Chapter 3

Purchase an Existing Business or Franchise

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Objectives

3-1 Describe the advantages and disadvantages of buying an existing business.

3-2 Explain how to evaluate a business for sale opportunity.

3-3 Understand and explain various legal aspects and requirements of franchising.

PURCHASE AN EXISTING BUSINESS

For many aspiring business owners, the best way to enter the world of entrepreneurship is through the purchase of an existing business. Before you decide to open a new business, it would be wise to investigate the business-for-sale market. Why? Talking to a current business owner is an excellent way to learn about market conditions in your community. As a potential buyer, you will be able to examine firsthand the sales revenues of an industry member and a possible future competitor. In addition, you will have a chance to determine the potential **market value** of the type of business you are interested in once it is established and any start-up problems have been worked out. Market value is the price at which buyers and sellers trade similar items in the open marketplace. Furthermore, it might lead to an opportunity to enter the market at a lower cost than you originally anticipated. For these reasons it makes sense to inquire about businesses for sale, even if buying an established business was not your original intention.

How to Find Businesses for Sale

Business owners wishing to sell their businesses commonly advertise their intentions in the classified section of newspapers, list their businesses with business brokers, or get the word out through industry and community networks.

Classified Advertising

Restaurant for Sale

Established 3 years. Good location. Seats 50. Profitable, family oriented. Must sell. $65,000. Call 404-555-1060.

Potential buyers should first check the "Business Opportunities" pages in the classified section of local newspapers. There they are likely to find numerous advertisements for a variety of businesses for sale. The information provided in these ads is often very general. However, a telephone call or mail inquiry should provide enough basic information to determine whether the business is worth investigating. If the idea shows promise, you should arrange a time to meet with the seller to discuss the opportunity. Since buying a business requires intensive research, the first meeting is normally a general discussion of why the business is for sale and how well the seller thinks the business will do in the future. If you are still interested after this initial discussion, you and the seller should schedule further meetings so that you can observe business operations during working hours.

Business Brokers Business sellers often work with agents called **business brokers**, who function in the same way real estate brokers do for people selling homes. Brokers represent sellers and bring them together with potential buyers. As part of handling a business sale, brokers advise sellers to have specific information available to answer potential buyers' questions. Brokers also handle advertising. Many sellers go through brokers to keep their intention to sell confidential. Brokers advertise without giving the name of the business and provide their own business phone number and address for interested parties to contact. Only when they have screened the prospects and identified

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qualified buyers do they tell the prospects how to contact the seller. Business brokers may also assist in drawing up sales contracts and arranging financing. Brokers are paid for their services with a percentage of the selling price, normally 10 to 15 percent.

Industry Sources Another way business owners publicize their intent to sell is by alerting other industry members. They do this either by advertising in industry publications or by encouraging referrals from salespeople. Since potential new business owners frequently ask industry suppliers about business opportunities, both are effective ways to learn about businesses for sale. Many companies have referral systems that put people making inquiries in touch with people wishing to sell. Industry sources normally get involved with the selling process only in a referring role.

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Entrepreneurs may also find businesses for sale through other sources, such as

- landlords/leasing agents
- attorneys
- bankers
- SBA
- Small Business Development Centers
- management consultants
- shopping center management offices
- venture capitalists
- chambers of commerce
- acquaintances
- bankruptcy announcements

Often the best business opportunities come from businesses that are *not* for sale. If an existing business meets all the criteria a potential buyer is looking for, the buyer can make the owner an offer. The owner may, of course, refuse. However, if the offer is attractive enough, he or she might consider the opportunity to sell.

Advantages of Purchasing an Existing Business

There are many advantages to buying an existing business, particularly for entrepreneurs with little experience. It is an ideal way to "learn the ropes" because, in many cases, the previous owner will stay on for a period of time to train the new owner or be available for consultation.

It is also a less risky way to become self-employed. The existing business has a track record—procedures are in place, suppliers are lined up, and a customer base has been established. New owners will have an idea of what to expect for revenues, expenses, and profits. These figures are easier to forecast for an established business than for a start-up. If new business owners have some of the security anchor characteristics described in Chapter 1, buying a business will alleviate some of the anxiety of owning and operating a business.

Purchasing an established business may also be financially advantageous. Sellers often assist with financing arrangements. It is not uncommon for sellers to accept an initial partial payment with the agreement that the balance will be paid off in monthly installments in the form of a promissory note. This arrangement may reduce or eliminate the need for bank financing and is often negotiated at a lower interest rate. If the seller does not wish to help with financing, buyers are still (in most cases) more likely to receive financing from a bank or other financial institution for an established business than for a start-up. Why? It is less risky for the lender.

Entrepreneurs sometimes purchase businesses because it is the only way to successfully enter the market. If a particular business dominates the market because of its superior location and reputation, buying that business might be the best way to ensure success.

Other advantages of buying an existing business include the following:

- No business start-up is required.
- Suppliers have already been tried and tested.
- The company has survived the start-up phase (the first year or two) and has a better chance of succeeding.
- Experienced employees will already be functioning and will probably require little, if any, training.

