

20 Due Diligence Considerations

for Buying a Franchise

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Everyone wants to sell you a franchise but is it the right deal for you?

Buying a franchise is a significant investment and it is a contractual commitment. You are usually locking in to a five - ten year agreement - so the personal, financial and legal factors need to be right for you now and over that entire period.

Franchising laws in Australia are relatively strong and provide for high levels of disclosure by franchisors. This certainly helps a buyer but there are many other factors to investigate and weigh up as part of your due diligence process.

So what is due diligence? Many people think it is getting advice from your lawyer or accountant on what they think of the business and what terms should be negotiated. This is only part of the process and sometimes it can also steer you in the wrong direction.

Franchising is a specialist field and many accountants and lawyers do not specialise in franchising and therefore are not familiar with the issues, trends, players and full range of considerations. Would you get your local doctor to perform heart surgery? No! So the same applies when buying a franchised business, use a specialist.

A good specialist will work with you to understand your objectives, your strengths and weaknesses and your exit plan, then they will interrogate a range of issues to ensure the fundamentals of the industry, the franchise and your local territory area all align to your objectives and your risk and financial appetite. It is important for you to be clear on your own motivation and objectives before you start digging into the details of the specific franchise.



As part of your due diligence process on a specific target franchise, here are 20 areas I suggest you consider:

1 WHAT ARE THE INDUSTRY CONDITIONS?

- Over the next five - ten years will this be a stable or growth industry?
- What are the likely changes to customer buying habits or technology?
- Who are the new competitors likely to be and how will they tackle the market?
- Is demand for the products / services sustainable and what will happen to profit margins?

2 WHERE IS THIS FRANCHISE PLACED IN THAT INDUSTRY?

- How strong is the brand and business relative to competitors?
- Is the franchise predator or prey in any changing market?

3 WHO IS THE FRANCHISOR?

- What is the structure of the franchise? Are master franchisees involved?
- Who owns the franchise or who are the key decision makers? Have you met them? What do you think of them?
- What experience or track record of success does the franchisor have?
- Is the franchisor financially stable?

4 ARE THE EXISTING FRANCHISEES MAKING MONEY?

- Look at the financial performance of existing franchisees. Reluctance to disclose details can be a warning sign given it is possible to disclose without identifying specific locations.
- What are the trends in franchisee performance – improving or declining?
- For start-up franchises, what earnings forecasts are being provided and what are the underlying assumptions and data that make those forecasts credible?

5 IS THERE A STRONG RESALE MARKET FOR THE FRANCHISES?

- How many existing franchises are on the market (publically and privately) – a high percentage of listings may be a warning sign that franchisees are looking to get out.
- What prices are they achieving for resales? Are they making capital gains or losses?
- How long is it taking to sell the franchises?
- Have any closed down or been terminated? If so, why?

6 WHAT IS THE INVESTMENT REQUIRED TO BUY IN AND SET UP?

- What is the total cost of buying the business, including fitouts, equipment, vehicles, training fees, launch marketing budgets, rental bonds and working capital?
- Within the total cost, what is the actual franchise license fee and how does that compare to competitor offerings?
- What is the expected payback period on your total investment?

7 ARE THERE FRANCHISE TERRITORIES?

- Are you granted a Territory or is it a 'hunt anywhere' model?
- With any Territory, what type of Territory? Full exclusivity? Marketing exclusivity? Lead allocation exclusivity?
- How are the Territories determined? What criteria were used to ensure they are viable, correctly sized and provide you with market depth that enables your target profitability over time?

8 WHO DOES THE SET UP?

- If you are buying a shop or retail based franchise, who handles the site selection, fitout and lease negotiation?
- If it is the franchisee, what guidance or support are you given?
- If it is the franchisor, how much extra are they charging to do it for you and do they receive any rebates or kickbacks from tradesmen or equipment suppliers?
- Who holds the site lease, you or the franchisor? Do you understand the implications of each?

9 HOW IS YOUR BUSINESS LAUNCHED?

- Is there a launch marketing program? If so, what is involved and what is the budget?
- What input do you get to the program?
- If buying an existing franchise, what

needs to be done to reinvigorate or relaunch it?

