

How to Perform Meaningful Due Diligence When Investigating a New Franchise Opportunity

Before entering into a franchise relationship, it is absolutely crucial for prospective franchisees to thoroughly investigate their proposed franchise opportunities.

A thorough [due diligence investigation](#) will examine both the qualitative and quantitative aspects of the franchise system, and should rely on information available from the franchisor, from current and former franchisees, and from other third-party resources. By performing thorough due diligence, prospective franchisees can better position themselves to make an informed decision about their franchise investment, and can boost their confidence in their decision to pursue or forego any particular franchise opportunity.

Qualitative Due Diligence

The [first questions most prospective franchisees seek](#) to have answered when considering a particular franchise opportunity relate to their financial investment in the enterprise and how much money they can reasonably expect to take home as the business grows over time. This is understandable—it is a business after all, and between the tight credit market and initial investments ranging anywhere from five to seven figures, prospective franchisees

are right to focus on the money side of the venture.

However, since it is a business, and since it is a business that involves a long close relationship with the franchisor, it is critical for prospective franchisees to undertake an in-depth, systematic review of the qualitative aspects of what the franchisor has to offer as well. After all, what you pay for in buying a franchise is the right to benefit from the franchisor's experience, systems, reputation and recognition in the marketplace. For long-term success (and with an eye toward salability), it is critical for prospective franchisees to have confidence in the value of being affiliated with their chosen franchisor.

A qualitative analysis of a franchise opportunity should focus on things such as system size and growth, strength of the brand, length of time in business, experience of the franchisor's officers and directors, discount purchasing arrangements, start-up and ongoing support, training programs, and generally what makes the franchise system stand out from its competitors. By investigating and obtaining real information on these aspects of a franchisor's system, prospective franchisees can better compare competing opportunities, and can reach a reasonable level of comfort before committing to a long-term franchise relationship.

Quantitative Due Diligence

On the money side, prospective franchisees need to analyze the franchisor's initial investment estimates and ongoing royalty and

advertising fees in relation to the levels of revenue they reasonably expect to bring in over time as their business matures. When can you reasonably expect to break even? Can you afford to pay your employees and still take home a reasonable salary? If not, do you have the reserves to weather the start-up phase of your new business?

Also on the quantitative side are considerations such as the length of the initial term and the number and length of any renewal terms, transfer rights, termination rights and liquidated damages provisions, mandatory purchases from the franchisor, dispute resolution provisions, and any other ongoing or extraordinary fees imposed under the franchise agreement.

Sources of Information

The Franchisor

The franchisor should be a go-to source for information on its own franchise system. A franchisor that is unable to answer basic questions about their “system” may in fact have no system in place at all, and this can be an early sign that the franchise opportunity is not ripe for investment. Franchise sales staff should be confident and well-versed in the system, and should have at least a basic understanding of the applicable franchise sales and disclosure laws.

The [Franchise Disclosure Document](#) and its Exhibits and Attachments should also provide clear, supportable and useful informa-

tion about what the franchisor has to offer. While preparation of the core franchising documents should be handled primarily by the lawyers, a sloppily-drafted and incoherent **Franchise Disclosure Document** can still reflect negatively on the franchisor's standards and attention to detail.

Current and Former Franchisees

In **performing the due diligence** necessary to properly investigate a franchise opportunity, it is also critical to speak with numerous active and former franchisees. These franchisees will be able to provide candid assessments of both the qualitative and quantitative aspects of the franchise system. And, unlike franchisors (who are limited by their Financial Performance Representations), franchisees are able to speak freely about the financial aspects of their operations. Of course, franchisees who see you as a potential competitor may be hesitant to share this type of information. As a result, prospective franchisees should seek to contact both local and geographically disparate franchisees, as well as former franchisees who no longer have a vested interest in the franchise system.

Appropriate topics to address with current and former franchisees include the following:

- How did your initial investment compare to the estimates the franchisor provided in the Franchise Disclosure Document?
- What is your annual gross revenue? What is your personal salary and net owner's profit?

- Do you see any benefits from your contributions to the franchisor's advertising fund?
- What benefits do you see from being a part of the franchise system generally?
- For former franchisees: Why did you leave the system? How did the franchisor handle your transition away from the brand?

Other Third-Party Resources

Finally, additional information can be found through various third-party resources, many of which are available online. Franchisee forums, franchise research websites and franchise industry publications can all be valuable sources of information. In addition, the California franchise registrar currently scans and posts all registration submissions to its website, and this resource is available to the public free of charge. This database can be used to obtain comparative data for competing franchises, and may also provide insight as to how a particular franchise offering has evolved over time. Of course, a franchisor's California Franchise Disclosure Document will not necessarily mirror the document that it offers in other states.

By fully investigating proposed franchise opportunities—and hiring experienced professionals to help guide you through the process—prospective franchisees can help ensure that their franchise ventures will be poised for success, and not destined for failure before they get off of the ground.

Do you have more due diligence tips for prospective franchisees? Have you engaged in due diligence yourself? If so, what information did you find particularly relevant to your decision to ultimately move forward (or not) with the franchise you were investigating?

Jeff Fabian is the owner of Fabian, LLC, a boutique law firm in Baltimore, Maryland that serves prospective franchisees in all aspects of investigating, negotiating and establishing a new franchised business.

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[Previous](#) [Next](#)