

JOURNAL OF FINANCE CASE RESEARCH

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CONTENTS

Odyssey Healthcare: Issues of Fiduciary Malfeasance and Class Action Suits John Newbold & Laura Sullivan	1
Interactive Advertising Agency: Negotiating a Merger in the Online Advertising Industry Dennis Zocco	15
The Golden Krust Caribbean Grill: Achieving Rapid Growth in a Mature Industry Larry A. Gillus & Susanne L. Toney	53
Family Furniture Corporation: Analyzing the Effects of a Pure Capital Structure Change on the Value of a Firm Robert Irons & Robert A. Weigand	63
Campbell's Resort Thomas Klaasen	73
An Investment Manager's Dilemma: Should She Recommend Selling Talisman Energy Dorothea Feils, Grace C. Allen & Kevin Roseke	83
Perdue Farms Sean F. Reid, Tylor E. Claggett & Danny M. Ervin	91
Olympic Optical Company: Valuing a Business Colene L. Coldwell & Marlene M. Reed	99
Multinational Capital Budgeting Using Monte Carlo Simulation: Intrawest Evaluates the Clearwater Beach Project Donald Flagg & Speros Margetis	119

Creation of Wealth Without Debt William P. Dukes & Paul R. Goebel	133
Promax: A Case on Transaction Exposure Merouane Lakehal-Ayat	139
Chad Myers: The Diary of a Debt Addict James McIntyre, Jr. & Faye Saint McIntyre	145
Reversing Acquisitions: The Case of Citigroup Natalya Delcours & Robert Stretcher	151

Letter from the Editor

Welcome to the 2008/2009 volume of the *Journal of Finance Case Research*, the official journal of *The Institute of Finance Case Research* (IFCR). Volume 10, Number 1 is the first of two issues for the 2008-2009 year. Kudos to the authors, reviewers and other supporters who have helped us get another issue put together.

I would like to express my gratitude to everyone who has helped in the transition to a new managing editor and editorial structure. Volume 10 will be my last set of issues as Managing Editor, with Jonathan Breazeale of Sam Houston State University taking over after that. The journal's popularity over the past few years, due to the efforts of our senior editor Bob Stretcher and other supporters, has made this job very demanding. I hope everyone will give Jonathan and Bob the same support they've given me in the recent past.

I would also like to thank the authors and reviewers for their extraordinary patience over the past two years. I have experienced a number of personal challenges during this time, and the process of putting these last two issues together has been a difficult one. I hope that everyone's patience and dedication to task will be reflected in our case offerings in Volume 10.

The IFCR provides a rare opportunity for the writing of cases and their submission for peer review. Cases accepted for publication in the *Journal* have met the requirements of a double-blind review process, and are available for use through *Journal* subscriptions or by contacting the *Institute* for multiple copies (for a small fee per copy of the case). Teaching notes are available to instructors desiring to use each case by contacting the *Institute*. Our acceptance rate has been consistently 25% or less. The *Journal* is listed in *Cabell's Directory of Publishing Opportunities in Economics and Finance* and other standard references..

Please consider participating in conference sessions sponsored through the *Institute*. The journal has sponsored or participated in case or teaching sessions at annual meetings of the Southwestern Case Research Association, the Financial Management Association, the Southwestern Finance Association, the Midwest Finance Association, the Academy of Economics and Finance and the Financial Education Association. Historically, cases presented at conferences have had more success in getting published, perhaps because of the scrutiny and comments they receive from other educators.

The *Journal* reviews and accepts cases of all types, as is evident from the content of this issue. Primarily, though, we want the *Journal* to be an outlet for interesting and challenging cases. We have focused on decision cases in the past, both "textbook"-style directed cases and also more involved, open cases. In every instance, we are seeking cases that will be relevant and engaging for students and professors alike.

Finally, I would like to encourage all of our readers to consider volunteering to review for the journal. Finding reviewers is a key part of the Managing Editor's job, and it is becoming more and more difficult as the volume of manuscripts increases.

This issue of the *Journal of Finance Case Research* contains 12 interesting and timely cases and an illustration of Monte Carlo simulation for classroom use. I urge you to put all of these to work in your classes and seminars.

For additional information about the *Journal* and the *Institute*, please go to jfcrr.org on the Web.

Timothy B. Michael
Journal of Finance Case Research

ODYSSEY HEALTHCARE: ISSUES OF FIDUCIARY MALFEASANCE AND CLASS ACTION SUITS

John Newbold, Sam Houston State University
Laura Sullivan, Sam Houston State University

Richard Burnham had major legal and public relations issues on his hands. He had stepped down as CEO of his for-profit hospice firm, Odyssey Healthcare, less than a year previously, in January of 2004. His cofounder, David Gasmire, had assumed his responsibilities while he stayed on as Chairman of Odyssey's Board of Directors. Now less than a year later, negative publicity and resulting class action suits were threatening the viability of his company. In the aftermath of a downside earnings announcement and an unfavorable article in Barron's, no fewer than seven class action suits had been filed against his firm. The suits were similar in nature and complaint, and for that reason were consolidated in December, 2004. They charged that Odyssey and its management team violated sections of the Securities Exchange Act of 1934. Essentially, the plaintiffs complained that the senior management team at Odyssey had misrepresented the firm's operations and financial condition in the time period between May 5, 2003 and February 23, 2004. At the same time, the suits alleged, Odyssey senior management, acting on insider information, had unfairly profited by selling stock options valued at over \$26 million. Immediate action was required.

INTRODUCTION

Richard Burnham had major legal and public relations issues on his hands. He had stepped down as CEO of his for-profit hospice firm, Odyssey Healthcare, less than a year previously, in January of 2004. His cofounder, David Gasmire, had assumed his responsibilities, while Burnham stayed on as Chairman of Odyssey's Board of Directors. An IPO in October of 2001 saw Odyssey debut at \$15 per share. Strong revenue growth, accompanied by handsome profits, catapulted the stock price to nearly \$40 by December of 2003, with two stock splits in 2003 alone.

Founded in 1995, Odyssey Healthcare had enjoyed tremendous growth for nearly 10 years. Odyssey had grown its base of business through "same store" growth, acquisitions and newly constructed operations to become one of the largest for-profit hospice organizations in the United States. The number of Odyssey hospices had more than doubled from 2001 – 2003, from 30 to 74.

In February 2004, Odyssey released its earnings for the fourth quarter of 2003. While the numbers for 2003 came in on target, Odyssey management advised investors that their earnings estimates for fiscal year 2004 were being lowered due to operational issues. Based upon this news, the stock price dropped 26% in a single day (Yu, 2004). In April, 2004, Barron's, a

widely-read financial periodical, published an unflattering article about Odyssey which strongly hinted at Odyssey engaging in less than ethical practices related to patient admissions, patient care and patient discharges (Ward, 2004).

In the wake of the downside earnings announcement and the unfavorable article from Barron's, no fewer than seven class action suits were filed against Odyssey and their senior management team. These seven suits were similar in nature and complaint, and for that reason were consolidated in December, 2004 (Class Action Suit; Layher, et. al., vs. Odyssey Healthcare, Inc., et. al. 2004). They charged that Odyssey and its management team violated sections of the Securities Exchange Act of 1934. Essentially, the plaintiffs complained that the senior management team at Odyssey had misrepresented the firm's operations and financial condition in the time period between May 5, 2003 and February 23, 2004. At the same time, the suits alleged, Odyssey senior management, acting on insider information, had unfairly profited by selling stock options valued at over \$26 million.

Odyssey filed a motion to dismiss the lawsuit. But this did not mitigate the "double-whammy" impact of the Barron's article and the class-action suits on Odyssey stock price. In the first quarter of 2005, the stock price wallowed near \$12 per share.

THE HOSPICE INDUSTRY

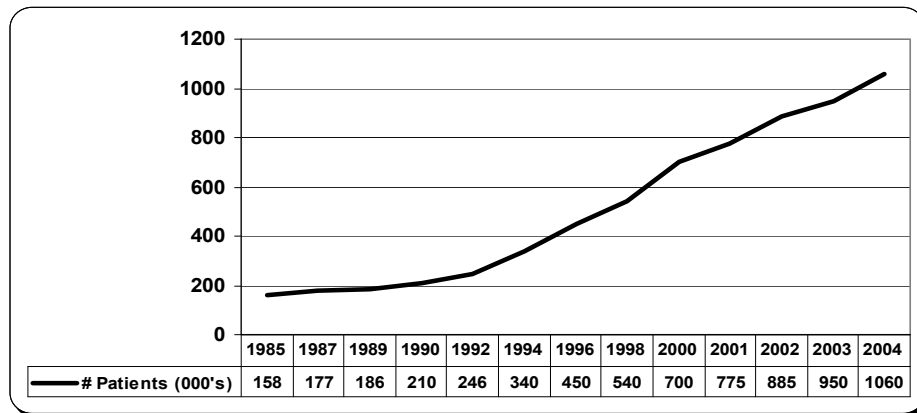
Hospice care is defined by the Hospice Association of America as:

"...comprehensive, palliative medical care (treatment to provide for the reduction or abatement of pain and other troubling symptoms, rather than treatment aimed at cure) and supportive social, emotional, and spiritual services to the terminally ill and their families, primarily in the patient's home. The hospice interdisciplinary team, composed of professionals and volunteers, coordinates an individualized plan of care for each patient and family." (Hospice Association of America website, 2005)

The palliative (pain reducing) care provided by hospices differs from curative care which is traditionally provided by hospitals in the sense that it is directed at making the patient more comfortable and improving the quality of life, rather than curing the patient of the ailment. A broad range of services, from traditional nursing care to respite care for family caregivers to bereavement services for family members is traditionally offered.

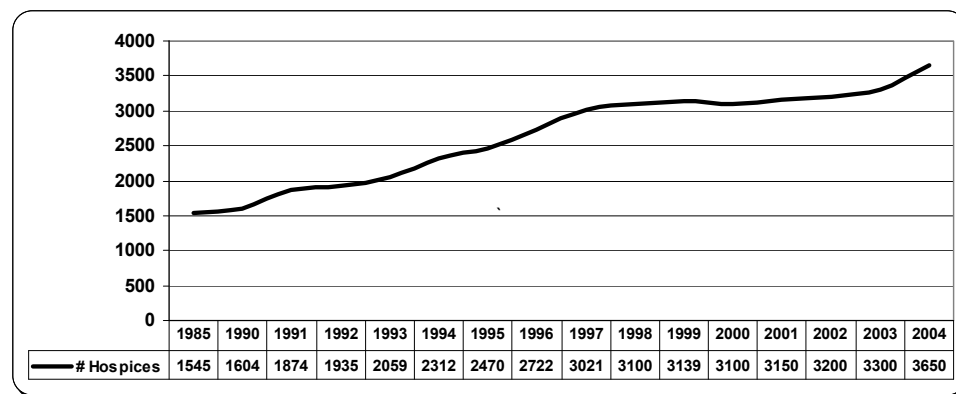
In 2003, the hospice industry in the US was a relatively small and fragmented component of the overall healthcare industry, generating aggregate annual revenues of about \$4.5 billion. Spending on hospice services amounted to less than one half of one percent of the \$1.4 trillion in annual US healthcare spending. Further, hospice spending accounted for only 1.5% of annual Medicare spending (Shattuck Hammond Partners, 2004).

In 1982, Congress enacted the Medicare Hospice Benefit on a provisional basis. In 1986, the provisional law was made permanent. Each state was given the option of including hospice care in their Medicaid program. In addition, hospice care was made available to terminally ill patients in nursing homes. A significant jump in usage of hospices occurred at this time. Yet the number of hospice patients was growing exponentially to over one million patients, as is shown in Figure 1.

Figure 1: Number of Hospice Patients: 1985 – 2004 (000's)

(National Hospice and Palliative Care Organization, 2005)

In 1996, the federal government initiated a program (“Operation Restore Trust”) focused on preventing Medicare fraud across all provider groups. This increased level of regulatory scrutiny, while probably needed, likely inhibited referrals of patients and reduced average and median lengths of stay industry-wide. The Balanced Budget Act of 1997 further negatively impacted reimbursement rates, dampening the growth rate of hospice sites. This is shown in Figure 2.

Figure 2: Number of Hospices: 1985 – 2004

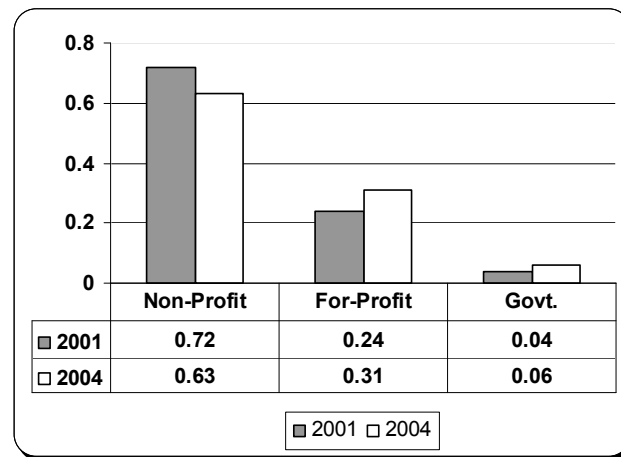
(NHPCO, 2005)

In 2004, there were several factors driving growth in the hospice industry. Foremost was the overall aging trend in the US and the increasing size of the over 65 population. In addition, there was an increasing role of advocacy groups in promoting hospice care over other end-of-life alternatives. Finally, The Center for Medicare and Medicaid Services (CMS) appeared to be

promoting hospice care through its liberal policies for reimbursement. The CMS's favorable treatment of hospice care in their reimbursement policies was thought to be at least in part because hospice is viewed as a lower cost alternative to traditional, hospital-based end-of-life care.

Traditionally, the hospice industry had been comprised of non-profit operations with an average of less than 50 patients at any given site at any given time. In 2004, 63 % of all hospices were non-profit, with for-profit operations comprising 31%. However, as Figure 3 shows, the trend had been toward growth in the for-profit area.

Figure 3: Trends in Hospice Profit Status (2001 – 2004)



(NHPCO, 2005)

At year-end 2003, 48% of hospices were free-standing entities, with 30% being affiliated with hospitals and another 22% affiliated with a home health agency or a nursing facility. The trend had been away from free-standing toward affiliation (NHPCO, 2004). The strategic rationale for a hospice to be a part of an integrated healthcare system was threefold. First, hospice was a critical and growing piece of the healthcare continuum and enabled acute care providers to offer patients an alternative to traditional end-of-life care. Second, hospice programs could act as a strong link to the community, given the large number of volunteers and the high level of emotional attachment to patients. Finally, affiliated hospices offered “hard-wired” opportunities to transfer patients from high-cost acute care situations to the relatively lower-cost hospice environment, thereby enhancing the financial performance of both entities.

THE MEDICARE HOSPICE BENEFIT

In 2003, Medicare and Medicaid accounted for 97% of all hospice industry payments. Private insurance paid for an additional 3%. (NHPCO, 2004)

Medicare had three key eligibility criteria for hospice care. First, the patient was required to have Medicare A coverage. Second, the patient's doctor and the hospice's medical director must have used their best clinical judgment to certify that the patient was terminally ill with a life expectancy of six months or less, if the disease ran its normal course. Third, the patient must

have chosen to receive hospice care rather than curative treatments for their illness. That is, the patient was required to agree that the future course of action was not to recover from the illness, but to mitigate the pain and suffering related to the inevitable advancement of the illness.

Medicare then paid the hospice a per diem rate, which was intended to cover virtually all expenses related to addressing the patient's terminal illness. Because patients required differing levels of care as they progressed in their diseases, Medicare provided for four levels of care to meet their changing needs. These levels are summarized in Figure 4.

Figure 4: Hospice Reimbursement Rates by Service (2005)

Level of Care	Description	<u>DAILY Rate (2005)</u>	<u>% of Total Medicare Payments</u>
Routine Home Care	Patient is at own home or nursing facility; hospice-led care-givers provide intermittent services.	\$121.98	95%
Continuous Home Care	Patient is at own home or nursing facility; hospice employees are providing care for blocks of 8 – 24 hours per day.	\$711.92	1%
Respite Care	Hospice employees relieve family member of certain care-giving duties for short periods of time to provide respite for the family care-giver.	\$126.18	0%
Inpatient Care	Patient is at a hospice- run facility being cared for continuously.	\$542.61	4%

(Centers for Medicare and Medicaid Services, 2005)

Typically, each October, Medicare adjusts its base hospice care reimbursement rates for the following year based on inflation and other economic factors.

Medicare limited reimbursements to hospice programs in 2 ways: A cap on the number of inpatient days as a percentage of total days of care, and a cap on the overall total benefit allowed per patient in a given year.

Inpatient Care Cap and the “20/80 Rule”: Inpatient care days could not exceed 20% of all patient care days per provider. If the cap was reached, reimbursement continued, but at a reduced rate. This was referred to as “The 20/80 Rule”. This meant that, when the government was reimbursing the hospice provider, they would not pay for inpatient days if they amount to more than 20% of the total number of days that the patient was under the care of the hospice provider. Since inpatient care was similar to hospital care, and was the most expensive of the four forms of care, the government was vigilant about the potential abuse of this form of reimbursement.

The Overall Medicare Benefit Cap Amount: In 2004, annual reimbursement per beneficiary was capped at \$19,635.67. This rate, which was updated every year, was multiplied by the number of new beneficiaries enrolled by the program during the fiscal year. If actual Medicare reimbursements to a program during the period exceeded the total, the provider was required to repay the difference to Medicare. This aggregate reimbursement cap effectively served as a corrective mechanism to programs with patients with very long lengths of stay. This version of the cap was applied on a site to site basis, not for hospice operations on an overall basis.

For example, a typical hospice site may have had 100 patients who were each receiving one of the 4 levels of care as previously described. For that given year, they were “capped” at receiving \$1,963,567 for each of those 100 patients, or $100 \times \$19,635.67$. If the hospice site somehow exceeded this amount in expenses, they would not be reimbursed for the amount over \$1,963,567. In this example, the \$19,635.67 amount, divided by 365 days in a year, came to only \$53.80 per day. But the government did not expect the patient at a hospice to have tenure much longer than 180 days (the six-month life expectancy requirement). This resulted in a hypothetical daily reimbursement rate of \$108.08, which was much closer to the daily reimbursement rate for routine home care, which accounted for 95% of the claims.

ODYSSEY HEALTHCARE

Odyssey was founded by Richard Burnham and David Gasmire, both former employees of another large, publicly held hospice organization – Vitas Healthcare. Burnham was a former regional manager for Vitas and Gasmire a former hospice site manager. With headquarters in Dallas, Texas, Odyssey Healthcare, Incorporated operated 74 hospice care facilities in 30 states and employed over 4,000 healthcare workers in 2004. However, roughly half of those operations were located in California, Texas and Arizona. With an average daily census of 7,700, they were the second largest hospice organization in the United States. Odyssey had grown its base of business through “same store” growth, acquisitions and newly constructed operations to be one of the largest for-profit hospice organizations in the US.

Odyssey Healthcare’s business strategies revolved around the following three imperatives: 1) Rapid expansion into new geographies with the ultimate objective to establish a broad geographic footprint, 2) Strict cost control and attention to the bottom line, and 3) A focus on marketing directed at increasing the admissions rate and average daily census, including the extensive training of their marketing, sales and operations personnel.