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Disadvantages of Purchasing an Existing Business

Many businesses are for sale because of internal problems. It is not a good idea for aspiring business owners to assume someone else's problems. If a business has a poor reputation with customers, has trouble with suppliers, or is inconveniently located, it is unlikely that new ownership will automatically change customers' negative opinions. Too many business buyers have learned the hard way that it takes a long time to restore customer confidence.

Another disadvantage is that buying a profitable business will initially cost more. The seller has built a business, poured time and energy into it, and will usually expect to be rewarded with a selling price that reflects those efforts. Capital limitations on the part of the buyer, however, might prevent the purchase. It might be economically more feasible to take the risk of creating a new business with a smaller capital investment.

Some entrepreneurs might consider investing in, or purchasing part of, a business. The risk is that the parties, who have essentially been forced together for economic reasons, might not be compatible. A bad partnership arrangement hinders the growth of the camaraderie that is so essential for small business success.

Another drawback to purchasing an existing business is that current employees may have to be replaced because of poor training by the former owner or unacceptable work habits. It may also be necessary to invest money in modernizing the operation.

Reasons Businesses Are Sold

When considering the purchase of a business, the potential buyer should find out why the business is for sale. This will help the buyer determine a fair price. If owners are under pressure to sell, they may be more flexible about the selling price. Some of the many reasons businesses are sold are

- insufficient profits
- owner's retirement
- death or illness of a working partner
- business heirs not interested in inheriting the business
- partner or shareholder dispute
- management "burnout"
- growth too slow or too rapid
- forced liquidation or sale
- fear of new competition
- fear of current or predicted economic conditions
- lack of desire or capital to do necessary remodeling
- owner's desire for a change of career
- owner's desire to take advantage of another opportunity requiring liquidation of business assets

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HOW TO PURCHASE A BUSINESS

Buying a business is an intricate process that requires the same thoroughness as starting a business from scratch. As a potential business buyer, you should follow these steps:

1. Write clear, specific, personal, and financial objectives about the kind of business you want to buy. Whatever the type of business for sale, it must match these statements before you consider it for purchase.
2. Identify business opportunities that offer growth and provide an attractive return on investment. Read classified ads, discuss opportunities with business brokers, and check industry sources as you compile a list of potential opportunities.
3. Meet with business sellers or brokers for an introduction to specific business opportunities. The initial information provided by the seller should include a brief financial report, the history of the business, the selling price, and the reason for the sale.
4. Request a second meeting to probe for more information if the seller's material fits the objectives you stated in step 1.
5. Inspect the facility closely to determine how well it has been maintained.
6. Prepare a checklist of information you need, including the following:
   - complete financial accounting of operations—income statements, federal income tax returns, state sales tax forms, and balance sheets—for at least the previous three years, or from the beginning of operation if the business is less than three years old
   - list of all assets to be transferred to the new owner, including an itemized list of all inventory as of the last accounting period
   - statement about any past or pending legal action against the business
   - copy of the business lease or mortgage
   - list of all suppliers
7. After you have examined the information, you should meet with several key individuals to receive their professional recommendations or approval before going any further.

   First, consult an accountant and a lawyer. They should be able to provide you with any further interpretation of the financial and legal information you received. Your accountant will review all the financial information and may uncover flaws or inaccuracies that provide a more accurate financial picture than the seller presented. Among other things, your lawyer will need to check if the lease or title may be transferred to you. You will need to conduct an on-site meeting with the landlord or mortgage holder to ensure the facility is in satisfactory condition. In the case of a lease, you should discuss the expiration date and, if possible, negotiate the terms and price to fit your needs.

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Potential buyers are wise to consult the chamber of commerce and other local assistance centers to discuss the future of the market and the location. It is also a good idea to contact industry representatives presently selling to the business to validate the sales reported and to get their assessment of the business's future growth.

8. Arrange a convenient time with the seller to observe operations. Evaluate employee and customer satisfaction and/or dissatisfaction, as well as the pros and cons of the operation in general. All these considerations enter into the final sales price.
9. Determine a fair price to offer the business owner. In some cases, the owner will have already stated a price; you now must make a counteroffer based on your research. Determine what financing arrangements are available through a lending institution or with the seller. Present a letter of intent to the seller that says, in essence, "I will purchase the business at the stated price and under the stated terms provided an audit shows that the inventory, work in process, accounts payable, and accounts receivable are as presented."

   At this point there is normally some negotiation. You will have to use your best persuasion techniques to point out the fairness of your offer and the advantages to the seller of accepting it. Either party may bring his or her attorney, or another agent, to assist in negotiations.
10. If an agreement is reached, an attorney should draw up a suitable sales contract. The terms of the contract address such questions as whether the seller is permitted to open a competing business within the buyer's market area. Which party will be responsible for paying any unreported claims, liens, or unpaid taxes on the business following its sale? What should be done about customers' long-standing debts? What about union contracts for unionized employees? Are employee benefits and pensions in order? How will costs for insurance coverage, taxes, and utilities be divided? As you can see, a lawyer can be very helpful at a business closing and can protect you from costly, unforeseen complications. The contract should be contingent upon examination of all assets to validate that what is represented is true.
11. Before signing a sales contract, the buyer should be present when the seller takes final inventory of assets.

COMSTOCK IMAGES

Evaluating Business-for-Sale Opportunities

Normally an investigation of businesses for sale produces opportunities that range from bad to promising to good. Categorizing a business opportunity helps prospective buyers determine the value of the business and, therefore, the price they are willing to offer.

