

# **Sample Due Diligence Questions**

**for use by prospective franchisees**

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## Introduction

The list of questions below should be used as part of your Due Diligence and before signing a Franchise Agreement. They are based on the information that Franchisors in regulated markets are required to provide potential franchisees as part of their disclosure process. As such, you should not be afraid to ask these questions. Please read my blog <https://wordpress.com/post/theperilsoffranchising.com/442> where I outline 5 simple steps you should follow as part of your due diligence and how these Due Diligence questions fit into that process.

## Training and support

- Will the initial **Training and support**, that the franchise fee funds, deliver everything needed to get the franchise up and running?
- **Where and when** will the training take place?
- What commitment does the Franchisor make regarding **ongoing support and any refresher training** and is this covered by commission payments?

*Why it matters* - One of the reasons why anyone would invest in a franchise is to get access to the training and support provided by a Franchisor and therefore it is important that you ensure the training and support, both initially and ongoing, is going to be sufficient for your needs. When meeting with existing franchisees it is important to check that their actual experiences are in line with the commitments made by the Franchisor. This is a useful article by a Franchisor about what to expect when it comes to support. <https://elitefranchisemagazine.co.uk/analysis/item/franchise-support-what-a-franchisee-should-and-should-not-expect-from-their-franchisor>

## Franchisee investment required

- What are the **initial investments** (e.g. training expenses, leasing costs, inventory requirements etc.) that you are likely to incur before your franchise opens for business?
- What are the **ongoing commitments**, such as commissions, royalties and advertising, that are required during the lifetime of the agreement. Are these costs should clearly specified in the Franchise Agreement?
- What is the **low and high estimates** for each cost item (so that you can do a resilience analysis to understand the impact on the bottom line and therefore cash required under various scenarios)?

*Why it matters* - In all regulated markets, Franchisors are required to specify every cost in detail before franchisees sign so that there are no surprises. There is no such requirement in the U.K. so you need to get estimates in writing from the Franchisor. Working Capital (WC) tends to be the real killer for franchisees, especially in the early days. Franchisors frequently underestimate the amount of WC required whilst getting the business off the ground. Experience has shown that Franchisees should budget for 50% more than the Franchisor suggests - see attached post [https://www.linkedin.com/posts/tim-michaels\\_item7-franchises-franx-activity-7249752859288739840-2nVU?utm\\_source=share&utm\\_medium=member\\_ios](https://www.linkedin.com/posts/tim-michaels_item7-franchises-franx-activity-7249752859288739840-2nVU?utm_source=share&utm_medium=member_ios)

## Franchisee turnover a.k.a. 'Churn rate'

- **What is the Franchisee turnover** for the franchise for the last 5 years? i.e. how many franchisees have come and gone each year and what were the reasons for this?
- What is the **renewal rate for franchisees** and for those that do not renew, what are the reasons why they don't?

*Why it matters* - This data shows you by how much the franchise has grown or shrunk over the previous years and a rough idea why people are not renewing which then provides a good proxy for the health of the franchise.

## Dispute resolution and Litigation history

- How does the Franchisor deal with any **breaches of the Franchise Agreement**?
- How many franchisees are **currently in dispute** with the Franchisor?
- Over the last 5 years how many franchisees in each year have ended up in **litigation** with the Franchisor and what were the reasons for this?
- How many of these cases ended up with the **Franchise Agreement being terminated**?

*Why it matters* - There is little or no visibility of any litigation and Franchisee failures in the U.K. because of the use of liquidated damages clauses in conjunction with NDAs. All regulated markets require this information to be provided so don't be afraid to ask for it in writing from the Franchisor.

## Franchisee contacts

- Please provide contact details of all **current and past franchisees** so that they can be contacted to understand and learn from their experiences

*Why it matters* - Franchisors have their 'favourite' franchisees that are also likely to be one of their better performing franchisees so ask for a full list of current and past franchisees and contact as many as you feel you need to. Don't be fooled when the Franchisor uses the GDPR card to avoid providing this data as it is 100% in their power to agree this with current and past franchisees.

## Franchisee profitability

- What is the **average profitability** of a franchise **by length of service**?
- What is the **low and high profitability** of a franchise **by length of service**?
- How does the Franchisor handle franchisees that are **struggling**?
- What are the financial projections for **new franchisees**?

*Why it matters* - you need to make a return on your investment over the term of your agreement and this includes being able to pay yourself and anyone else involved a salary (or more likely dividends) for the work you do. As well as understanding the numbers, you also need to know this based on the length of service as the longer a franchisee is in existence theoretically the more the franchisee should be making. It is also very useful to understand the figures in early years to see whether you will be able to survive personally with the money you have available to invest.

