



The Canteen Case Study

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The Canteen is a local franchised restaurant and pub serving quality lunches at reasonable prices at ten area locations in the tri-city area. The franchise is well-known throughout the region and has a strong customer base, ranging from professionals on the go to retirees and local college students. The Canteen's five area locations are organized as individual corporations which are, in turn, owned and operated by Thor Holdings, LLC, a local company that also owns several other franchise restaurants, ice cream shoppes, and gourmet coffee houses. Louie Peters, Helga Stevenson, and Harvey Rogers own Thor Holdings, LLC and are seeking to sell two of the Canteen locations that are outside their immediate territory. They had started the two locations about eighteen months ago as part of an expansion plan incentive offered by The Canteen's parent company. Since then, Thor Holdings declined the rights to additional franchises in those outlying locations.

The two Canteen locations that Thor Holdings is seeking to sell had revenues of roughly \$750,000 each in the last fiscal year as compared to the other locations that each generated revenues in excess of \$1 million per year. Both locations have had trouble maintaining quality staff, and the managers have been largely unsuccessful in running the business and controlling costs. However, the locations are in high traffic strip malls where rent is roughly \$10,000 per month. These two locations experienced net losses for the last fiscal year of roughly \$50,000 each.

Mark and Diane Jones both work at one of the Canteen's more profitable locations. Upon hearing rumors that Thor Holdings is contemplating a sale of the two underperforming locations, they approach Louie Peters to discuss the possibility of purchasing the franchises. All parties agree that this would be an ideal situation, given Mark and Diane's background with the Canteen and their commitment to increasing the franchises' revenues through additional marketing and cost cutting initiatives. Thor Holdings offers to sell the two franchises for an aggregate price of \$1,000,000. Mark and Diane agree, in principle, on the price. The deal is contingent upon their ability to secure financing for the acquisition.

Mark and Diane consult Lee Davis, a local business consultant and former head of the state's Small Business Development Center who has extensive experience in negotiating deals and working with entrepreneurs to develop a viable business plan. After reviewing the tax return (which lacks a balance sheet) provided by Thor Holding's accountants, Lee has several concerns over the viability of the plan. Mark and Diane believe that they will be able to increase sales by over \$200,000 at each of the locations within twelve months. In subsequent years, they anticipate sales to increase by 8% annually. They expect to accomplish this through increased advertising initiatives that will have a marginal cost of \$10,000. In addition, they estimate that employee retention and training programs will help to reduce their turnover expenses by roughly \$20,000 per location. They also believe that they will be able to reduce their cost of sales from 35% to 30%, saving \$50,000 at each location, through better employee training and inventory management. The other Canteen locations have cost of sales of roughly 32%.

As a way of assessing the acquisition of the Canteen locations and in order to facilitate the lending process, Lee suggests that Mark and Diane engage a business valuation firm to provide an estimate of the fair market value of the firm. They agree to this and feel this is an excellent way of obtaining an impartial opinion on the value of the business relative to the price being paid.

The valuation analyst receives the tax returns for the Canteen locations. The valuation utilizes an income approach and a market approach to value these two locations. Within these approaches, the valuation analyst employs the multi-period discounted earnings method (income approach) and the direct market data method (market approach). The final value estimate for each of the Canteen locations is \$300,000 for a total value of \$600,000 for the two locations. In arriving at this indication of value, the valuation analyst suggests the following:

- There is little to suggest that Mark and Diane will be able to reduce the cost of sales at each location to 30%, a level that is below that of the other Canteen locations, particularly given that the cost of sales is now in excess of the average.
- The growth expectations for the two locations are higher than the current and historic growth rates of the more established Canteen locations. The 8% growth rate is unlikely to be sustained indefinitely into the future.
- The valuation analyst states no opinion as to the likelihood of the marginal increase in advertising to increase sales by such a disproportionate amount.
- After a visit to both locations, the valuation analyst does not believe that the local traffic is sufficient to support any dramatic increase in sales. Further, the analyst does not believe that the locations are conducive to the business.

- The break-even point for each of the Canteen locations is roughly \$1.1 million. The ability of the firm to reach this level of sales is possible only under highly optimistic projections. In addition, Mark and Diane would likely be forced to make additional capital contributions to the business in order to maintain operations until they reach break-even.

In light of the comprehensive valuation report, Mark and Diane begin to reassess their acquisition of the two Canteen locations. Lee is glad that he arranged for the valuation to be conducted. The bank is also glad to have the insight on the business in order to more fully assess the loan request. Thor Holdings is not pleased with the results of the valuation and its role in killing the deal that would unload these two unprofitable assets that are a drain on the resources of the other Canteen locations. The Thor owners realize, however, that it is the job of the valuation analyst to provide an objective opinion of value, not to work toward a particular value that would get the deal done.

This case study should clearly indicate the value-added nature of business valuations when entrepreneurs are assessing the acquisition of an existing business. The prospective owners benefit from the valuation of the firm which reveals, in this case and in many others, that the companies being acquired are underperforming assets that warrant a lower valuation than the contemplated transaction price. The valuation report may also serve as a reality check to the prospective buyers by providing an independent assessment regarding the future earnings potential of the firm and the errors or overreaching in their assumptions regarding future operations. In addition, the bank benefits from not making a loan to the prospective buyers whose business venture would likely be doomed from the start. Finally, Thor Holdings could also benefit by considering its options for the two underperforming locations—close the locations and liquidate the limited assets, maintain existing operations that drain the other resources of the company, or sell the locations to Mark and Diane at a lower price that is more reflective of fair market value.