In organizing for rapid growth, Odyssey established eight regional territories. Each territory was headed by a Regional Vice President, who, in turn, managed teams of District Managers. At headquarters, Odyssey maintained a dedicated acquisitions team, as well as a dedicated expansion/startup team for de novo operations. Having a broad footprint in a particular geography aided large for-profit hospices in receiving referrals from similarly broad-based health care providers. National and regional nursing home and assisted living communities often sought the administrative and service consistency benefits which resulted from working with a limited number of broad-based hospice service providers.

The hospice business model is also highly sensitive to scale. Once the average daily census breakeven point was reached (between 30 – 40 patients per month), operating margins in the 10% range were achievable and increased as the census rose.

Hospice providers who achieve significant scale were able to negotiate volume discounts on the purchase of pharmaceuticals, durable medical equipment and medical supplies. In addition, they were in a better position to enter into favorable contracts with private insurers HMOs and pharmacy benefit managers. Finally, large hospice operations were able to spread certain fixed costs (corporate overhead, IT infrastructure, and marketing spending) over a large patient population.

In 2003-2004, Odyssey struggled to adequately control their pharmaceutical costs. In many locations, they were paying local rates. In 2004, Odyssey completed an extensive project whereby a national formulary plan and an electronic drug adjudication system was implemented. This system provided better visibility and control over the drug side of the business. Odyssey also completed a switch-over to a new internal management IT infrastructure. The new software and hardware system, obtained from the McKesson healthcare consulting firm, and dubbed the "Horizon" system, was intended to improve the clinical and billing systems. It provided management at Odyssey better real-time visibility into the day-to-day operations of the firm, such as drug usage rate, patient length of stay and Medicare Cap accrual issues. Perhaps more importantly, the system helped to prevent errors in claim preparation, thereby avoiding lengthy delays in Medicare reimbursements.

In order to be certified by Medicare, marketers of hospice services were required to offer specific core and non-core services. However, marketers at certain for-profit hospices recognized the value of differentiating their services to appeal to certain types of referrers. Hospices were beginning to differentiate themselves by specializing in services for specific diagnoses. For example, some facilities began to invest in the durable medical equipment necessary to care for cancer patients with acute symptoms and a need for continuous care.

With over 90% of their revenues obtained from Medicare and Medicaid, all hospice operators worked under a fixed pricing system. Thus, the revenue function for a hospice operator was linear – a fixed per diem payment over time. The cost function, however, was not linear. The cost of a marginal day of care was relatively high at the onset of care, when there were initial costs of learning about the patient's background, and when the hospice developed a plan for facilitating the move to a hospice environment. Similarly, costs were relatively high in the days immediately prior to death. Between the high costs at the start and at the end of the period of care, costs were lower (Huskamp, et. al., 2001). This pattern of cost was the same regardless of diagnosis. The important implication of the linear revenue function and the U-shaped cost function was: *Longer lengths of stay would yield higher profits*. Further, a patient's diagnosis served as a predictor of length of stay. Cancer patients tended to be referred late and have relatively short stays. In contrast, non-cancer patients tended to have longer lengths of stay. For these reasons, there had been a natural tendency of for-profit hospices to target *non-cancer* patients for admissions.

Patient length of stay appeared to have the most impact on net patient revenue. For each patient, if length of stay was only a few days, the high costs were spread over fewer days of care, which increased patient care expenses as a percentage of net patient revenue. Consequently, profitability was negatively impacted. Clearly, the ideal scenario for a for-profit hospice was to have each patient stay as long as possible so that the patient care expenses were spread over more days, positively impacting profitability. Thus, Odyssey was faced with a challenge of managing the type and number of their patients in an environment where they were expected to take on all types of cases.

By May 2004, Odyssey had added 17 new hospice sites in just the past 12 months. To assist in ramping up the patient counts in these nascent programs, Odyssey dedicated an increasing share of its operational budget to establish personal selling teams to call on the various referring entities. In some cases, the teams specialized by type of client, such as nursing homes and cancer centers. These referral representatives were referred to as “Community Education Reps” or CERS. In 2004, Odyssey employed more than 200 CERs. They had over 70 hospice sites, with the number of CERs per site fluctuating between 2 and 6 depending on the market conditions of each individual site.

Compensation plans were geared around numbers of referrals and types of patients obtained. In January 2004, the compensation plan was modified. Base salaries were set slightly higher than market (i.e., other hospices in each area). Bonuses were established to be awarded after each quarter based upon growth over the previous quarter.

ODYSSEY’S EARNINGS MISS: FEBRUARY 2004

Since its IPO in September of 2001, the stock price had risen from an initial price of \$15 per share to nearly \$40 per share in December of 2003, adjusting for two stock splits. In other words, without the stock splits, the stock price for Odyssey would have been over \$150, or 10 times its initial level. This heady stock price growth was fueled by strong patient and revenue growth through December of 2003.

In February of 2004, Odyssey released its earnings for the fiscal fourth quarter of 2003. While the numbers for 2003 came in on target, Odyssey management advised investors that their earnings estimates for the fiscal year 2004 were being lowered. The primary drivers of Odyssey’s reduced profit outlook included: 1) higher than anticipated costs in the form of newly acquired hospices, 2) greater pharmacy and salary expenses, and 3) greater than anticipated costs in the form of Medicare cap accruals (give-backs to Medicare, their primary source of revenues). It appeared that the prodigious growth rate of the company had finally outstripped its management’s ability to effectively control operations. The market was caught off guard by this negative announcement from the industry high-flier. The stock price lost over a quarter of its value in a single day (Yu 2004).

THE *BARRON’S* ARTICLE: APRIL 2004

The last thing Odyssey needed on the heels of their February 2003 earnings announcement, where expectations were revised downward and the stock price fell 26% in a single day, was to have an unfavorable publicity created by a prominent business newspaper. Yet on April 12, 2004, Barron’s featured an unflattering article entitled: “Troubling Odyssey, Questions Arise About Hospice Company’s Patient Care, Level of Medicare Payments” (Ward, 2004). On the surface, the article appeared to be about operational problems associated with Odyssey’s tremendous recent growth. However, the article intimated that Odyssey may have been engaging in certain less-than-ethical marketing practices.

THE CLASS ACTION SUIT

The class action suit charged that Odyssey and certain individuals in senior management violated the anti-fraud provisions of the Securities Exchange Act by issuing a series of material misrepresentations to the market for the period May 5, 2003 to February 23, 2004. More specifically, the class action suit alleged that the defendants' statements during the time period specified in the suit failed to disclose and misrepresented the following material adverse facts:

1. That the company's financial results were materially inflated because at least six of its hospice programs exceeded the amounts they were entitled to receive in Medicare reimbursements,
2. That the company admitted patients to its hospice programs who were not eligible for Medicare yet claimed that such patients were,
3. That the company's financial results were a result of providing a level of care and services below the standards set forth under government guidelines because the company's caseloads were heavier than industry norms,
4. That the company could not keep up with its heady growth due to higher labor costs - especially in California, which represented 13 % to 15 % of Odyssey's revenues,
5. That higher drug costs were hurting the company's margins, and
6. That Odyssey was suffering from negative cash-flows.

More specifically, the suit alleged that the defendants had violated sections 10(b) and 20 (a) of the Securities Exchange Act of 1934. (Consolidated Class Action Suit, Odyssey Healthcare, Inc. 2004) It was not the fact that Odyssey was having trouble effectively managing their business that disturbed the plaintiffs. Rather, it was the fact that these facts were hidden from or misrepresented to investors. Further, the suit alleged that members of senior management were engaging in illegal insider trading, as described in the next section (Class Action Suit; Layher, et. al., vs. Odyssey Healthcare, Inc., et. al., 2004).

The shareholders could have brought either a class action suit or an individual suit. A class action suit is brought when several shareholders have been similarly injured. The shareholders sue on behalf of all similarly injured shareholders. One benefit of a class action suit is that, if the shareholders are successful with their suit, they can recover reasonable expenses, which includes reasonable attorneys' fees and costs. However, a downfall is that if the suit is unsuccessful, the shareholders may have to pay the company's legal expenses. An individual suit is when an individual shareholder brings suit for an individual harm. The key is that the court wants to ensure judicial efficiency, by having all parties bring one suit. A class actions suit ensures that the court only has to hear the matter one time. This is most cost effective for the judicial system, the defendant and the plaintiff.

In addition, the shareholders can bring suit on behalf of themselves or on behalf of the company. If the shareholders elect to bring suit on behalf of the company it is called a *derivative* suit. Damages awarded by the court and or jury go to the corporation not the shareholder.

Derivative suits are appropriate when a director or officer has violated a fiduciary duty. A fiduciary duty is when an individual occupies a position of trust or confidence in another. This relationship requires the fiduciary to act in good faith and with fair dealing. Corporate officers and directors owe the corporation a fiduciary duty. There are three primary duties—obedience, loyalty and due care. The most commonly litigated duty is the duty of loyalty. The duty of loyalty requires that the officer or director must put the corporation's interest above his own. It is the requirement of selflessness and complete candor. Further, the officer or director will be especially scrutinized in which they derive personal profit from a transaction.

The Odyssey directors had the obligation to exercise the utmost loyalty to the corporation. Any material misrepresentations would be a breach of their fiduciary duty. Further, insider trading would be a violation of loyalty because the officers and directors would have personally benefited at the expense of the corporation.

Insider trading is defined as the trading of securities based upon knowledge that was not freely available to all investors. Thus, the trades were executed based upon "inside" information.

At the February 2004 earnings conference call, one analyst called into the question the fact that 10 senior executives and directors at Odyssey had engaged in insider selling in the months ahead of the announcement with total proceeds of around \$16 million. This selling was going on at the same time that management was expressing confidence in the future prospects of the firm (Odyssey Healthcare 4Q 2003 Earnings Conference Call Transcript).

More specifically, during the time period covered by the class action suit, Chairman Richard Burnham, CEO David Gasmire and CFO Douglas Cannon had sold over \$26 million in Odyssey stock, as summarized by Figure 5.

**Figure 5: Stock Sold by Odyssey Senior Management
May 8, 2003 – December 11, 2003**

Name	Value of Stock Sold
Richard Burnham	\$16,957,851.83
David Gasmire	\$7,750,109.36
Douglas Cannon	\$1,697,715.00
TOTAL	\$26,405,676.19

(Class Action Suit: Layher, et. al. vs. Odyssey Healthcare, Inc., et al., 2004)

At issue is whether or not the members of senior management at Odyssey sold their stock with the inside information that the situation at the firm was deteriorating. That is, they were "getting out while the getting was good".

The most immediate financial implication of the class action suit was the need to retain legal counsel to begin to address the complaint. Costs were likely to run in the millions of dollars over a period of years. While the case was being litigated, Odyssey would set aside a sum of cash from retained earnings as a contingency to an adverse ruling. Finally, and not the least of Odyssey management's worries, was the adverse impact of the negative publicity upon the firm's image and the resulting downward pressure on its stock price, particularly in the short-term.

THE SECURITIES EXCHANGE ACT OF 1934

With the Securities Exchange Act of 1934, Congress established the Securities Exchange Commission to oversee and enforce the laws governing the securities industry. Among the powers invested in the SEC were:

- The power to register, regulate and oversee brokerage firms, transfer agents and clearing agencies,
- The power to register, regulate and oversee the nation's securities self-regulatory organizations. The largest of these are the New York Stock Exchange, The American Stock Exchange and NASDAQ (The National Association of Securities Dealers), and
- The power to require periodic reporting of information by companies with publicly traded securities.

The Securities Exchange Act of 1934 also prohibits certain types of conduct in the markets, and provides the Commission with disciplinary powers over regulated entities and persons associated with them. In particular, the Act gives the Commission broad powers to investigate and prosecute acts of market manipulation, securities fraud (including the misrepresentation of company performance) and insider trading (Securities Exchange Act 1934).

ODYSSEY'S RESPONSE

Odyssey management defended their actions by filing a motion to dismiss the consolidated class action suit. They felt Odyssey was not the first company that had an unexpected dip in earnings, and it was not fair to punish them for selling some of their holdings while the stock price was high. This was just good management of personal finances.

However, coupled with the Barron's article, the class action suits further sullied the image of Odyssey in the eyes of investors.

Chairman Burnham and his senior management team needed to reestablish the integrity of their operations and financial reporting. But first, they needed to deal with the class action suits at hand. Key issues included:

- What, exactly, had they done wrong to warrant a spate of class action suits? Specifically, what laws had been broken?
- Which type of lawsuits should the shareholders have brought? Should they have brought a derivative action?
- How should the company and or the individual officers defend themselves against the class action suits?

- What are some of the specific financial implications of both compliance and non-compliance in a heavily regulated industry, such as the hospice industry?
- Going forward, what should they do differently to avoid this type of litigation?

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INTERACTIVE ADVERTISING AGENCY: NEGOTIATING A MERGER IN THE ONLINE ADVERTISING INDUSTRY

Dennis Zocco, University of San Diego

The primary subject matter for this case concerns the negotiations leading to a potential combination of two Internet advertising agencies of different valuations. Issues examined include corporate governance, employment contracts, division and vesting of equity in mergers, subjectivity of valuations, compensation plans, and the endowment effect. The case requires two negotiation sessions. The first is a negotiation within each owner group to reconcile potential differences in objectives of the potential combination of their company and another as well as to establish common negotiating goals and strategy to be used in the following negotiation, which takes place between the owner groups to determine whether terms of the combination of companies can be agreed upon. The case has a difficulty level appropriate for junior and senior undergraduates and 1st or 2nd year MBA or MS students. The case is designed to be taught in one three-hour class or two 1 ½ hour classes and should require one to two hours of outside preparation by students. This case is based on an actual negotiation in which the author served as a consultant to the owners of IAA and was project manager during the due diligence process.

(A) GENERAL INFORMATION

Interactive Advertising Agency (IAA)

Interactive Advertising Agency (IAA) is an interactive advertising agency that specializes in developing and implementing marketing campaigns for companies via the Internet. The company was founded in 2002 by two young entrepreneurs, Andy Layne and Janice Reynolds. IAA is a full service agency, providing services in creative design, programming, media buying, search engine marketing (SEM) and search engine optimization (SEO).

When the company was created in 2002, the economy was still in the throes of a downturn that started in 2000, with companies still reluctant to increase their advertising spending. However, the interactive advertising industry had continued its impressive growth, primarily as a result of increasing allotments of advertising budgets to online venues. Andy and Janice believed that the opportunity existed to enter the industry at a very advantageous time.

When IAA was founded, Andy had just received his MBA but had virtually no business experience. Janice had a joint computer science and graphic arts degree. Her only business experience had been working for her uncle's Manhattan advertising company, The Reynolds Agency (TRA), maintaining their computers and doing general information technology tasks.

When Andy and Janice met in 2001, they discovered that a few of the clients of TRA were asking for implementation of an internet-based marketing campaign to supplement their traditional media campaigns. They saw an opportunity and approached Janice's uncle with the idea that the two young entrepreneurs would start a company with interactive marketing capabilities and give TRA a percentage of revenues from all clients referred to IAA from TRA. Andy and Janice each contributed their entire savings of \$5,000, with each holding a 45 percent ownership stake in the company. TRA agreed to contribute \$50,000 over the first year of operation for a 10 percent stake in the venture. TRA was to have no management role in IAA. Andy and Janice rented a small office space in Brooklyn, NY, and, from the first referral from TRA - the Signature Hotel in Manhattan - began operations.

Andy was in charge of business development and account management, while Janice took charge of the creative side of the company, designing and implementing the interactive ad campaigns. From this bootstrap beginning and the immediate revenues generated from their initial client, they were able to build their client base through referrals, both from clients and from other traditional advertising agencies that needed interactive advertising capabilities but did not have them in-house. IAA was profitable from the beginning, generating positive and increasing earnings for each year since its inception. The company's growth has been purely organic, with no outside funding throughout the history of the firm. IAA expanded over the last five years to a staff of forty. After years of sub-market compensation while financing the company internally, Andy and Janice each had compensation last year of \$120,000 with a year-end bonus of \$250,000 each. Last year (2006), IAA had a net income of \$1,994,700 (Exhibit 1a).

Creative Interactive Marketing (CIM)

Creative Interactive Marketing (CIM) is an interactive advertising agency, located in the lower East Side of Manhattan, NY and very similar to IAA in that it specializes in developing and implementing marketing campaigns for companies via the Internet. The company was founded in 2004 by two young entrepreneurs, Danielle Adams and Rob Moyer. Before the CIM venture, both had started a search engine marketing (SEM) firm, but did not succeed in that venture. They subsequently dissolved that company and started CIM to offer a broader range of internet marketing services. They found the going very difficult for the first two years, forcing them to open a \$100,000 line of credit from a local bank, of which they drew the entire \$100,000 and currently have a balance of \$35,000.

Danielle and Rob paid themselves annual salaries of \$40,000 in each of the first two years of CIM's existence. Last year, Danielle's salary increased to \$75,000 and Rob's to \$65,000 (with no bonuses), still well below market value for their experience and positions. Those are their current compensation levels. However, they are willing to make that sacrifice in anticipation of growing the company where they will more than make up for the lost income.

Danielle and Rob worked hard at building a prestigious client list, most of which are based on outsourcing projects from a traditional advertising agency, First Avenue Agency (FAA), with which they have a close relationship. In fact, 70 percent of their revenues are generated from FAA outsourcing engagements. In return, CIM pays FAA a percentage of the revenue. Their remaining business is generated from clients obtained on their own.

When they formed CIM two years ago, Danielle and Rob were the sole owners of the company and each contributed \$4,000 for an equal 50 percent ownership stake. Danielle is President of CIM and Rob is Director of Media Planning and Production, but in operational

responsibility, company decision-making, and ownership, they are equals. Currently, CIM has ten employees, including Danielle and Rob. After two years of operation at a loss, in the past six months they have seen signs of their company turning the corner to profitability.

The Potential Merger

Andy and Janice of IAA and Danielle and Rob of CIM are professional acquaintances, having met at industry conferences. Since their companies are in the same industry and in the same city, they are friendly competitors, although they have never gone head-to-head in competing for a client.

Four months ago, Andy received a call from Danielle suggesting that the two companies explore the possibility of a merger. Andy was receptive to the suggestion. During the following four months both groups of owners engaged in the process of due diligence, the necessary prelude to any merger. Many meetings were held where critical information was exchanged, including their respective current client base, critical issues facing the firm, composition of their service offerings, and organizational structure of the firms. They visited each others' company to experience the similarities and differences in company cultures. They also met socially on several occasions to strengthen the personal relationships between the entrepreneurs.

Six weeks ago, the firms exchanged historical and pro-forma financial statements, as shown in Exhibits 1a-d and 2a-d below. Three weeks ago, the discussions became focused on the potential terms under which some form of combination of the firms would take place. They anticipated that eventually negotiations would take place regarding the possible equity split of the combined company and agreed to hire an impartial business valuation company to value the companies.

The valuation firm used a methodology combination of 1) an EBITDA (Earnings before Interest, Taxes, Depreciation, and Amortization; equivalent to Net Income in the IAA and CIM financial statements) multiplier, 2) discounted future cash flows, and 3) shareholders equity. For IAA, they based their valuation mainly on the earnings multiplier method and used a multiplier of five (5 x trailing twelve months Net Income). For CIM, they relied mainly on a shareholder's equity analysis, as they believed that the current earnings were still too speculative to base a valuation on or to forecast cash flows. The recent turnaround and quality client base of CIM were taken into account. They informed both sets of owners that the valuations are derived from widely-accepted methods, are based on their thorough analysis of projected future performance of both companies, and are subjective, which is the nature of company valuations. The results of that valuation, provided to both IAA and CIM, are as follows: IAA Valuation = \$12,000,000; CIM Valuation = \$750,000.