NB. The vast majority of small businesses, including franchisees, only take the minimum salary required to get NI credits and therefore it is critical that you understand any profit (or losses!) will need to cover your salary, otherwise you will be working for nought!

Ask yourself these questions about your financial investment (from [post](#) by Peter Knight on LinkedIn)

- Will I get my money back and if so how long will it take?
- What return will I get on my money?
- If I invested those funds elsewhere, could I get a better return?
- What happens to my investment at the end of the franchise term?
- If I wasn't going to work in this business, would I invest in it?

People buy franchises for many different reasons. Lifestyle, earning potential, to be their own boss to name a few. But it's always important to be financially discerning and consider carefully the amount of money you're about to invest.

### Product and service provision and pricing

- Which products or services is the franchisee **required to procure** through the Franchisor
- Is there any **flexibility** on these procurement arrangements?
- Does the Franchisor receive **discounts/rebates/kickbacks** from the supplier and if so are these passed onto franchisees in FULL as the BFA (@j advises? Is the Franchisor completely transparent about this?
- Does the Franchisor provide any assurance regarding the **competitiveness** of their pricing to franchisees as the BFA (@) advises?

*Why it matters* - You want to avoid a situation where you have no control over your purchase costs and worse still you are contractually obliged to buy your products at uncompetitive prices.

### Culture and values

- Does the Franchisor provide any **statement** regarding its culture and core values.
- What **processes** does the Franchisor have in place to ensure alignment with the culture and values?
- Do you carry out any engagement **surveys** with employees or franchisees, and if so please can you share the results?

*Why it matters* - investing in a franchise where the culture and values are toxic and / or are not aligned with your own will likely result in you wanting out but because of the Franchise Agreement and the draconian liquidated damages, this may not always be possible and even if it is, it may be prohibitively expensive. As part of any 'Go See' or 'Day in the life of' with existing franchisees, it is imperative that any prospective franchisee tests the 'mood' music.

### Franchisor financial health

- Request copies of the last three years **financial statements**
- Request details of the franchise's **strategy** going forward

*Why it matters* - The financial stability of the franchisor is essential for ongoing support and brand development and is especially important in the food industry where investments required are much higher.

### Brand recognition and reputation

- Has the Franchisor carried out any **market research** regarding the brand and if so, ask the Franchisor to share it.
- Does the Franchisor use **Net Promotor Score (NPS)** to measure customer loyalty and if so ask the Franchisor to share the results?
- Does the Franchisor do any other analysis to understand the **strength of the brand** and if so, ask the Franchisor to share it.

*Why it matters* - The strength and reputation of the franchise brand are crucial factors. Prospective franchisees should assess how well-known and respected the brand is in the market. Understanding customer perception of the brand is essential, as it can significantly influence business success. Investigating any recent controversies or negative press is also important to gauge potential challenges.

You should question yourself whether it is worth investing in a brand that either has low brand awareness and / or is perceived poorly by its consumers.

## **Franchise ownership and strategy**

- Does the Franchisor have any plans to **change strategy or direction?**
- Do the overall owners of the franchise have any **intention of selling the business?**

*Why it matters* - a change in ownership or strategy/direction could have a massive impact on the Franchisor / Franchisee relationship which could fundamentally change something as simple as product pricing or commission payments to franchisees which would then massively impact franchisee margins.

## **The Franchise agreement**

The Franchise Agreement outlines the **terms and conditions of the relationship between the Franchisor and Franchisee**. It is highly advisable that you get legal advice to understand any implications of the various terms and obligations with particular focus on the aforementioned items but also the terms for renewal or termination. It is imperative that you understand the absolute worst case scenario, especially any liquidated damages clauses in the case of early termination, because your livelihoods could be on the line.

The results of your analysis and any legal advice should result in lots of questions and clarifications about the Franchise Agreement

*Why it matters* - As attractive as a franchise may appear on paper, Franchise Agreements are very one sided with most of the obligations on the Franchisees and therefore it is imperative that you understand the implications if things do not work out as expected. Because of the lack of regulation in the U.K. marketplace and the extensive use of NDAs by Franchisors, the true level of franchisee failures are not visible.

## **Other agreements**

Depending on the franchise, there may be other critical agreements, such as a property lease agreement, that need signing at the same time as the franchise agreement. The same diligence is required with these agreements as with the Franchise Agreement. You may also need input from other specialist advisers such as a property expert.