Types of Opportunities The first sign of a bad business opportunity is poor bookkeeping. If a business owner has been negligent in maintaining proper financial records, it is more than likely that the business has suffered because of it. Failure to present adequate verification of sales revenues and expenditures is often a sign that the seller is attempting to hide information. It would not be wise to pursue this opportunity.

Many business opportunities are not easy to classify or measure. For example, a business's record keeping may be adequate but not entirely complete; a solid but unspectacular customer base may have been established; relationships with suppliers may be satisfactory but not as efficient as they could be. Often these are the best business opportunities because their

FUN FACTS

On July 2, 1962, Sam Walton, entrepreneur, opened the first Wal-Mart in Rogers, Arkansas. Today, Wal-Mart is the biggest company in the world.

Ethics for ENTREPRENEURS

Millie Tan has worked in the hotel business for the last 14 years. Immediately upon graduation from high school, she went to work as a maid at a 200-room hotel in her hometown. She financed her college education by continuing to work in the hotel for the next four years.

As she progressed toward a business degree in marketing, she worked her way up in responsibility. During her sophomore year in college, she was hired by a large multinational hotel chain to work the front desk. With success at that position came a promotion to night auditor, then to director of marketing. After college she continued to work for the hotel chain.

Recently, Millie has been looking for a small, owner-managed motel where she can apply her years of hotel experience on a smaller scale and in a fashion she thinks best. She is tired of the corporate style of management. In short, Millie wants to become an entrepreneur.

Yesterday she met with the owner of a small beachfront motel on the Gulf Coast of Mississippi. The property met all her requirements for her new business venture. It was in a resort location, it had fewer than 100 rooms, and it was generating a profit of at least $50,000 annually. There was one problem, though.

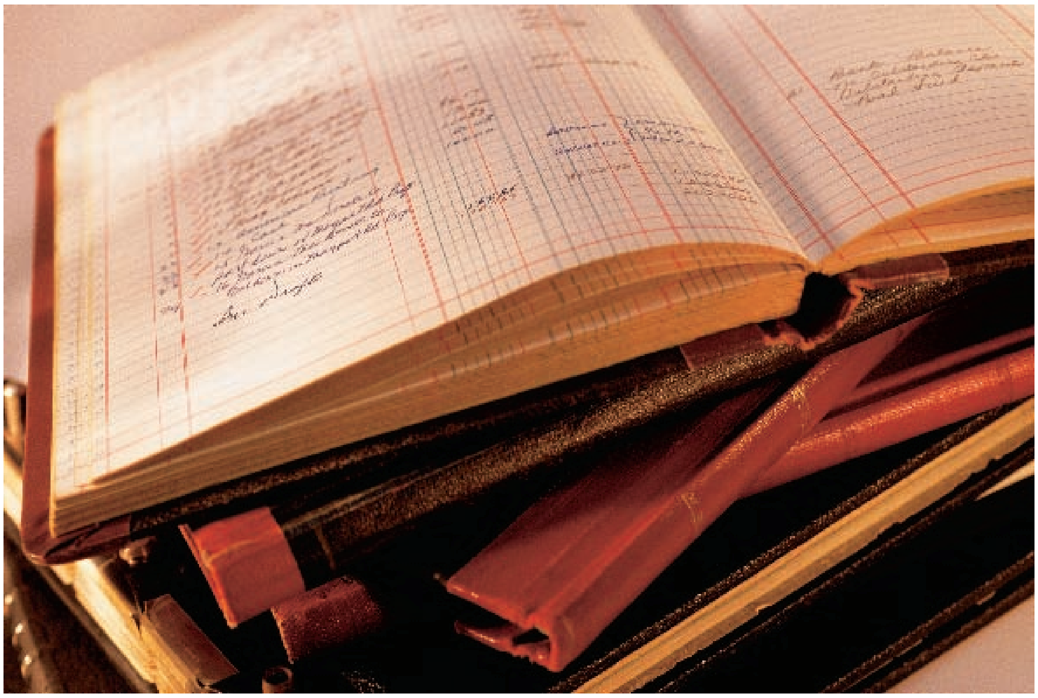
The owner told Millie that the way he kept the profit margin up was by using a contract employment agency for his cleaning staff. He paid the agency $7 per maid per hour for the service. He knew the agency used undocumented illegal immigrants, but that was not his concern. By using the agency, he saved on wages and benefits. The owner admitted that even though he was not technically breaking the law, some might consider the practice unethical.

Think Critically

Do you consider the employment practice either illegal or unethical? What would you advise Millie to do?

greatest need is better management. Proper management might generate greater sales, better customer reception, and goodwill. **Goodwill** is an intangible but salable asset, such as the reputation or location of a business, that makes the business worth more to a buyer. Since previous management has not been able to reach all its objectives, the selling price of the business should not include goodwill. Therefore, it might be a bargain for the right buyer.

An example of a promising business opportunity is a store that has leveled off in sales at a certain point and cannot seem to increase them even though the market is good. Management is evidently not doing some things right or else does not have the capital to aggressively pursue the market. If a new owner can make some changes, such as remodeling, adding new inventory, or increasing advertising expenditures, he or she could quite possibly increase profits and receive a healthy return on investment. Potential buyers should look for this type of opportunity.