At the conclusion of their last series of meetings, held one week ago (see Exhibit 3), the IAA and CIM owners agreed that they had spoken often enough over the past four months and had sufficient information that their next meeting would be the final one during which either an agreement would be crafted to describe the manner in which the two companies would combine or, if an agreement cannot be reached, both would shake hands, go their separate ways, and continue running their companies as separate entities.

Exhibit 1a. Interactive Advertising Agency's (IAA) Statements of Operation – Actuals

(Amounts in thousands)	2002	2003	2004	2005	2006	2007 (YTD, six months)
Revenue						
Analytics revenue	16.8	42.7	87.1	189.5	284.9	496.9
Adserving	11.2	28.5	63.1	118.1	189.9	130.4
Email marketing	28.0	71.2	144.1	186.4	474.8	198.8
Media buys	246.4	626.5	1,375.2	2,982.9	4,083.4	2,608.7
Paid search	106.4	270.5	540.5	1,242.9	1,709.3	1,304.4
Design and Production	151.2	384.4	792.7	1,491.4	2,753.9	1,472.1
Total Revenue	560.0	1,423.8	3,002.6	6,211.2	9,496.2	6,211.3
Cost of Service						
Analytics revenue	1.7	4.5	9.1	19.3	29.9	49.7
Adserving	0.6	1.4	3.0	5.9	9.7	6.5
Email marketing	14.0	35.6	73.5	96.0	251.6	99.4
Media buys	209.4	526.9	1,141.4	2,466.8	3,315.7	1,956.6
Paid search	85.1	215.1	425.9	922.2	1,282.0	913.1
Design and Production	7.6	18.8	39.6	70.1	137.7	73.6
Total Cost of Service	318.4	802.3	1,692.5	3,580.4	5,026.6	3,098.8
Gross Profit	241.6	621.5	1,310.1	2,630.8	4,469.6	3,112.5
Operating Expenses						
Salaries and related exp.	104.0	269.3	567.4	916.5	1,633.7	1,111.4
Office and general exp.	53.6	138.7	292.3	472.1	841.6	572.5
Total Operating Expenses	157.6	408.0	859.7	1,388.6	2,475.4	1,683.9
Net Operating Income	84.0	213.6	450.4	1,242.2	1,994.2	1,428.6
Other Income	0.5	0.5	0.5	0.5	0.5	0.5
Net Income	84.5	214.1	450.9	1,242.7	1,994.7	1,429.1

Exhibit 1b. Interactive Advertising Agency's (IAA) Statements of Operation – Projections

(Amounts in thousands)	2007	2008	2009
Revenue			
Analytics revenue	1,088.0	1,584.0	2,200.0
Adserving	256.0	360.0	374.0
Email marketing	601.6	900.0	1,056.0
Media buys	4,992.0	6,930.0	8,096.0
Paid search	2,816.0	3,420.0	5,060.0
Design and Production	3,046.4	4,806.0	5,214.0
Total Revenue	12,800.0	18,000.0	22,000.0
Cost of Service			
Analytics revenue	111.0	158.4	224.4
Adserving	12.8	16.9	18.7
Email marketing	309.8	495.0	543.8
Media buys	4,128.4	5,544.0	6,695.4
Paid search	2,089.5	2,359.8	3,749.5
Design and Production	143.2	240.3	245.1
Total Cost of Service	6,794.6	8,814.4	11,476.9
Gross Profit	6,005.4	9,185.6	10,523.2
Operating Expenses			
Salaries and related expenses	1,936.0	3,330.1	3,605.7
Office and general expenses	997.3	1,715.5	1,857.5
Total Operating Expenses	2,933.4	5,045.6	5,463.2
Net Operating Income	3,072.0	4,140.0	5,060.0
Other Income	0.5	0.5	0.5
Net Income	3,072.5	4,140.5	5,060.5

Exhibit 1c. Interactive Advertising Agency's (IAA) Balance Sheets – Actuals

(Amounts in thousands)	Dec. 31 2002	Dec. 31 2003	Dec. 31 2004	Dec. 31 2005	Dec. 31 2006	June 30 2007
Assets						
Cash	87.1	172.0	339.7	671.0	1,325.2	1,875.2
A/R	246.6	197.4	489.2	1,282.3	2,595.9	2,872.4
Current Assets	333.7	369.4	828.9	1,953.3	3,921.1	4,747.6
Fixed Assets	54.0	97.1	174.9	314.8	566.6	1,019.8
Total Assets	387.7	466.5	1,003.8	2,268.1	4,487.7	5,767.4
Short Term Liab.	243.2	107.9	194.4	215.9	269.8	291.4
Long Term Liab.	0.0	0.0	0.0	0.0	0.0	0.0
Total Liabilities	243.2	107.9	194.4	215.9	269.8	291.4
Stockholders' Equity	144.5	358.6	809.5	2,052.2	4,046.9	5,476.0
Total Liabilities & Stockholders' Equity	387.7	466.5	1,003.9	2,268.1	4,487.7	5,767.4

Exhibit 1d. Interactive Advertising Agency's (IAA) Balance Sheets – Projections

(Amounts in thousands)	Dec. 31 2007	Dec. 31 2008	Dec. 31 2009
Assets			
Cash	2,454.3	3,472.9	4,545.3
A/R	3,185.6	3,268.0	5,661.1
Current Assets	5,639.9	6,740.9	10,206.4
Fixed Assets	1,835.7	3,304.2	4,956.3
Total Assets	7,475.6	10,045.1	15,162.7
Short Term Liab.	356.2	428.6	485.7
Long Term Liab.	0.0	0.0	0.0
Total Liabilities	356.2	428.6	485.7
Stockholders' Equity	7,119.4	9,616.5	14,677.0
Total Liabilities & Stockholders' Equity	7,475.6	10,045.1	15,162.7

Exhibit 2a. Creative Interactive Marketing's (CIM) Statements of Operation – Actuals

(Amounts in thousands)	2004	2005	2006	2007 (YTD, six months)
Revenue				
Analytics revenue	3.3	11.1	33.2	49.7
Adserving	5.7	8.5	19.5	11.7
Email marketing	9.1	8.9	8.5	27.5
Media buys	144.0	190.4	266.5	228.2
Paid search	60.0	89.7	150.8	128.7
Design and Production	78.0	116.5	171.6	139.2
Total Revenue	300.1	425.0	650.0	585.0
Cost of Service				
Analytics revenue	0.7	2.8	9.3	5.0
Adserving	0.3	0.4	1.1	0.6
Email marketing	5.8	5.8	5.4	17.1
Media buys	127.0	154.8	216.3	171.1
Paid search	50.3	74.2	127.9	106.0
Design and Production	30.7	42.5	58.7	50.4
Total Cost of Service	214.8	280.5	418.7	350.2
Gross Profit	85.3	144.5	231.3	234.8
Operating Expenses				
Salaries and related expenses	39.2	70.6	108.2	84.2
Office and general expenses	76.1	95.5	132.7	80.3
Total Operating Expenses	115.3	166.1	240.9	164.6
Net Operating Income	(30.0)	(21.6)	(9.6)	70.2
Other Income	0.1	0.2	0.2	0.3
Net Income	(29.9)	(21.4)	(9.4)	70.5

Exhibit 2b. Creative Interactive Marketing's (CIM) Statements of Operation – Projections

(Amounts in thousands)	2007	2008	2009
Revenue			
Analytics revenue	99.4	170.0	286.0
Adserving	22.6	28.9	52.0
Email marketing	56.5	81.6	130.0
Media buys	435.1	625.6	988.0
Paid search	214.7	391.0	624.0
Design and Production	301.7	402.9	520.0
Total Revenue	1,130.0	1,700.0	2,600.0
Cost of Service			
Analytics revenue	10.1	17.0	29.2
Adserving	1.1	1.4	2.6
Email marketing	29.1	44.9	67.0
Media buys	324.1	450.4	817.1
Paid search	174.3	312.8	462.4
Design and Production	14.2	20.1	24.4
Total Cost of Service	553.0	846.6	1,402.6
Gross Profit	577.0	853.4	1,197.4
Operating Expenses			
Salaries and related expenses	160.9	224.9	289.4
Office and general expenses	144.9	274.8	326.4
Total Operating Expenses	305.8	499.7	615.8
Net Operating Income	271.2	353.7	581.6
Other Income	0.5	0.7	0.9
Net Income	271.7	354.4	582.5

Exhibit 2c. Creative Interactive Marketing's (CIM) Balance Sheets – Actuals

(Amounts in thousands)	Dec. 31 2004	Dec. 31 2005	Dec. 31 2006	June 30 2007
Assets				
Cash	2.1	14.5	15.6	85.0
A/R	24.3	38.5	52.3	58.6
Current Assets	26.4	53.0	67.9	143.6
Fixed Assets	8.0	15.0	85.0	95.0
Total Assets	34.4	68.0	152.9	238.6
Short Term Liab.	72.3	127.3	221.6	236.8
Long Term Liab.	0.0	0.0	0.0	0.0
Total Liabilities	72.3	127.3	221.6	236.8
Stockholders' Equity	(37.9)	(59.3)	(68.7)	1.8
Total Liabilities & Stockholders' Equity	34.4	68.0	152.9	238.6

Exhibit 2d. Creative Interactive Marketing's (CIM) Balance Sheets – Projections

(Amounts in thousands)	Dec. 31 2007	Dec. 31 2008	Dec. 31 2009
Assets			
Cash	150.0	300.0	600.0
A/R	200.0	400.0	700.0
Current Assets	350.0	700.0	1,300.0
Fixed Assets	170.0	225.0	275.0
Total Assets	520.0	925.0	1,575.0
Short Term Liab.	437.0	487.6	555.1
Long Term Liab.	0.0	0.0	0.0
Total Liabilities	437.0	487.6	555.1
Stockholders' Equity	83.0	437.4	1,019.9
Total Liabilities & Stockholders' Equity	520.0	925.0	1,575.0

Exhibit 3. IAA/CIM Due Diligence Meeting Timetable and Agenda**Monday, June 19****IAA Office**

1. Management Discussion – Process Overview **9:00am - 10:30am**
 - a. Discussion of due diligence approach & transaction timetable
 - b. Comparison of business models

- c. Organization structure overview – management & departments
- 2. Sales Review **10:45am – 12:30am**
 - a. Review of current service and product offerings
 - b. Business Development organization & strategy
 - c. Client profiles & relationships
 - d. Product and service development history
 - e. Product and service pricing strategy
 - f. Revenue performance by functional area
 - g. Customer relationships
 - h. Competitor analysis
 - i. Revenue growth opportunities
 - j. Sales pipeline
- 3. Finance Discussion **1:30pm – 5:00pm**
 - a. Business Plan and Assumptions
 - 1. Review of Historical Operating Trends & Key Metrics
 - 2. Confirm revenue and profitability targets: Projections
 - b. Financial Control Environment
 - c. Accounting Procedures
 - d. Finance and Administrative Organization

Tuesday, June 20**CIM Office**

- 4. Creative Services **9:00am – 12:00pm**
 - a. Area organizational structure
 - b. Strategic vision (branding, design)
 - c. Production processes in place
 - d. Information architecture/User interface engineering capabilities
 - e. Contract structure
 - f. Pricing & margin performance
 - g. Capacity constraints
 - h. Scalability capabilities
 - i. Technologies: in-house and third-party
- 5. Media Buying **1:00pm – 2:45pm**
 - a. Organization & Strategy
 - b. Financial controls
 - c. Pricing & margin performance
 - d. Scalability capabilities
 - e. Technologies: in-house and third-party
 - f. Publisher relationships
- 6. Search Engine Marketing **3:00pm – 4:00pm**
 - a. Organization & Strategy

- b. Paid search management processes
- c. Pricing & margin performance
- d. Scalability capabilities
- e. Technologies: in-house and third-party

7. Search Engine Optimization**4:00pm – 5:00pm**

- a. Processes
- b. Pricing
- c. Results
- d. Integration with strategic vision
- e. Contractual terms
- f. Technologies: in-house and third-party

Wednesday, June 21**IAA Office****8. Tax Discussion****9:00am – 10:45am**

- a. Review of last three years' tax returns
- b. Review of revenue recognition policies
- c. Income Tax Planning & Compliance Strategies
- d. Status of Income Tax Return Examinations

9. Legal Due Diligence - Pending/Threatened Litigation**11:00am – 12:00pm****10. Human Resources Discussion****1:00pm – 5:00pm**

- a. Performance evaluation process
- b. Performance-based incentive & commission programs
- c. Employee development & training
- e. Comparison of company benefits
- f. Salary structure
- g. Organizational headcount

Thursday, June 22**CIM Office****11. Technology Discussion****9:00am – 12:00am**

- a. Infrastructure
- b. Servers
- c. Network equipment & topology
- d. Operating system
- e. Equipment inventory
- f. Disaster recovery, backups
- g. Scalability
- h. Current system load

- i. Maximum system capacity
- j. Network connectivity
- k. Database
- l. Software technology components
- m. Contract obligations
- n. Phone system

**(B1) INFORMATION FOR ANDY LANE AND JANICE REYNOLDS,
OWNERS/CO-FOUNDERS, IAA**

The Phone Call

Four months ago, Andy received the initial phone call from Danielle Adams, President of Creative Interactive Marketing (CIM), suggesting that Andy and Janice meet with her and her partner/cofounder, Rob Moyer, to discuss the possibility of a merger of the two companies. Andy was intrigued by the idea. He immediately called Janice into his office and told her about his phone conversation with the CIM president. Andy asked Janice what she thought of the idea, and she responded that she had been reading more and more about companies in the interactive marketing industry either merging or being acquired, and she thought it might be worth meeting with Danielle. Andy and Janice discussed the reasons why a combination of the two companies might be beneficial. Both agreed that IAA faces several important issues. These issues are not critical to the survival of the company, but need to be addressed in order for the company to continue to accelerate its growth.

The issues they identified are:

- 1) IAA is missing experienced, Director-level members of the management team. In particular, the company needs a Director of Account Services and a Director of Media Buying.
- 2) The acquisition of quality, national clients with large marketing budgets has stalled in the last year. IAA has never put much effort in marketing itself, relying on networking and referrals to generate new business. The company needs a new strategy to grow its client base, and either a marketing campaign or an acquisition (or both) would address this problem.
- 3) IAA has grown at very high rates over the past several years. Organic growth will not allow that momentum to continue. Growth through acquisition seems like a better way to maintain the momentum of high growth and value-creation.
- 4) The company needs some type of public relations event that provides IAA with a regional and even national reputation as a company of substance and on the rise.

Janice also identified creative design as the critical capability of the agency, Andy agreed to an extent, but countered that, as a full-service ad agency, there are other important advertising services provided by IAA. Furthermore, IAA is still a business, and there is a budget that currently places limits on the ability to attract top-notch designers.

Andy and Janice agreed that a lunch meeting was worth the effort to learn more about CIM and the potential for a merger with that company to address these issues.

The Meeting

Andy and Janice met with Danielle and Rob at a restaurant equal distance between their offices. They were impressed by what they learned about Danielle and Rob, both personally and professionally. The CIM owners had gone through the same process as Andy and Janice in starting their company, with the same ambitions and fears. Both sets of owners saw the same opportunity in interactive marketing. Danielle was honest in revealing that she and Rob had a rough time during their first two years, but they have been successful in gaining high quality clients, mostly through their relationship with a traditional advertising firm, from which that agency receives a percentage of revenues. Andy and Janice were impressed with her honesty and thought that it was a good start to the process of combining the companies in some way. At the conclusion of the meeting, the four owners agreed to begin the due diligence process with the ultimate objective of determining whether some type of combination of companies is feasible.

The Rationale

The possibility of some type of combination of the two companies interests Andy and Janice for the following reasons:

- 1) CIM is smaller than IAA and therefore, in apportioning the equity of the combined company, Andy and Janice, in combination, would have a majority position and, therefore, would not have to give up control of the company.
- 2) For the last two years, Andy had been putting in 60 to 80 hour weeks with rare and relatively short vacations. To relieve that burden, IAA needs an experienced and capable person to manage IAA's six account executives as well as be the company contact with clients. Danielle Adams would be a perfect fit for that role. IAA also needs someone to manage the media buying area of the company, as that activity within IAA is expanding and becoming very profitable, but mistakes are beginning to appear due to excessive work being put on a staff of three. On occasion, media spending exceeds budgets, resulting in lost profits for the company. Rob has the qualifications to manage that effort, as that is his role with CIM, and he might eventually become COO of the combined company. Rob is also in charge of keeping the financial statements in order and making projections for CIM. During their lunch meeting, Andy and Janice realized that Rob is much more aware of the financial performance of CIM and that Danielle seemed to quote numbers without completely understanding them or having a valid basis for them.
- 3) The CIM client list is attractive in that it contains several nationally recognized brand name clients. IAA's client list is more extensive but with fewer nationally recognized names. You see a real benefit in extending IAA's client list with CIM's.
- 4) Andy and Janice have worked very hard at growing the company and see the merger with CIM as a viable means for accelerated growth and quickly increasing the scale of IAA, which would be beneficial in seeking some type of liquidity event, such as being acquired by a larger company. The IAA owners believe that being a much larger company in the still very young interactive marketing industry is very beneficial.
- 5) Andy likes the idea of making a press release of the merger, which would help in putting the IAA name out among potential clients. IAA has done no self-marketing so far and has relied completely on referral business.

The Valuations

During the subsequent IAA/CIM due diligence discussions, Andy and Janice became more convinced that the merger would work. Recently, the two sets of owners focused on the split of the ownership of the combined company. There was a verbal agreement that the equity split among them would be determined by the relative values of the companies, based on a valuation done by an impartial third party company that specializes in company valuations. A mutually agreed upon valuation firm was engaged for that purpose.

When Andy and Janice received the valuation report, they were pleasantly surprised by the high valuation of IAA, having never before had their company valued. They realized that so far this year, with six months complete, the revenues and profits of IAA were in line for another year of significant growth. In managing the business since 2002, Andy has controlled cash expenditures very closely and guided the company to significant growth in both revenue and earnings. Both IAA owners were excited that their hard work has resulted in significant value.

Both Andy and Janice were surprised by the great disparity in valuations. They had expected the IAA valuation (\$12MM) to be higher than that of CIM (\$750,000), but not to that extent. However, the valuation firm has a very good reputation, so there is no basis to question the validity of the numbers.

After seeing the disparity in valuations, Andy suggested another approach to the combination, one that would be more advantageous to IAA. Instead of a “merger”, as Danielle had been referring to the combination throughout the months of discussions, Andy suggested that the best approach would be to have Danielle and Rob dissolve CIM, and IAA offer them employment contracts as part of a compensation package that would include equity in IAA. The advantage is that this approach would be much simpler and have much lower transaction costs. Danielle would be offered the position of Director of Account Services and Rob would be offered the Media Director position. Andy has every intention of maintaining his position of President/CEO of the combined company, with Janice keeping her position as Creative Director.

The Compensation Strategy

Andy’s compensation research, based on Advertising Age salary surveys, for the position of Director of Account Services (Danielle’s proposed position) revealed a range of \$120,000 to \$180,000. Media Buying Directors (Rob’s proposed position) have a salary range of \$90,000 to \$150,000. The ranges reflect differences in company size, region, experience, and seniority in position. The past success of IAA is a result of spending wisely, which means offering Danielle and Rob a compensation package attractive enough for them to give up running their own company, but provide IAA with some protection in the event that they are not contributing to the combined company as anticipated.

