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Java For You

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Introduction

On a bright and sunny morning in 2011, Jim Miller, Co-Owner and Sue Thompson, Manager of Operations of Java For You, were enjoying their morning java as they reviewed the past quarter's financials. Jim Miller and Kathy Smith opened the coffee shop in 2005 as joint partners, and Sue joined the staff midway through 2006. Generally speaking, the coffee business had been good to them since they opened their doors six years previous. Through the expansion of the business to another location and subsequent closing, they had maintained a solid level of solvency. At that moment, Kathy brought her cup of coffee over to the table with an obvious look of concern on her face. As she approached the table, Jim suspected that he was about to hear what was troubling her.

Before Kathy could even get settled in her chair, she blurted out "I will need to sell off my part of the business". At that point, Jim and Sue had absolutely no idea of what was going on. Kathy proceeded to describe a particularly unsettling trip to the doctor with her husband. The diagnosis was that her husband would no longer able to work in the occupation in which he was trained. It was for these reasons that Kathy felt the need to sell off her portion of the business as soon as possible. As Jim listened to Kathy's explanation, he felt a strong sense of urgency as Kathy and he had built this business together from the ground up.

Background

In 2005 Jim and Kathy had pondered whether a small coffee shop would be sustainable against the industry giants such as Starbucks, Panera and now McDonalds. They wondered what they could offer that would differentiate them from these powerhouses. After all, the United States was the largest coffee consumer in the world (Hoovers, 2012). Was there room in this industry for everyone? They found the answer in Java For You, with a quality product, supreme location and a competitive pricing structure.

Locating themselves near two college campuses seemed a good fit with the ongoing caffeine need of college students. According to the St. Louis University official website, they boast a student population of 13,200 with 8,100 being undergraduates and 5,100 being at the graduate level (2012). Washington University had a student population of 11,967 students with 6,000 being undergraduates and 5,967 being at the graduate level (Washington University official website, 2012). The location of their shop was adjacent to St. Louis University on Lindell Blvd. and a short walk or short drive from Washington University.

Java For You served up a variety of coffee blends which included brewed coffee, Espresso beverages, Frappucino beverages, chocolate beverages, teas and smoothies with unique recipes not shared with their competitors. Additionally, light lunch or dinner items such as salads, wraps, soups and sandwiches were offered. Their entire menu was derived from market research conducted on the two campuses, in which they looked at components including preferred menu choices and pricing based upon the student's perceived value.

The atmosphere in the Lindell Blvd. shop was that of a comfortable home-setting. The shop was split into three sections: one with tables and chairs that resembled your kitchen, another with several couches and a fireplace that resembled your living room, and another with larger tables typically used by students working on group projects. The overall decorating scheme represented both St. Louis University and Washington University with displays from each scattered throughout.

The pricing structure was established at a below-the-market level that appealed to the cost-conscious target market, college students. While the use of organic materials was appealing to this market, the price levels were found to be of greater importance.

The last component of success was in the area of efficient and pleasant service. Both Jim and Kathy agreed that students were looking for efficiency in the level of service. The drive-through and pre-mixing recipes decreased the wait time for students who always seemed to be running late. The ample meeting facilities equipped with wi-fi and ample plug-ins were an added necessity for students who were interested in meeting at their shop. The hours of operation were from 7:00 am until midnight with the greatest volume of traffic in the shop in the latter part of the day and the drive through type of business earlier in the day.

Brookings Drive Expansion
Washington University

Riding high on their 2006 profits of over $7,000 at the Lindell Blvd. location (see Figure 1), the decision was made to open an additional shop located closer to Washington University on Brookings Drive. Unfortunately, they found a solid evening traffic crowd with lukewarm reception for the balance of the day. Due to financial reasons as demonstrated in Figure 1 and Figure 2, this shop was closed in July 2009. After the closing of the Brookings Drive shop, the profit margins once again turned upward with focus ultimately on the original shop on Lindell Blvd.

Competition

This industry was complex as consumer taste and population growth drove demand in the consumer sector and economic growth of businesses drove demand in the commercial sector (Hoovers, 2012). As in many industries, large companies had scale advantages in purchasing, distribution, manufacturing and marketing and small companies had advantages in specialized products and/or serving a local market. Additionally, there was intense competition in the coffee industry from alternate beverage companies such as soft drink, bottled water and juice manufacturers. The main competition for Java For Me in St. Louis, Missouri with respect to the college student target market was Starbucks, Panera and McDonalds.