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Good businesses keep good records and maintain a good customer image. Buying a business that has been properly managed is an asset to the new owner. Customers will not have to be convinced that they will be given better service, quality, or prices under the new management. However, if a business has been profitable and managed well, it will cost more to purchase. It is customary for the seller of a successful business to specify a dollar value for goodwill.

Evaluation Considerations Unfortunately, there is no easy, standard formula for computing the value of a business. Many deals are based on how motivated both the seller and the buyer are to close the deal. Sometimes the terms are more important than the price. However, the following evaluation methods will help you generate a price at which you can begin negotiating.

Prospective buyers must evaluate opportunities for buying a business in terms of profit earnings and return on investment. The most important factor to look for is the business's potential to make money. Unfortunately, this is not always easy to determine because the buyer is dealing with what he or she thinks *might* happen. To help, most buyers use a method called the **earnings approach**, in which they determine whether the business will be able to pay them for their time. Potential buyers should identify their proposed changes and develop pro forma (projected) financial statements to examine the impact of those changes on the business. If this forecast looks positive, they then need to examine their return on investment.

Entrepreneurs should expect earnings to provide a return on investment over a period of time. Usually that period is five years, or 20 percent per year. Too often, businesses are bought with the assumption that as soon as the new management takes over, business will improve dramatically. It takes time to change operations procedures, employee performance, and customer buying habits. Opportunities must be evaluated by considering the long-term potential.

Buyers must also research the market value of the business for sale. This requires learning the selling prices of similar businesses and comparing them to the price of the business being considered. It is a good way to get a general idea of the market, but since no two businesses are exactly alike, it is not always accurate. Buyers would be wise to hire an appraiser to appraise the building and other assets.

Buyers must determine the **replacement value** of the assets they are considering for purchase. Since the value of assets such as equipment, furniture, fixtures, and inventory listed on a balance sheet is based on their previous purchase price, the buyer should determine their current replacement value. The replacement value is usually higher than the asset value.

A final measure should be the **liquidation value** of a business's assets. Using a worst-case scenario, the prospective buyer should determine the immediate cash value of all assets (including the present value of future income) in the event a problem arises that requires the immediate sale of the business.

It is a good idea for prospective buyers to review the current income statement of a business for sale and indicate any foreseeable adjustments to that statement due to the new owner. Table 3-1 is an example of such a list of adjustments.

TABLE 3-1 INCOME STATEMENT ADJUSTMENTS FOR YEAR ENDING DECEMBER 31, 2003

ACTUAL		NEW OWNER COMMENTS
Sales and revenues	$180,000	Should increase 10%
Less cost of goods	93,000	Add $25,000 for new inventory
Gross profit	$87,000	Minus approximately $7,000
Operating expenses		
Payroll	26,000	–$5,000 cut one employee
Rent	19,500	No change
Utilities	2,200	No change
Maintenance	1,600	+$500 for new lights
Insurance	2,400	+$200 to cover additional inventory
Accounting	2,000	–$1,000 keep own books
Advertising	2,800	+$550 announce new owners
Supplies	4,100	+$600 new bags, boxes
Miscellaneous	4,000	+$1000 other changes
Total operating expenses	$64,600	Minus approximately $3,150
Net operating profit	$22,400	Approximately $18,500

Inadequate review and investigation before buying a business can lead to problems such as those experienced by Bailey Robinson, who bought a retail clothing business believing she could increase profits as soon as she took over. The business financial statement looked like this:

Sales	$ 250,000
Cost of goods	–130,000
Gross profit	120,000
Operating expenses	–95,000
Net profit	$25,000

To buy the business, Bailey borrowed from the bank with a promise to pay back $20,000 per year. She knew that this would leave only $5,000 per year for her salary, but she was sure that she could immediately increase sales by $50,000. This would allow her a salary of $25,000. One year later she was forced to sell the business. Although she had increased sales by $10,000, it was not enough and she ran out of time.

PURCHASE A FRANCHISE

FUN FACTS

Most franchise companies have fewer than 100 units.

A person who has a burning desire to become an entrepreneur and own a small business may have no real idea what particular business to choose or how to run a business. This aspiring entrepreneur may want to consider a **franchise**, which is the contractual right to market a product or service. There are an estimated 1,500 franchised companies in the United States from which entrepreneurs can choose. Well-known franchises include Subway, McDonald's, Kentucky Fried Chicken, Curves, Midas, Wendy's, Century 21, Dunkin' Donuts, Dairy Queen, and Ramada Inn.

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There are numerous benefits—as well as some drawbacks—to franchising. One of the benefits of franchising is business experience. When someone purchases a franchise, the past experiences of other entrepreneurs who have chosen that franchise are included in the purchase. In other words, practical business advice, based on the experiences of all other owners of the same franchise, comes with the franchise. This advice is a valuable asset.

Purchasing a franchise is a desirable option for some entrepreneurs. For others it is not. Read the following information carefully and decide if a franchise may be the right decision for you.

Definition

The U.S. Department of Commerce defines **franchising** as a method of doing business in which a franchisee is granted the right to engage in offering, selling, or distributing goods or services under a marketing format that is designed by the franchisor. The International Franchise Association defines franchising as a method of distributing products or services. At least two levels of people are involved in the franchise system: the franchisor and the franchisee.

