Fictitious Fast Food Services

Summary

- The business does not appear to be in good shape for the reason mentioned below:
  - Declining sales in the last 4 years. The sales have declined by approx. 12%-13% annually in the last years. From Year 1 to Year 4 the sales have cumulatively declined by 33%.
  - The marketing and advertising has been reduced significantly in the last 2 years. This may have reduced the business' brand with their past customer base. The new owners may need to spend significant effort and money to bring those customers back and improve business.
  - Purchase cost as % of sales has increased in each year. The current owners do not appear to be managing the purchase well; possibly because higher waste, lower sales reporting, employee stealing or combination of all.
- Even though sales have been declining the current owners have held the operating profit relatively steady. It appears that this is achieved via cost reduction. We have concerns about this trend and strategy.
- The breakeven point (sales at which the profit is zero) is $29,000 based on the expenses in the last year
- There is significant opportunity of improvement if attention is paid to key areas such as advertising, customer service, and owner involvement that have negatively impacted the business in the past. However, you should be careful not to overpay for this business as the business will require sizable investment to improve from where it is today.
- The fair price of the business is in the range of $90,000 to $130,000 based on the sales and profit trends and industry benchmarks

Trend Analysis

Positive Trends	Negative Trends
• Operating margin has been increased from 8.0% in year 1 to 7.8% in last year. However, as noted in Red Flags the reasons for this need to be clarified	• Sales have been declining for the last 4 years at 12%-13% annually. Sales have been down 33% from year 1 to year 4.
• Labor cost has been reduced from 28% in year 1 to 25% in last year. However, as noted in Red Flags the reasons for this need to be clarified	• The marketing and advertising has been reduced significantly in the last year. The marketing spend was down by 67% in the last year. This may make it difficult to bring the customers back in the future.
• The breakeven sales point was at $29,000 per month last year. This was improved from approx. $44,000 in Year 1	• Purchase cost as % of sales has increased from 35% in year 1 to 38% in year 2.
•	• Rent has increased from $31,200 in year 3 to $27,600 in year 4.

Red Flags

- The operating margin has increased over the years (from 7.0% in year 1 to 7.8% in last year) even when the sales has been declining. This seems unnatural? How is this achieved?
- The labor cost as % of sales has declined from 28% in year 1 to 25% in last year. Is this for real? How have they been able to do so?
- The breakeven sales point was at $29,000 per month last year. This was improved from approx. $44,000 in Year 1. This is a substantial reduction. How was this made possible?

Improvement Opportunities

Improvement Areas	Impact	Actions Required
• Sales improvement	• Operating profit can be increased by approx. $50,000 by bringing the sales to first year level of $581,000 provided all expenses are kept at last year's levels	• Better management • More marketing and advertising •
• Purchase cost	• Operating profit can be increased by $9,300 by reducing the purchase cost from 37.8% to 35.4% (year 1 level) as % of sales; while keeping the sales at last year level	• Better inventory control • Negotiate better price with suppliers • Reduce waste • Reduce employee stealing
• Customer Service	• Improving the customer service can increase your sales and build customer loyalty; which will improve your profit and take-home cash	• Hire better employees • Employee training • More hands-on management • Customer feedback

Follow-up Questions

- How much of the total expense includes the personal expense?
- Why have the sales declined in the last 4 years?
- How have you managed to keep the profit up; while sales have been declining in the last 4 years?
- Why have you reduced the marketing in the last year substantially? What impact has there been on the sales? What type of marketing did you use in the past?
- Why has the purchase cost as % of sales has increased in the last 2-3 years compared to year 1?
- Utility expense was reduced from $24,922 in year 3 to $22,592 in year 4. How was this achieved? Will this continue in the coming years?
- There appears to be higher marketing and advertising expense in the months of March and October. Is this tied to any promotions or festivals? Do you see higher sales resulting from this?