According to Fortune 500's annual ranking, Starbucks ranked #229 based upon annual revenues (2012). With 17,000 coffee shops in 40 countries offering coffee drinks, food items, roasted beans, coffee accessories and teas, their predominance in the coffee industry was obvious. In 2011, their annual sales peaked at $11,700.4 million (Hoovers, 2012).

Panera Bread took a slightly different approach preferring to focus on the quick casual restaurant business with about 1,550 bakery-cafes in 40 states and Canada (Hoover, 2012). Their main product line was made-to-order sandwiches using a variety of artisan breads. Additionally, they offered soups, salads and gourmet coffees as well as offering its products to-go. Their business model included 660 of its locations being company-operated and the balance run by franchisees.

McDonalds holds the record as the #1 fast-food company based upon sales with more than 33,500 restaurants in 119 countries (Hoovers, 2012). While its popularity began with its Big Macs, Quarter Pounders , Chicken McNuggets and quick service, it had extended its focus to healthier food alternatives and the coffee business. As a matter of fact, before specialty coffee shops, McDonalds was the "best coffee in town". According to Fortune 500 rankings, based upon annual revenues, McDonalds ranked #111 (2012).

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Financial Details

Figure 1. Profit & Loss Statement Summary
(Years 2005-2010)

	2005 #1 only	**2006 #1 only**	**2007 #1**	**2007 #2**	**2008 #1**	**2008 #2**	**2009 #1**	**2009 #2**	**2010 #1 only**
Total Income	290,353	399,421	444,062	152,437	460,564	227,418	426,613	111,821	442,116
Cost of Goods	102,718	148,331	157,805	56,434	166,361	90,867	156,028	41,767	148,297
Gross Profit	**187,635**	**251,090**	**286,257**	**96,003**	**294,203**	**136,551**	**270,585**	**70,054**	**293,819**
Total Advert	5,829	9,135	8,382	4,843	36,797	16,126	29,175	5,001	22,904
Amortization	1,148	1,148	1,148		1,148				
Assoc.Relation	753	148	402	36	1,670	659	1,963		228
Bank Svc	5,391	6,622	6,384	3,585	7,769	2,882	6,996	357	7,652
Christmas Bon		2,100		500					
Computer		293	420	2,264		870	200		
Credit Card							2,071		
Depreciation	21,992	25,296	12,827	12,873	11,136	21,594			16,326
Donations			220		100	1,025	375		
Dues/Subscript	1,373	310	819	395	772	12	1,625	181	1,779
Expense	288								
Insurance	5,796	1,855	4,298	1,937	4,140	3,258	4,248	2,649	2,793
Interest Exp				3,544	233	3,176		2,793	328
Janitorial	980	939	1,199	748	1,046	783	1,467	388	1,631
Legal/Acct	1,360	1,955	2,338	538	1,766	1,766	1,549	1,070	3,947
License/Permit	380	1,099	459	1,050	732	412	747	522	852
Misc.	16,656	272	-2966	2,125	3,051		40	-4262	
Office Supp	1,663	956	581	727	1,184	1,115	480	240	250
Postage/Del		199	58	72				15	
Printing/Repro		335	155						
Promotion			684	61	103	1,000	1,396	103	
Rent	18,079	22,376	24,121	24,857	25,806	35,664	27,547	28,395	21,439
Repairs	2,401	6,389	3,628	2,065	6,521	1,074	4,986	1.291	3,285
Rest. Supplies	3,296	11,202	2,936	8,352	3,234	3,210	886	743	184
Shipping	107	95			391	145	66	41	33
Store Display				260					
Total Taxes		1,898	27,241	2,933	4,833	2,081	1,804	2,290	1,603
Telephone	1,031	1,085	535	177		441		259	
Training/Educ.	1,261	470	49		16	8	1,125	10	124
Travel	1,013	2,438	1,456	1,413	251	710	831	349	844
Utilities	9,534	11,274	14,854	6,664	15,913	10,085	13,528	6,001	14,788
Water filter					605	552	957	644	1,034
Payroll Exp	96,481	134,055	137,486	84,064	113,647	106,776	138,762	35,508	147,578
TOTAL EXP	**196,811**	**243,944**	**244,292**	**166,083**	**242,864**	**215,424**	**242,824**	**84,588**	**249,602**
Net Ordinary Income	**-9,176**	**7,146**	**41,965**	**-70,080**	**51,339**	**-78,873**	**27,761**	**-14,534**	**44,217**
Net Other Income/Exp.	-743	146	278	147	-862	-1,364	-563	4,352	-5,872
NET INCOME	**-9,919**	**7,292**	**42,243**	**-69,933**	**50,477**	**-80,237**	**27,198**	**-10,182**	**38,345**