1. The **franchisor** lends his trademark or trade name and a business system.
2. The **franchisee** pays a **royalty** (percentage of sales or outright fee) and often an initial fee for the right to do business under the franchisor's name and system.

Technically, the contract binding the two parties is the "franchise," but that term is often used to mean the actual business that the franchisee operates.

Classifications

Franchising opportunities are available in many types of business in all areas of the U.S. A publication available from the Department of Commerce, the *Franchise Opportunities Handbook*, lists these franchise opportunities by category. Entrepreneurs have more than three dozen categories from which to choose. The publication includes information about costs, capital required, number of franchises already operating, and so on. A current copy can be obtained from the U.S. Government Printing Office in Washington, D.C.

Some of the categories in the *Franchise Opportunities Handbook* are

- automotive products/services
- business aids/services
- campgrounds
- clothing/shoes
- cosmetics/toiletries
- dental centers
- educational products/services
- employment services
- foods
- motels/hotels
- printing
- real estate
- security systems
- vending

Other sources for information about franchise opportunities include the Small Business Administration, the Federal Trade Commission, *Franchising World Magazine*, the International Franchise Association, and *Entrepreneur* magazine.

Small Business Technology

Many franchises now use an extranet to speed up communication with their network of franchisees. An extranet is a shared network that uses Internet technology to link businesses with suppliers, customers, or other businesses. It is designed to share information or operations with authorized business users. An extranet can be viewed as part of a company's intranet that is extended to users outside the company.

Advantages of Purchasing a Franchise

There are many advantages to purchasing a franchise. The entrepreneur should evaluate these (as well as the disadvantages) carefully before deciding to purchase.

A franchise provides an established product or service. One of the most challenging problems any entrepreneur faces when starting a new business is that of product/service acceptance by the consumer. The process of becoming established can take years. With a franchise, the process has already been under way for some time and is usually reinforced by large-scale advertising.

Many, but not all, franchisors offer management and/or technical assistance. Management assistance usually includes providing the knowledge needed to start the new business and handle daily operations as well as crises. This assistance is available through on-site training or classes at the franchisor's base. Technical assistance can include anything from site selection and building design to equipment purchase and food recipes.

For consumers, one of the main attractions of franchised businesses is consistency. A franchise contract mandates a certain level of quality, which is determined by past business experience. Most franchisees realize that they must match or exceed the quality available in related franchises if they are to be successful. The consumer knows that a franchised business in New Jersey will offer the same basic range of products or services as the same franchised business in California. It is unlikely there will be any major surprises.

The operating capital required for a new business can be considerable. Association with a franchise may reduce some of those expenses. General supply purchases are a good example. Franchisors may be able to negotiate low prices because of the large volume they purchase. Independent entrepreneurs usually do not have that advantage. The same holds true for equipment, insurance, and other expenses.

A franchise contract may provide for the franchisee's professional growth. If the contract guarantees a certain geographic territory to the franchisee, future competition within that territory cannot come from within the same franchise. Any growth in the territory is limited to the purchase or sale of additional locations by the original franchisee. For example, if you purchased a franchise for a certain submarine sandwich business and, as part of the contract, were given an exclusive geographic territory, you may be able to purchase franchises for additional locations within that territory or sell franchises to others.

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Disadvantages of Purchasing a Franchise

Entrepreneurs who purchase franchises may have certain expectations as to services they are to receive from the franchisor. If these services are not clearly spelled out in the contract, they may not be provided. The franchisor's only legal responsibilities are those included in the contract.

A franchisee is required to pay the franchisor on an ongoing basis. If the value of the services the franchisee receives does not at least offset the payment, the payment becomes a financial drain on the new business.

Franchisees may depend heavily on the advice of the franchisor at first but should aim for greater self-reliance over time. Overdependence often clouds common sense and interferes with sound business practices. The level of dependence should decrease as time passes.

The Global ENTREPRENEUR

According to the International Franchise Association (IFA), "Franchised businesses continue to grow in all corners of the world." It has been estimated that one in seven American franchisors attempts to market franchises abroad.

When it comes to international franchising, business is rarely business as usual. One of the biggest concerns for franchisors such as fast food companies is the need to consider language and cultural differences.

McDonald's International Division was created in 1969. Since then it has expanded to include 119 countries all over the world. With the expansion often comes a need to adapt the food to local tastes.

In India, for instance, McDonald's had to accommodate religious beliefs. The hamburgers at McDonald's in New Delhi are made of chicken and called Maharaja Macs. Also offered is the McVeggie, which is made from a breaded fried vegetable patty (peas, carrots, green beans, red capsicum, potatoes, onions, rice, and seasoning), lettuce, and eggless mayo, served on a toasted sesame seed bun. An additional menu item is the McAloo Tikki Burger, consisting of a fried breaded potato-and-peas patty (flavored with special spice mix), fresh tomato slices, onion, and tomato mayonnaise, served on a toasted bun.

In Israel, all meat served in McDonald's restaurants is 100 percent kosher beef. McDonald's operates kosher and non-kosher restaurants.

Other international issues for McDonald's include translating "quarter pounder," an English measurement term. When selling food in countries that use the metric system, an alternate approach is necessary. Franchises in many European and Asian McDonald's have replaced the name with "McRoyal" or "Hamburger Royal."

