Franchise Times®

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# Avoiding Pitfalls

## The Top 10 financial mistakes new franchisees make

By Dennis Monroe

For years, my partner, Randy Evans, and I have been helping franchisors and franchisees navigate the tricky waters of getting into the franchise world, then developing a franchise business. Many of our franchisee clients have gone from one unit to hundreds of units, and many of our franchisor clients have grown from a core group of businesses to become multi-national concepts. We have seen it all and thought it would be helpful at this time of year, when people are looking at new opportunities, to address some basic common financial mistakes made by franchisees in the early stages of entering into franchise agreements, buying assets, leasing locations, and, in general, operating a franchise business. Here are 10 common financial mistakes we have observed over the years:

**1.** Failing to understand the legal and financial obligations contained in the franchise disclosure document (FDD), the franchise agreement, any accompanying development agreement and other related franchise contracts. The relationship between the franchisor and the franchisee is multi-faceted and highly regulated. Spend a little money on the front end to obtain advice from legal and financial advisers who have experience in franchising—it will help you understand the legal and financial obligations of the franchise relationship that you are entering into.

**2.** Underestimating the build-out and other opening costs in connection with starting up a franchise business. These costs include things like lease held improvements, inventory, employee training, advertising and other pre-opening expenses. It is important to have a good handle on all of the costs that will be incurred in order to ensure that you have arranged for appropriate levels and sources of financing.

**3.** Underestimating the working capital needs of the business, particularly in the initial start-up phase. It is critical not to run short on working capital as you work to establish the business. A good rule of thumb is to have six months of cash flow on hand to help weather the ups and down of a new business.

**4.** Not understanding how the royalties, advertising funds and other required payments will be calculated and collected by the franchisor. These represent significant and ongoing costs of operating a franchise business, and must be accounted for in your business plan.

**5.** Overleveraging the business. It is important to have the proper capital structure, including an appropriate level of equity capital, to ensure the cash flow of the business is sufficient to satisfy all debt and other obligations. This is less of a problem in the current credit environment, as lenders are insisting on higher levels of equity contribution by the owner. In the


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current credit environment, it may be necessary to have as much as 30-percent to 50-percent equity in order to access necessary funding for a new franchise business.

**6.** Not properly planning for future capital needs, including remodeling, re-imaging, new equipment packages and other financial needs in order to comply with franchisor requirements and keep the business fresh and current. It is important to set aside a reserve fund or make other arrangements to fund these necessary capital expenditures. You should not assume that you will be able to pay for these types of capital improvements out of cash flow from the business.

**7.** Undervaluing your personal liability as the owner in connection with franchise agreements, leases, bank loans and other aspects of the business. It is common for the franchise owner to be required to personally guarantee all of these types of obligations of the business, and it is critical to understand both the scope and nature of these personal liabilities.

**8.** Not properly documenting partnership or similar relationships. It is important to think about and provide for voting, buy-sell and related issues on the front end of starting the business in order to avoid timely and costly disputes further down the road. In addition, your corporate covenants should address future needs of the business, including additional capital calls if necessary.

**9.** Misjudging the time commitment required to make the business successful, especially in the first year. Starting a franchise business takes an enormous commitment of time and energy on the part of the franchisee, and it is essential to understand that before committing to a long-term franchise relationship. Management is a key factor in the success of a franchise business. It is important to have the right managers in place from the start. If necessary, you should seriously think about providing incentives in the form of current or future ownership to attract key management talent.

**10.** Viewing the franchise as a short-term business opportunity, with the option of selling the business as an easy exit strategy. Most franchise agreements run for a minimum of 10 to 20 years, and any sale is contingent on approval of the new owner by the franchisor. It is important to understand the long-term nature of franchise relationships and to plan accordingly. We are currently in a down market in terms of the valuation multiples for franchise businesses, and may be there for some time. An early sale is not a prudent exit strategy at this point.

Understanding and avoiding these common mistakes can make the difference between success and failure when buying and operating a franchise business. It all comes down to proper planning, knowledge of franchising and strategic use of your professional advisors. FT

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