General Observations

- The sales appear to be higher in the months of March, April and May; while they are lower in August, September, November and December on an average.
- There appears to be higher marketing and advertising expense in the months of March and October.
- Purchase cost as % of sales is higher than average in the months of November and December; while labor cost as % of sales is lower than average in those months.
- Of the total expense purchase cost is 39%; labor cost is 32%; real estate 8%; marketing is 4% and utilities represent 6% on an average over year 1 to year 4
- The breakeven point (point at which revenue and expense are equal; after which the business can make profit) is at approx. $29,000 per month at current expense levels. However, there is an opportunity to lower this breakeven sales by reducing the expenses as proposed in improvement opportunities section

Fair Market Price Analysis

The standard benchmark multiple fort this industry is 0.4 of sales and 3 of operating profit. Based on the financial information provided for the last few years we estimate the fair price of this business as follows:

We assume sales multiple of 0.4 to arrive at the fair market price.

	Price based on Sales Multiple			
	Year 1	Year 2	Year 3	Year 4
Sales	$581,098	$514,090	$441,379	$390,207
Expected Sale Price	$232,439	$205,636	$176,552	$156,083

We assume profit multiple of 3 to arrive at the fair market price.

	Price based on Profit Multiple			
	Year 1	Year 2	Year 3	Year 4
Operating Profit	$40,733	$26,326	$32,925	$30,623
Expected Sale Price	$122,200	$78,977	$98,774	$91,868

We believe that the fair price to be paid for this business is in the range of $90,000 to $130,000. You can use following arguments to your advantage in the negotiation over fair price:

- The business shows declining sales for the last 4 years. It will require additional investment to bring the sales to the level of year 1.
- Even though the operating profit has been steady it is questionable how long this can be sustained. It appears that the profit was maintained as a result of cost cuts. This will impact the business negatively in the long run.
- The current owners have not invested in advertising in the last 2 years. This will negatively impact the sales in the coming years as the long-term impact of advertising usually lags by several months.