The global franchisor faces many challenges unheard of in this country. Planning the small business becomes even more critical.

Think Critically

Can you think of other U.S. products that have to be modified to sell in another country? Name two and discuss the necessary modifications.

The franchise package usually carries restrictions involving products or services to be offered, types of customers to be served, geographic territory, and pricing. Many entrepreneurs object to this type of control because it inhibits the freedom they seek as business owners.

Franchise contracts usually control to some degree the terms of a sale or closure. This means that a franchisee may have little or no say about the terms of a termination of the franchise agreement. For franchises that are part of a chain, the performance of existing locations may influence the success of new businesses. If service and quality slip at one location, customers may associate that decline with the other locations as well.

Legal Aspects of Franchising

An entrepreneur should not sign a franchise contract without the advice of a competent attorney. Only an attorney can properly analyze the legal documents that are required for a franchise arrangement. These documents are covered in the **Federal Trade Commission Franchise Rule**.

FTC Rule The FTC states the following purpose for the Rule: "The Rule is designed to enable potential franchisees to protect themselves before investing by providing them with information essential to an assessment of the potential risks and benefits, to meaningful comparisons with other investments, and to further investigation of the franchise opportunity."

Rule Requirements The Rule imposes six requirements in connection with the "advertising, offering, licensing, contracting, sale, or other promotion" of a franchise in or affecting commerce.

1. ***Basic Disclosures*** The Rule requires franchisors to give potential investors a basic disclosure document at the earlier of the first face-to-face meetings or ten business days before any money is paid or an agreement is signed in connection with the investment (Part 436.1(a)).

2. ***Earnings Claims*** If a franchisor makes earnings claims, whether historical or forecasted, they must have a reasonable basis, and prescribed substantiating disclosures must be given to a potential investor in writing at the same time as the basic disclosures (Parts 436.1(b)-(d)).

3. ***Advertised Claims*** The Rule affects only ads that include an earnings claim. Such ads must disclose the number and percentage of existing franchisees who have achieved the claimed results, along with cautionary language. Their use triggers required compliance with the Rule's earnings claim disclosure requirements (Part 436.1(e)).

4. ***Franchise Agreements*** The franchisor must give investors a copy of its standard-form franchise and related agreements at the same time as the basic disclosures, and final copies intended to be executed at least five business days before signing (Part 436.1(g)).

5. ***Refunds*** The Rule requires franchisors to make refunds of deposits and initial payments to potential investors, subject to any conditions on refundability stated in the disclosure document (Part 436.1(h)).

6. ***Contradictory Claims*** While franchisors are free to provide investors with any promotional or other materials they wish, no written or oral claims may contradict information provided in the required disclosure document (Part 436.1(f)).

RUBBERBALL PRODUCTIONS

Amended Franchise Rule (12/30/93) The Rule was amended in 1993 with the intention to: "improve the clarity of disclosures by requiring the use of 'plain English' and of tables that highlight important information; add new and enhanced disclosures; and enhance uniformity among the states by minimizing state-specific requirements."

Registration Requirements There is no requirement by the Federal Trade Commission that franchisors register with it or any government agency. The following states, however, do require registration: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.

Buying A Subway® Franchise

Subway Restaurants, which were started in 1965 by Fred DeLuca and Dr. Peter Buck as a single sandwich shop called "Pete's Subs" in Bridgeport, CT, opened its 20,000th location in November 2003.

Offering franchise opportunities since 1974, Subway receives more than 1,000 requests for information each week. The total investment required for a Subway franchisee ranges from $86,300 for a lower-cost store to $213,500 for a higher-cost store.

Subway offers these services to new franchisees prior to opening:

- *Training* An intensive two-week program takes place at Subway HQ in Milford, CT. Programs are also conducted in Miami, Australia, Germany, and China.
- *Site Selection* Subway works with franchisees to secure a location for the business.
- *Restaurant Design* Subway provides floor plans for the specific location.
- *Equipment Ordering* Subway helps the franchisee order the necessary equipment package for timely delivery.

After the Subway is open, a high level of services continues:

- *Operations Manual* An in-depth manual covers a full range of topics important to running the business.
- *Field Support* Each franchisee is assigned a field consultant who will help them get started and provide ongoing operational evaluations.
- *Franchisee Services* Each franchisee is assigned a coordinator who serves as the main contact person at headquarters and is just a phone call or e-mail away.
- *Research and Development* Subway continually strives to make its food better.
- *Continuing Education* Franchisees receive periodic newsletters, e-mails, and voicemails. Videos and additional training classes are also available.

Subway information from the official Subway web site.

The 15 states have franchise investment laws that require franchisors to provide pre-sale disclosures, known as "offering circulars," to potential purchasers. Thirteen of these state laws treat the sale of a franchise like the sale of a security. They typically prohibit the offer or sale of a franchise within their state until a franchise offering circular has been filed on the public record with, and registered by, a designated state agency.

These state laws give franchise purchasers important legal rights, including the right to bring private lawsuits for violation of the state disclosure requirements. The FTC encourages potential franchise purchasers who reside in these states to contact their state franchise law administrators for additional information about the protection these laws provide.