Notes: All figures rounded to nearest dollar
Fiscal year = calendar year

Source: Java For You Financial Reports (2011)

#1: Original shop on Lindell Blvd. located adjacent to St. Louis University
#2: Second shop on Brookings Drive located close to Washington University

Figure 2. Balance Sheet Summary
(Years 2005-2010)

	2005 #1 only	2006 #1 only	2007 #1 and #2	2008 #1 and #2	2009 #1 and #2	2010 #1 only
Current Assets	36,688	67,806	47,449	40,907	30,320	39,213
Fixed Assets	115,107	100,917	221,574	190,452	98,067	92,120
Other Assets			120	120	120	120
TOTAL ASSETS	**151,795**	**168,723**	**269,143**	**231,479**	**128,507**	**131,453**

Current Liabilities	16,654	26,020	7,732	10,058	6,501	4,446
Long Term Liabilities			100,000	88,500	71,071	34,550
TOTAL LIAB	**16,654**	**26,020**	**107,732**	**98,558**	**77,572**	**38,996**
Equity	135,141	142,703	161,411	132,921	50,935	92,457
TOTAL LIAB & EQUITY	**151,795**	**168,723**	**269,143**	**231,479**	**128,507**	**131,453**

Note: all figures rounded to dollar
Interest rate = 4% for long term liabilities
Internal cost of equity assumed to be 21% and found using the CAPM equation and assuming a risk-free rate of 1%, a market return of 12%, and a beta of 1.8
Applicable tax rate is 35%

*Includes initial partner investments: $75,000 from each of two partners

#1: Original shop on Lindell Blvd. located adjacent to St. Louis University
#2: Second shop on Brookings Drive located close to Washington University

Source: Java For You Financial Reports (2011).

The Dilemna

As Kathy continued to explain her husband's illness, it seemed apparent to Sue and Jim that there was no convincing her otherwise. Jim suggested that Kathy think about her decision for a week but she was not receptive to this idea, continuing to push the discussion towards how they would value the business in order for her to break free from the responsibility of the business.

While Jim didn't necessarily want to see Kathy depart from their partnership, he knew that he wanted to maintain his 50% ownership. Sue had indicated that she would be interested in buying Kathy's half of the business, which would create a nice segway into a new business arrangement.

As they continued to discuss the task at hand, Jim reminded the group that there were a variety of methods that could be used to value the business and deciding on the most appropriate would need careful thought. Using her background as a Financial Analyst, Sue directed the group towards the discounted cash flow analysis (DCF) as a widely accepted method within the industry in respect to valuation of a firm. As a result, Sue knew that cash flow and the weighted average cost of capital were important pieces to the valuation puzzle. Kathy suggested that they also review the valuations of the main competitors to see how their firm stacked up against the industry.

Conclusion

With Kathy's impending financial concerns, the obvious first step seemed to be determining the value of the business. As Jim, Kathy and Sue had become steadfast friends through the building of this business, they all agreed that the value needed to be fair to all parties and should only be focused on store #1, as store #2 was simply not successful. Additionally, understanding how the value was calculated was important to all three. The annual cash flows generated as well as the weighted average cost of capital were crucial metrics that played an integral part in determining the firm's valuation. Kathy was also concerned that the value of their business be compared against their competitors. Specifically, when comparing the price/earnings ratio of Java For You with its closest competitors, how "cheap" or "expensive" was Java For You relative to its competition? With the state of the economy, this seemed a particularly important consideration as market values were significantly inconsistent.

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