FINANCIAL PLANNING PERSPECTIVES

IS FRANCHISING A GOOD INVESTMENT FOR YOU?

By the time you finish reading this article, another franchise will have opened somewhere in this country—let alone in the rest of the world.

Franchising has been around for many years, but low interest rates, stubborn unemployment and investors fed up with the stock market have made them especially attractive. While a franchise can be a good investment, it can lose money or, worse, go belly up. A study by the U. S. Small Business Administration found that 38 percent of franchises associated with smaller franchisors went out of business within five years.

A franchise is where an independent owner (franchisee) pays an initial start-up fee and periodic royalties for the right to do business for a certain contract period under a franchisor's name and business system. Many people think of fast-food chains when they think of franchises, but in fact, franchises represent 75 industries, according to the International Franchising Association. Examples include house cleaning, home repair, hair salons, dog grooming, used CDs, fitness, executive recruiting, computer services, tutoring, travel agencies, wine, tax centers, helping retirees move, and even small hotels. American franchises are spreading overseas, and foreign-based franchisors are looking to establish in the United States.

The IFA estimates that 1 out of every 12 retail businesses in the United States is a franchise, accounting for over 40 percent of all retail sales. It says that in 2000—before the market decline and the soft economy made them even more popular—a new franchise outlet opened in the United States every eight minutes.

So what's involved in buying a franchise—or several of them, as some investors do? What are the costs, potential profits, risks, restrictions, benefits and drawbacks?

First, consider seriously whether you're right for a franchise. One of the major attractions of a franchise is that you're working with an established name versus starting your own unknown business. The franchisor typically provides, to varying degrees, everything from a business model and training to marketing support and approved vendors. Some are virtual turnkey operations. This may appeal to the less adventurous, but others may find it too restrictive, preferring to launch their own business.

Still interested? Start checking out what types of franchise interest you. You can find franchises for sale through trade organizations such as the International Franchising Association (www.franchise.org) and www.franchiseopportunities.com. Or you can hire an independent broker.

Ideally, choose a franchise you know something about, though good business management skills often can count as much as knowledge of the business. While some franchisors are open to passive investors, many prefer to have active investors. Some experts feel that active franchisees tend to earn better financial returns on their investment.

Available investment funds are another factor. A one-time startup fee can run as little as a few thousand dollars to as much as a million or more, though fees for the vast majority of franchises run $40,000 or less, according to the IFA. But this figure doesn't include additional costs such as equipment, inventory, rent, and in some cases, the real estate. An IFA survey found that the average investment, excluding real estate, was $319,000, though the majority cost less than $250,000. Most franchisees will have to come up with their own financing, which can be especially difficult for new franchises. Undercapitalization is a major problem for franchises.

Once you've identified one or more potential franchises, get their federally required Uniform Franchise Offering Circular, which spells out the franchise agreement, startup and investment costs, training, turnover rate, list of franchisee bankruptcies and any litigation history.

A key step is to talk to at least half a dozen or more of the company's franchisees (listed in the Offering Circular), including "failures." Find out their experiences regarding customer demand, costs, corporate marketing support (often a problem among newer, smaller franchises) and other issues.

Carefully review with your financial advisor, and an attorney experienced with franchising, the circular and the subsequent contract. You'll want to scrutinize such issues as royalties (four to eight percent of gross sales is typical), territory, required vendors, noncompete clauses, renewal options and how you can sell the business or pass it on to your children.

In short, invest only after you've done your homework to make sure you've got the right franchise for you and that the deal is a good for you—not just the franchisor.

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