Questions to Ask

Entrepreneurs should ask several pertinent questions before they purchase a franchise. The final decision to purchase should not be made until these questions have been answered satisfactorily. These questions involve the franchise, the franchisor, the franchisee (entrepreneur), and the franchisee's market.

The Franchise Prospective franchisees should ask these questions about the franchise in general.

1. Was the franchise agreement approved by a lawyer?
2. Are any of the requirements of the contract illegal in the area where business is to be conducted?

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3. Will the franchisee receive an exclusive territory for the duration of the franchise term, or can the franchisor sell additional franchises in the territory?
4. Is there a connection between the franchisor and any other franchise company dealing in similar merchandise or services?
5. If there is a connection between the franchisor and another franchise company, is the franchisee protected against competition from the second franchise company?
6. What is required if the franchisee wishes to cancel the contract?
7. Will the franchisee receive any payment for goodwill (customer loyalty) if the franchise is sold?

The Franchisor Prospective franchisees should ask these questions about the specific franchisor with which they are dealing.

1. How long has the company existed, and how long has the franchisor been in business?
2. Do other franchisees consider the franchisor honest and fair?

3. Has the franchisor shown the franchisee profit statements for several franchise locations? Have they been verified by the franchisee at each location?
4. Does the franchisor provide the following services?
   - credit
   - capital marketing assistance
   - management training
   - employee training
   - marketing and/or marketing assistance
   - merchandising assistance
   - site selection assistance

DIGITAL VISION

5. Is the franchisor on firm financial ground?
6. Is there an experienced management team from which the franchisee can seek advice?
7. What services or opportunities can the franchisor provide that the franchisee cannot otherwise obtain?
8. In what kind of detail has the franchisor investigated the franchisee and the franchisee's ability to run a profitable business?
9. Has the franchisor followed all state, federal, and local laws that govern the sale of franchises?

The Franchisee Each prospective franchisee must determine the answers to these questions before he or she can make a decision about investing in a franchise.

1. How much money is required to open and run the business until it becomes profitable?
2. Does the value (monetary and/or psychological) of the franchise outweigh the loss of the freedom of being an independent business owner?
3. Does the franchisee have what it takes to open the franchise and turn it into a profitable business?
4. What kind of commitment is the franchisee willing to make to the franchise? Is the franchisee willing to devote years to its success?

The Franchisee's Market And, finally, prospective franchisees should consider these questions about the market and the location of the franchise.

1. Has the franchisee conducted in-depth marketing research to determine that the franchise will be successful in the intended location?
2. What does marketing research indicate about potential future changes in the intended location?
3. What is the projected demand for the franchised product or service in the area surrounding the intended location?
4. What is the competitive environment for the franchised product or service?

Chapter Review

Ship in a BOTTLE

New Opportunity

"The only way to see if this idea makes any sense is to take it on the road and talk to retailers," Fred told his wife, Jeanie. "We can learn more from them than from any other source. So let's plan a trip."

They decided to use their vacation time to travel up the East Coast, from Florida to Maine. They would visit gift shops, show samples, and, they hoped, take some orders.

Initially they were disappointed. Store owners liked the idea, but it was not a buying season and they questioned whether the product would sell well once the wholesale cost was doubled. The news improved the further north they traveled. When they got to the New England coast, they were amazed at the number of stores that sold nautical items. Their ships in bottles were enthusiastically received. Fred was pleased, but also cautious—he was still trying to coordinate delivery times from Germany and deciding which models to stock. He was not guaranteeing anything at this point, but he welcomed the retailers' comments and suggestions.

In a picturesque village on the Maine coast, Fred was taken aback when he walked into The Maritime Store. The proprietor, John Wilkins, talked at length about setting up a display of the models in the best section of his 1,500-square-foot store. Fred recalled Johann telling him about a similar display in a restaurant in Hamburg, Germany, that outsold all his other retail outlets. John told Fred that he planned to sell The Maritime Store after the current tourist season. He had opened the store 12 years earlier after a career as a teacher and was looking forward to retirement in Florida.

That evening Fred and Jeanie discussed their future. Since it appeared that ships in bottles would sell better in the Northeast than in the South, wouldn't it make sense to relocate? And wouldn't a nautical gift shop make a good home base from which to sell their products? They could easily imagine living in Maine. It would mean giving up their jobs and leaving friends and family, but their two children were in college, so they were "empty nesters" with more freedom than they had experienced in years. Tomorrow they would look into buying The Maritime Store.

John, of course, was more than pleased to discuss a possible sale. They reviewed the previous year's finances.

Sales	$ 354,000
Less cost of goods	– 183,000
Gross profit	171,000
Less operating expenses	– 124,000
Net profit	$47,000

John was willing to sell the store for the retail value of his inventory, $125,000, $35,000 for his display cases and equipment, and $20,000 for leasehold improvements he had made to the property—a total of $180,000. Three years remained on the lease, and he was sure it could be extended with a minimal increase. Although sales had been stagnant for the previous three years, John admitted he had not advertised during that period. He pointed out that if Fred and Jeanie could produce a $50,000 annual profit, they would achieve a return on investment of 27 percent and earn back the $180,000 investment in a little over three years. Fred and Jeanie had a lot to discuss on their way back to Georgia.

continued

Fred was excited—a new beginning, an adventure in a beautiful setting, sailing, fishing, becoming active in the community. Jeanie was more cautious. The lifestyle sounded wonderful, but the risks were great. Was the return on investment really 27 percent, since the profit would be their salary? Did they know enough about retailing to make it a career? Should one of them operate the store while the other worked a salaried position? If so, were there job opportunities in the area? Had John given them enough information to make such a big decision? Where would they get $180,000—a bank loan, selling their retirement plans, taking investors, or asking John to finance part of the purchase? There were so many questions it made Jeanie's head spin. By the time they reached their home, they agreed that buying a business now would be too much too soon.

