

Start A Business From Scratch Or Buy A Franchise?

Evaluation Guide

By

**Jeff Williams
Bizstarters.com**

Welcome to the “Start a Business From Scratch Or Buy A Franchise?” Guide.

We’ve designed this guide for use by anyone considering whether to turn their own idea into a great business, or buy into someone else’s business model through franchise purchase.

We detail for each of these two entrepreneurial paths, the insider background information you need, as well as the pros and cons of each method and our suggested first steps to take to carefully examine each path.

Let’s get started.

Option 1 – Purchase a Franchise

Background

There are currently more than 250,000 franchised businesses operating in the U.S. in more than 70 Industries.

With so many different types of business being offered, it can be confusing to sort through what’s available.

There is a very useful resource you can use to organize your search for a starting point in examining a franchise purchase - The Entrepreneur Magazine “Top 500 Franchises” issue available at www.entrepreneur.com

The magazine uses a specially concocted formula for rating the rank of each franchise. The formula includes such factors as:

- Financial strength and stability
- Growth rate and size of system
- Number of years the franchiser has been in business
- Start-Up costs

For 2008, the top 10 franchise operations as selected by Entrepreneur magazine are (I've included the range of start-up costs for each):

Ranking	Franchise Name	Start-Up Cost Range
1	Subway	\$70k - \$220k
2	Quiznos	\$72k - \$251k
3	Curves	\$38k - \$53k
4	UPS Store	\$161k - \$267k
5	Jackson-Hewitt Tax Service	\$49k - \$94k
6	Dunkin Donuts	\$179k - \$1.5 million
7	Jani-King	\$11k - \$43k
8	RE-MAX	\$20k - \$220k
9	7-Eleven	\$100k+
10	Liberty Tax Service	\$42k - \$52k

On to How The System Works



How The System Works

When you purchase a franchised business outlet, you're usually paying for a number of features:

1. **Business systems** that have been tested with multiple outlets for marketing, operations, accounting, etc.

2. **Recognition by the public of the name** of the business (Be aware that this is often a benefit only for the very largest franchise operations, such as McDonalds or Midas Muffler).

The typical franchise system today has fewer than 50 franchise outlets, so ask yourself: "How well known is the business name?"

3. Very specific directions on how **to run each and every detail of the business**.

4. Designated **sources of supplies**.

5. Where necessary, **blueprints for retail layout**, as well as **site selection** assistance.

6. **Training**.

Personality Considerations

When you purchase a franchise, you're taking on a legal business partner – the franchising company.

For as long as you own your franchise, you will be subject to a variety of rules and regulations enforced by them.

Violate the rules too often and you may have your franchise taken away.

Any smart franchiser will tell you during your exploration process that your success with their franchise will come largely as the result of following their business strategy and operational plan...to the "T".

While you are encouraged to use some imagination in running your franchised business, it is expected that you will roll out your new business according to the franchiser's detailed guidelines.

You should carefully consider how you will feel after you invest a good deal of time and money to get your franchised business started and you still must pay a percentage of all of your sales to the franchiser.

You should also be brutally honest with yourself about how independent you really are.

When you look back over your working life, have you shown an ongoing interest in coming up with your own solutions to business problems and then put them into action?

You should be cautious about pursuing the franchise route if:

1. You think you may start to resent paying a perpetual royalty to the franchiser as time goes on and you are relying less and less on them to run your day-to-day business.
2. You really don't like taking orders from others.
3. You like to continually tweak the way you do business.

The Real-World Reality

To end up quite satisfied with the purchase of a franchised business, you need to be aware of a number of realities:

Reality Factor 1 - Franchisers are quite selective in whom they choose.

When you buy a franchise, you are **buying someone else's system** – in most cases based on someone actually running a single unit business, expanding and then franchising. For example, Fred DeLuca, founder of Subway, ran a small local sandwich shop for more than 7 years before attempting to franchise.

You are paying for the details that have already been experimented with and documented. The franchiser, therefore, is very insistent that you follow their system and only their system to run your business. **THEY DICTATE EACH AND EVERY DETAIL. And many of these details can affect your profitability.**

For example, one of my clients recently bought a muffler franchise outlet. Under the terms of the franchise agreement, she is required to have two full-time mechanics on site during all hours the shop is open, regardless of the level of sales coming in.

Reality Factor 2 - Franchise purchase can be quite expensive.

It is not uncommon for the new franchisee to invest \$100,000 or more during the first year in business.

Let's compare two top franchise operations – one a retail food chain and the other professional services.

Quiznos

- 3844 franchise outlets
- \$25,000 franchise fee – Up to total investment of \$250,000
- 7% royalty
- Cash liquidity - \$60,000

Sandler Sales Institute

- 162 franchise outlets
- \$55,000 franchise fee – Up to total investment of \$85,000
- \$1200 per month royalty
- Cash liquidity - \$70,000

Reality Factor 3 - Financing of the franchise purchase is sometimes difficult to obtain.

