Is Buying a Franchise Right for you? SBTV 7

Dennis Zink: Welcome to SCORE Business TV. In this series, experts share their opinions with

business owners on a variety of topics. Today, we're addressing the benefits about how to buy a franchise business. We'll be exploring what a franchise is, what types of franchises are available, how to choose the best one to fit your needs, and the cost of buying into a franchise and operating a franchise.

Dennis Zink: Before we begin, I'm happy to introduce our two experts. First, we have Jenny

Sutter, a franchise consultant and owner of FranNet in the local market. FranNet is a national SCORE partner that helps entrepreneurs find the best franchise to fit their budget and their needs. Jenny is a Florida native with a background in corporate franchise marketing. She now provides consultation on the franchise discovery process, working with aspiring entrepreneurs to help them navigate

through the world of franchise opportunities.

Dennis Zink: Next, welcome Bob Melberth. Bob is a SCORE mentor and a franchising expert

with operations leadership in the hospitality industry. He's worked for

McDonald's, Wendy's, Popeyes, and Beef O'Brady's, just to name a few. He's a specialist in local and media marketing, and Bob has been a franchise business

owner/operator three times. Welcome.

Bob Melberth: Thank you.

Dennis Zink: Let's start with the first question on, what is a franchise? Jenny, why don't you

start with that one?

Jenny Sutter: Yeah, so a franchise is essentially the right to use a brand name, trademark,

business services or products, marketing structure, training structure, business

processes in exchange for a franchise fee and ongoing royalties.

Dennis Zink: Okay. Bob, you want to answer that?

Bob Melberth: No, I think she covered it very well.

Dennis Zink: Okay, great. Bob, let's ask you, what's the difference between a licensing

agreement and a franchise agreement?

Bob Melberth: Well, I think from different points of view, from the franchisor or licensor's point

of view, franchise is governed by the Federal Trade Commission, where a license agreement is governed by contract law. The aspect from a franchise purchaser or business purchaser is a franchise is going to be a little more restrictive in terms of its structure following the rules that the franchisor establishes. That license agreement, the licensee pays a one-time fee and perhaps some override

on a product that they control and distribute themselves.

Dennis Zink: Jenny, what would you say are the biggest misconceptions about a franchise?

Jenny Sutter: There's quite a few of them. A lot of it is that they are expensive, so I would say

that's probably the biggest one. Another is that they're only fast food or retail. There's a lot of different franchises in a lot of different industries, so those are

the two biggest.

Dennis Zink: Bob, what would you say the success rate is with franchises as opposed to non-

franchise businesses?

Bob Melberth: Well, there was a study done by the U.S. Chamber of Commerce that showed

over a 10-year period of time that 93% of the franchises were still in business 10 years after they started as opposed to about 45% of... actually it's less than that, it's about 25% of independent businesses that are still in business 10 years later.

Dennis Zink: One of the things you mentioned, you talked about the process, and I'm

wondering, if you're looking at a franchise, are you kind of locked in? Is there any leeway to do your own thing so to say? Or do you really have to follow A to

Z and you're stuck?

Jenny Sutter: Yeah, so each franchise is a little bit different in how restrictive they are as to

the process, but essentially you do have to follow their process, their rules and regulations, but for some emerging franchises for instance, there is a little more

leeway to have your opinion on how things should be run.

Dennis Zink: If you have a... if you come up with something and you say, "Hey, this is really

working. I tried it in my store and it's going great", could the franchisor know and maybe they'll roll it out throughout the rest of the units? Or at least look

into it? Has that ever happened?

Jenny Sutter: Yeah, you definitely should talk to the franchisor about whether it's something

they want to create as part of their process.

Dennis Zink: Now, you mentioned restaurants, and I know you worked for probably at least

four restaurants, McDonald's and

Bob Melberth: I owned a couple as well.

Dennis Zink: You owned a couple. It seems like there's a lot of franchises with restaurants. Is

that like the best way to have a restaurant these days? Or... why is that such a

valuable aspect of owning and running a business to be in a franchise?

Bob Melberth: Well, I think the key point there is that a restaurant is a little more replicatable,

and the franchisor can have a lot of control over menu, pricing. There's also some advantages in terms of being able to purchase for a chain, et cetera, so that your costs of being in business versus a local single-operator's unit would

be greater for lower cost of goods, but I think primarily because restaurants... Most people associate the big names... I've worked for a couple, McDonald's, Wendy's, et cetera... With franchising, I just think that's kind of popular opinion. The International Franchise Association says that there is about 97 different industries that franchise their business concepts.