Appendix – A
Sales Analysis

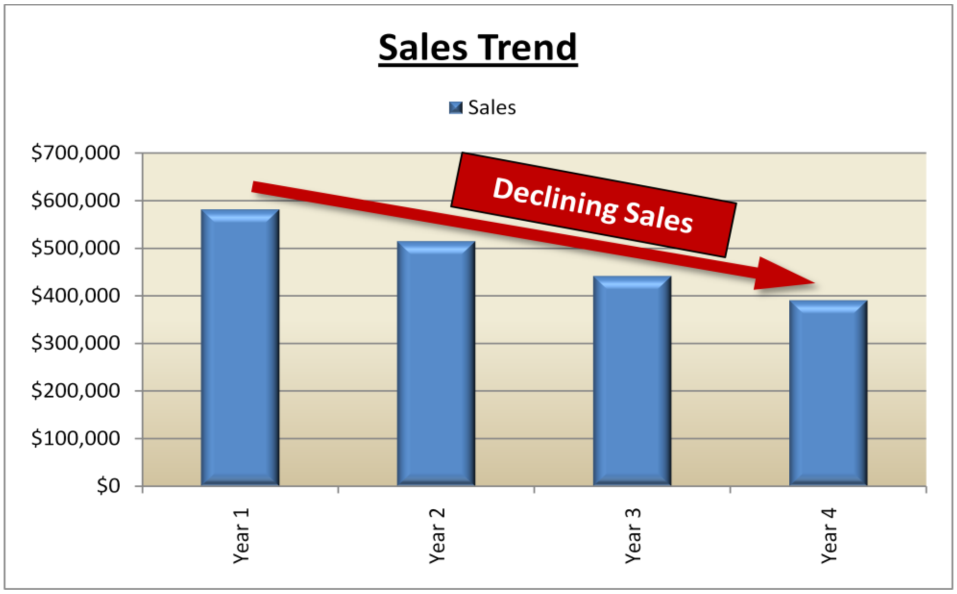


Chart A.1 - *Sales Trend*

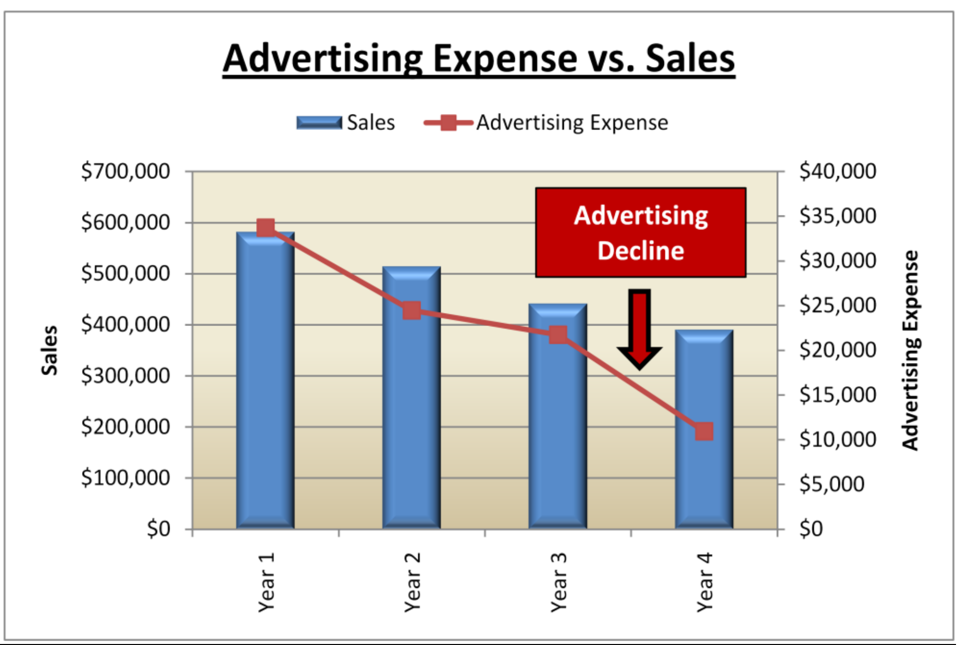
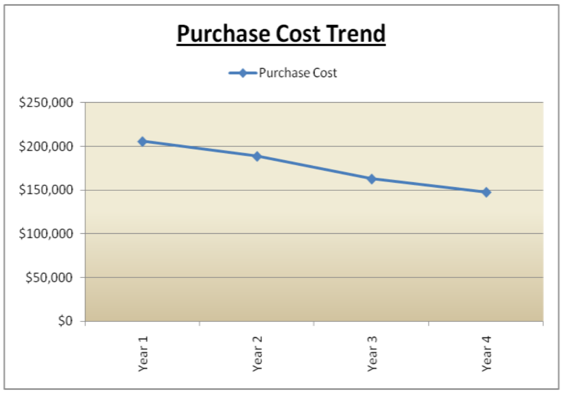


Chart A.2 - *Advertising Expense vs. Sales Trend*

Appendix – B

Expense Analysis



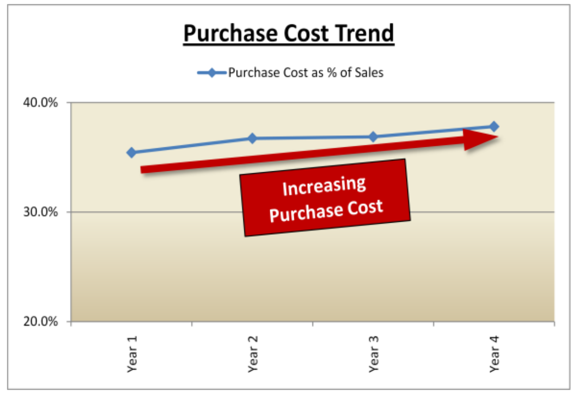
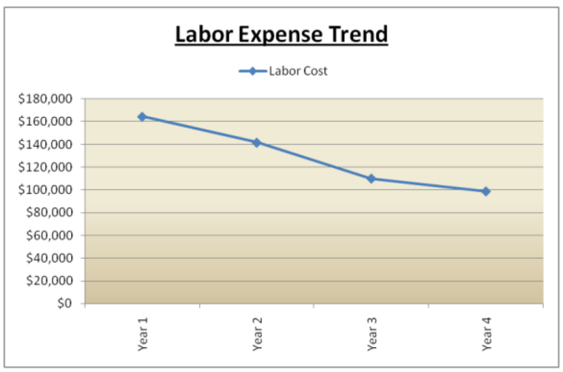


