



CAPSTONE
FRANCHISE CONSULTING

FDD Guide

Every Franchise Disclosure Document (FDD) is organized into the 23 Items below.

ITEM 1

THE FRANCHISE COMPANY

This is an overview of the history, ownership and corporate family of the franchisor, including the types of franchises offered. This section will also include information related to any special licenses or permits necessary to operate a business of this type. A company overview that is not clear or readable may be a red flag. You should be able to get an accurate picture of the organization here without significant effort.

ITEM 2

BUSINESS EXPERIENCE OF FRANCHISE EXECUTIVES

This item provides information related to the executive of the franchise system and their experience. Gaining knowledge of the franchisor's leadership is crucial. Look for a solid group with experience in the industry and franchising.

ITEM 3

LITIGATION

This item lets you know about any litigation involving the company and its principals and directors. It notifies you of potential claims against the franchisor, as well as whether it has filed suits against any entities, including lawsuits filed against franchisees. We live in a somewhat litigious world, and many businesses will be a party to a lawsuit at some point in their history. A company that is frequently the plaintiff or defendant in legal disputes with franchisees may be a red flag. The best franchisors are able to resolve disputes with franchisees without resorting to legal action.

ITEM 4

BANKRUPTCY

It's most likely that you already discovered that a franchisor is in bankruptcy prior to receiving the FDD, but that information must be disclosed in this section. Any officer or director who has a personal bankruptcy, or was previously involved in a bankrupt franchisor, also must be listed.



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ITEMS 5, 6 and 7

INITIAL FEES, OTHER FEES AND INITIAL INVESTMENT

Item 5 is an overview of the initial fees required to open your franchise. The largest component of Initial Fees is most commonly the Franchise Fee. Initial Fees may also include technology or training fees.

Item 6 is a chart of other fees, including royalty and advertising fees, which you will be required to pay on an ongoing basis. Be aware that not all fees are listed here, including the cost of products and inventory.

Item 7 lays out the expenses you may expect to incur prior to opening the franchise and the working capital needed for the “initial period” of operation. This “initial period” estimate commonly includes three months of working capital as part of Item 7. Franchisees can get into trouble when they are undercapitalized. Do not assume that the working capital listed in Item 7 is sufficient to sustain your business until you start making money. When you complete your franchisee validation calls, be sure to ask other franchisees how long it took them to break even. Review these items with an accountant before signing a franchise agreement.

ITEM 8

RESTRICTIONS ON SOURCES OF PRODUCTS AND SERVICES

The franchisor has a vested interest in knowing that the products and services you are utilizing or selling meet its standards. To ensure that, the company may sell you products itself or insist you use designated suppliers. Watch out for franchisors who are getting large rebates from suppliers. The best franchisors will use the purchasing power of a large system to negotiate favorable rates on products and services purchased by the franchisees. Ask current franchisees if they feel the prices they pay for designated products are fair.

ITEM 9

FRANCHISEE'S OBLIGATIONS

Here you will find a list of your contractual obligations with cross-references to the franchise agreement and the rest of the FDD. Item 9 allows you to see each obligation and then review the language contained in the actual franchise agreement. Item 9 descriptions that are not consistent with the franchise agreement are red flags.



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ITEM 10 FINANCING

The franchisor will disclose whether it offers a lending program, or whether the franchisor has agreements with lenders who have agreed to help finance its franchisees. The item also discloses any financial relationship the outside lender has with the franchisor. Remember that borrowing from your franchisor is no different from borrowing from a bank. If you default, the franchisor may be able to terminate your franchise agreement.

ITEM 11 FRANCHISOR'S ASSISTANCE, ADVERTISING, COMPUTER SYSTEMS AND TRAINING

This item outlines the content and scope of the franchisor's support services. Be alert to qualifying words such as "at our discretion" or "as needed," and know that you cannot count on receiving those services. Look carefully to see how much of your required advertising fees actually get spent on advertising and how much can be siphoned off into uses that mainly benefit the franchisor. Also note if franchisees are involved in managing the national marketing fund and program. During your franchisee validation, ask franchisees about the quality of the training and support they have received.

ITEM 12 TERRITORY

Whether you need a protected territory depends on the nature of the business. The franchisee of a retail outlet wants to know that another unit cannot open within a certain radius; a service business might require five to 10 franchisees in a geographic area. Be aware that any territorial protection lasts only for the duration of your franchise agreement, and the franchisor has the flexibility to change it when you renew your contract. Watch out for retail franchises that provide no geographic protection.



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ITEMS 13 and 14

TRADEMARKS AND PATENTS, COPYRIGHTS AND PROPRIETARY INFORMATION

These straightforward items list the trademark and copyright registrations the franchisor has obtained. Watch out for a trademark that is not registered, as it is in your best interest that the brand be protected.

ITEM 15

OBLIGATION TO PARTICIPATE IN THE ACTUAL OPERATION OF THE FRANCHISE BUSINESS

Franchisors want to be sure franchisees are devoting full time and effort to running each location. Some franchises require franchisees to run the business themselves; others allow them to be passive owners and hire someone else to manage day-to-day operations.

ITEM 16

RESTRICTIONS ON WHAT THE FRANCHISEE MAY SELL

This item lets you know that you can sell only what the franchisor allows. Watch out for franchisors whose product offerings are too limited.

ITEM 17

RENEWAL, TERMINATION, TRANSFER AND DISPUTE RESOLUTION

This chart provides a summary of the franchise relationship to the franchisee, with cross-references to the franchise agreement, showing terms of termination and renewal and stating where and how disputes will be resolved. In franchising, you do not have a right to renew. Instead, you will commonly have a right of first refusal on a new contract which may contain higher royalties and other charges. When signing your first contract, try to perpetuate as many financial conditions into the renewal contract as you can.

ITEM 18

PUBLIC FIGURES

This is relevant only if you are buying into the less than 1 percent of franchise systems that use public figures in their advertising.



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ITEM 19

FINANCIAL PERFORMANCE REPRESENTATIONS

Item 19 is the only section of the FDD that is optional for franchisors. At this time, approximately 60 percent of franchisors provide information regarding the financial performance of the franchise system or some portion of the system. Please note that franchisors have a fair amount of latitude with regards to what data they include as the Financial Performance Representations (“FPR”) in Item 19, however, they must be very clear about which stores are being measured and how they are being measured. Examine the footnotes carefully to understand the basis of the FPR in Item 19 if a franchisor chooses to include one. Be sure to understand what proportion of franchisees exceed the averages reported in the Item 19. Finally, always validate the information through phone calls with current franchisees. Ultimately, franchisee validation will be your single best resource to gain an understating of potential earnings.

ITEM 20

OUTLETS AND FRANCHISE INFORMATION

These charts show the number of franchises that have opened, transferred and closed in the last three years. These data allow you to determine if the system is growing or shrinking as well as the continuity rate of franchisees currently in the system. Item 20 also contains a list of current and former franchisees. Perhaps the most critical part of your due diligence will be contacting several current (and perhaps even some former) franchisees get an independent perspective on the health of the system.

ITEM 21

FINANCIAL STATEMENTS

Financial statements will most commonly be included as an attachment to the FDD. These audited statements let you know if the franchisor is stable. You may need an accountant to determine whether the current ratio of assets to liabilities is favorable and how the franchisor accounts for deferred revenue. Be sure to read the footnotes. Watch out for franchisors who earn most of their money from franchise sales. The best franchisors are recurring revenue self-sufficient on the basis of royalty payments.