Dennis Zink: Wow. That's unbelievable. How do you choose the best one? There's so many

choices. Jenny, why don't you start with that one?

Jenny Sutter: Yeah, it really has to come down to personal fit. Not... A restaurant is not going

to be for everyone. They're seven days a week generally. Not everyone wants to work seven days a week. Does it meet their budget needs? Does it meet their income needs? Is it going to meet their personal leisure needs or personal project needs? It really does need to be a fit with the individual and what their

goals and motives and values are.

Dennis Zink: You mentioned that one of the misconceptions was the cost, that people think

it's more expensive than it is. What's the least amount of money ballpark you

can spend to get into a franchise?

Jenny Sutter: It really does... it really ranges. From newer franchises it could be rather low,

but it can get up into the millions of dollars, so a general range between \$50,000 and up to a million. Now, that's not to get into the franchise. That's to get a franchise up and running. The only difference between that and if you would start to start your own business would be the franchise fee. That doesn't run

millions of dollars.

Dennis Zink: Now, Bob, for example, I know two people that are in different franchise, I'm

not going to mention which ones, but one's a hair cutter-type business, you know who it is, too, and the other one you don't know is a spa. What... they each had to buy a certain amount of units on the front end, or at least they took three units each of what they were doing, and I'm wondering, is that something is typical? Are you better off getting units on the front end? Or can you have a

chance later on and acquire more units?

Bob Melberth: Well, for our franchisor, the most profitable way for them to grow is to grow

with existing franchisees. Some people approach the marketplace saying that we're going to sell a package of three stores or five stores or 10 stores at a time, but that's not the case with all franchises. A lot of franchises will only allow you to purchase one, and then if you're successful with that and you're the kind of community of franchisee partner that they want to continue to do business

with, then they'll allow you to grow more and more.

Dennis Zink: Jenny, does it cost more for the second unit? Or is it discounted?

Jenny Sutter: If you buy them at the same time, so if you buy that three pack that Bob

mentioned, it's... you're going to generally get a discount. If you do it upfront. If

you buy one later, you may or may not get that discount.

Dennis Zink: Bob, is it typical for franchisees to sell to each other? Or do they have to go

through the franchisor?

Bob Melberth: Well, they do have to sell to a partner or a purchaser, excuse me, that is

approved by the franchisor. However, most transactions take place between franchisees. That's one of the advantages of a franchise because you've already got a built-in sort of consumer base for your business should you choose to sell it. Many franchisors also have what they call a first right of refusal, so if you get a contract to sell your restaurants or businesses, then the franchisor has the

opportunity to step in and pay you that same price.

Dennis Zink: Jenny, when you're involved with a franchise as an owner, do you build equity?

Do you really have something to sell? How does that compare to just having a business that's not a franchise unit and selling it? Were the multiples better for

the franchise or not?

Jenny Sutter: Business is a business, so yes, you build equity as you build your business,

whether that's your customer base or it's your physical space, what your book

of sales is. Yes, you're building equity, but again, a business that's not a

franchise can do the same thing.

Dennis Zink: What's tending to be the most profitable types of franchises? Are they

restaurants? Or does it just depend?

Jenny Sutter: It really just depends. It's going to come down to the owner and how they

operate, whether or not they're being profitable or not and how they run their

business.

Dennis Zink: I'm sure in the industry, if you have a certain... you're among many franchisee

owners of the same system that there probably is a relatively narrow gap in profitability, whether it's 30% or 12% or whatever it is. Bob, can you comment

on that? Is that.

Bob Melberth: Yeah, I think it really depends on the business model. If you've got to make an

investment in real estate, physical facility, equipment, et cetera, like that, then I believe that the profit margins may be a little lower in that type of business. If you're offering a service and you perhaps are using your talents and skills and that's really the only cost you have, one of my businesses was as a consultant and so I didn't have a whole lot of costs built in. That one may have a better profit margin, but you're also limited to your 168 hours a week that you have to

deliver the product.

Dennis Zink: Mentioning costs, let's look at costs from a different perspective, cost structure.

If I'm looking to buy a franchise, you mentioned royalties before, you

mentioned... I don't know if you mentioned advertising. What are the different

areas where I have to pay in terms of the structure?