Chart B.1 - *Purchase Cost Trend*



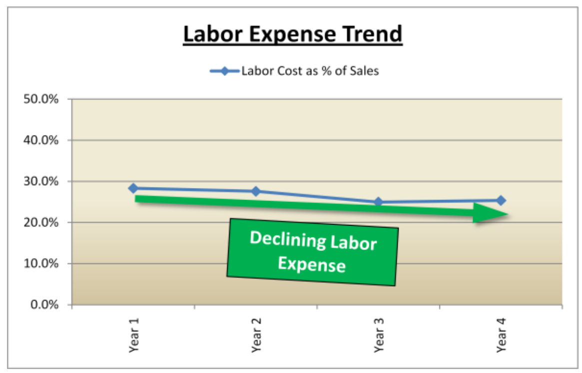
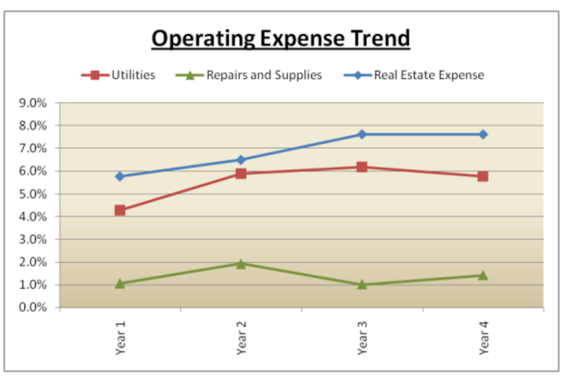


Chart B.2 - *Labor Expense Trend*



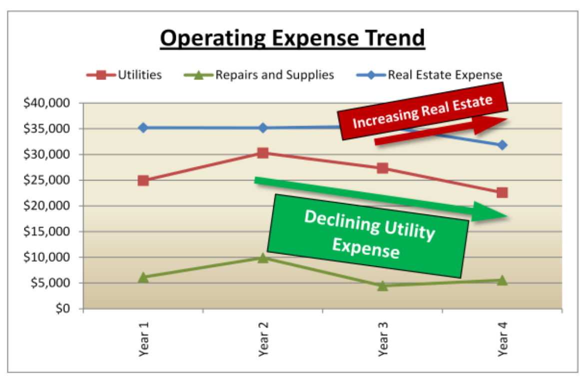
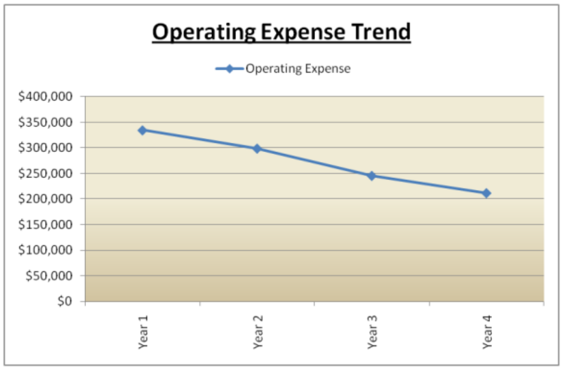
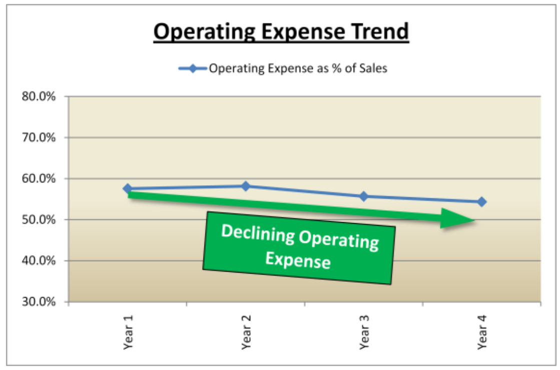
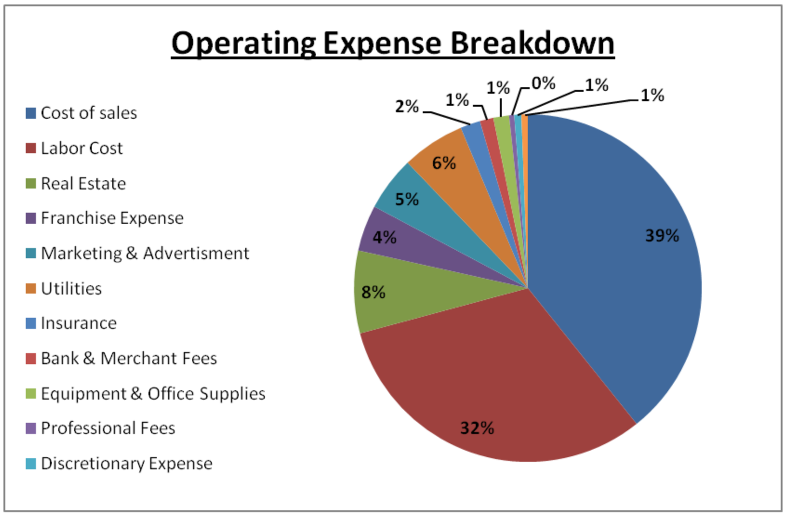


