Franchise Basics

Investigations Beyond the DISCLOSURE DOCUMENT

BY JOHN YIOKARIS

A franchisor's legal documents will naturally favour the franchisor's rights, not the franchisee's. This is true no matter how many revisions are made to those documents. It is therefore all the more critically important, when contemplating an investment in a business opportunity, to approach any franchise system by thoroughly researching as many aspects of that system as possible.

The laws of Alberta, Manitoba, Ontario, New Brunswick and Prince Edward Island require franchisors to provide a disclosure document to prospective franchisees. Each of these provinces' franchise legislation also mandates the minimum disclosure content to be included in such documents. These laws are intended to make a prospective franchisee's due diligence investigations more feasible and the results of such investigations more meaningful in

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evaluating the prudence of a proposed investment in a franchise opportunity.

Doing due diligence

If you are thinking of investing in a franchise, I would strongly encourage you to do as much due diligence as you can with regard to the franchisor before making any final decision. You should use the information presented in the disclosure document to help you undertake further inquiries.

These will include obtaining as much publicly available information as possible concerning the franchisor's business reputation and financial health. You should also order a commercial credit report on the franchisor and carefully consider the results. It would obviously be unwise to invest in a franchise opportunity if such information indicates some cause for concern about the franchisor's short- or long-term business prospects.

I would also strongly encourage you to speak to the system's current franchisees, whose contact information must be set out in the disclosure document. You should never purchase any franchise until after you have spoken to at least several current and former franchisees of the system, as they may be good sources of information regarding a range of concerns, including the sort of franchisee conduct the franchisor would consider serious enough to lead to termination. Is the franchisor relatively tolerant of minor (*e.g.* non-monetary) breaches of franchisees' obligations under their franchise agreements or does it waste no opportunity to 'write up' those breaches, perhaps with a view to relying on them later, if the franchisor subsequently decides it does not want to grant a particular franchisee a renewal of his/her franchise agreement?

Ask how the franchisees would describe the franchisor's general reputation. Is the corporation known for its professionalism and equitable, fair business dealings with its franchisees? Do the franchisees tend to view their relationship with the franchisor as adversarial? Do they feel the franchisor is solely concerned with advancing its own interests?

Check whether or not the franchisees found the franchisor's original estimates of their startup costs—which should also be set out in the disclosure document—were reasonably accurate, wildly understated or somewhere in-between. Further, do the franchisees feel the costs of goods supplied by the franchisor and/or its approved suppliers are fair or inflated and not market-competitive?

Does the franchisor provide sufficient guidance and support to all of its franchisees, especially those located some distance away from the corporate headquarters? Is the training program sufficiently well-thought-out and to properly equip franchisees with the necessary knowledge and skills to operate their businesses competently and profitably?

Find out if there are competitors in your preferred territory that may not exist in proximity to the chain's other existing franchises. What is the franchisor's plan—if it has one—to deal with competition, especially in difficult and saturated markets?

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Also, find out if franchisees directly lease the premises for their locations themselves. If so, what options are available to those who wish to leave the system if their franchises do not perform as well as anticipated?

Franchise Factoid

Food quality, customer service, convenience and value are often cited as the cornerstones of a positive restaurant dining experience, but a recent Canadian consumer study by Technomic, a research and consulting firm, suggests restaurant ambiance plays a critical role, too.

By surveying customers' assessments of restaurant décor, music and atmosphere, Technomic found while ambiance could easily be overlooked because of its 'intangible' nature, it is associated with overall satisfaction and can become a key factor in consumers' decisions to visit a restaurant. A strong majority of both casual-dining restaurant patrons (86 per cent) and quick-service restaurant (QSR) customers (82 per cent) said a welcoming, comfortable and appealing ambiance was important to them.

Technomic collected data and insights for more than 40 Canadian restaurant chains. The following franchise systems ranked highest in customers' ambiance ratings across the country:

- British Columbia: Milestones Grill & Bar.
- Prairies: Moxie's Grill & Bar.
- Ontario: Moxie's Grill & Bar.
- Quebec: The Keg Steakhouse & Bar.
- Atlantic Canada: Pizza Delight. CBF

Is there a committee of franchisees or some other sort of genuine collective that takes franchisee-initiated concerns to the franchisor for consideration? On a related note, is the franchisor genuinely responsive to franchisees' concerns and complaints or does it merely pay 'lip service' to them?

Ask the franchisees if the franchisor and/or its authorized suppliers deliver all products used in the provision of services to customers on a timely basis. Do the franchisees also feel they are getting enough 'bang for their buck' from franchisor-initiated advertising programs? In some cases, the advertising fund may instead seem to simply provide another profit centre for the franchisor.