Jenny Sutter: Going into buying a franchise, you have to pay that upfront franchise fee, and

then beyond that, you're going to pay ongoing royalties. Those can be structured in various ways, whether it's a monthly percentage of gross sales, whether it's a flat fee on a monthly basis. When they start, is it two years in? Is it immediately? Those are royalties that you do have to pay, and then there's also... Not all franchises, but quite a few of them make you pay into what's called an ad fund or an advertising fee, so that also would be a percentage of gross sales generally or a flat fee on a monthly basis. There's even some that will charge a technical fee, so depending on what kind of technical aspects there are

to the business.

Dennis Zink: With the fees adding up, what kind of percentage would you say are a range of

the royalties plus the advertising plus the other fees? What kind of percentages

of the gross sales?

Jenny Sutter: The average royalty is about 6.75, so between 6% and 7.5% is the average. Now,

they go higher depending on the kind of service or the kind of franchise that you're buying into, but then you also... it does again vary from an advertising standpoint. Whether it's 1%, 2%, or a flat fee, so it really does range on a franchise-by-franchise basis based on what they're providing you in return.

Dennis Zink: Let's look at... Bob, did you want to weigh in on that one?

Bob Melberth: Well, the only thing I'd add would be, if indeed you operate to the end of your

term, because every franchise has an operating license term, five years, 10 years, McDonald's was 20 years, you can renew that license if you've operated properly and the franchisor wants to renew with you. Many times they do have a renewal fee that would be at the end of your timeframe for your operating

license.

Dennis Zink: You're saying that at the end... let's say it's 20 years for argument's sake. Jenny,

at the end of 20 years, I have to pay for it again basically?

Jenny Sutter: There's a fee, too, yeah, to buy into the franchise again.

Dennis Zink: Does it cost as much as the first time? Or is it discounted?

Jenny Sutter: In some cases, it does-

Dennis Zink: Really? Okay

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Jenny Sutter: And in some cases it's discounted. Again [crosstalk 00:13:37]-

Dennis Zink: Well, that's interesting.

Jenny Sutter: Every franchise operates in a different way.

Dennis Zink: If you're looking to sell and you're on your 19th year, then it has a different

value for the buyer because they're going to have to re-up at year 20 if it's a 20-

year contract?

Jenny Sutter: Potentially, yes.

Dennis Zink: Jenny, let's talk about financing. Is it easier to finance a franchise unit or a non-

franchise business?

Jenny Sutter: Yeah, it can be easier to finance a franchise business, and the reason is because

your traditional SBA loans, banks are going to require that you have a business plan in place as well as some experience in the industry. If you don't have experience in the industry, starting your own business, it's going to be tough. Whereas with a franchise, even if you don't have experience in the industry, the franchise does, so it can become a little bit of an easier path to finance through

SBA.

Jenny Sutter: Now, there's other options. There's options through institutions such as

FranFund that offer what's called a ROBS Program, and those ROBS Programs essentially allow you to rollover your retirement fund, whether that's a 401(k) or IRA at no penalties, no taxes, and you can use that in order to fund your

business.

Dennis Zink: Wow. Can you do that with a regular business, too?

Jenny Sutter: You can, but that's not specific to franchises, but it's a great opportunity.

Dennis Zink: Bob, what have you found in your experience with financing? Is it easy to get a

loan? I understand that from one of our banker friends that they have a list that they look at that says, "These are the acceptable franchises that we will loan

for", and it's a long list.

Bob Melberth: The SBA maintains what's called a Franchise Registry. Banks who are working

with the SBA in terms of their guarantee for their loan, for the bank's loans will look at that registry list and if indeed your franchise is on that list, it's a lot easier to get the deal done. If it's not on the list, the bank probably won't loan

you the money.

Dennis Zink: Jenny, are there other franchise financing options? Or have we kind of covered

it?

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Jenny Sutter: Obviously, self-funding and then whether you get it... money from family

members or an angel investor, but generally in terms of financing for your business it's going to be some sort of SBA loan or the ROBS Program.

Dennis Zink: They used to call it the UFOC, and I think it was Uniform Franchise Operating

Contract or something like that.

Bob Melberth: Offering Circular.

Dennis Zink: Offering Circular, okay, I was close. Anyway, today it's the FDD. Can you explain

what that is and what does that stand for?

Bob Melberth: Sure. It's a Franchise Disclosure Document, and it is a requirement of the

Federal Trade Commission. Franchises are governed by the FTC. They require 23

items to be communicated by every franchisor to every franchisee. This document is required to be consistent franchisee to franchisee. People who want to negotiate the franchise document run into some problems there, but sometimes you can negotiate territories and things like that, but fees and the rest of the structure of the business is typically governed by that document that

is, again, regulated by the Federal Trade Commission.

