U.S. Department of Agriculture (USDA)**

12th Street and Independence Avenue, SW  
Washington, DC 20250

The USDA offers publications on selling to the USDA. Publications and programs on entrepreneurship are also available through county extension offices nationwide.

### **U.S. Department of Commerce (DOC)**

Office of Business Liaison  
14th Street and Constitution Avenue, NW  
Room 5898C  
Washington, DC 20230

DOC's Business Assistance Center provides listings of business opportunities available in the federal government. This service also will refer businesses to different programs and services in the DOC and other federal agencies.

### **U.S. Department of Health and Human Services (HHS)**

**Public Health Service**  
**Alcohol, Drug Abuse and Mental Health Administration**  
5600 Fishers Lane  
Rockville, MD 20857

Drug Free Workplace Helpline: 1-800-843-4971.

Provides information on Employee Assistance Programs.

National Institute for Drug Abuse Hotline: 1-800-662-4357. Provides information on preventing substance abuse in the workplace.

The National Clearinghouse for Alcohol and Drug Information: 1-800-729-6686 toll-free. Provides pamphlets and resource materials on substance abuse.

**U.S. Department of Labor (DOL)  
Employment Standards Administration**

200 Constitution Avenue, NW  
Washington, DC 20210

The DOL offers publications on compliance with labor laws.

**U.S. Department of Treasury  
Internal Revenue Service (IRS)**

P.O. Box 25866  
Richmond, VA 23260

1-800-424-3676

The IRS offers information on tax requirements for small businesses.

**U.S. Environmental Protection Agency (EPA)  
Small Business Ombudsman**

401 M Street, SW (A-149C)  
Washington, DC 20460

1-800-368-5888 except DC and VA  
703-557-1938 in DC and VA

The EPA offers more than 100 publications designed to help small businesses understand how they can comply with EPA regulations.

**U.S. Food and Drug Administration (FDA)  
FDA Center for Food Safety and Applied Nutrition**

200 Charles Street, SW  
Washington, DC 20402

The FDA offers information on packaging and labeling requirements for food and food-related products.

**For More Information**

A librarian can help you locate the specific information you need in reference books. Most libraries have a variety of directories, indexes and encyclopedias that cover many business topics. They also have other resources, such as

- **Trade association information**  
Ask the librarian to show you a directory of trade associations. Associations provide a valuable network of resources to their members through publications and services such as newsletters, conferences and seminars.
  
- **Books** -- Many guidebooks, textbooks and manuals on small business are

published annually. To find the names of books not in your local library check Books In Print, a directory of books currently available from publishers.

- **Magazine and newspaper articles** -- Business and professional magazines provide information that is more current than that found in books and textbooks. There are a number of indexes to help you find specific articles in periodicals.

In addition to books and magazines, many libraries offer free workshops, lend skill-building tapes and have catalogues and brochures describing continuing education opportunities.