Buying a Franchise?
What It's Worth To You

If you are considering entering the world of franchising, an important consideration is assessing the value of the business. All of the following factors either affect or help determine valuations of typical franchise operations:

1. Franchise Agreements: Typically, franchise agreements can cover a period of twenty years; sometimes with added options. In most situations where a franchise unit has fewer than ten years remaining on the agreement (and options, if any), the value would diminish proportionately.

2. Territory Exclusivity: Many franchisors do not, as a matter of course, provide an "exclusive" to franchisees within a given territory. More commonly, however, the franchisor will offer a franchisee limited protection for five years, during which time only he or she will be allowed to expand operation to additional units. Even limited protection can be assigned some value; any current territorial rights may have additional -- and significant -- value.

3. Business Hours: Potential franchisees should consider operating hours when assessing the value of a business. Business in general, and franchise operations in particular, are staying open for increasingly longer periods -- some operate 24 hours a day, seven days a week. Locations in certain areas -- city centers, bus stations, train depots -- may open for shorter hours and fewer days. Since most business owners/managers would prefer the less demanding hours of operation, a premium value will be placed on these units.

4. Location: This is the most obvious variable. A franchise operation in a suburban or small-town setting has a higher value than one in an inner-city or high-crime-rate area, regardless of other similarities (rent, sales volume, etc.).

5. Cash Flow: Surprisingly, profitability may not necessarily be the key factor in valuing a franchise operation. A demonstrated, well-documented cash flow can definitely add value to the unit; however, the smart buyer will also look at other variables, such as unusually low food cost or labor costs, sales history, and potential for growth or improvement under new management in determining the overall value. Extreme situations provide the obvious exceptions to importance of cash flow: where the cash flow is extraordinarily high, capitalization of earnings becomes a truer method of valuation; case where the franchise is actually losing money due to inefficient management, would indicate some reduction in value.

6. Leases: Taking into consideration market variation, the typical rent will be set at approximately ten percent of retail sales. Modifications in value could result if the lease does not cover a period of at least ten years.

7. Remodeling: Many franchise agreements will require units to be refurbished within a certain number of years (ten is typical), with the franchisee bearing the cost. Since these costs typically fall within a range from $75,000 to $150,000, potential franchisees should pay particular attention to where the operation stands on this timeline. For example, a unit due for remodeling in a year or less could be reduced in value by a fair percentage of the cost of the improvements. The total cost would not be deducted from the value, since these improvements would also be expected to improve business anywhere from five to twenty-five percent.