Chart B.3 - *Other Expense Trend*





<u>Chart B.4 – *Total Operating Expense Trend*</u>



<u>Chart B.5 – *Operating Expense Breakdown*</u>

Appendix – C
Margin Analysis

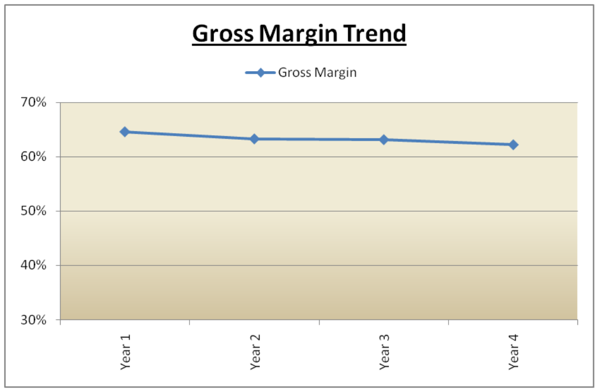


Chart C.1 – *Gross Margin Trend*

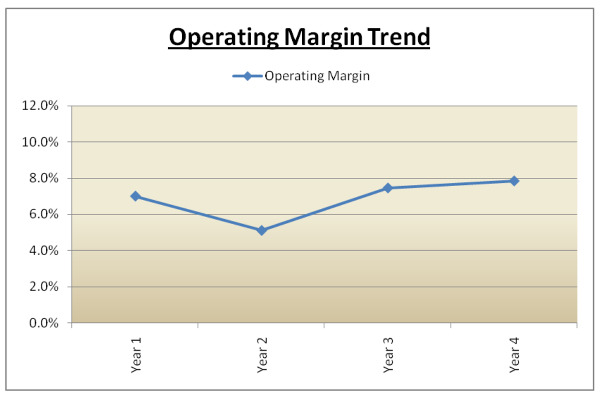


Chart C.2 – *Operating Margin Trend*