Some of the larger franchisers have arranged with outside companies to provide some or all of the cost of the franchise purchase.

But with many newer or smaller franchises, you must come up with all of the money to buy the franchise and run it for the first year.

As a result, franchisers often insist upon seeing a detailed personal financial statement from you very early in the process.

If they aren't comfortable with the level of your personal assets, they will often tell you that they cannot go any further with you.

Franchisers are particularly interested in all of the sources of income you have in your household. Just owning a lot of assets is not enough, because they don't all produce income, such as your family home.

And some banks will refuse to grant home equity loans to buy a franchise.

Reality Factor 4 - The number of franchise failures may be underreported.

The Franchising industry claims that only 5% of franchise units fail each year.

But, if you are doing so poorly in your franchise business that you must give it back to the franchiser, it is not considered a failure under their definition.

For example, I know of one quick print franchise outlet that has been bought, taken back and resold at least three times over the past 10 years – each time with a substantial franchise fee.

Reality Factor 5 - You must check out the financial strength of the franchise company.

The American Association of Franchisees & Dealers estimates that 15% of franchisers go out of business each year.

That means that in any given five-year period, up to 75% of franchisers disappear.

Reality Factor 6 - You may be paying for something you're really not receiving.

Particularly for retail franchises, you're told that one of the benefits you are buying is that people already know the name of the business.

But there are dozens of new franchised businesses brought to the marketplace each year. Many will never grow beyond 100-200 outlets. At this size of operation, is the brand name really that well known?

Reality Factor 7- Franchisers are looking for managers, not entrepreneurs.

The strength of the franchising system in America is that you can buy someone else's hard-won experience from day one of your business.

And you enter into an ironclad legal agreement that specifies exactly how you will run the business...and the penalties if you don't follow the agreement.

Because a franchiser's strength is a reliably reproducible system, franchisers don't want new owners who will try to innovate the system, try to change key parts or suddenly create their own plan to market the business.

The Pros And Cons Of Franchise Purchase

Pros	Cons
You start off with operational steps that have been tested.	It is often costs as much or more to buy a franchise as it did to buy your house.
You usually receive ongoing management support.	You have little freedom to try out new ideas or customize the business process.
You may gain instant name recognition for your business.	More franchises fail than the industry says.
You can make a fairly predictable salary.	You can lose your business for violating the Franchise Agreement.
You often have other similar business owners to discuss problems with.	It may be difficult to sell your business for a profit when you are ready to do so.

How to Proceed

I recommend the following preliminary steps to move ahead with your interest in purchasing a franchised business:

1. Visit <http://www.entrepreneur.com> and click on the “Franchise Zone” at the bottom right-hand of their homepage. This area permits you to search either lists of franchises or for information on a specific franchise.
2. Once you’ve found one or more franchises that seem to interest you on paper, visit <http://www.franchisebusinessreview.com> to see if they list survey results among owners of the franchise you’re inquiring about.
3. If after identifying one or more franchise opportunities and carefully considering the pros and cons I spoke about you want to move to the next step, contact a franchise purchase consultant to request an in-person consultation. There are three primary companies providing this service:
 - Frannet – <http://www.frannet.com>
 - FranChoice – <http://www.franchoice.com>
 - The Entrepreneur’s Source – <http://www.theesource.com/>

Option 2 – Start A Business From Scratch

Background

Here are some facts about self-employment in America:

1. At any given time about 1 in 25 adults are taking concrete steps to create a business in the U.S.
2. Each year, between 3-4 million new businesses are started. 75% are started from scratch.
3. Around 30% of new businesses start with more than one active owner.
4. Most new businesses are tiny, however more than 800,000 employ people.
5. 4 out 5 new businesses reach their first birthday. 40% survive through their fifth year in business.
6. The National Federation of Independent Business estimates that over the lifetime of a business started from scratch, 39% are profitable, 30% break-even and 30% lose money.
7. Small-business owners are older and better educated than is the general population.
In fact, people who are age 50 or older own more than half of all small businesses.
8. Just over 42% of full-time small business owners have annual earnings of \$40,000 or more (about 2 out of 5).

On to How The Process Works



How Starting A Business From Scratch Works

In a franchised business, the basic business idea was conceptualized and tested vigorously some time ago.

You are often buying into the business development process long after the concept has been shown to be a moneymaker.

When you start a business from scratch, you must put together by yourself, or with a partner, the following business development steps:

Step 1. You must identify a business concept that:

- You will enjoy, are very good at doing, and which you know how to do.
- For which you can demonstrate enough customer demand to provide a nice income for you and your family.
- You can figure out how to run with little or no immediate staff, but still grow substantially should you wish to do this.
- Can be started for an initial investment that is an amount you can afford to lose without bankrupting yourself.

Step 2. You must build an operations system that will permit your company to grow while still providing the same excellent customer service it provided during its first year in business.

Step 3. You must create a support team, usually of independent contactors, to make each hour worked as productive as possible.

Step 4. You must manage your money wisely, using a disciplined combination of automated record keeping and a sharp eye for bargains.