Think Critically

1. Address Jeanie's concerns. Is this a good, promising, or bad opportunity?
2. How important is experience to such a decision?

Summary

Many entrepreneurs choose to buy an existing business rather than create a new business. To find business-for sale-opportunities, prospective buyers research the classified sections of the newspaper, make inquiries to business brokers, discuss their interest with industry representatives, and inquire throughout the community.

The advantages of buying an established business include owning a business with a history, which reduces risk because the buyer knows what to expect. The new owner inherits a customer and supplier base and often receives preferable financial arrangements through seller financing. However, many businesses that are for sale have poor customer relations or negative images that take new ownership a long time to improve.

Buying an existing business requires detailed research and planning, just as in starting a new business. Buyers must make sure that all documents presented are accurate and that the final price is fair. If the opportunity does not appear to be a good investment, it should be avoided. The buyer should realistically project what impact the change of ownership will have on the business. The buyer should not expect an immediate turnaround of profits and growth.

A person who wants to become an entrepreneur but does not know what business to choose or how to run a business may want to consider a franchise. Franchising is a method of doing business in which a franchisee is granted the right to engage in offering, selling, or distributing goods or services under a marketing format designed by the franchisor.

An entrepreneur should not sign a franchise contract without the advice of a competent attorney who can analyze the legal documents required for a franchise arrangement. These documents are covered in the Federal Trade Commission Franchise Rule.

Several pertinent questions should be asked and answered before the entrepreneur purchases a franchise. These questions involve the franchise, the franchisor, the franchisee (entrepreneur), and the franchisee's market.

Chapter Review

A Case in POINT

Career Decision

Joe Ramos is a third-generation Mexican-American who lives in a suburb of Chicago. He has worked for his uncle Paco in the restaurant business for 20 years. Uncle Paco's restaurant, Casa de Mexico, is very successful.

When Joe began working for Uncle Paco, he bussed tables. Over the years he has performed every job in the restaurant, including chef. Since Uncle Paco went into semiretirement five years ago, Joe has managed the restaurant.

Joe has always been very happy working at Casa de Mexico. He figured he would stay there until he retired. All that changed recently, however. Uncle Paco's oldest son, Luis, moved back from the West Coast and began working at the restaurant.

During the six months that Luis has been working with Joe, things have been changing. Joe is sure that it is just a matter of time before Uncle Paco makes his son manager of Casa de Mexico. Joe sees his career suffering a serious setback when that happens.

Because of what is happening, Joe has decided that going into business for himself might be a good idea. He has always invested a portion of his earnings and now has quite a nice nest egg. He plans to either purchase a franchise or open a small restaurant on his own.

Think Critically

1. Would you advise Joe to purchase a franchise or open his own restaurant? Why?
2. What should Joe consider as he decides which option is best for him? What questions should he ask?

Vocabulary Builder

Write a brief definition or explanation of each word or phrase.

1. business broker
2. earnings approach
3. franchise
4. franchisee
5. franchising
6. franchisor
7. FTC Franchise Rule
8. goodwill
9. liquidation value
10. market value
11. replacement value
12. royalty

Review the Concepts

13. Why is it a good idea to investigate business-for-sale opportunities before deciding to start a new business?
14. What are three advantages of buying an existing business?
15. What are three disadvantages of buying an existing business?
16. Why is it important to determine why a business is for sale?

17. What information should a prospective buyer collect to properly evaluate a business opportunity?
18. What does an earnings approach determine when used to evaluate a business for sale?
19. What is determined when calculating liquidation value?
20. Why is it wise to make a pro forma (projected) income statement before purchasing a business?
21. Name four advantages and four disadvantages of franchising.

Critical Thinking

22. What are some characteristics of a promising business opportunity?
23. What steps should an entrepreneur take to investigate a business for sale?
24. How does replacement value differ from the asset value listed on a balance sheet? Why should prospective buyers determine the replacement cost?
25. What are royalties? What effect do they have on business profits?
26. What are three of the questions entrepreneurs should ask about a franchisor before purchasing a franchise?

Project

Build Your Business Plan

Review the classified section of the newspaper to find a business for sale similar to the hypothetical one you are planning. Contact business brokers and inquire if they have any current listings of similar businesses. How do the newspaper or brokers' descriptions compare with what you have learned about your business project? Write a report that analyzes the existing business opportunities and compares them with your planned new business.

Choose a franchise, gather as much information as you can, and answer the questions that were presented in this chapter to decide if this franchise would be a viable option for you. Then answer the following questions.

1. What are the advantages and disadvantages of purchasing a franchise in your particular situation?
2. Is purchasing the franchise you researched a suitable option for you? Why or why not? If not, might you consider purchasing a different franchise? Why or why not?