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Buying a Franchise Can Limit Risk

“Business” is “entrepreneurial activity” - risking capital to make financial gains. To a prudent businessperson this may mean calculating and limiting the risk as far as possible relative to the potential gain to be made from the start-up of a business or acquisition of a business as a going concern. In any event, great care must be taken.

What is a franchise?

It is a method of doing business through the marketing of goods and services where a person known as the franchisor who owns the name and/or the idea, secret process or equipment together with the goodwill and know-how associated with it, consents (by way of franchise or licence) to another person (“franchisee”) exploiting the name, idea, process or equipment and the goodwill in return for payment by the franchisee of an initial (“one off”) franchise fee and a continuing royalty (usually a proportion of the gross sales of the business). The franchisor also usually undertakes to provide “back-up” support, advertising and promotion of the system/brand. In addition and depending on the nature of the franchise, the franchisee may be required to purchase the fitout of the business, stock in trade, equipment, tools and machinery. The degree of capital payment is of course dependent on the nature of the business.

The term “franchise” usually means a “business format franchise” which is a franchise where an entire ready-made business format is available.

Look for a system that works

A successful franchise system is one which usually incorporates a documented business format that “works” and before signing any agreement you should speak with as many existing and former franchisees of the system as you can to find out any problems

In a well run franchise system there is a mutual interest between the franchisor and the franchisees because if the franchisees do well (i.e. by increasing gross sales) then the franchisor also does well through increased royalties.

Be the right person for the business

The purchaser must realise that the selling agent is usually retained by the vendor and is attempting to sell the business for his client. He has a vested interest in seeing the deal come to fruition. A selling agent experienced in selling franchised businesses would know of the necessity of obtaining the franchisor’s consent to a proposed sale and be less likely to solicit offers from proposed purchasers who are unlikely to meet the franchisor’s requirements. Notwithstanding this before signing any agreement you should meet with the franchisor to satisfy yourself that you have the type of personality, skills and experience needed for the business.

Bank Barometer

To be able to offer facilities banks specialised in franchise lending have been (and continue) to benchmark the performance of various franchise systems.

The confidence of a banker in a franchise system is shown by the extent (ratio of the loan to the price) to which it is prepared to lend at usual rates of interest on the purchase of an outlet and taking the assets of the business as security.

Upfront Information

The Franchise Association of New Zealand Incorporated (“FANZ”) is an association which franchisors may join subject to meeting its requirements. Whilst membership of FANZ is not to be taken as a guarantee of a particular standard, practice has shown that the more established and professional franchisors tend to be members of FANZ. It is a requirement of FANZ that prior to signature of a franchise agreement the franchisor must have given the proposed franchisee a Disclosure Document which should provide:

- Identifying data of the franchisor.
- Full details of the directors’ and key executives’ previous business experience and show a good record.
- The franchisor company’s track record inter alia containing the rate at which franchises have been granted and performance results.
- A full understandable description of the franchise.
- A clear indication of the total initial investment required including working capital.
- A clear description of the money/payments that will become due and payable to the franchisor from time to time.
- Such help that the franchisor may be able to give in introducing the franchisee to sources of finance and particularly institutions that have financed the purchase of other franchises in the system.
- The extent to which the franchisee will be restricted from carrying on any other business.
- The extent to which the franchisee is obliged to be present and personally work the business.
- The length of term of the Agreement together with rights of renewal if any (and if renewal will involve a payment of a renewal fee).
- The franchisor’s right to select or oblige the franchisee to operate from sites approved by the franchisor.

- The amount of training and back up and support that will be provided to the franchisee and whether payment for such training is included in the initial purchase price or in addition to it, and the extent of ongoing backup from the franchisor.
- Documentation explaining and evidencing (i.e. third party statements) the value and appeal of the product or service comprising the franchise.
- Uptodate accounts of the franchisor (showing a healthy financial situation hopefully).
- Number, name and contact details of franchisees within the franchise system and confirmation that it is permitted to discuss about any aspect of the business and with a view to obtaining an honest and thorough explanation from existing franchisees.

If the franchisor is not a member of FANZ and does not provide the above information you should nevertheless ask for it and vet the information thoroughly.

Take Legal Advice

It is very important if you are buying a business whether it be franchised or non-franchised to engage the services of an accountant and an experienced lawyer, and Clive Neifeld and Stewart Germann of Stewart Germann Law Office are here to assist you. Once an agreement is signed it is too late to go back and negotiate missing provisions or required protections. SGL is a member of FANZ and adheres to the New Zealand Franchising Code of Practice. SGL is a boutique business firm providing friendly service and expert advice and you should visit www.germann.co.nz.

