

START-UP BRIEFING



Highlands & Islands
ENTERPRISE

Buying a franchise

● Buying a franchise allows you to set up your own business without starting from scratch. You use a tried and tested formula, and benefit from the experience and support of the franchisor (the company offering the franchise).

Franchisees can enjoy many of the benefits of self-employment with less risk. Successful franchise operations have a much lower failure rate than completely new businesses. You can make a good living (though rarely a fortune) if you make the business work. But you need to be aware of the potential pitfalls.

This briefing outlines:

- ◆ The advantages and disadvantages of buying a franchise.
- ◆ How to evaluate a franchise.
- ◆ Negotiating to buy a franchise.

1 The advantages

A A franchise is usually based on a proven **business idea**.

You are basically copying a viable product, service or business (but see **3**).

- ◆ It is easy to check with existing franchisees whether the business really works.
- ◆ A good franchisor will continuously research and update the business idea.

B You may be able to exploit a recognised **brand name**. It can be easier to sell to customers who are familiar with the name.

- ◆ You will benefit from any advertising or promotion undertaken by the franchisor, often funded by additional fees.
- ◆ You will also be able to use any trade marks the franchisor owns.

C A good franchise operation will give you full **support**. Typically, this includes:

- ◆ Introductory training, usually covering general skills (eg book-keeping), as well as training for that particular business.
- ◆ Help in setting up the business.
- ◆ A detailed operations manual which tells you how to run the business.
- ◆ Ongoing support and advice.

Top franchisors often provide a franchise award manual. Issued after initial interview and confidentiality agreement, it contains all the information needed to conduct due diligence.

D You usually have **exclusive rights** in your own territory.

You will almost always be given exclusive

FURTHER HELP

There are other Start-up Briefing titles that can help you. These briefings are referred to in the text by name and by the code given to each briefing. For example, SuB 30.

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rights to the franchise in a specified region, or to an exclusive client base.

- ◆ There will still be competition from other businesses.

E Financing the business is likely to be more straightforward.

It can be easier to borrow money to invest in a franchise with a good reputation than for an unproven start-up.

- ◆ Some franchisors have relationships with banks and can help you borrow money, and local enterprise initiatives may supply start-up finance.

2 The disadvantages

A The **cost** may be more than meets the eye.

- ◆ You pay an initial franchise fee to buy into

Types of business arrangement

A Some of the most successful franchises offer a full **business blueprint**.

This is known as a business-format franchise. Examples are Burger King and Prontaprint.

B Many other franchises offer a **less complete** package. For example:

- ◆ *Distributorships and dealerships.*

You have an agreement to sell the product, but do not usually trade under the franchise name and have more scope to run the business as you see fit.

- ◆ *Agencies.*

You sell goods on behalf of the supplier.

- ◆ *Licences.*

You can make and sell the licensor's product, usually with no restrictions on how you run your business.

C **Multi-level marketing** (or network marketing) is sometimes regarded as a form of franchising.

Self-employed distributors sell goods on a manufacturer's behalf, gaining commission on their own sales and on sales made by secondary distributors they have recruited.

- ◆ *It is often difficult to make a good return from this sort of arrangement, unless you can recruit many other distributors.*

- ◆ *There are special regulations governing this loose type of business arrangement.*

Contact your LEC, through Highland & Islands Enterprise (www.hie.co.uk), for more information.

the franchise (often £5,000 to £10,000, but it can be as much as £250,000).

You also have the usual business costs (premises and equipment, stock and other supplies). In many cases, these will be bought from the franchisor.

- ◆ You pay a continuing royalty on sales, or a management fee, regardless of whether you are making a profit or not. This can be fixed or a percentage of sales or a mixture of both.

- ◆ Some extra costs may be charged separately.

For example, a contribution towards the franchisor's advertising costs or fees for the training you receive.

As a prospective franchisee, you need to be happy that the franchisor's services will justify all these costs.

B You have to agree to operate within certain **restrictions**.

The contract between you and the franchisor will usually restrict what you are allowed to do.

- ◆ You cannot change the business.

For example, you cannot introduce new products to suit your local market.

- ◆ You can only sell your franchise to a buyer approved by the franchisor.

Some people find these restrictions unacceptable and dislike the fact that they cannot take decisions independently.

C Your relationship with the franchisor means you are exposed to certain **risks** which are outside your control.

- ◆ The risk of the franchisor failing to fulfil its obligations (eg providing support in the form of brand advertising or training).

- ◆ The risk of the franchisor going out of business.

- ◆ The risk of the franchisor being sold to a new owner who changes the operation or is simply more difficult to deal with (see **3B**, last point).

- ◆ The risk of actions by the franchisor or other franchisees giving the brand a bad reputation.

3 Evaluating a franchise

The franchisor should provide a prospectus that answers all the basic questions. Do not take everything at face value. Look for factual evidence that what the franchisor says is true, and guarantees that it will stay that way (see **5**).

A What is the **business**?

You need enough detail to give you a broad understanding of the business concept.

- ◆ What trading locations or territories are being offered?
- ◆ Who are the competitors?
A good franchisor should provide a realistic assessment of the competition.
- ◆ What steps does the franchisor take to extend and update the business concept?

B Who is the **franchisor**?

- ◆ How long has the business been going?
- ◆ How long has it been a franchisor?
Many franchisors are members of the British Franchise Association (see **6B**). If yours is not, why not?
- ◆ What experience and achievements do the key people have?
- ◆ How solid are the franchisor's finances?
Ask for three years' audited accounts and a bank reference.
- ◆ How many UK franchisees does the franchisor have?
If all its franchisees are abroad, or only a few are in the UK, this shows the concept is not well tested in this country.
Ask how the concept has been piloted.
If it has not, why not?
- ◆ How many franchisees have failed?
Check the reasons for failures.
- ◆ Is the franchisor completely independent?
If not (for example, if the franchisor is the UK licensee of a US company), check what the original owner's rights are and how these could affect you.