With the help of the IAA attorney, Andy developed employment contracts for Danielle (D1) and Rob (D2). They are just planning tools to be used in the negotiations. The contracts for Danielle and Rob are exactly the same except that Danielle will be offered \$120,000 and Rob will be offered \$90,000. The policy at IAA is that all salary information is held confidential, so the decision has been made to give the contracts to Danielle and Rob separately with verbal instructions that they can share the information if they want but they are not required to by IAA.

Andy and Janice have decided that their annual salaries will increase to \$160,000 each (from \$120,000) regardless of whether an IAA/CIM agreement takes place. They have told their plans to Danielle and Rob. The financial condition of the company now supports those salaries and the proposed salaries of Danielle and Rob. Year-end bonuses will depend on the earnings and cash balance of the company at that time.

The Risks

Andy and Janice had dinner together after work one evening and agreed that they are enthusiastic about the possibility of combining the two companies in an advantageous way and having Danielle and Rob as integral employees/owners of IAA. They also agreed that the following risks exist:

- 1) A 94%/6% valuation split is very surprising. But the valuation firm is reputable, so it should serve as a solid basis for the equity split as agreed. If there was concern about giving away too much equity in IAA, the valuation results reduce that significantly. Undoubtedly the CIM owners also are surprised at the valuation disparity. How will they react?
- 2) This large difference in company valuations makes employment contracts seem very prudent and feasible. The strategy now is to offer them employment contracts, which includes ownership in IAA and then dissolve CIM. Of course, the CIM client base and all work being done by CIM would then fall under IAA. How will Janice and Rob react to employment contracts? Possibly IAA concessions on other issues might be required to make that work.
- 3) Do the company cultures match? The culture starts at the top. Danielle has been late to or has not showed up for several scheduled meetings during due diligence. She had what seemed to be valid reasons. Should her work ethic be a concern? It is not a deal breaker. The most important factor is financial success. Good morale will happen if the company is financially successful. That benefits everyone.
- 4) The CIM bank line of credit balance of \$35,000 is a risk, especially since IAA has never had debt. There have been discussions between the parties about how that debt will be resolved in light of the combination. Danielle and Rob should bear the burden of paying off that debt from their personal cash. They seemed reluctant to do that and suggested that IAA should pay off the debt for them. This is an issue that needs to be resolved.
- 5) The success of IAA is apparent and is in large part due to the business decisions made by Andy and Janice. Both Danielle and Rob have already stated that they would like a significant influence on important decisions of the combined company. This could be a problem as Andy is accustomed to making the critical decisions in the company. Would Danielle and Rob, as minority owners, complicate the decision-making process that has worked so well for IAA, or possibly complement it? Keeping them off the board will protect against interference. If concessions have to be made, a possible concession would be to give them one seat, with Andy and Janice having one seat each. Andy and Janice would still control the board.
- 6) Conversations with both Danielle and Rob revealed that their main concern is that the compensation package they will receive in the combination will reward them for the

income sacrifices they have made in building CIM to the stage where it is an attractive company to IAA. Andy and Janice don't think it is the responsibility of IAA to overcompensate them as a make-up for their previous sacrifices. The IAA owners made the same sacrifices in the early years of IAA. With a combined company, the CIM owners spoke about getting the same year-end bonuses as the IAA owners. That doesn't seem fair to the IAA owners, given the difference in ownership percentage. Are these going to be critical issues?

7) As new owners of IAA, Danielle and Rob will have a special status in the company. However, what happens if they don't perform as expected? They are employees, after all. There needs to be some means to terminate their employment, even though they are owners. Danielle and Rob mentioned having assurances that they would not be fired at the whim of Andy and Janice. They also mentioned a severance payment agreement, which has never been given to anyone at IAA.

8) On the other hand, if they perform at a high level, which is expected, then there needs to be some incentive for them to stay with the company and continue to create value. This likely means some ownership vesting plan for them so that they get their ownership interest in the company over several years instead of on the first day.

The Negotiations

Andy and Janice are about to meet to put the final touches on their negotiating strategy. Even though some risks exist, they have agreed that IAA would benefit from an agreement with Danielle and Rob under acceptable terms and want to agree on terms for many reasons. Their objective in this meeting is to establish a common set of goals to achieve in the following negotiations with Danielle and Rob. There may be some issues where Andy's goals may differ from those of Janice, but both are hopeful they can be resolved quickly. Immediately after this meeting, Andy and Janice will go into their meeting with Danielle and Rob to attempt to reach a mutually beneficial agreement. The IAA owners are confident of their views of the business benefits and risks to this transaction. They will use all their negotiating skills to craft a win/win agreement.

(B2) CONFIDENTIAL INFORMATION FOR ANDY LANE, OWNER/CO-FOUNDER, IAA

After four months of due diligence, you are ready to move forward with this transaction if the terms are favorable to IAA. As co-owner and co-founder of IAA with Janice Reynolds, you are very proud of the progress you and she have made with your company. It wasn't easy and there were sacrifices. There were tough decisions that had to be made along the way, but you relied on your business education, experience, and instinct to make those decisions. You made some decisions yourself and brought Janice into the process on others. Janice's background and education is in computers and design, so her assistance in those decisions was limited.

In general, the partnership has worked out very well. Janice took charge of the creative side of the company and left running the business side of the company to you. There were some rough times when Janice felt as if she needed a say in a major decision, but you felt as if she did not have the background or experience to influence you away from the decision you thought was best for the company.

Nevertheless, the potential combination of some type with CIM was a major step for IAA. With Janice as co-owner of the company, she needed to be included in this decision-making process. You have a few concerns about her, however. As the creative force in the company and without any formal education in business, she believes that the success of the company is dependent solely on providing the best creative product to the company as possible. This often resulted in her going over budget on design contracts to take the creative work to higher and higher levels. Yet, the client would have been very satisfied with the product at a less-creative level.

Janice also tends to be an advocate for salary increases for our staff to keep them happy, even though the increases would result in paying them above market. You believe that this is not good business practice, as large increases restrict the company's ability to hire more staff to meet the increasing demands in all areas of the company. Her rationale is to make the company one big happy family. You are in favor of good morale in the company, but with a staff of very young individuals, they need some guidelines. Good business practices are those guidelines, and they result in not everyone getting the salary increases they want.

You believe the negotiations with CIM will be intense, but cooperative. Danielle and Rob likely will not expect to be offered employment contracts and dissolution of CIM. Based on your discussions with them, they are expecting a straight merger. However, you believe your approach will provide Danielle and Rob with all the benefits of a merger, but without the associated large legal expenses. There are going to be other issues in which the differences on issues may be significant, so it is critical that you and Janice have common negotiating goals and a consistent strategy. Janice was very firm in wanting to be present and to participate in the upcoming negotiations. You want to make sure that she does not offer concessions when they are not strategic.

You are about to enter your meeting with Janice to agree on the goals of your negotiation with Danielle and Rob and the strategy for achieving them. You will be starting that negotiation shortly after your meeting with Janice. Since time is of the essence, you made some notes to yourself in anticipation of meeting with Janice. They are:

- We must have specific, optimistic, and justifiable goals, with the understanding that some reasonable concessions may be required to come to an agreement. However, I believe we have the leverage and I intend to use it. After all, we are the significantly larger company, and they need this combination more than we do. I still want the agreement to be win/win, if an agreement is possible. But I have a responsibility to use our leverage while still being cooperative in the negotiations. I believe the leverage is real. If necessary, I will point out that the expected CIM value-added to IAA might not happen due to (a) weak client relationships – lots of dependence on FAA; clients must come with Danielle and Rob to IAA, (b) potential inability to expand business development with CIM existing clients, but I am confident we can do it, (c) mismatch in cultures; ours is very good; not sure about theirs; seems okay.
- My goal is to give Danielle and Rob 6% - 8% IAA ownership (in total, not each). This is fair based on valuation results, and it was the verbal agreement between us to have valuations serve as the basis for the equity split.
- Another goal is to have them accept the employment contract approach rather than formally merging the two companies. We need to convince them of the benefits and get them over the psychological hurdle of leaving their company behind.

- The goal on the employment contract is to have them accept it as written. We may need to make some concessions, but I think it is fair.
- Reverse vesting contract is a critical part of the employment contract. Part of the value we are buying with the IAA equity is their expertise. I want to avoid giving them equity with the potential for them to walk away from the company in a short period of time without giving that value. The purpose of reverse vesting is to structure a compensation package to provide incentive for them to stay at least three years.
- The goal related to the open balance on the CIM line of credit is for them to personally pay off that debt.
- I will propose one seat on the board for Danielle. With both Janice and I each having a seat, we still control the board.
- Voting rights for non-board, owner-related decisions will be based on ownership percentage.
- My proposed organizational structure is for Danielle to be Director of Account Services and Rob to be the Media Director initially and then potentially moving to be the Chief Operating Officer. Both will report to me.
- Bonus payout will be at my discretion and based on company performance, individual performance, and contribution to the value creation of the company.
- CIM company is dissolved and IAA has ownership of CIM brand, or as a concession, CIM name is still owned by Danielle and Rob but cannot be used for a period of five years from signing of employment contracts.
- No outside ventures allowed by any owners that would represent direct competition to IAA.

**(B3) CONFIDENTIAL INFORMATION FOR JANICE REYNOLDS,
OWNER/CO-FOUNDER, IAA**

After four months of due diligence, you are ready to finalize the negotiations with Danielle Adams and Rob Moyer, co-owners of CIM, and come to some agreement if the terms are favorable to both sides. As co-owner and co-founder of IAA with Andy Lane, you are very proud of the progress you and he have made with your company. It wasn't easy and there were sacrifices.

In addition to the issues you identified jointly with Andy, you also made the case that design is the essence of the agency, and any success of the company depends on having the very best web designers on staff. All else is just supporting creative design. This highlights a frustration you have with Andy, who believes that the success of the company does not depend purely on the design effort, but largely on meeting budgets and offering other services to clients. You agree to an extent, but superior design is sometimes giving the client more than they realize they need. In the end, great designs are the best business development tool the company has. Media buying and search engine management are important, but without great designs, clients would switch to those agencies that can give them great creative work.

Also, you had known for some time that Andy has been working very long hours and is under lots of stress taking on the role of president, business developer, account manager for the firm's largest clients, and supervisor of the other account executives, most of whom are young and have little experience on the job. You immediately wondered whether some aspect of the motivation to explore this potential merger is merely a means to relieve the pressure on him by

having Danielle and Rob assume some of his responsibilities. You wonder whether hiring an experienced account supervisor and media buying manager might be a better solution.

Andy has always wanted to make the important decisions, and his reaching out to include you in the process seems at times to be only a gesture. Even if you disagree, he still presents a strong argument, some of which you don't understand, and then does what he wants anyway. Most of the time they seem to work out, but sometimes they don't, and the company winds up losing money. You've been successful, so you haven't made an issue of your opinion not always being valued. You believe you can contribute more than Andy thinks you can. That is why you insisted on being present and participating in the negotiations. You intend to be very active in the negotiations.

One thing that is very important to you is to maintain high morale in the company. The staff is like a second family to you, and you like to have fun with them. Andy wants more of a business atmosphere, but these are young people and they don't produce as well in a corporate structure. The creative staff needs some freedom to be creative. You want to make sure that bringing the CIM staff into IAA will not upset the culture you worked so hard at building.

When you saw the valuations for both companies, the disparity surprised you and bothered you slightly. From the creative work you have seen coming out of CIM, they do great work. It is one of the reasons why you are excited about having their designers join your staff. They also have some great clients who would be fun to work with, which is why their low valuation troubled you. Could the valuation firm have made a mistake? A 94%/6% split makes IAA sixteen times more valuable than IAA. Although that would benefit IAA in the upcoming negotiations with CIM, it seems as if it could be too large a difference. Is it fair? If an agreement is made at that split, would Danielle and Rob be coming into IAA with a bad attitude and spoil the morale and culture of IAA? Maybe an 80%/20% or even a 75%/25% split would be fairer.

Another issue that you are concerned about is the board representation. You don't think they should have a seat on the board. Now, it is only Andy and you. With them having a seat, they could ally with Andy and potentially your influence would be diminished.

You are about to enter your meeting with Andy to agree on the goals of your negotiation with Danielle and Rob and the strategy of achieving them. You will be starting that negotiation shortly after meeting with Andy and, since time is of the essence, you made some notes to yourself in anticipation of that meeting. They are:

- We must have specific, optimistic, and justifiable goals, with the understanding that some reasonable concessions may be required to come to an agreement. I want to make sure that we don't appear too aggressive, as is the case at times with Andy. If we are going to bring them into the company, we need to continue to establish a good relationship with them.
- My goal is to try to stand by our agreement on using the valuations as the basis for the equity split, but if necessary, I am willing to go as high as giving them an equity percentage in the range of 10% - 12% (each). This would have been my guess if the valuations were not made.
- The employment contract approach seems like a simple idea, maybe a little drastic. But I see the benefits to IAA, and I don't see much difference to Danielle and Rob versus having a formal merger of the two companies. The goal is to convince them of the benefits and get them over the psychological hurdle of leaving their company behind.
- The employment contract is pretty detailed and we may need to make some concessions to have them accept it. We may need to make some concessions, but I think it is fair.

- Reverse vesting contract seems like a good idea. If I were them, I would not like the idea of losing all of the IAA equity if they leave within a year. Something may happen in their personal life that would require them to leave. But I guess that is business. As long as their creative staff doesn't leave with them, I'm not too concerned. So the goal is to get them to accept the reverse vesting, which gives them the incentive to stay with IAA for at least three years.
- Their open balance on the CIM line of credit is currently \$35,000. The goal is to have them pay that off themselves. If that is causing hard feelings, then maybe we could pay half of it, but definitely not all of it.
- My goal is no seats on the board for them.
- The bonus part of their employment contract should be based on their position with and contribution to the company. It will be determined by Andy and me, as we determine the bonuses to all other employees based on those criteria.
- The goal is to take CIM out of play altogether. With CIM in existence, Danielle and Rob could take the IAA equity after three years and restart CIM as a competitor again to IAA. Then they would own CIM and part of IAA. That wouldn't make sense.

**(C1) INFORMATION FOR DANIELLE ADAMS AND ROB MOYER,
OWNERS/CO-FOUNDERS, CIM**

The Phone Call

Four months ago Danielle and Rob decided to call Andy Lane, CEO of the Interactive Advertising Agency (IAA), suggesting a meeting with him and his partner, Janice Reynolds, to discuss the possibility of a merger of the two companies. For some time, both owners of Creative Internet Marketing (CIM) have admired the progress of IAA. It seems as if the growth of IAA occurred extremely fast while at the same time Danielle and Rob had a much more difficult time growing CIM, the company they founded 3 1/2 years ago. The CIM owners met the IAA owners several years ago at an advertising convention and have cultivated a professional friendship with them over the recent years. Andy especially has gained a reputation as a dynamic and successful businessman. Danielle both envied and admired Andy's growing status in the interactive advertising industry.

Just prior to making that call, Rob showed Danielle the latest financial performance documents as well as his financial forecasts, and both owners were very excited about the prospect that CIM had turned the corner and finally would see some profits this year. In fact, Danielle thought that Rob's projections were too conservative and would like him to show them even higher, but Rob resisted.

One of the reasons Danielle and Rob were excited about the increased level of business and projections is that they would be able to pay themselves more than their current annual compensation. Danielle's annual compensation currently (2007) is \$75,000, while Rob's is \$65,000. Those compensation levels are well below market for their experience and position. Rob's research, based on Advertising Age salary surveys, showed Danielle's salary range of \$120,000 to \$180,000 and Rob's range of \$90,000 to \$150,000. The ranges reflect differences in company size, region, experience, and seniority in position. This year, however, based on Rob's forecasts, Danielle determined that she would be able to take \$90,000 in total compensation for

herself, still leaving her under-compensated. She would suggest that Rob's compensation be at \$80,000.

Unfortunately, both CIM owners see a long road ahead, and don't like the prospect of having to earn less than market for several years while waiting for significant increases in cash flow, which in this industry always has risk. After work one day, Danielle and Rob began to explore the possibility of merging CIM with a larger firm, taking a significant equity position, and accelerating the process of value creation for themselves. Both agreed that a company that is profitable and growing fast and is from 2-3 times as large as CIM would be a good fit, as then potentially they would each be able to have at least a 15%-20% equity position in the combined company and would merit a significant say in the major decisions.

In deciding that a merger may make sense, Danielle and Rob identified the issues facing CIM as:

- 1) CIM's growth is not at the level where significant value is being created in the company. Traction is not being made in the industry and, as a result, CIM is falling behind other similar advertising agencies. The most recent financials show that profitability is turning the corner, but there is some uncertainty of the extent and duration of that turnaround.
- 2) CIM's quality, national clients with large marketing budgets have been reluctant to allocate more of their budgets to CIM. In fact, they have been putting CIM in a competitive situation with other firms to continue the business already with CIM. One reason might be that they believe CIM is too small for them, and feel more comfortable with a larger agency.
- 3) CIM has not been able to add quality clients on its own. It relies on referrals from First Avenue Agency (FAA) and that agency's business also has slowed. This is a significant risk going forward and could be addressed favorably with an increase in scale of the agency.
- 4) Cash flow is a constant worry, requiring outside debt at times. This requires owners to sacrifice compensation to keep the company moving forward.

IAA seems like the perfect merger candidate. Their relative size was right; the owners are acquaintances and seem like very honest, hard-working people. They are in the same city, in fact only a few miles from CIM's location, so there would be no dislocation. Rob said to Danielle that they would have to do a good job of convincing Andy that, even if the financials for past years do not show the prospects for emerging growth, the figures for first six months of the current year show signs of a real turnaround. Danielle told Rob not to worry, that she has always been very good at winning people over to her point of view. They agreed that Danielle would make the call to Andy Lane to determine whether the owners of IAA would be open to discuss a possible merger.

The Meeting

Danielle and Rob met with Andy and Janice at a restaurant equal distance from their respective offices. The CIM owners were impressed by what they learned about the owners of IAA, both personally and professionally. Andy and Janice had gone through the same process as Danielle and Rob in starting their company, with the same ambitions and fears. They saw the same opportunity in interactive marketing. Danielle and Rob discovered that Andy is clearly the driving force of the company and seems to have great insight into the industry and vision as to

where future opportunities will be evolving. He took risks, but calculated risks that created value for IAA. Danielle and Rob thought that it was a good start to the process of combining the companies in some way. At the conclusion of the meeting, the four owners agreed to begin the due diligence process with the ultimate objective of determining whether a merger is feasible.