10 WHERE DO THE LEADS OR CUSTOMERS COME FROM?

- Who is responsible for generating leads or customers?
- Does the franchisor guarantee any lead flow or quality of leads?
- What methods are usually successful for lead generation?
- Is there a group marketing fund? If yes, how does it work and how much do you pay?
- Can you generate online leads via your own website or social media activity?

11 WHAT IS THE CASHFLOW CYCLE?

- Understand the lead time between marketing and cash in your bank account
- How do most customers pay – cash, eftpos, on trading terms?
- What level of bad debts should you expect?
- Will this business generate money quickly or does it build up over time?

12 WHO CONTROLS THE FLOW OF MONEY?

- Who do the customers pay? You, the franchisor or a nominated supplier?
- If you are to be paid commissions by the franchisor, are they reliable and solvent?

13 WHAT ARE THE ONGOING ROYALTIES OR FEES TO PARTICIPATE?

- Industry norm is royalties in the 6 per cent – 9 per cent range for standard retail and service franchises.
- If it is a flat fee royalty, find out what motivation the franchisor has to help you grow.
- Are there any other fees that apply?

14 WHAT SERVICES DOES THE FRANCHISOR PROVIDE?

- Get a clear understanding of who does what and what ongoing services you receive from the franchisor. Also understand the value of such services and weigh up against the toyalty charge.
- Most franchisors provide the brand, the system, the back end support and product. Others also provide marketing and business development support.

15 WHAT TRAINING IS PROVIDED?

- Most franchisors provide training but how good is it – speak to existing franchisees
- Is there an extra charge for training, can you bring your staff?
- What is the cost of any subsequent training?

16 WHO ARE THE SUPPLIERS AND ARE THERE ANY REBATES PAID?

- Disclosed rebates are legal but you should understand who gets what and from whom.
- Some franchisors either refuse rebates or if they take them, reinvest them in the franchise network – how does your franchisor handle it and why?

17 DOES THE FRANCHISOR IMPOSE ANY RESTRICTIONS?

- Investigate restrictions relating to the website, social media and blogs. Often for brand protection purposes a franchisor will impose restrictions – you need to know what they are.
- Who owns the customer database? Are the customers really yours?
- Do you have to buy your stock or products from a specific supplier?
- Are you subject to performance requirements?

18 WHAT IS NOT IN THE FRANCHISE AGREEMENT THAT SHOULD BE?

- Franchise documents are prepared by lawyers for the franchisor so they are designed to protect the franchisor. Therefore you need to ask ‘for my own protection, what is missing’?
- There is a Special Provisions section in the Agreement – here you can agree to insert non-standard or customised terms for your situation or deal.
- If there are any critical representations that you believe the franchisor or vendor has made, being so significant they have influenced your decision to buy, then make sure these representations are documented in the agreement or are noted on any certificates they ask you to sign about representations or advice given or received.

19 WHAT DO EXISTING FRANCHISEES SAY ABOUT THE BUSINESS?

- Advocacy by existing or previous franchisees is a critical factor – if they are happy with their decision to buy and happy with the relationship they have with the franchisor, then this is usually a good indicator you will be too.
- Run Google searches of the franchise name and search for any franchisee blogs or comments as occasionally disgruntled franchisees take to social media to vent their dissatisfaction – it is not always justified criticism but building a picture of professional and amateur PR always helps

20 WHAT DO FRANCHISE EXPERTS AND BANKS SAY ABOUT THE BUSINESS?

- Talk to franchise experts and franchise bankers about the franchise system – see what they know and say as they are often tapped into both the good and the bad news relating to different franchises. Being arm’s length they can give impartial



feedback or guidance that will help you investigation and decision making.

- Also, some franchise systems have accreditation arrangements with various banks. Whilst this is not a bank endorsement, it usually indicates the bank has been through a due diligence process itself to understand the working and success rates of that franchise and are happy enough to lend to their franchisees.

The above 20 considerations are not an exhaustive list but they will help you make a more informed purchase decision and they will help you negotiate the purchase terms. We always recommend you obtain specialist help to conduct your due diligence as it is not just about asking the right questions, it is also about knowing what to do with the answers and how to weigh up the overall personal, financial and legal considerations that make up your ultimate decision on whether or not to buy.

No business is perfect and no deal is perfect, so it is about getting the right balance and terms for you based on the risk / reward equation.

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