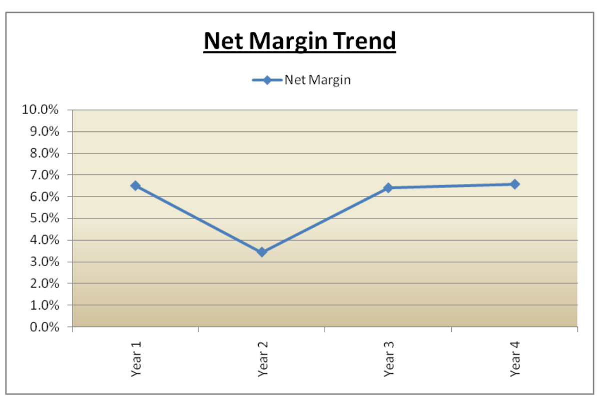
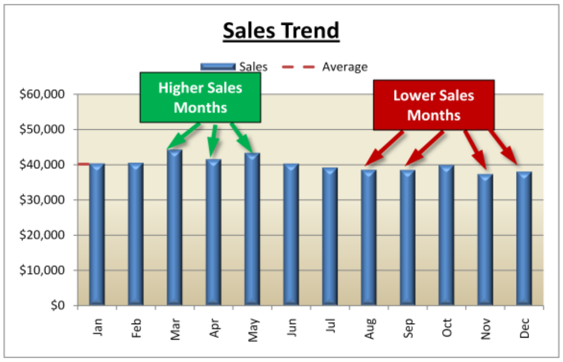


Chart C.3 – *Net Margin Trend*

Appendix – D
Monthly Trend Analysis



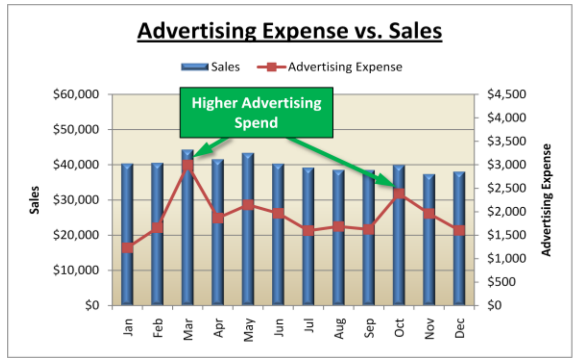
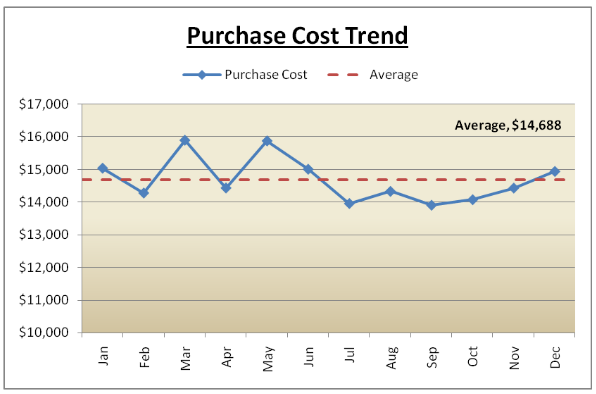


Chart D.1 – *Monthly Sales Trend*



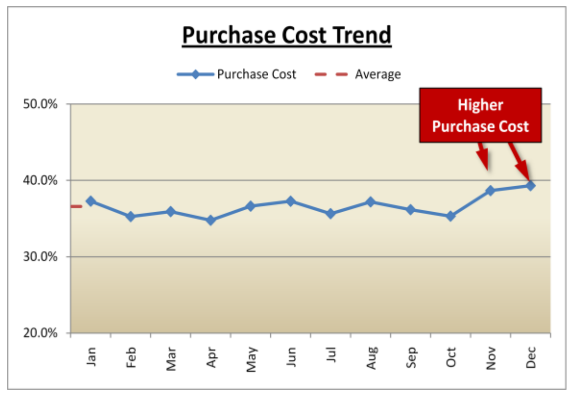
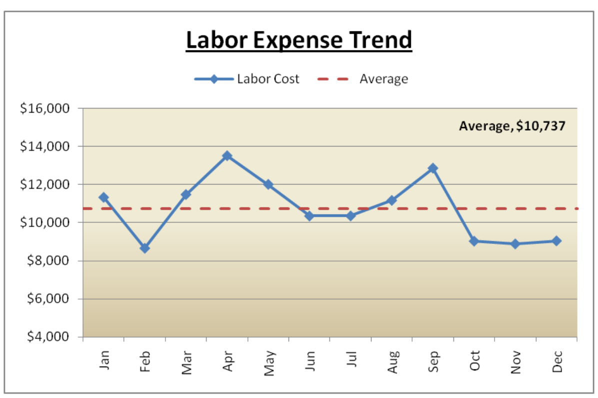