The Rationale

The possibility of some type of combination of the two companies interests Danielle and Rob for the following reasons:

- 1) IAA is a financially sound, growing company, with a CEO who is gaining a great reputation in the industry as someone who can lead an organization to success. To be a partner with him and Janice in a much larger company than CIM would have many benefits. Danielle and Rob believe they can contribute significantly to the leadership of the combined company and create value at a much faster rate than they currently could with CIM.
- 2) In the due diligence, Danielle and Rob discovered that the IAA owners were able to pay themselves a good salary (\$120,000) and a great bonus (\$250,000) at the end of each of the past two years. They were honest in revealing that they plan to increase their salaries for the coming year to \$160,000 each based on the financial success of the company. Danielle and Rob see the merger of the two companies as an opportunity to immediately and significantly increase their annual compensation. They never felt comfortable with sacrificing so much income just to grow CIM.
- 3) In the due diligence discussions, Andy revealed that his plans were to have Danielle assume the role of Director of Account Services and Rob the role of Media Director. Both positions report directly to Andy as CEO. With CIM, Danielle currently is the lead business developer and account manager. Her expertise is client relationship-building. Rob manages the media buying for the CIM and is in charge of keeping the financial statements in order and making projections for CIM. During their lunch meeting, Andy and Janice realized that Rob is much more aware of the financial performance of CIM and that Danielle seemed to quote numbers without completely understanding them or having a valid basis for them.
- 4) IAA has a very diverse list of clients, many of which they secured through their business development efforts. Danielle admitted to Rob that she could have done a better job in developing business. She depended almost entirely on FAA to refer clients to CIM. An advantage, however, was that those clients are national companies with large upselling capabilities. In fact, they are of a higher quality than the clients of IAA, although less in number than the client base of IAA. In return for the access to those national clients, CIM pays FAA a commission which lowers the profit margin on those engagements. With the merged companies, the IAA business development effort would benefit everyone.
- 5) IAA has been very successful at expanding their client engagements by up-selling more services to those clients. The CIM clients do not seem to be willing to expand their engagements, choosing instead to diversify their portfolio of agencies. Danielle and Rob often discussed the possible reasons, conjecturing that diversification was the objective, or possibly that the larger clients felt that CIM is too small to handle expanded engagements, or even that CIM was not doing a very good job for them. Regardless,

having the capabilities of IAA would enhance the ability to up-sell services for the current CIM clients which Danielle and Rob are assuming will stay with them after the merger.

6) Even though Danielle and Rob would have a combined minority equity position in the merged company, both believe that there is a high probability (although not 100%) that the value of that position would grow significantly faster than the equity position they now have in CIM.

The Valuations

During the subsequent IAA/CIM due diligence meetings, a few of which Danielle was not able to attend due to family obligations, the CIM owners became more convinced that the merger would work. Recently, the two sets of owners focused on the split of the ownership of the combined company. There was a verbal agreement among the four owners that the valuations, performed by an impartial third party company that specializes in company valuations, would be a basis for the discussion of the equity split among the four owners. A mutually agreed upon valuation firm was engaged for that purpose.

When Danielle and Rob received the valuation report, both were shocked by the low valuation for CIM (\$750,000) and the high valuation for IAA (\$12MM), creating a disturbing disparity in the valuations. They surmised that either 1) they had completely underestimated the success and value of their company, or (2) the IAA valuation was much too optimistic, or (3) the CIM valuation was much too pessimistic, or (4) the valuation methods used were not correct (even though the valuation firm was a reputable one). Based on these relative valuations, the CIM owners knew that Andy and Janice would argue for a much lower equity split than they had anticipated, and they need to have reasons ready to negotiate a split more favorable to them.

The Risks

Danielle and Rob met at Danielle's house on a Saturday morning and agreed that they are enthusiastic about the possibility of combining the two companies in an advantageous way and being integral employees/owners of IAA. They also agreed that the following risks exist:

1) A 94%/6% split just cannot be right. IAA is not that much more valuable than CIM. In fact, the CIM client list is of higher quality than that of IAA, even though IAA has more clients. For Danielle and Rob to give up their company and only get 6% of IAA might not be worth it, unless they get a super compensation package that makes up for the valuation of CIM that is not being captured in the numbers. They will have to argue the case that the valuation company did not fully consider the future prospects of CIM based on the recent turnaround in profitability and that a true valuation would result in a more realistic split of the equity in the combined company.

2) The risk exists that Danielle and Rob will be treated simply as employees and not be given the appropriate influence in the decision-making of the merged company. Their ownership will be a minority, yet no owner will have a majority. All owners will have a minority interest. For giving up controlling the destiny of their own company to become minority owners of the merged company, Danielle and Rob feel as if they need to have some control in guiding the future of the new company.

- 3) Are Andy and Janice going to be fair in setting Danielle and Rob's compensation? The CIM owners have made considerable compensation sacrifices since starting CIM, and with the turnaround, they can see the opportunity with CIM to increase their salaries to market. But with the combined company, who would be setting their compensation, which includes salary and bonus? They will be at the executive level in the combined company and believe they need to be compensated slightly above market to make up for those sacrifices.
- 4) Will Danielle and Rob have board representation with Andy and Janice so that they can ensure that they will have a say in important company decision? Equal board representation would give them considerable power, but one seat to Andy and Janice's two would significantly reduce that power.
- 5) What security will Danielle and Rob have that their position in the combined company will not be at the whim of the majority owners? Will they have some assurance of employment with the company, and, at the least, a severance package?
- 6) If Danielle and Rob are forced to give up the right to the Creative Interactive Marketing (CIM) name, they feel they are giving up an escape route to regain some of the value that might still be in the CIM name if, for some reason, Andy and Janice terminate their employment with the merged company. As security, they would like to keep ownership of the CIM name.

The Negotiations

Danielle and Rob are about to meet to put the final touches on their negotiating strategy. Even though risks exist, the CIM owners believe they are manageable and have agreed that CIM would benefit from an agreement with Andy and Janice under acceptable terms and want to come to an agreement for many reasons. Their objective in this meeting is to establish a common set of goals to achieve in the following negotiations with Andy and Janice. There may be some issues where Danielle's goals may differ from those of Rob, but both are hopeful they can be resolved quickly. Immediately after this meeting, Danielle and Rob will go into their meeting with Andy and Janice to attempt to reach a mutually beneficial agreement. The CIM owners are confident of their views of the business benefits and risks to this transaction. They will use all their negotiating skills to craft a win/win agreement.

(C2) CONFIDENTIAL INFORMATION FOR DANIELLE ADAMS, OWNER/CO-FOUNDER, CIM

After four months of due diligence, you are ready to move forward with this transaction if the terms are favorable to CIM. As co-owner and co-founder of CIM with Rob Moyer, you are very proud of the progress you and he have made in growing your company. There were tough decisions to be made. Some you made based on information provided by Rob. Others you made by gut instinct. You wish you could take back a few of those "gut" decisions, but not many.

One of the issues you did not identify in your meeting with Rob is the fact that recently he has been getting frustrated very easily. He seems to be overly cautious about every decision that has to be made in the company. Risk is part of running a business, and without taking some risk, there is little return. You have begun to think that you may need to talk to him about this, instilling in him more of a "nothing venture, nothing gained" attitude toward decision-making.

You believe that Rob's conservative mind-set has influenced his financial projections. This profitability turnaround is real and dramatic, and you intend to make it a significant part of your negotiation strategy. You want to make sure that Rob does not convey any reservations about those projections. In your opinion, they are too conservative, and the performance of CIM in the next few years has a high probability of exceeding them.

With regard to the IAA/CIM merger discussions, early in those discussions you had entertained the idea of being president of the merged company, with Andy maintaining his CEO role. This would allow you to maintain some prestige in the industry and clout in the company. After all, you are the CEO of a well-respected company, CIM, and would be giving that up to facilitate the IAA/CIM merger. You have not brought up this proposal to Andy in your discussions, as you felt it would risk having Andy back away from the merger. However, you have not decided whether or not to make this an issue.

You believe the negotiations with CIM will be intense, but cooperative. Andy is known to be an extremely competent negotiator. With this merger, even though you will lose the prestige of leading your own company, the value-creation opportunity with the larger, combined company will be significant. Furthermore, given the cash-generating capabilities of the combined company, your compensation will increase dramatically. If all goes as expected, there likely will be a liquidity event in the next few years, after which you will have the funds to start a new company.

You are about to enter your meeting with Rob to agree on the goals of your negotiation with Andy and Janice and the strategy for achieving them. You will be starting that negotiation shortly after you meet with Rob. Since time is of the essence, you made some notes to yourself in anticipation of that meeting. They are:

- We must have specific, optimistic, and justifiable goals, with the understanding that some reasonable concessions may be required to come to an agreement. I want to be aggressive, yet not antagonize, as Andy will likely be the leader of the combined company. However, before the merger, we are at the same leadership level, so I will negotiate for a leadership role in the combined company, with significant influence in the decision-making process.
- A key goal is to challenge the disparity in valuations. They are subjective, based on projections of future performance. The valuation company apparently did not place the appropriate value on our projections, which are based on our recent turnaround. They clearly did not place enough value on our client base. Although Andy and I agreed that the valuations would serve as a foundation for discussions on the equity split, those valuations can certainly be challenged. I believe more reasonable relative valuations would be that IAA has 2 or, at most, 3 times the value of CIM. That would make our equity split between 25% and 33% of the combined company.
- One of my goals is to significantly increase the level of my compensation. I've sacrificed enough, and I need some catch up. IAA has the cash flow to support this. They are getting a proven leader who will add significant value to the company, so I feel as if I deserve a compensation package that represents my talents and experience. I also will negotiate for an annual bonus that is comparable to the majority owners of the company, that is based on the performance of the company, and that the majority owners cannot decide unilaterally that Rob and I get a disproportionately low end-of-year bonus.

- Another key goal is to get some assurances from Andy and Janice that we will be treated as owners and not merely employees. One way to accomplish this is to get board representation. We need to negotiate for two seats to match those of Andy and Janice.
- Some very preliminary discussions have taken place regarding the \$35,000 open balance on the CIM line of credit. That line of credit comes with CIM, so our goal is to make a justifiable case that it will become the debt of the combined company.
- Another issue that was not discussed at all in our previous meetings with Andy and Janice is what becomes of the Creative Interactive Marketing brand. Does it belong to the combined company? Rob and I spent nearly four years building the value of that brand. Our goal should be to maintain ownership of that brand, regardless of whether the new company will maintain the IAA name or have a new name.

**(C3) CONFIDENTIAL INFORMATION FOR ROB MOYER,
OWNER/CO-FOUNDER, CIM**

After four months of due diligence, you are ready to move forward with this transaction if the terms are favorable to CIM. As co-owner and co-founder of CIM with Danielle Adams, you are very proud of the progress you and she have made in growing your company. The journey has not been easy or smooth, but both of you have persevered and maintained the belief that the company will be successful.

When the idea of merging with IAA was first discussed, you were guardedly excited. IAA was clearly a success story with great leadership. To be part owner of that company as well as a key executive would provide you with the opportunity to create more value for yourself in the future than you have with CIM and more job security. Ever since founding CIM, you have been concerned with the company's ability to generate positive cash flow. The company always seemed to be a line of credit away from closing its doors. But that changed recently, with some clients increasing their budgets and new clients coming on board. You are sleeping much better these days. Maybe it's your conservative nature, but you are not completely sure that the turnaround is permanent. Ad agencies are just a phone call away from losing significant business. When you showed the latest financial results and your projections to Danielle, she was ecstatic, in contrast to your cautious optimism. In fact, she wanted you to increase your projections, which did not surprise you, but you resisted.

Since the start of CIM, you and Danielle have had a very good working relationship. However, you are gradually losing confidence in Danielle's ability to lead the company. She has the best intentions, but often makes decisions based on intuition rather than solid business principles and research. She listens to your more cautious approach to major decisions, but in the end makes her own decisions. As equal partners, you feel as if your input should have some influence on the decisions that guide the company into the future. Also, you have been in meetings when she has quoted numbers that have no basis in fact. Her rationale is "nothing ventured, nothing gained." That approach to discussions has been making you feel uncomfortable. You know if you were just more firm with her, you would be able to influence her, but you have not taken that approach yet.

Operating under the leadership of Andy Lane seems like a welcome change, but you never know until it occurs. On the one hand, they have grown IAA to a much greater degree than we have grown CIM, however, they are an unknown with respect to how they are going to treat you and Danielle. Are they going to treat you like owners or employees? Are you going to have a

say in the strategic direction of the company? Will you be on the board to ensure that you will have a say in important company decisions? Board representation equal to Andy and Janice would give you and Danielle considerable power, but one seat to their two would at least give you some influence in the major decisions. These issues are important to you.

Another issue that is important to you is job security, even if it means taking slightly less compensation. What security will we have in the company so that our position in the combined company will not be at the whim of the majority owners? We need to face the fact that we will be minority owners, with some minority negotiated percentage, but will we have some assurance of employment with the company, and, at the least, a severance package? After all, we are giving up our company to cast our lot with IAA.

Titles are not that important to you. Since the formation of CIM, you and Danielle have contributed exactly the same in initial funding and shared somewhat equally in making the key decisions in the company. Even though Danielle's title is President, it bothered you that last year she insisted that her compensation be at the \$75,000 level while yours is \$65,000. Her rationale is that as president of the company, she has higher-level responsibilities than you do. You did not make a big issue out of it, but it still is on your mind. Will Danielle and I have the same compensation? Will we be able to negotiate compensation separately with Andy and Janice?

The open balance of \$35,000 on the CIM line of credit seems to be an issue that needs to be resolved in the negotiation. You believe that the combined company should assume that debt, as they are also assuming the assets of the company, plus the staff and clients. But this issue does not have enough significance to you to be a deal breaker.

You believe the negotiations with CIM will be intense, but cooperative. Andy is known to be an extremely competent negotiator. With this merger, even though you will lose the prestige of leading your own company, the value-creation opportunity with the larger, combined company will be significant. Furthermore, given the cash-generating capabilities of the combined company, your compensation will increase to market levels and maybe higher.

You are about to enter your meeting with Danielle to agree on the goals of your negotiation with Andy and Janice and the strategy for achieving them. You will be starting that negotiation shortly after you meet with Danielle and, since time is critical, you made some notes to yourself in anticipation of that meeting. They are:

- We must have specific, optimistic, and justifiable goals, with the understanding that some reasonable concessions may be required to come to an agreement. The merger of the two companies would likely benefit CIM more than IAA, which leads me to believe that Andy and Janice have the leverage in the upcoming negotiations. However, we are bringing something of value to the merger and Andy and Janice realize that or else they would not have come this far. We need to be firm, yet cooperative. It is important that we show leadership in the negotiation and not just concede to everything that Andy and Janice want.
- A key goal is to challenge the disparity in valuations. They are subjective, based on projections of future performance. The valuation company apparently did not place the appropriate value on our projections, which are based on our recent turnaround. They clearly did not place enough value on our client base. Although there was agreement that the valuations would serve as a foundation for discussions on the equity split, those valuations certainly can be challenged. Given their performance relative to ours, I believe more reasonable relative valuations would be that IAA has 3 or, at most, 4 times the

value of CIM. That would make our equity split between 20 and 25% of the combined company.

- One of my goals is to at least be compensated at the market level for a Media Director, which I was told by Andy will be my position with the combined company, with over four years experience.
- Another key goal is to get some assurances from Andy and Janice that we will be treated as owners and not merely employees. One way to accomplish this is to get board representation. We need to negotiate for two seats to match those of Andy and Janice and, if necessary, concede to one seat.
- Will the Creative Interactive Marketing (CIM) brand name belong to the combined company? Danielle and I spent nearly four years building the value of that brand. Our goal should be to maintain ownership of that brand, regardless of whether the new company will maintain the IAA name or have a new name.
- I am concerned about Danielle's aggressive style of negotiating. What if she antagonizes Andy and Janice and they pull out of the deal? Is it possible for me to negotiate separately with them? Is that ethical? How would that work if I pursued a deal without Danielle? I would not reveal this thinking to Danielle, as she would think I would be betraying her. It would really be a last resort, and I don't even know if it is feasible.

(D1) EMPLOYMENT AGREEMENT - DANIELLE ADAMS

Interactive Advertising [Company] is prepared to offer Danielle Adams [Employee] a three-year employment agreement under the terms and conditions in this term sheet. The "effective time" of the employment contract is October 1, 2007 to September 30, 2010.

In General. Interactive Advertising Agency [Company] and Danielle Adams [Employee] agree that, as of the Effective Time, the Employee will enter into this Employment Agreement with the Company. This Employment Agreement includes the following terms:

Base Salary. Base salary of U.S. \$120,000 per year.

Bonus. Targeted annual bonus, determined by the majority decision of the Board of Directors, to be paid in a year-end (Dec. 31) bonus payment in accordance with the company's performance for that year. First bonus payment to occur on Dec. 31, 2008.

Severance Payment. In the event of termination of Employee for any reason other than just cause, as defined in the "Effect of Termination" paragraph below, and change of ownership of Company, Company will pay Employee a lump-sum severance payment equal to the maximum of 1) employee's salary, at the time of termination, prorated over the remainder of the employment contract and 2) one-year's salary at the employee's salary level at the time of termination. No severance payments will be paid upon a Change of Control of Ownership of Company.

Equity. Company will convey, upon commencement of this employment contract and in combination with this employment contract for six (6) percent of Company outstanding common stock, in total and not to each, of the current owners of CIM to be distributed among the owners as the owners see fit. Owners will communicate in writing, within five days of the commencement of the earliest signed of the employment contracts for Employee and Rob Moyer, the ownership distribution of the six (6) percent of Company common stock issued as part of the acquisition of employment contracts. If this communication is not made, both

employment contracts are void. This paragraph is duplicated in the employment contract to Robert Moyer, and the duplication does not indicate an additional six (6) percent distribution but pertains to the same six (6) percent distribution which pertains to the employment contracts of Employee and Robert Moyer in combination. In the event that either or both employment contracts are not executed, this paragraph is void.

Vesting and Forfeiture. The Employee's shares, based upon the distribution indicated in "Equity" paragraph above, are vested immediately subject to the following condition: In the event that the employee decides to leave the employment of Company prior to the completion of this employment contract, the common shares issued on commencement of this employment contract will revert back to the Company according to the following schedule:

Anniversary of the date of the Effective Time -----	Percentage of Shares Reverted Back to Company -----
First Year	100.0%
Second Year	66.6%
Third Year	33.3%

The common shares issued by Company will remain subject to forfeiture in the above percentages until the completion of this employment contract.

Effect of Termination. If the Employee's employment with the Company is terminated by the Company for any reason other than for Cause (as defined below), or is terminated due to the death or disability of the Employee, the Company relinquishes all rights to have shares revert back to the company. If the Employee voluntarily terminates the Employee's employment with the Company or the Company terminates the Employee's employment with the Company for Cause, reversion of shares back to the company will occur according to the above schedule. The Employee will receive no consideration from the Company on account of such reversion.

Cause. For purposes of this Agreement, "Cause" shall mean (a) a willful act by the Employee which constitutes fraud and which is injurious to the Company; or Conviction of, or a plea of "guilty" or "no contest" to, a felony; or (b) employee's continuing repeated willful failure or refusal to perform his material duties required by the New Employment Agreement which is injurious to the Company. No act, or failure to act, by the Employee shall be considered "willful" unless committed without good faith and without a reasonable belief that the act or omission was in the Company's best interest. The Employee's employment with the Company may not be terminated for Cause unless Employee has first been given the opportunity, together with his counsel, to be heard before the Board of Directors of the Company.

Change of Control. In the event of a Change of Control (as defined below) of Company, all reversion rights by the Company on common shares issued to employee through this employment will be relinquished by the Company. A "Change of Control", with respect to a company, will be deemed to occur (a) upon the sale by such company of all or substantially all of its assets, the consolidation of such company with another company, or the merger of such company as a result of which such company is not the surviving entity, or (b) if any other

company or group of affiliated companies acquires, directly or indirectly, ownership of more than 50% of the voting power with respect to the outstanding securities of such company.

Voting Rights. Employee voting rights are proportional to the shares of Company common stock owned.