The franchisor may also have a policy that periodically requires franchisees to purchase new equipment or pay for renovations. These policies can become contentious and financially sensitive issues for the franchisees. In some cases, the franchisor appears to be primarily motivated by a genuine desire to protect the goodwill of the entire franchise system by ensuring all of its franchised locations project a clean, efficient and attractive image. In other cases, however, franchisees feel they are required to dedicate unreasonable amounts of capital funds to constant rebranding.

The list of questions for former and current franchisees could obviously go on indefinitely. The most important are those whose responses will allow you to formulate well-rounded opinions about the character of the individuals in charge of day-to-day management of the franchise system.

By doing your due diligence and investigating the company, you are seeking the comfort that the franchisor has a reputation for treating its franchisees fairly and equitably.

Areas of disclosure

As mentioned, the provinces with franchise legislation require a franchisor's disclosure document to contain very specific information about a number of important matters.

You should carefully review, with the assistance of a financial advisor, the franchisor's financial statements that are included in the disclosure document. While these statements may comply with the franchisor's legal requirements for disclosure as of the date of the document, you should also ask for any other interim financial statements that have been prepared since that date, as this may avail you of additional financial disclosure.

Franchisors must also provide the underlying assumptions for all earnings claim information in their disclosure documents. It would be prudent of you and your financial advisor to avail yourself of this 'backup' information, so you can reach your own independent judgment concerning the accuracy and reasonableness of the franchisor's various cost assumptions. How many of the existing franchisees actually experience the figures disclosed?

Elsewhere in the disclosure document, you should carefully review the general comments about the market in which you will compete, the chain's main competitors and the regulatory environment affecting the proposed franchise. Clearly, these are all important factors in deciding whether or not to purchase a franchise.

Franchisors must also disclose certain information in connection with their franchisees' ad fund contributions, including: what percentage of the fund was spent in the last two fiscal years and what percentage was saved; the projected amount of the ad fund contributions from all franchisees; and the projections of what percentage of the fund will be spent and what percentage will be saved for the current fiscal year.

You should have the franchisor confirm it does in fact use these contributions for advertising. Indeed, the franchisor should already agree to provide an annual report on its advertising activities to all franchisees.

Further, if you end up becoming a franchisee, you should regularly review the portion of the ad fund the franchisor spends on administration. You should also make it a habit to obtain the franchisor's annual report on all advertising activities and review it with your financial advisor, to determine whether or not the type of marketing being conducted provides any benefit to you. A common source of complaints from franchisees is the sense there is a lack of effective advertising in return for their contributions to the fund.

You will also want to make sure the franchisor has a reputation for treating all franchisees fairly and equitably.

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That said, in addition to the ad fund contributions payable under the franchise agreement, you should also expect to allocate anywhere from two to four per cent of your own gross sales to conduct local advertising for your franchise.

Most franchise agreements will require almost all of the franchisee's purchases of products and services to be from companies that are specially approved by the franchisor. You should carefully review any such restrictions on purchasing processes and on the products and services you may sell. If the authorized suppliers are unable to provide competitive pricing within your market, you should have the franchisor confirm—in writing—that you have no obligation to purchase non-proprietary products or services from those suppliers.

Prior to the signing of the franchise agreement, you should determine whether or not you are being granted an exclusive area or territory, where the franchisor agrees not to operate or grant others the right to operate another franchise. This would entail a specific, protected perimeter around the location of your franchise.

It is very important, in this respect, to review the franchise agreement carefully, as most franchisors will reserve the right to (a) operate or grant others the right to operate an additional franchise just outside your perimeter, (b) distribute non-competing products through alternative channels of distribution, such as wholesale and retail, under different trademarks within your perimeter and (c) operate another business within your perimeter that does not compete with your franchise. With all of these exemptions, unless the products described are truly non-competing, you may well end up having to compete for customers against your own franchisor and/or your fellow franchisees. So, be sure to ask the franchisor to explain in writing what it considers to be 'non-competing' products.

The starting point

With these issues in mind, it is important to carefully and methodically review the disclosure document, all of the backup information, the reputation of the franchisor and all aspects of its system with financial advisors and other relevant professionals, to ensure you are satisfied with the business terms of your prospective investment. For example, it is worth keeping in mind the distinct possibility your startup costs will exceed the franchisor's estimates.

Therefore, you should view the disclosure document merely as a starting point for your due diligence inquiries, rather than as the be-all and end-all of the process. CBF

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Time to Review

1. Which provinces require franchisors to provide a disclosure document to prospective franchisees?
2. How much of an advertising fund, reasonably speaking, should pay for administration?
3. Why might there be 'non-competing' exemptions within a franchisee's exclusive, protected territory perimeter?