Chart D.2 – *Monthly Purchase Cost Trend*



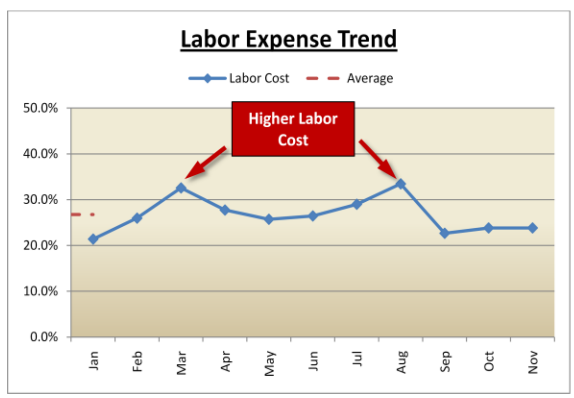
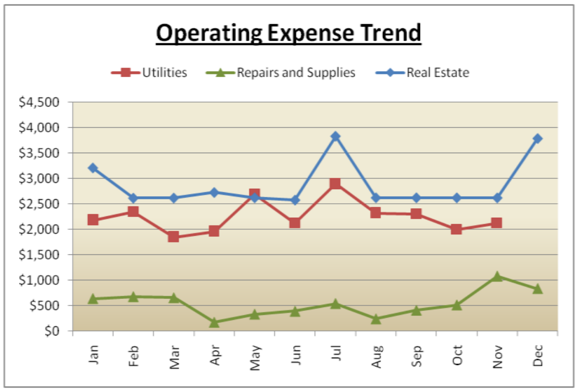


Chart D.3 – *Monthly Labor Cost Trend*



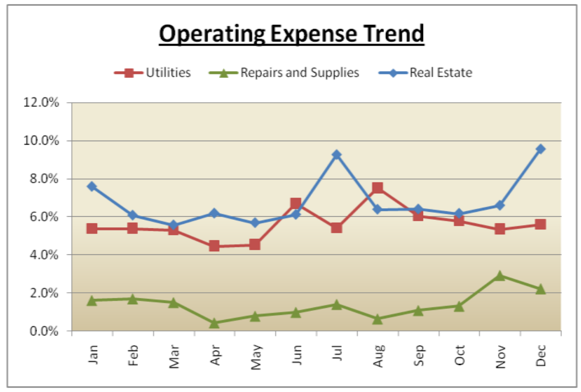
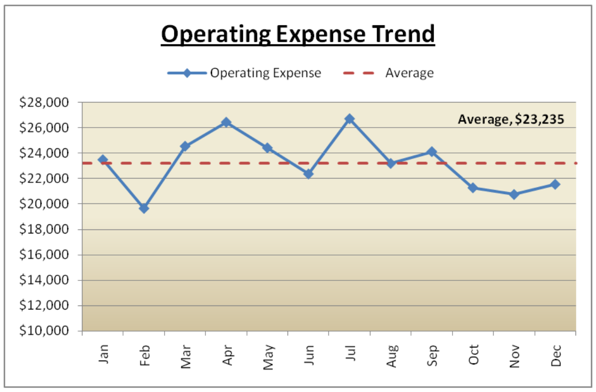