CIM Company. Upon commencement of the employment agreements of both Employee and Rob Moyer, owners of CIM will dissolve CIM.

Use of CIM name. Upon commencement of the employment agreements of both Employee and Rob Moyer, owners of CIM grant the Company a five-year exclusive right to use the name Creative Internet Agency as a trade name.

Employee Manual. Employment under this agreement is subject to the terms and provisions of the Company's Employee Manual.

Board of Directors. Employee and Rob Moyer will have _____ seats on the Company Board of Directors.

Representation of Company. Company represents and warrants to the Employee that:

The issuance and delivery of the Issued Shares in accordance with this Agreement has been, or will be as of the Effective Time, duly authorized by all necessary corporate action on the part of Company, and the Issued Shares have been duly reserved for issuance; and the Issued Shares will be, as of the Effective Time, validly issued, fully paid and non-assessable.

Binding Effect. This Agreement shall be binding the Company and the Employee and their respective heirs, executors, administrators and successors.

Governing Law. This Agreement shall be governed by the laws of the State of _____.

Headings. The headings contained in this Agreement are for reference purposes only and shall not affect in any way the meaning or interpretation of this Agreement.

Confidentiality. The material contained in the Employment Agreement is confidential. It is intended for use of Employee solely in determining whether he desires to enter into an employment contract with Company and it is not to be copied or discussed with any other person.

IN WITNESS WHEREOF, the parties have executed this Transition and Stock Vesting Agreement, as of the date first written above.

Company

By:

Name: Andrew Lane

Title: President

By:

Name: Janice Reynolds

Title: Creative Director

Company

By:

Name: Danielle Adams

Title: Employee

(D2) EMPLOYMENT AGREEMENT – ROB MOYER

Interactive Advertising [Company] is prepared to offer Rob Moyer [Employee] a three-year employment agreement under the terms and conditions in this term sheet. The “effective time” of the employment contract is October 1, 2007 to September 30, 2010.

In General. Company and Rob Moyer agree that, as of the Effective Time, the Employee will enter into this Employment Agreement with the Company. This Employment Agreement includes the following terms:

Base Salary. Base salary of U.S. \$90,000 per year.

Bonus. Targeted annual bonus, determined by the majority decision of the Board of Directors, to be paid in a year-end (Dec. 31) bonus payment in accordance with the company’s performance for that year. First bonus payment to occur on Dec. 31, 2008.

Severance Payment. In the event of termination of Employee for any reason other than just cause, as defined in the “Effect of Termination” paragraph below, and change of ownership of Company, Company will pay Employee a lump-sum severance payment equal to the maximum of 1) employee’s salary, at the time of termination, prorated over the remainder of the employment contract and 2) one-year’s salary at the employee’s salary level at the time of termination. No severance payments will be paid upon a Change of Control of Ownership of Company.

Equity. Company will convey, upon commencement of this employment contract and in combination with this employment contract for six (6) percent of Company outstanding common stock, in total and not to each, of the current owners of CIM to be distributed among the owners as the owners see fit. Owners will communicate in writing, within five days of the commencement of the earliest signed of the employment contracts for Employee and Danielle Adams, the ownership distribution of the six (6) percent of Company common stock issued as part of the acquisition of employment contracts. If this communication is not made, both employment contracts are void. This paragraph is duplicated in the employment contract to Danielle Adams, and the duplication does not indicate an additional six (6) percent distribution but pertains to the same six (6) percent distribution which pertains to the employment contracts of Employee and Danielle Adams in combination. In the event that either or both employment contracts are not executed, this paragraph is void.

Vesting and Forfeiture. The Employee's shares, based upon the distribution indicated in “Equity” paragraph above, are vested immediately subject to the following condition: In the

event that the employee decides to leave the employment of Company prior to the completion of this employment contract, the common shares issued on commencement of this employment contract will revert back to the Company according to the following schedule:

Anniversary of the date of the Effective Time -----	Percentage of Shares Reverted Back to Company -----
First Year	100.0%
Second Year	66.6%
Third Year	33.3%

The common shares issued by Company will remain subject to forfeiture in the above percentages until the completion of this employment contract.

Effect of Termination. If the Employee's employment with the Company is terminated by the Company for any reason other than for Cause (as defined below), or is terminated due to the death or disability of the Employee, the Company relinquishes all rights to have shares revert back to the company. If the Employee voluntarily terminates the Employee's employment with the Company or the Company terminates the Employee's employment with the Company for Cause, reversion of shares back to the company will occur according to the above schedule. The Employee will receive no consideration from the Company on account of such reversion.

Cause. For purposes of this Agreement, "Cause" shall mean (a) a willful act by the Employee which constitutes fraud and which is injurious to the Company; or Conviction of, or a plea of "guilty" or "no contest" to, a felony; or (b) employee's continuing repeated willful failure or refusal to perform his material duties required by the New Employment Agreement which is injurious to the Company. No act, or failure to act, by the Employee shall be considered "willful" unless committed without good faith and without a reasonable belief that the act or omission was in the Company's best interest. The Employee's employment with the Company may not be terminated for Cause unless Employee has first been given the opportunity, together with his counsel, to be heard before the Board of Directors of the Company.

Change of Control. In the event of a Change of Control (as defined below) of Company, all reversion rights by the Company on common shares issued to employee through this employment will be relinquished by the Company. A "Change of Control", with respect to a company, will be deemed to occur (a) upon the sale by such company of all or substantially all of its assets, the consolidation of such company with another company, or the merger of such company as a result of which such company is not the surviving entity, or (b) if any other company or group of affiliated companies acquires, directly or indirectly, ownership of more than 50% of the voting power with respect to the outstanding securities of such company.

Voting Rights. Employee voting rights are proportional to the shares of Company common stocked owned.

CIM Company. Upon commencement of the employment agreements of both Employee and Danielle Adams, owners of CIM will dissolve CIM.

Use of CIM name. Upon commencement of the employment agreements of both Employee and Danielle Adams, owners of CIM grant the Company a five-year exclusive right to use the name Creative Internet Agency as a trade name.

Employee Manual. Employment under this agreement is subject to the terms and provisions of the Company's Employee Manual.

Board of Directors. Employee and Danielle Adams will have _____ seats on the Company Board of Directors.

Representation of Company. Company represents and warrants to the Employee that:

The issuance and delivery of the Issued Shares in accordance with this Agreement has been, or will be as of the Effective Time, duly authorized by all necessary corporate action on the part of Company, and the Issued Shares have been duly reserved for issuance; and the Issued Shares will be, as of the Effective Time, validly issued, fully paid and non-assessable.

Binding Effect. This Agreement shall be binding the Company and the Employee and their respective heirs, executors, administrators and successors.

Governing Law. This Agreement shall be governed by the laws of the State of _____.

Headings. The headings contained in this Agreement are for reference purposes only and shall not affect in any way the meaning or interpretation of this Agreement.

Confidentiality. The material contained in the Employment Agreement is confidential. It is intended for use of Employee solely in determining whether he desires to enter into an employment contract with Company and it is not to be copied or discussed with any other person.

IN WITNESS WHEREOF, the parties have executed this Transition
and Stock
Vesting Agreement, as of the date first written above.

Company

By:

Name: Andrew Lane

Title: President

By:

Name: Janice Reynolds

Title: Creative Director

Company

By:

Name: Rob Moyer

Title: Employee

Review Questions

1. Compare the business conditions of IAA and CIM at the time that Danielle Adams made the initial call to Andy Lane.
2. What was the motivation behind Danielle's call to Andy?
3. Why was Andy receptive to Danielle's call?
4. What were the issues that concerned Andy and Janice?
5. What were the issues that concerned Danielle and Rob?
6. Initially, why was Andy and Janice focused on calling the proposed combination an acquisition while Danielle and Rob wanted to call it a merger?
7. Do you feel that valuation was a justifiable standard upon which to base the equity split?
8. Without going into the detail of the valuation calculations, why do Danielle and Rob feel the relative valuations of IAA and CIM were not in line with their true relative values?
9. Was Danielle justified in objecting to the CIM valuation (and arguing for a higher valuation) even after she agreed to have an independent, impartial valuation firm perform the valuations?
10. Was Andy justified in arguing that the valuations should serve as the standard for the equity split even if he was surprised by the great disparity in the valuation of CIM as compared to IAA?
11. Do you think that Danielle and Rob should have equal board representation as Andy and Janice? If so, how can you justify it given that they do not have an equity ownership equal to Andy and Janice? If you believe they should have less board representation than Andy and Janice, say only one board seat for the two of them versus one each for Andy and Janice, then are they giving complete control over the direction of the company to Andy and Janice and, in effect, become truly only employees?
12. Why do you think Andy and Janice decided to use the "employment contract" approach to facilitating the combination rather than a merger or acquisition?
13. Under what conditions would you accept that approach if you were Danielle and Rob?
14. With regard to the compensation package that IAA is offering Danielle and Rob, do you think Danielle and Rob should have a say in determining their bonuses. Should they receive

bonuses equal to the bonuses received by Andy and Janice? If so, why? If not, how do you believe their bonuses should be determined?

15. What is your assessment of the employment contract that Andy and Janice are proposing to offer to Danielle and Rob? Make your evaluation separate from your opinion as to whether this is an appropriate approach to combining the two companies.

16. Under what “cause” conditions do you believe that either Danielle or Rob could be fired by Andy and Janice?

17. Do you believe a severance payment is warranted for Danielle and Rob in the event that they are fired? Explain.

18. What do you think would be the ideal board composition for the combined company?

19. From a strategic viewpoint, after the combination, do you believe that CIM should be dissolved or kept going in some form but being owned by IAA?

20. Do you believe it is in the best interests of Andy and Janice to negotiate with Danielle and Rob separately? On all issues? If not on all issues, then which ones?

21. Do you think it was a good strategy for Andy and Janice to give Danielle and Rob their employment contract separately? Why?

22. Do you think it is best for the two owner groups to (1) negotiate directly with each other, (2) hire an M&A firm to be an intermediary, or (3) hire professionals to negotiate the terms of an agreement?

23. As this is a real-life situation, what do you believe was the outcome of the negotiation?

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THE GOLDEN KRUST CARIBBEAN GRILL: ACHIEVING RAPID GROWTH IN A MATURE INDUSTRY

**Larry A. Gillus, Hampton University
Susanne L. Toney, Hampton University**

Golden Krust is a privately owned regional quick serve restaurant chain, operating primarily in the northeast region of the United States. The president and CEO is committed to rapid growth in the number of franchise restaurant locations. The goal is to expand the number of franchises from one hundred locations to six hundred over the next six years. Golden Krust must develop a new marketing strategy for achieving and sustaining this desired rapid growth. The financial impact of rapid growth in the number of franchise locations and the resulting sales creates new funding requirements for the organization. The critical task of the case is to analyze a private business enterprise without direct access to their confidential financial statements.

INTRODUCTION

Lowell Hawthorne, President and the Chief Executive Officer of Golden Krust Caribbean Bakery and Grill, Inc. ("Golden Krust"), spoke softly about the history and success of his company over the past fifteen years. Hawthorne was speaking to a large group of young entrepreneurs and other business people at the Black Enterprise Magazine Tenth Annual Entrepreneur Conference in Dallas, Texas. He was one of several event speakers at the Conference in May of 2005. At the Conference, Hawthorne announced plans to open 600 additional outlets over the next six years in the United States and Canada.

Lowell Hawthorne recognized the problems for achieving rapid growth at Golden Krust would be finding suitable locations and acceptable candidates to operate franchisee outlets in a mature industry. The quick serve restaurant industry was saturated by several large fast food chains with industry sales growing at roughly 4% per year. The number of outlets was growing at 1% per year with many fast food chains reducing their number of outlets due to changes in consumer taste for healthier diets. Hawthorne wondered if there was a need to change the marketing approach for their restaurant products and services.

The Hawthorne family started the business concept of the Golden Krust from their establishment of a small bakery in 1949 on the island of Jamaica. The family established their first quick serve American restaurant in 1989 at an urban location in New York City. Golden Krust started selling franchises in 1996 and was currently actively seeking rapid growth through franchising.

BUSINESS DESCRIPTION

Golden Krust is a regional quick serve restaurant chain offering and specializing Jamaican-style meat (beef and chicken) patties, jerk chicken, and other Caribbean dishes including bakery items such as pastries, cake and buns. The Company develops, operates, and licenses approximately one hundred quick serve restaurant locations in New York and seven other states. Golden Krust is a small private corporation organized in the state of New York with roughly \$ 1 million of invested capital.

Golden Krust develops, operates and licenses a chain of quick serve restaurants featuring dine-in, carryout and, at some locations, drive-by meal service. The Company license and sells franchises in malls, airports, convenience stores, stadiums, parks, universities and other locations. Golden Krust also manages operations of company-owned locations and other franchise locations under management support contracts with the independent owners of the franchises.

The Company promotes food quality through inspection, testing and continued evaluations of products and ingredients for the quick serve restaurants. Generally, independent third-party distribution companies deliver food products, paper supplies and other materials used in the restaurant operations to individual locations by under separate procurement contracts with Golden Krust. Certain major suppliers, such as Pepsi-co, have separate strategic agreement promoting their products and services.

The mission of Golden Krust is to develop, operate and grow into a large chain of restaurants in the United States and Canada offering a wide variety of high quality and delicious Caribbean-style meals and dishes to health conscious consumers. Company sales and other revenues are generated from operating restaurants, licensing franchises, and supporting franchise operations.

INDUSTRY BACKGROUND

Golden Krust competes regionally in the quick serve restaurant industry with approximately fifty thousand restaurant businesses in the United States. The highly competitive industry includes quick serve restaurant categories for burgers, chicken, pizza, sandwiches and other specialty items. This large industry is dominated by nationally branded restaurant marketing systems such as McDonald's, Subway, Domino's, and KFC. The industry includes limited service restaurants and their suppliers.

Competitors in the quick serve restaurant industry balance a desire for higher quality meals with the need for rapid consumer service and inexpensive pricing. The restaurant chains are able to successfully compete through innovation, novelty, timing and superior locations in market niches with unique segments of the fast food market. The difficult balancing of nutritional quality with meal service is address by some branded restaurant chains with better food variety and higher pricing.

The quick serve restaurant industry, in which Golden Krust competes, consists of roughly 167,000 limited-service eating places with approximately \$115 billion in annual sales based on 2002 economic data from the census survey of business owners. Limited-service locations are defined as restaurants where consumers select order and pay for cooked or prepared food before serving or eating those food items. The industry estimates of the quick serve restaurants excludes locations selling primarily alcoholic beverages, tobacco products and other non-food merchandise in addition to the food items.

Quick serve restaurants vary widely in size of operations and food selections. The average quick serve restaurant had annual sales of \$ 626 thousand in 2002 with an average of 16 employees. Most of the hourly employees worked on a part-time basis and received relatively minimal wage rates. Total wages and other payroll expenses represented about 25% of the total restaurant sales on average for each location according to the 2002 census data.

Separate independent wholesale distribution companies deliver the food and other supplies used in the daily operations, which generally represent about 35% of the total sales on average for individual quick serve restaurant locations. Buildings and related utilities generally represent 20% of the total sales with the remaining balance covering the administration and profit from the business. The franchisor operations tend to follow the operating cost patterns of the industry with regard to materials, labor and overhead.

BRANDED CHAINS

The quick serve restaurant industry is dominated by branded retail chains, which control over 60% of all locations in the industry. While the number of restaurant locations for the quick serve industry has been growing at 1%, the average growth rate for locations in the branded retail chains has been 5% per year for the past five years. The branded retail chains develop, operate and license restaurant locations on a direct and indirect basis. Approximately eighty-percent of the branded chains operate on an indirect basis as franchises under license agreements with independent third parties. The remaining restaurants operate on a direct basis as company-owned operations.

The franchise agreement is designed to assure consistency and quality in the operations. Under the standard agreements, franchisees supply financial capital by initially paying the franchise fee, obtaining operating facilities and purchasing inventory items for the business. The franchisees continue to reinvest and pay a percentage of the sales in royalties to the branded retail chain to support administration and promotion of branded quick serve chains in the fast food consumer market.

The primary type of food being offered at the quick serve location generally determines industry classification for each branded retail chain. The food classifications for the quick serve restaurants include burgers (26%), pizza (8%), chicken (9%), sandwiches (34%) and specialty items (23%). While the type of food competes for the same meal money, most quick serve restaurants do not consider other food categories of quick serve restaurants to be direct competition among fast food consumers.

The burger category of restaurants is led by McDonald's with 19,000 locations, Burger King with 9,000 locations and Wendy's 8,000 locations in the United States. While these large chains are focused on increased sales growth in foreign markets, the number of quick serve locations in this category has been declining in the USA by an average of 1% per year for the past five years.

The pizza category of restaurants is led by Domino's with 5,000 locations. While Domino's has been growing on an average of 2% per year, Papa Murphy's with 900 locations has been growing at 8% per year and CiCi's with 500 locations has been growing at 12% per year. The number of quick serve locations for this category has been growing at an average of 4% per year for the past five years.

The chicken category of restaurants is led by KFC (Kentucky Fried Chicken) with 7,000 locations including multi-branding with other affiliated quick serve chains. While the KFC

brand has been growing on an average of 2% per year, Popeye's with 2,000 locations has been growing at 5% per year, Church with 1,500 locations has growing at 4% per year, and Bojangles with 300 locations has been growing at 13% per year. The number of quick serve locations for this category has been growing at an average of 4% per year for the past five years.

The sandwich category of restaurants, which includes delicatessens, is led by Subway with 18,000 locations in the United States. While Subway has been growing on an average of 10% per year, Quiznos with 3,000 locations has been growing at 41% per year and Panera with 700 locations has been growing at 38% per year. The number of quick serve locations in this category has been growing at an average of 9% per year for the past five years.

The specialty category of restaurants, which includes ethnic themes, novel dining and special food groups, is lead by Taco Bell with 5,000 locations, Dunkin Donuts with 4,000 locations, and Sonic with 3, 000 locations in the United States. Taco Bell has been growing at 3% per year, Dunkin Donuts has been growing at 4% per year and Sonic has been growing at 5% per year.

The specialty category of restaurants includes Golden Krust (Caribbean) growing at 43% per year with 100 locations. This rate of annual growth compares to Maui Wiji (Hawaiian) with 400 locations growing at 44% per year and Qdoba (Mexican) with 200 locations growing at 38% per year. The number of locations in this category has been growing at an average of 6% per year for the past five years .

RESTAURANT OPERATIONS

Golden Krust currently operates and supports its restaurant locations in eight states and seeks to expand its operations by increasing the number of locations throughout the United States and Canada. The management plans to increase the number of restaurant locations by attracting independent minded people to license future franchise locations. Golden Krust seeks, what is described as, people with good common business sense to operate and own their franchises.

Golden Krust provides an unusual variety of Caribbean dishes and meals for individual taste and nutritional needs. The Company offers specialty dishes (jerk chicken, curried chicken, curried goat and fried fish) and combination meals (beef, chicken, fish and goat) with side items (steamed vegetables, white rice, fried plantains. The bakery provides a wide variety of products including cakes (carrot, rum, rock, fruit and bulla) buns (sugar, cheese, spice and round), breads (coco, wheat, duck and hard dough), rolls (coconut and currant) and puddings (bread and sweet potato).