C How much **support** will you receive?

- ◆ What initial training is provided?
For some franchises, selling skills are crucial.
- ◆ Will you get help to set up the business?
Some franchisors will provide advice on the premises and equipment you need, legal support (eg with planning permission), and so on.
- ◆ What continuing support is provided?
This can vary widely from almost nothing to full support.
- ◆ Can you get help when you need it?
The franchisor may have support staff you can telephone whenever necessary.
- ◆ Does the franchisor pass on its market research to you?

This can help you keep up with national trends, new competitors and so on.

D What are the terms of the **agreement**?

- ◆ How long will the franchise agreement run (typically five to ten years)?
Check whether you have an option to renew the franchise after this time.
- ◆ Will you have exclusive rights in your area for the full term of the franchise?
- ◆ What conditions and restrictions are there if you want to sell the franchise?
- ◆ What happens if you die or cannot continue in business for some reason?

4 Costs and returns

A What are the **costs**?

- ◆ How much is the up-front fee?
Good franchisors will usually make most of their profits from the continuing stream of royalty payments from successful franchisees.
The initial fees should only reflect the costs of franchise development and administration.
- ◆ How much will you need to invest?
Check that the franchisor's figures include realistic costs.
Ask whether items you buy through the franchisor (eg a sub-lease on premises) will include any mark-up.
- ◆ What percentage royalty is payable and how is it assessed?
Some franchisors reduce the percentage payable once a set turnover is reached. By growing the business over that threshold you can increase your profitability.
- ◆ What price is charged for materials bought from the franchisor (eg stocks)?
The franchisor may mark up the prices. Alternatively, you may benefit from the franchisor's buying power.
- ◆ What other charges (eg promotions, training) will you have to pay?
Clarify what you get for your money.

B What **financial performance** can you expect?

- ◆ What actual returns are existing franchisees achieving (see **5C**)?
Be aware that the earliest franchises may have cornered the easiest or most profitable territories.
- ◆ What financial returns are projected for new franchisees?

Projections of very high profits from a small investment are probably unrealistic.

5 Final reality checks

Do not commit yourself in any way before completely evaluating the franchise.

Do not pay any non-refundable deposit and do not part with money until the draft agreement is seen by a lawyer.

- A** Visit the **franchisor**. Ask specific questions about anything which is not clear from the prospectus.
- ◆ Do the people seem honest and open?
 - ◆ Are they trying too hard to sell the franchise to you? Do not allow yourself to be hurried into making a decision.
- B** Get a specimen **contract** for your lawyer to examine.
- ◆ Never enter into any franchise agreement without legal advice. (See **Business law and using a solicitor**, SuB 28.)
 - ◆ Use a lawyer who has experience of franchises. Many large legal firms have a specialist, while smaller ones may have individuals with relevant expertise.
- C** Visit at least two **franchisees** — and phone at least three more. This will help you find out what the risks and opportunities are.
- ◆ Ask them how their business is going, what they think of the franchisor, and what problems they are having.
 - ◆ Insist on a full list of all present and past franchisees, including any that have failed. Beware of franchisors who refuse to reveal this information.
- D** Carry out your own **market research** in your proposed territory. Even if the business works elsewhere, you need to be sure it will work in your area.
- ◆ What potential customers are there?
 - ◆ What competition is there?
 - ◆ What are the long-term prospects?
- See **Researching your market**, SuB 3.
- E** Prepare a **business plan**, just as you would for any other start-up business. Base this on your market research and on your own financial projections — not those provided by the franchisor.
- ◆ Consult your professional advisers for any help you need.
- See **Writing a business plan**, SuB 1.

6 Further information

If you are seriously considering buying a franchise, gather information from a variety of sources. Aim to know as much about the industry and the market as you would if you were starting your own business from scratch.

- A** As well as advice, your LEC may offer the following support.
- ◆ Franchise publications.
 - ◆ Franchise databases.
 - ◆ A specialist franchise counsellor.
- B** Contact the **British Franchise Association** (BFA) on 01491 578049.
- ◆ The BFA publishes an information pack (£29). It includes a full list of BFA members (franchisors and advisers).
 - ◆ Visit www.british-franchise.org, www.whichfranchise.com or www.franchiseadvice.com for further help and advice.
- C** Talk to your **bank**.
- ◆ Most banks have franchising specialists and can offer information and advice.
- D** Read the **trade press**. Publishers include:
- ◆ Franchise Development Services (01603 620301 or www.franchise-group.com).
 - ◆ Franchise World (020 8605 2555 or www.franchiseworld.co.uk).
 - ◆ Business Franchise (020 8332 9995).
- Your business library may take franchising magazines or hold directories of franchisors.
- E** Keep an eye on the **rest of the press**. Many franchisors advertise in the business-opportunities sections of national papers.
- ◆ Many of these advertisements are for untried franchises or multi-level marketing schemes, which should be approached with some scepticism.
- F** Go to franchise **exhibitions**. There is a major annual franchise exhibition in Glasgow.
- ◆ The BFA can provide details of specialist and regional exhibitions.
- G** You may want to talk to franchise **consultants**. Reputable franchise consultants generally work on behalf of the franchisor to develop the franchise package.
- ◆ Be wary of anyone selling franchises as an agent. As a rule, good franchisors almost always sell their franchises themselves.

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