Chart D.4 – Monthly *Other Expense Trend*



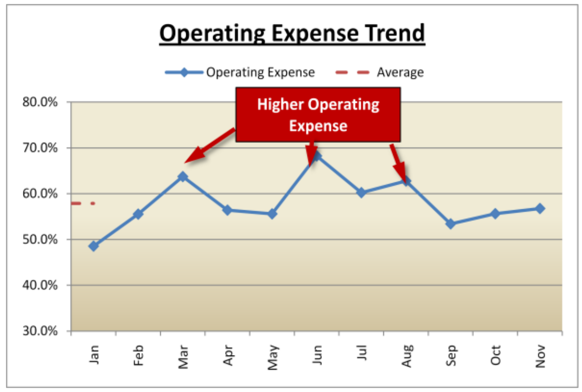
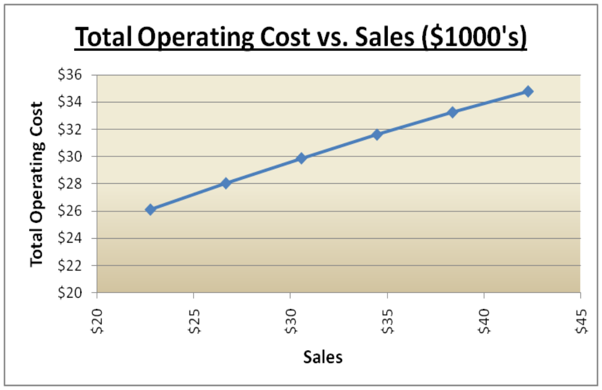


Chart D.5 – *Monthly Total Operating Expense Trend*

Appendix – E

Breakeven Analysis



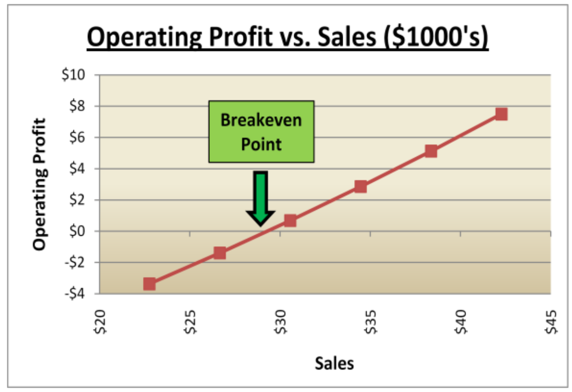
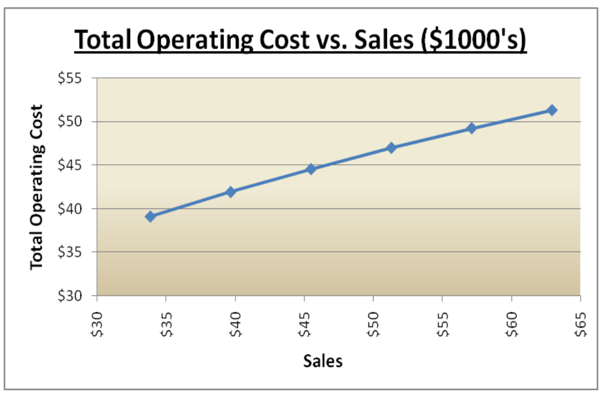


Chart E.1 – *Breakeven Analysis – Last Year*



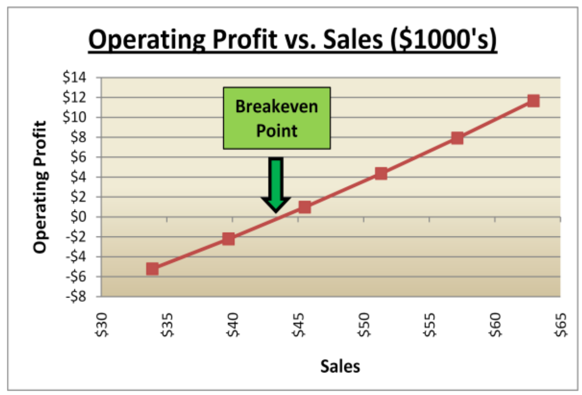


Chart E.2 – *Breakeven Analysis – First Year*