Golden Krust offers nine varieties of Jamaican-style baked turnovers, which are described as nutritious and delicious. These small five-ounce patties may include quality meats or fresh vegetables with authentic Jamaican spices. The varieties include beef, chicken, shrimp, vegetable, spinach, soy, cheese and jerk chicken. Calories per serving range from 300 to 400 depending on the variety, with calories from fat ranging from 100 to 150 per serving. Nutritional value in cholesterol, sodium, fiber, sugar and protein vary with each meal variety to meet individual dietary needs.

Golden Krust produces and promotes Jamaican-style jerk chicken, which is marinated with twenty authentic herbs and spices, then slow roasted. While jerk chicken is popular among traditional customers, chicken is the principal ingredient. Chicken is served in three of the six specialty dishes, three of the eight combination meals and two of the nine patties. The high

frequency of products with chicken in the menu would qualify Golden Krust in the chicken category of quick serve restaurants. However, Golden Krust is generally considered to be in the specialty category due to its Caribbean theme bakery.

Golden Krust restaurants prepare, package and sell a menu of competitively price food items to consumers for dining in or out of the restaurant. Restaurant operations and organizational structure varies by location with the normal operating hours between 11:00am and 3:00pm for the lunch meal and between 5:00pm and 9:00pm for the dinner meal. The restaurants are open seven days per week and 52 weeks per year with operations closed for Christmas, Easter Sunday and Thanksgiving holidays.

An ideal restaurant organization consists of a general manager, an assistant manager, four shift supervisors and four teams of hourly employees for shift operations. Each shift has a maximum of two food handlers, two meal servers, two cashiers and two cleaning specialists. Team members are part-time employees, who work a maximum of one thousand hours per year. The management and supervisors are full-time employees with health and educational benefits plus matching 401-K retirement savings.

Golden Krust develops and distributes detailed operating manuals covering every aspect of the operations including food handling, food preparation, employee moral, site safety, and maintenance at the location. The location management and supervisors are responsible for the daily operations and ensuing compliance with the operating standards for hospitality, food quality, cleanliness, service speed and facility maintenance. Restaurants are routinely visited by Golden Krust to assure operating compliance.

Compensation varies by location with the average annual salaries for general managers being \$60,000 and \$45,000 for assistant managers. Shift supervisors earned roughly \$30,000 per year. Hourly wages for part-time employees with their pay ranged between \$8 and \$12 per hour with the average being \$10 per hour. The payroll cost, including all payroll taxes, is roughly \$600,000 per year per location.

The operating cost of a restaurant will vary by location, complexity and volume. However, a typical quick serve restaurant operates with food and supplies representing thirty-five percent (35%) of net sales, building and utilities representing twenty percent (20%) of net sales and the payroll cost representing twenty-five percent (25%) of net sales. Golden Krust receives six percent (6%) of the restaurant sales in royalties and uses 80% of the revenue for advertising to promote products and the brand name.

RESTAURANT START-UPS

The initial cost of creating new restaurant locations generally begins with employee training and development. The operating management attends and completes a required training session prior to the initial opening of the restaurant. The initial training session consist of supervisory skills, food product preparation, quality control, restaurant safety, customer service, labor management and normal equipment maintenance. The two-week training session was part of a continuing management development program.

Golden Krust believed it was important to maintain strong and open relationships with franchises and their representatives. The Company designed the franchise program to assure consistency and quality by being selective in granting franchises. Under a standard franchise agreement, the franchisees supply investment capital, lease the building space, purchase the equipment, and install signs for the operations.

The franchisee uses the investment capital to pay the franchise fee (\$25,000), pay for permanent leasehold improvements (\$150,000), pay for the furniture and equipment (\$85,000), and provide working capital (\$115,000). Operating management uses working capital to cover the costs and expenses of the first month including food and supplies (\$35,000), payroll expenses (\$50,000), rent and utilities (\$15,000), and advertising (\$15,000). The average cost of starting a franchise is approximately \$ 400 thousand.

Golden Krust generally provide capital expenditures, equaling 50% of the capital spending by the franchisee, to cover equipment and other improvements to support the additional franchise location. The company also requires the purchasing or leasing of certain kitchen equipment and dining area furniture to operate the restaurant. The required kitchen equipment would normally include four patty ovens, four food warmers, two freezers, three refrigerators, four steam tables and two menu signs. The dining area furniture will generally include tables and chairs for a seating capacity of fifty patrons.

Golden Krust is a primary purchaser of certain food products, paper supplies and other items used in quick serve restaurants. The key restaurants items were chicken products, beef products, flour, cheese, seafood, cooking oils, seasoning and packaging materials. Franchise restaurants must buy food and other supplies from Golden Krust with payment due in 10 business days of delivery, which is standard for the industry. The Company strives to provide food at the lowest sustainable site-delivered prices.

Golden Krust owns certain registered trademarks and several other service marks. The Company believes these marks have significant value and would vigorously oppose any infringement of its rights in state and federal courts. The Company would also pursue registration of any other marks, whenever it is feasible and the marks prove to be important to the business. Golden Krust authorized the use of the marks by franchises and licenses in their agreements. The rights to these marks can remain in effect indefinitely under current law and proper use.

Golden Krust is subject to various federal, state and local laws affecting the restaurant business and other commercial activities. The Company must comply with state laws that regulate the franchiser and franchisee relations in each state. New restaurant locations must comply with licensing and regulations from government authorities. The authorities include building, health, sanitation, safety and fire agencies.

Golden Krust is also subject to federal and state laws governing employment practices, overtime, and working conditions. Most employees were paid an hourly rate on the basis of federal and state wage guidelines. The Company is subject to child labor laws, which among other items, prohibits the use of hazardous equipment by employees 18 years of age or younger. Golden Krust has not been adversely affected by any of these laws.

Golden Krust maintains a central corporate staff of 130 individual to support and grow franchise operations. The company continues to develop and have certain valuable patents in food preparation and distribution, which are important to the restaurant business. The annual budget for selling, general and administrative expenses is roughly \$ 3 million. The management

continues to monitor and evaluate the organization to assure there is no material adverse activities taking place in the restaurant operations.

Golden Krust is subject to various litigation involving customers, employees and suppliers due to the nature and activities of the restaurant business. The Company continues to monitor its operations for compliance with all federal, state and local regulations. Golden Krust believed it has sufficient liability and property insurance to protect the assets of the Company and insure continued operations.

MARKET OPPORTUNITIES

The quick serve restaurant industry is characterized by franchise systems, part-time employment, rapid customer service and inexpensive low quality meals. Most of the quick serve restaurant companies sell franchise licenses and provide support with products, advertising and training. Some companies do not follow the usual pattern of offering franchises. Notable exceptions in the chicken category of quick serve restaurants are Chick-Fil-A with 1200 locations and Boston Market with 600 locations.

The fast food consumer market is constantly affected by the changes in consumer taste, economic conditions, traffic patterns, disposable income and other alternatives such as full service restaurants. The market is intensely competitive with respect to food quality, meal price, service speed and convenience for consumer. Generally consumers of fast food meals include all social and economic groups without regard to any occupations or any specific demographics. However, preferences for food content will vary among demographics due to health considerations.

There has been a continuing shift in consumer taste with a greater interest in the nutritional value of meals including counting calories and fat content. Consequently, there has been a movement by consumers from some of the traditional fast food meals such as burgers and fried chicken to roasted and smoked meats with more fruit and vegetable selections. This change has resulted in expanded menus, an increase in sandwich quick serve restaurants and a reduction in traditional quick serve burger restaurants.

The shift for more nutritional value has been joined by a desire among some fast food consumers to enrich and enhance the dining experience with a more upscale environment. Market segmentation by food quality has created opportunities for quick serve restaurants with consumers seeking non-traditional fast food meals with the convenience of quick service. The change resulted in an increase in the number of quick serve specialty restaurants.

The changes in consumer taste with nutritional value and upscale environment are reflected in the advertising by the branded quick serve chains in television and other mass media. The restaurant chains offer more salads and provide glass-enclosed sunroom for inside dining area. A fast-casual category has evolved as a growing segment in the fast food market with a wide diversity of quick serve food products and an increased emphasis on the food quality.

Consumers in the fast-casual segment are concerned with the food quality as measured by the calories, fat content, the level of cholesterol and the sodium content. Chicken offers the best nutritional value for fast-casual consumers seeking better food quality. Subway, from the quick serve sandwich category, would be a leader in the fast-casual market segment as well as Boston Market, from the quick serve chicken category with 600 locations. Boston Market is a wholly owned subsidiary of McDonald's.

Boston Market combines the quality of traditional American home cooking with the convenience of quick serve and the value of family dining. Boston Market features home-style meals with chicken, turkey, ham or meatloaf. Meals include steamed vegetables and other side dishes plus salads, soups and deserts. Ham and turkey sandwiches are available for the convenience of customers. Rotisserie grilled chicken provides a competitive advantage to Boston Market against other quick serve chicken restaurants.

Family living arrangements for children and the breakup of the two parent family unit contributes to the growth in the fast-casual market segment by providing low cost family meals with an emphasis on food quality and quick service. The market continues to be highly price competitive due to low price and low quality alternatives being readily available from other quick serve restaurants. Prices for meals at most quick serve restaurants generally stay in the area of \$5 per individual meal.

The growth in the fast food market is shifting away from the more traditional fast food such as burgers and independent quick serve restaurants. Quick serve restaurants chains are increasing through the expansion of operations and the selling of franchises. Consumers appear to be more receptive to branded quick serve chains with good nutritional value based on high volume mass media advertising. Accordingly, the sandwich category of quick serve restaurants was growing faster than other types of quick serve chains

MARKETING APPROACH

Golden Krust offered authentic traditional Caribbean dishes appealing to Caribbean immigrants and other consumers with similar taste. There were roughly 3 million foreign-born persons in 2000 from the Caribbean living in America. Golden Krust successfully opened 100 quick serve restaurants in local communities with Caribbean immigrants. However, the Caribbean immigrant population appeared to be insufficient to support the current level of growth at 25% per year with 20 new locations in 2005.

Golden Krust offers a variety of traditional and authentic Caribbean meals with chicken, beef, fish and goat served in combination with steamed vegetables, rice and other side dishes plus turnover patties, soup and a variety of Caribbean and American pastries. The slow-roasted marinated Jamaican jerk chicken provides the competitive advantage to Golden Krust against other quick serve specialty restaurants.

Golden Krust can not grow rapidly as a specialty ethnic restaurant with a relatively small ethnic group of consumers. The company will need to broaden its appeal and attract other consumers to grow at a high rate. Golden Krust is not able to challenge any of the major quick serve chains in the mass market due its small size, limited resources and lack of name recognition among consumers in the general public.

FINANCIAL IMPACT

Revenues in the quick serve restaurant industry are normally handled as cash transactions with some credit card usage. Suppliers generally require short credit terms (10 business days) due to the cash nature of the business with high turnover rates for receivables, inventories and payables. The average turnover rates are roughly 24 for receivables and roughly 12 for inventories. The overall asset turnover rate for the industry is 2 with long-lived assets representing 50% of the total assets.

Golden Krust derives most of its revenues from the manufacture and distribution of pre-prepared, ready-to-bake, traditional Caribbean food dishes. The food and other supplies are packaged and shipped to individual restaurant locations throughout the United States. Golden Krust quick serve restaurant locations are owned as franchises and operated by independent business people. The Company earns revenues from the sale of food and other supplies to franchises and projects these sales to grow significantly in the future.

Golden Krust earns additional revenues from the payment of the initial franchise fees, the leasing of certain specialized cooking equipment and the collection of royalties based on a percentage of gross retail sales at franchise restaurants. The Company also earns revenues by providing various services to franchisees and other customers. The Company earns franchise fees, royalties, support fees and other charges and projects revenues from these sales to also grow significantly in the future.

CORPORATE OUTLOOK

Golden Krust is a private family-owned corporation with Lowell Hawthorne as President (Chief Executive Officer), Leroy Hawthorne as Vice President (General Manager) and Herma Hawthorne as the Compliance Manager for the Company. The management team includes Lorraine Morrison as Director for Franchise Operations, Pauline Bennett-O'Leary as Director of Marketing, Steve Ament as Director of Operations and Desmond Barnet as Financial Comptroller.

In addition to senior corporate officers, responsibilities for line functions include food contracts, beverage contracts, paper supplies, transportation, labor relations and facilities. Line responsibilities include regional managers for visiting locations to assure consistency and quality control. Responsibilities for staff function include health, safety, taxes, permits, training and other support. In addition to the line and staff functions at the corporate level, the Company provides site services for location selection, lease negotiations, external architecture, internal engineering and building construction.

The anticipated growth and expansion of Golden Krust has required the hiring and placement of individuals into various management positions in order to facilitate a rapid growth in franchises. Senior management considered the challenges of rapid growth for Golden Krust and how to achieve the desired annual sales over the next five years. Management realizes it must develop a competitive advantage against the major quick serve chains and grow as a branded quick serve restaurant chain similar to other new successful restaurant chains.

Lowell Hawthorne expressed his pride in the growth of Golden Krust over the past fifteen years without borrowing money. He wondered if the company would be able to achieve and sustain the rapid growth of one hundred new locations per year, while maintaining no long-term debt.

Questions for Students

1. Assess the ability to sustain and support a rapid growth of one hundred new franchise locations per year with the current marketing strategy for Golden Krust. What is the total estimated capital requirement, for all parties, to fund and support this level of rapid growth with Golden Krust?

2. Prepare a set of hypothetical 2005 financial statements for Golden Krust Grill with one hundred (100) franchise restaurant locations based on industry statistical data. The hypothetical statements for Golden Krust should include an income statement and a balance sheet. What additional public information could be used to improve the accuracy of the financial statements?
3. Prepare a three-year projection of total revenues for Golden Krust based on the rapid growth of franchise restaurants with one hundred new locations per year, at a rate of two sites per week. Assume the industry average for annual inflation at three percent (3%) on the price of goods and services during each of the five years in the revenue projections.
4. Determine the total debt and equity capital investment requirement for Golden Krust to finance and sustain the rapid growth of one hundred new franchise locations per year by developing a forecast of the funding needs over a three-year period. Assume buildings and other occupancy-related equipment are leased from independent third parties.
5. Calculate a valuation of Golden Krust as a business based on the pro forma financial statements from the forecast of funding needs. The business valuation should be based on the discounted free cash flow generated by the operations of Golden Krust as the franchisor.

FAMILY FURNITURE CORPORATION: ANALYZING THE EFFECTS OF A PURE CAPITAL STRUCTURE CHANGE ON THE VALUE OF A FIRM

Robert Irons, Dominican University
Robert A. Weigand, Washburn University

The new CEO of a manufacturing firm is using the opportunity afforded by her recently acquired leadership role to analyze how introducing debt into the firm's capital structure might increase the value of the firm. The case leads students through an analysis of the effect of leverage on a firm's equity risk, required return, weighted average cost of capital, and ultimately, its value. The first part of the analysis involves assessing the firm's financial strength using financial ratios and valuation metrics, and evaluating whether external capital markets are likely to view the firm positively and provide debt capital at a reasonable cost. The second part of the analysis involves estimating the expected impact of debt on the firm's value and risk using both the adjusted present value and adjusted discount rate method. The case is deliberately framed in terms of a relatively small, family-controlled company so students can more directly relate to the strategic reasons firms pursue pure capital structure changes, a topic that can appear abstract and theoretical when taught in the context of large multinational corporations. The level of the case is appropriate for undergraduate finance majors or MBA students in a first-semester corporate finance course. Expected time to complete the case analysis is 10-14 hours of outside class time.

INTRODUCTION

Family Furniture Corporation is a U.S.-based manufacturing firm that produces a unique line of furniture for the consumer market. The firm was founded in Chicago in 1960 by Gustav Reinfeldt, a European immigrant descended from a long line of hand-crafted furniture makers. Over the years Gustav's conservative management methods resulted in sustainable growth and consistent profitability, even during economic slowdowns and recessions. By the late 1980s, when his daughter Lena and son Asa joined the firm, Family Furniture employed over 300 people in a variety of manufacturing, sales, distribution and clerical positions, and was generating \$12 million a year in profits on annual sales of over \$100 million. The firm's reputation for producing quality furniture at a reasonable price was well-established among many middle-class and upper middle-class families in the Chicago area, and the company enjoyed higher profit margins than

its competitors due to a near-zero advertising budget. Shortly after Lena and Asa joined the business the Chicago manufacturing facility was expanded, which allowed the company to begin distributing their product line in Milwaukee, Kansas City and St. Louis.

Lena advanced quickly within the firm and eventually reached the position of chief financial officer, in charge of both accounting and finance, while Asa gradually assumed the role of chief operating officer. The family members proved to be an effective management team, and the company's sales and profits continued to increase over time. By 1999 the company had reached the point where increasing demand for their furniture lines in the Milwaukee, Kansas City and St. Louis markets would require additional investment. Lena wanted to acquire existing manufacturing facilities in each of these "rust-belt" cities and modify them to produce furniture. This would require an infusion of external capital, however, and Lena lobbied hard to her father on behalf of two strategies: an initial public offering (IPO) of common equity and the introduction of debt into the firm's capital structure. She argued that floating public debt and equity and aggressively expanding into the three cities would provide growth opportunities for the firm and its employees, and create significant new value for the firm.

Gustav struck a compromise with his MBA-educated daughter: they would sell a 50% stake in the firm in an initial public offering of 25 million shares of stock. Another 25 million shares would be retained by the family, with Gustav owning 15 million shares and Lena and Asa owning 5 million shares each. Gustav was adamant on one additional condition before agreeing to sell stock to new shareholders: the firm had to begin paying a dividend to shareholders no later than its second year as a public company. Gustav envisioned shareholders as another type of customer, and he had built his business model on always treating his customers well. He would not agree to raise debt capital, however, as the proceeds from the IPO would be sufficient to fund their plans to expand regionally. His reasoning was "why pay to use someone else's money when we have plenty of our own?"

In the spring of 2000, with stock valuations peaking, the firm raised \$467 million in its equity IPO, issuing 25 million shares at a price of \$18.70 per share. Proceeds from the IPO were used to open new manufacturing facilities in Milwaukee, Kansas City and St. Louis, which resulted in a significant increase in sales as well as lower transportation costs to retail furniture stores in these markets. An additional strategy envisioned by Family Furniture also paid off: the company was able to hire many highly-skilled workers with experience in manufacturing due to a surplus of this type of labor in the rust-belt manufacturing economies. Gustav was particularly gratified by being able to employ more "good working people," and spent a lot of time at the new plants to make sure that his family-friendly business culture was implemented properly.

The firm continued on a successful trajectory until late 2007, when, while recovering from an illness, Gustav decided to retire and turn full control of the company over to Lena. While his heart was still in the business, he knew his physical health would not allow him to be as involved as he liked, and that his daughter had the knowledge and drive needed to continue to grow the company in the 21st century. Seizing the

opportunity, Lena, now CEO, hired Darren McCaferrey, a consultant, to investigate the possibility of introducing debt into the firm's capital structure by issuing bonds. Lena viewed her father's retirement as the perfect catalyst for issuing debt that would be used to fund a stock repurchase plan. Given the success of the company following its IPO, the key executives needed to diversify their wealth holdings, which had grown significantly and were highly concentrated in the stock of the firm. Additionally, Gustav had a need for short-term liquidity to make arrangements for his retirement. (On a strictly family level, the Asa and Lena agreed on another point as well — Gustav needed to find fulfillment in retirement, lest he become restless and desire to come back to a management role with the firm.) The firm's board of directors authorized Lena to investigate the economic benefits of a leveraged recapitalization, with the maximum amount of debt the firm would be allowed to raise strictly capped at \$400 million.