Dennis Zink: Jenny, does that mean if you're buying into let's say a McDonald's franchise,

everybody knows what that is, are you getting the same deal as everybody else

that bought into one? Or does it vary by the territory?

Jenny Sutter: You essentially would be getting the same deal as you would for everyone short

of them having some sort of territory, if the territory is bigger, that maybe that expands upon how much you have to pay, but you're buying in the FDD from

McDonald's is the FDD from McDonald's.

Dennis Zink: Veterans are really good potential franchise owners, isn't that right?

Bob Melberth: I've found that to be the case.

Dennis Zink: Why would that be?

Bob Melberth: I used to do a lot of work out of McDill and worked with the veterans looking for

businesses as a next career primarily because number one, they appreciate a system, and that's what you're buying when you're buying into a franchise. Secondly, they're disciplined people. They know how to work hard, and they typically can take advantage of some other financing benefits that are available

only to veterans.

Dennis Zink: Who makes other good franchise owners?

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Jenny Sutter: It's all walks of life, I'll be honest with you. Everyone from people coming out of

Corporate America, so former high level all the way down to anyone who just wants to work hard. It's all about the passion and getting into business. We see bankers and accountants and firemen and teachers going into business. It's all

about the passion.

Dennis Zink: You really don't need the experience to have run that type of business before

except from a financing standpoint. They may require you to have that

experience. Isn't that a catch-22?

Jenny Sutter: Yeah, you want to have some transferable skills that are going to help you out

with the business that you're looking for. It's definitely not just coming in completely without zero experience, it's how are those transferable skills going

to be able to apply to the business?

Dennis Zink: I just flipped a coin and got the tail side and, why do franchises fail? Bob?

Bob Melberth: The franchises that I've seen fail primarily fail because, number one, the

franchisee failed to follow the system. Number two, a partnership fails and the businesses split apart because of that. Those are the two primary reasons.

Dennis Zink: If I'm a franchise owner, can I talk to other franchise owners about what they're

doing and what works or just tips and tricks that they've learned? Jenny?

Jenny Sutter: Yeah, oh yeah. Absolutely. That's what part of your getting into when you get

into your franchise. I like to say that when you're getting into a franchise, you're buying a business for yourself but not by yourself, so not only do you have the franchisor support, but you also have your fellow franchisees that you can call upon and get a better understanding if you have a problem if they've

experienced the problem and maybe what their solution was.

Dennis Zink: My last question basically has to do with reversing the process. I've got a

business and I think, "Gee, this could be a franchise possibly." Who do I call? Is

that something that you handle at FranNet?

Jenny Sutter: It is not something we handle at FranNet. I will refer that out. I will first refer to

an attorney who understand franchising. I think that that should be their first

call and understanding what their options are there.

Dennis Zink: Bob, did you want to weigh in on that?

Bob Melberth: Yes, I think it's a good idea. We get in SCORE a lot of folks who come to us with

their business and think that perhaps that it's worthy to franchise and they want to expand. I think you should look at franchising as really a growth vehicle, growth alternative for your business, but rules of thumb, you should be in business a couple, three years, something like that. If you're buying a business, you'd want to look at three years-worth of tax return. If you're going to sell a

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cash flow, you need to verify that for the person that's going to be purchasing it, and that investor is also going to be looking for a return on investment. The rule of thumb is if you can get at 20%... if you can demonstrate a 20% return on investment, then I think maybe you have the financial model that's worth trying to franchise.

Dennis Zink: Is there any last comments you'd like to make that we didn't cover, Jenny?

Jenny Sutter: I think we covered a lot.

Dennis Zink: All right, well, great. Thank you very much. You've both been very helpful in

covering this very complex topic and we thank you for your advice and your

expertise. Jenny, how can people reach you?

Jenny Sutter: Oh, so you can reach me. My email is probably the easiest way,

jsutter@frannet.com, or just go to frannet.com and you'll find me there, too.

Dennis Zink: Bob, how can our viewers reach you?

Bob Melberth: Well, viewers can reach me via the SCORE website, manasota.score.org, and I'll

be happy to help.

Dennis Zink: Thank you. I'd like to thank our guests for appearing on this episode of SCORE

Business TV. I'd also like to thank our sponsor FranNet and FranFund. Please tune in for our next episode. Until then, this is Dennis Zink saying thank you and

have a great day.