Step 5. You must carefully craft a marketing strategy that clearly communicates the competitive value added you offer to potential customers, and which is based on highly profitable pricing.

Step 6. You must research a wide variety of promotional activities, carefully experiment with them to find the most profitable ones, and then have the courage to do a whole lot more of the winners and get rid of the losers.

Personality Considerations

As you've seen in our discussion of franchising, you're making a very considerable trade-off when you buy a franchised business.

You are giving up operational freedom, the chance to think up and enact totally new business processes as you need them and a chunk of your company's sales for as long as you continue to own the franchise.

When you start a business from scratch, you conceptualize, plan and implement every little detail of the business and how it will be run.

There can be certain circumstances in your life that make you feel that you do not want to take on this heavy of an entrepreneurial burden.

But, for others of us, the freedom to run your business exactly as you wish is exhilarating.

It is estimated that more than 70% of new businesses launched in the U.S. are started from scratch. So, there is obviously something very attractive.

In fact, each year INC magazine publishes its **INC 500 list**, which details the 500 fastest growing privately held companies in the U.S.

At one time, Gateway Computer was at the top of the INC 500 list.

According to the INC magazine editors, the typical INC 500 CEO started his or her business with less than \$50,000, many with less than \$10,000 in cash.

The Real-World Reality

It has been incorrectly reported in the business press that 80% of businesses fail within the first couple of years.

In fact, the National Federation for Independent Business conducts an annual survey on business survival and has found that 4 out of 5 new businesses survive for at least two years. Unfortunately, there is a big difference between surviving and thriving in your own business.

The financial standard I use with my clients is to use their profit formula to see how many sales it will take to achieve a first level of \$50,000 in personal income.

Let me share the story of one of my coaching clients to illustrate what it takes to do this:

>>>> YOU MAY WANT TO TAKE OUT A PIECE OF PAPER HERE TO DO YOUR OWN CALCULATION

Case Study: A Consultancy

John is an expert in health and safety issues faced by large manufacturing companies.

He runs his consulting company from home, with himself as the sole employee, although his wife does pitch in regularly to help him with tasks and he uses outside service providers as needed.

Because he does not pay rent for office space (and extra utility costs), John's monthly business expenses, other than his salary, run around \$600 (his travel is reimbursed by his clients).

John has more than 25 years of experience in his specialty, and so feels comfortable charging \$100 per hour on consulting assignments.

If his goal is to make a \$80,000 salary and he has annual business expenses of around \$8,000, then he needs to produce around \$90,000 in consulting revenue to cover salary and other expenses.

If you divide the \$90,000 sales figure by his hourly consulting fee of \$100, John must deliver 900 hours of consultations per year, or around 17 hours of client work per week. This equals approximately 2 ¼ days of billable consulting each week for a year.

The Pros And Cons of A Scratch Start-Up

Pros	Cons
You can often launch your business for much less than \$50,000.	It can take 2 years or longer to grow your sales to the point where you can pay yourself a corporate-like salary.
You create your own business model and run it as you wish.	It often takes months of planning and a year or more of operations to perfect the revenue generation of your business model.
As changes in your business model are needed, you can quickly make them.	Particularly if you are working by yourself, you may not notice the need for change as quickly as you should.
If you wish, you can reap all of the profit from your business.	If you wish, you can reap all of the profit from your business.
If you wish, you can reap all of the profit from your business	It can sometimes be hard to discipline yourself to regularly re-invest in your business, rather than taking all your profit as salary.
Most of the firms in the INC 500 started as one or two-person operations.	To get on the INC 500 list, very often requires that you find a very lucrative strategic partnership with a larger company.
It is widely accepted for businesses to be based at home today.	It can be lonely working by yourself at home.

How To Proceed

Starting a business from scratch is, by its nature, a very individualized process.

So, we're not going to suggest here that there is any perfect length of time necessary to plan and launch a new business.

We've helped some clients launch in 5 weeks or less, and others have taken more than a year to open for business.

Here are the key first steps on the path to launching a great business:

Step 1. Make a preliminary identification of one or two potential business concepts that match the following criteria:

- You will enjoy running the style of business that results from the concept.
- You are honestly talented at performing the key operational steps of the business.
- The money required to run the business for the first-year is in a realistic financial range for you.
- The business promises the potential to provide a salary that will be competitive with the corporate world.

Step 2. For each concept you want to seriously explore, complete a short feasibility study, before investing significant time and money.

Use your experience and research where necessary to determine the following factors:

- Start-up costs and operating expenses for your first year in business.
- Dollar amount of a typical transaction and dollars of profit on a typical transaction.
- Evaluation of your most immediate competition – what do you have to do with your new business to better and different from them?

Step 3. Contact Jeff Williams at jeff@bizstaters.com to discuss your exact needs, such as:

- Preliminary assessment of whether self-employment is right for you.
- Help in identifying and evaluating a business concept that is well matched to your personality, your desired lifestyle and your financial goal.
- Creation and implementation of a well-thought-out business launch plan.