

Use This Checklist to Avoid Buying a 'Zombie' Franchise

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"Zombie franchises" are out there. What is a zombie franchise? It's one that has stalled out but still markets its franchise opportunity as if nothing is wrong. The brand is typically shrinking in both relevance and the number of open units. Previously loyal customers are being siphoned away by more innovative concepts. Underlying demographics may have shifted. Market trends may be working against the brand, but management hasn't created a new path. Unit-level economics are weakening. Management inertia or denial may compound the brand's problems.

Zombie franchise systems are usually filled with franchisees who would gladly exit if only they could! Poor unit-level economics and an undercurrent of franchisee discontent scare away buyers, so resale volumes are low. Expansion-minded franchisees look outside the brand.

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Don't get trapped

New franchisees who miss the signals eventually realize their mistake. They may feel disclosures were inadequate or misleading. They often look back on conversations with franchisees and wonder how they didn't hear the negative feedback. They may remember sunny conversations with consultants/brokers and the corporate team and feel duped. Or

perhaps corporate is truly out of touch and doesn't even realize there is a problem! All of this destroys franchisee trust and usually the relationship.

Franchisees in a zombie system are typically shackled to the business with personal guarantees, a site lease, equipment or vehicle leases, a Small Business Administration (SBA) loan, a loan against their home, a loan against their investments or 401(k) or loans to family and friends. The long-suffering franchisee can't hire enough help because they can't afford it, can't sell the business and can't close it down. They are essentially indentured servants.

Often these brands spend significant money on branding and advertising to try to convince potential franchisees that they are still worthy of investment. They try to reinvigorate franchise unit sales, but not the underlying business.

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20 signs of a zombie franchise

You're too smart to get pulled into a weak franchise concept. Here is an easy checklist to keep your due diligence on track and avoid zombie franchises. If you're a founder hoping to sell to private equity, PE will screen out brands with these attributes unless they are dedicated turnaround investors, so fixing these issues becomes your to-do list:

1. Lack of unit growth, especially via existing franchisees. Talk to as many franchisees as possible. If they don't want to expand even though the territory is available, I advise moving on.
2. Weak unit-level profitability
3. Unfulfilled development agreements. Franchisees would rather lose their deposits than follow through and open promised units. Item 20 in the Franchise Disclosure

Document lists franchisees and holders of development agreements. Connect with those franchises.

4. Corporate parent overly dependent on selling franchises. Look at how much revenue is related to franchise fees compared to recurring royalty revenues.
5. Corporate parent putting more attention on supply chain and rebates to drive revenue, again usually a signal of falling recurring royalties. Murky disclosures about rebates and supply chain costs to franchisees should also encourage you to move on to other concepts.
6. Bloated sold not open (SNO) funnel or SNO numbers that are quietly adjusted from year to year due to weak unit openings. Google prior year press releases and industry articles. Was management bragging about "400 units sold" five years ago but only 50 units are open, and the rest are still sitting in the Item 20 sold not open list? Red flag.
7. An increasing number of poorly performing franchises. Again, it is worth the time to track down old disclosures so you can compare several years of unit-level performance. How resilient is the concept? Are trends positive?
8. The franchise stops publishing Item 19 earnings representations when Item 19s were routinely included in prior disclosures.
9. Increased franchisee litigation
10. Franchisees who want to sell before the expiration of their first license agreement.
11. Prospective franchisees drop out after considering resale options.
12. Franchisee discontent spills onto internet sites

dedicated to publishing stories from unhappy franchisees.

13. During validation, you discover that franchisees aren't following the system. They have developed "hacks" to improve profitability.
14. Poor franchisee validation, poor franchisee surveys or other signals of a dysfunctional franchisee-franchisor relationship.
15. Shrinking candidate funnel
16. Weakening customer interest; falling market share.
17. Corporate team turnover, especially among field support (they are the staffers working most closely with potentially unhappy franchisees). Do franchisees provide positive grades on management team performance?
18. Do you see danger signs but management seems to be in denial? Complacent? Blaming franchisees? Has anyone from the corporate team ever left to become a franchisee themselves? Why not?
19. Is there evidence of ongoing investment in innovation to keep the brand relevant? Do franchisees say this is a problem area?
20. Relatively high Small Business Administration (SBA) loan-charge offs. These are lagging indicators due to time but certainly a troubling signal.

Related: What You Really Need to Look for When Considering a Franchise

Is working through the above list work? You bet! You owe it to yourself to conduct thorough due diligence. The above list will save you time, money and headaches. If you see weak

signals, don't waste your time. Just move on. There are many strong, healthy, proven franchise options out there. Be picky and protective of your time and money. Only the worthiest concepts deserve your attention and commitment.

What if you're a franchisor and you recognize troubling signals of your own brand in this list? Start with improving unit-level economics and rebuilding trust and strong communication with your franchisees. Those are the two highest impact areas in any franchise.

Are you interested in eventually selling your franchise business to private equity? Preventing problems in the first place is key. Any whiff of trouble can have a big impact on your deal terms, business valuation and even which investors will take a serious interest in your brand. Once you've stalled out, the bar is raised to prove you're back on track. Remember that most PE investors in franchising want a growth story, not a turnaround project. Are you building a valuable reputation?

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