Darren is charged with determining the impact adding debt to the capital structure will have on the firm's current common share price of approximately \$20.00. After consulting with the company's bank and a Wall Street analyst that follows the firm's stock, Lena and Darren agreed on several parameters to be used in the analysis. The banker contributed what the firm's market cost of debt would be at various debt/assets ratios (ranging from 10-50%, shown in Exhibit 3), as well as the schedule of debt, which outlines the increments of debt the firm could raise. The stock analyst contributed the firm's beta, the risk-free rate, the market return, and the firm's long-term growth rate, to be used as inputs into the firm's cost of equity calculation (provided in Exhibit 4). Lena and the consultant further agree that the best way to proceed with the analysis is as follows:

1. Analyze the firm's financial statements from the past 5 years (2003-2007) to determine whether or not the firm exhibits sufficient financial stability and success to raise debt from capital markets. The analysis will focus on trends in the usual financial ratio categories such as liquidity, asset management and profitability, as well as more finance-based metrics such as NOPAT, FCF, EVA, MVA, and an estimate of the firm's fair value based on a discounted cash flow model of FCF (specific metrics for the analysis are shown as Exhibit 5). Also, estimate the annual returns the firm has provided for shareholders since their IPO in 2000 (including the firm's dividend yield, which has averaged 3-4% since 2001).
2. Estimate the impact of debt on the risk and expected return of the firm's stock at various levels of borrowing, ranging from \$50 million to \$400 million. (The cost of debt capital to the firm at various debt/assets ratios and the borrowing break points at which the risk and expected return of the firm's equity should be computed are provided in Exhibit 3.)

3. Estimate the impact of debt on the firm's weighted average cost of capital (WACC) at various levels of borrowing (provided in Exhibit 3).
4. Estimate the impact changing the firm's capital structure will have on the value of the firm, the market value of the firm's equity, and the firm's market-value added. At each level of leverage, specifically indicate the overall gain in value achieved and the number of shares that must be repurchased to complete the leveraged recapitalization.
5. Make a recommendation regarding the optimal level of debt to use in the firm's capital structure.

Lena also informed Darren that she was going to conduct the same analysis based on her business experience and business school education, using a different theoretical approach to the analysis. Lena felt that by using different analytical approaches to the same issue, they were likely either to come to the same conclusions, thus adding support to their conclusions, or uncover issues that may cause them to rethink the assumptions they are using in their analysis. In either case, Lena felt that two heads were better than one.

Exhibit 1. Family Furniture Corporation Balance Sheets 2003 – 2007

Family Furniture Corporation
Annual Balance Sheet
Year Ending December 31 (000s)

	2007	2006	2005	2004	2003
Assets					
Current assets					
Cash	49,951.3	47,170.7	46,000.6	45,114.1	38,612.7
Marketable Securities	12,873.1	10,994.0	9,194.0	5,994.6	5,791.9
Receivables	84,601.6	81,661.8	78,824.1	74,085.1	73,441.2
Inventories	63,976.0	73,058.3	81,780.8	88,706.8	95,492.1
Other Current Assets	71,726.5	63,583.1	47,483.8	39,579.7	25,410.3
Total current assets	283,128.6	276,468.0	263,283.3	253,480.3	238,748.2
Non-Current assets					
Property and equipment, gross	425,241.2	397,575.3	376,670.1	350,493.0	336,012.4
Accum. Depreciation and Depletion	55,422.5	50,571.7	45,911.0	41,441.0	37,140.3
Property and equipment, net	369,818.7	347,003.6	330,759.1	309,052.0	298,872.1
Intangibles	32,234.5	32,065.7	30,937.0	30,775.8	29,594.1
Other Non-Current Assets	33,313.2	30,925.0	29,137.8	28,819.9	25,350.9
Total Non-Current Assets	435,366.4	409,994.2	390,833.9	368,647.7	353,817.1
Total assets	718,495.0	686,462.2	654,117.2	622,128.0	592,565.3
Liabilities and stockholders' equity					
Current liabilities					
Accounts payable	51,502.4	51,287.4	50,124.4	47,607.2	45,949.4
Short-term Debt	0.0	0.0	0.0	0.0	0.0
Other Current Liabilities	2,266.2	3,211.6	3,157.9	3,105.1	3,053.2
Total current liabilities	53,768.6	54,499.0	53,282.3	50,712.3	49,002.6
Non-current liabilities					
Long-term debt	0.0	0.0	0.0	0.0	0.0
Deferred income taxes	0.0	0.0	0.0	0.0	0.0
Other non-current liabilities	0.0	0.0	0.0	0.0	0.0
Minority interest	0.0	0.0	0.0	0.0	0.0
Total non-current liabilities	0.0	0.0	0.0	0.0	0.0
Total liabilities	53,768.6	54,499.0	53,282.3	50,712.3	49,002.6
Stockholders' equity					
Preferred Stock	0.0	0.0	0.0	0.0	0.0
Retained Earnings	197,556.0	164,792.8	133,664.5	104,245.2	76,392.3
Common Stock	467,170.5	467,170.5	467,170.5	467,170.5	467,170.5
Total stockholders' equity	664,726.4	631,963.2	600,834.9	571,415.6	543,562.7
Total liabilities and stockholders' equity	718,495.0	686,462.2	654,117.3	622,128.0	592,565.3
Shares Outstanding (thousands)	50,000	50,000	50,000	50,000	50,000

Exhibit 2. Family Furniture Corporation Income Statements 2003 – 2007

Family Furniture Corporation
Annual Income Statement
Year Ending December 31 (000s)

	2007	2006	2005	2004	2003
Sales Revenue	402,410.9	389,933.0	376,746.9	364,711.4	353,402.5
Cost of sales	203,752.4	198,453.7	193,292.8	188,082.9	181,775.3
Gross Operating Profit	198,658.4	191,479.3	183,454.1	176,628.5	171,627.2
Selling, General and Administrative Expense	68,968.3	68,942.1	68,599.1	68,571.7	69,439.7
Other taxes	0.0	0.0	0.0	0.0	0.0
EBITDA	129,690.1	122,537.2	114,855.0	108,056.8	102,187.5
Depreciation and Amortization	4,850.8	4,660.7	4,470.0	4,300.7	4,190.7
EBIT	124,839.3	117,876.5	110,385.0	103,756.1	97,996.8
Other income (net)	0.0	0.0	0.0	0.0	0.0
Total Income available for interest expense	124,839.3	117,876.5	110,385.0	103,756.1	97,996.8
Interest expense	0.0	0.0	0.0	0.0	0.0
Minority interest	0.0	0.0	0.0	0.0	0.0
Pre-tax income	124,839.3	117,876.5	110,385.0	103,756.1	97,996.8
Income taxes	48,391.9	45,243.8	41,739.9	38,766.0	36,414.9
Special Income/Charges	0.0	0.0	0.0	0.0	0.0
Net Income from Continuing Operations	76,447.4	72,632.7	68,645.0	64,990.1	61,582.0
Net Income from Discontinued Operations	0.0	0.0	0.0	0.0	0.0
Normalized Income	76,447.4	72,632.7	68,645.0	64,990.1	61,582.0
Extraordinary Income	0.0	0.0	0.0	0.0	0.0
Income from Cumulative Effect of Acct Changes	0.0	0.0	0.0	0.0	0.0
Income from Tax Loss Carryforward	0.0	0.0	0.0	0.0	0.0
Other Gains (Losses)	0.0	0.0	0.0	0.0	0.0
Total Net Income	76,447.4	72,632.7	68,645.0	64,990.1	61,582.0
Dividends	43,684.2	41,504.4	39,225.7	37,137.2	35,189.7
Dividends per share	0.87	0.83	0.78	0.74	0.70
Preferred Dividends	0.00	0.00	0.00	0.00	0.00
Addition to Retained Earnings	32,763.2	31,128.3	29,419.3	27,852.9	26,392.3
EPS from Total Operations	1.53	1.45	1.37	1.30	1.23
Diluted EPS from Total Operations	1.53	1.45	1.37	1.30	1.23
Income Tax Rate	38.8%	38.4%	37.8%	37.4%	37.2%
Shares Outstanding (thousands)	50,000	50,000	50,000	50,000	50,000

Exhibit 3. Cost of Debt Schedule & Borrowing Schedule (from the Banker)

Weight of Debt (W_d)	Cost of Debt (r_d)
1.00%	5.50%
5.00%	5.75%
10.00%	6.00%
15.00%	6.35%
20.00%	6.75%
25.00%	7.25%
30.00%	7.90%
35.00%	8.60%
40.00%	9.40%
45.00%	10.10%
50.00%	10.75%

Borrowing Schedule
50,000
100,000
150,000
200,000
250,000
300,000
350,000
400,000

Exhibit 4. Levered Beta, Capital Asset Pricing Model, and Valuation Data Items

Unlevered Beta (B_U)	1.15, per the analyst
Tax Rate (T)	Avg. tax rate from 2002-2006 Income Statements
Risk-free Rate (r_F)	4.00%, per the analyst
Expected Market Return	11.00%, per the analyst
Long-Term Growth Rate	Average rate of DPS and EPS growth 2003-2007, per the analyst

Exhibit 5. Financial Ratios and Valuation Metrics

Liquidity

Current
Quick
Net Working Capital to Total Assets

Asset Management

Days Sales Outstanding
Inventory Turnover
Fixed Assets Turnover
Total Assets Turnover

Cash Conversion Cycle

Inventory Conversion Period
Days Sales Outstanding
Payables Deferral Period
Cash Conversion Cycle

Profitability

Gross Profit Margin
Operating Profit Margin
Net After-Tax Profit Margin
Total Assets Turnover
Return on Assets
Equity Multiplier
Return on Equity

Growth Rates

Dividend Growth Rate
Earnings Growth Rate
Sales Revenue Growth Rate
EPS (earnings per share)
DPS (dividends per share)

Exhibit 5. Financial Ratios and Valuation Metrics (continued)

NOPAT, EVA and FCF

NOPAT (net operating profit after tax)

ROIC (return on invested capital)

EVA (economic value added)

FCF (free cash flow)

Weighted Average Cost of Capital (Cost of Equity based on CAPM)

Calculations of Total Capital (supports FCF calculation)

Net Operating Working Capital

Operating Long Term Assets

Total Operating Capital

Discounted Cash Flow Valuation Model (using 2007 inputs)

Long-term Growth Rate (average of DPS and EPS growth rates)

Value of Operating Assets (PV of growing perpetuity of FCF)

Value of Non-Operating Assets

Total Intrinsic Value of the Firm

Per Share Intrinsic Value of the Firm

MVA (market value added)

CAMPBELL'S RESORT

Thomas Klaasen, Texas Wesleyan University

The Renshaws, a couple in their mid-forties, are considering the purchase of a fishing resort on the White River in northern Arkansas. The asking price of \$650,000 is fixed. Bank financing is available assuming a \$200,000 equity investment by the Renshaws. Their financial analysis includes an evaluation of the asking price, an estimation of expected return on their equity investment, and determination of income to provide a comfortable living.

In November, 2001, Steve and Janet Renshaw were reviewing an opportunity to purchase Campbell's Resort on the White River in northern Arkansas. The package would include approximately 5 acres of land, a residence with a retail tackle shop attached, nine rental units of various sizes, a double wide mobile home, a floating dock, and four boats equipped with outboard motors. Opportunities to purchase this type of operation in that area were infrequent and the Renshaws felt they needed to make a decision as to whether they should express serious interest in the opportunity before Christmas. The asking price for the resort was \$650,000 which appeared to be non-negotiable.

THE RENSHAWS

The Renshaws were in their mid-40s. Janet had received an associate degree in electrical technology from Westview Community College. She was initially employed as an installer of electrical equipment and later as a consultant in the electrical design and installation business. In 1997 she was employed by a company to install software for inventory, cost and production management. In 1999 she started her own consulting firm performing the same tasks for businesses.

Steve had a degree in electrical engineering from Ohio State University. He owned and operated his own metal fabricating business, building custom made electrical equipment. The business was very successful, but the Renshaws decided they would prefer a warmer climate. Thus, Steve sold the business and they moved to Austin, Texas. The technology boom in Austin allowed Janet to pursue her software interest while Steve pursued an interest in drag racing, both building and racing the cars.

During this time, the subject of some day owning a resort was discussed and occasional visits to websites were made just to see what opportunities were available. The issue came to a head in September of 2001. On 9/11 Janet was stranded out of town as air traffic came to a halt. While driving home in a rental car, she decided that being on the road some 200 days a year was not the way she wanted to live, and a serious search for a resort for sale should begin. Although they had set no geographical boundaries in their initial search, they favored certain areas where they had spent vacation time, the Ozark Mountain region of Arkansas being one of them. After

correspondence with a real estate broker via the internet, they traveled to the region in November of 2001. It was then that the opportunity to purchase Campbell's Resort presented itself.

The Renshaws viewed themselves as a good team to run a business. Janet had the experience of inventory, accounts receivable and production management and was a "detail" person. She also enjoyed meeting and conversing with people. Steve had experience in the broader picture of management and viewed his skills as being a visionary for long-term planning. He also had vast outdoor experience in fishing and possessed the skills to become a licensed guide. Both were very mechanically inclined and felt they could handle much of the maintenance that would be required at a small resort.(Renshaw, 2004)

THE LOCALE

The resort area of the Arkansas Ozarks was somewhat different from most peoples' view of a resort region. There were very few large, single destination resorts, i.e. resort locations that were self contained, offering a large variety of services where the guest has no need to leave the resort itself for food, entertainment or activities. Most Ozark resorts were small with fewer than 50 beds and less than 10 acres. The attraction is the small, friendly, and relaxed approach to vacationing where the outdoors offers opportunities for fishing, hiking, horseback riding, and other water sports such as canoeing, water skiing, scuba diving, and swimming. Most resorts offer housekeeping units allowing guests to cook their meals and eat on location. The area is relatively pollution free as evidenced by the clear night sky where stars can be seen at the horizon.

The area in which Campbell's Resort is located is known as the Twin Lakes Region of the Ozarks. It lies in north central Arkansas and is so named because of two large lakes, Bull Shoals Lake and Lake Norfork. Four other geological attractions are important to the area: the White River, the Norfork River, the Buffalo National River, and the Ozark National Forest. The shorelines of the lakes and rivers are little developed offering an unspoiled natural resource. According to the Arkansas Department of Parks and Tourism, approximately 800,000 tourists visit the area each year, spending about \$129 million. (Cooley)

The population center of the area is Baxter County where the city of Mountain Home is located. With a population of approximately 40,000, the county offered most services that a visitor might want, including a regional medical center and a general aviation airport.

THE WHITE RIVER

In the late 1940s, a dam was constructed on the White River in northern Arkansas, creating Bull Shoals Lake which stretches from northern Arkansas into Missouri. Water that is released from the dam is cold and clear making excellent habitat for rainbow, brown and cutthroat trout. The Arkansas Conservation Department began to stock trout in the river in the early 1950s, creating a productive recreational fishery. This fishery stretches for over 100 miles below the Bull Shoals dam and has become known nationally as a productive trout river offering excellent fly and bait fishing and the chance of landing very large fish. The State of Arkansas supports the fishery through its Game and Fish Commission which annually plants over one million trout in the White River.(GFC) Articles featuring the river have appeared in outdoor magazines such as *Field and Stream* (Merwin, 2001) and *FlyFisher* (Whitlock, 2001). The

tremendous increase in the popularity of fly fishing has brought many people to the White River in recent years. Yet because of its size, fishing conditions remain uncrowded. Although the sales of fishing licenses in the State of Arkansas have grown at a rate of less than one percent the past five years, the sale of trout permits has grown at an annual rate of 3% during the same period.(Arkansas FGC)

THE RESORT

In 1951, Fred Johnson built a camp on the river that consisted of four cabins and a house. Attached to the house was an office/tackle shop. In 1974, the resort was sold to the Campbells. Additional facilities were constructed bringing the total rental units to seven. Mr. Campbell was an avid fly fisherman and stocked the tackle shop with flies that were productive on the river. He also provided guide services. During the 1990s, the facilities did not receive adequate maintenance, and the resort began losing customers. In 1999, as they reached their middle 70s, the Campbells decided to sell. Shortly after the sale, Mr. Campbell died. Mrs. Campbell retained a portion of the property and continued to live in a double wide mobile home located there until the resort was again put on the market in late 2001.

In 1999, Peter Wilson bought the resort from the Campbells and began an extensive remodeling program. He installed new fiberglass shower stalls, new refrigerators and stoves, and new bedding linens. He also added two rental units and converted the water system from well water to the local community source. Because he was not a fly fisher, Wilson also shifted his emphasis away from fly fishing by eliminating all fly tackle from the tackle shop. Even though the occupancy rate increased, Mr. Wilson decided after two years to put the camp on the market. At about the same time, Mrs. Campbell decided to sell her adjacent property and the mobile home.

The resort that the Renshaws considered purchasing included the house with the office/tackle shop attached, nine housekeeping rental units of varying size, the double-wide mobile home, a floating dock, and four boats and motors that would either be used for guided fishing trips or that people could rent by the day for their own use. The resort occupied about five acres of land. Approximately $\frac{3}{4}$ of an acre was undeveloped.

THE COMPETITION AND LOCAL INDUSTRY

As they evaluated the business opportunity, the Renshaws wanted to isolate who exactly their competition would be. Although the yellow pages for Baxter County listed dozens of accommodations for the area, they felt most would not likely be direct competition. They decided to focus on those other resorts located directly on both the White and Norfolk Rivers in Baxter County. Both rivers had excellent fishing reputations and were in close proximity because the Norfolk flows into the White within Baxter County. They felt that location on the river was an important feature for many visitors to the area. There were nine such resorts in Baxter County. Except for two who offer on-location food service, the others offered the same services as Campbell's: housekeeping units, small convenience store, boat rental, and guide service. The lack of food service at Campbell's was not viewed as a disadvantage. The typical visitors to the area preferred to prepare most of their meals, especially with the opportunity to eat their catch of the day. Many nearby restaurants were available for those not wanting to cook all of their own meals.

One of the key advantages Campbell's offered was its specific location on the river. There are many areas on the river where wade fishing is almost impossible and even if attempted, not very productive. Fishermen staying at resorts located at those locations must either rent a boat to reach other areas or drive to other public access points. Campbell's was located on a half-mile stretch of river that offered easy access and excellent fishing. One repeat customer reported, "We started coming here in 1997 when the facilities were pretty run down, but because of its location on the river we keep returning. The renovations of the past two years make it that much more attractive.(Jenkins, 2004).

Pricing competition on the river was not aggressive. The rates Wilson was charging at the time of sale were about 10% below average for the rental units, even though he had raised his rates some to help recoup his renovation costs. His fees for guide service and boat rental were average. (See Exhibit 2)

FINANCIAL DATA

To develop pro-forma financial statements, the Renshaws acquired data from several sources. First, the current owner, Peter Wilson, offered some ideas but provided no past financial statements. His most useful information centered around the seasonal aspects of the business, a breakdown of the sources of revenue and a rate chart. Second, Gary Cooley, a local real estate broker involved in the resort business for a number of years provided data on average occupancy rates.(Cooley) Finally, industry expense data were available from BizStats.com and RMA Industry Ratios.

As the Renshaws began serious evaluation of the opportunity, they first reviewed the assets they would be purchasing. In many ways, this was a turnkey operation. The resort has been in existence for over 50 years, and while it lost customers in the 1990s, a base of repeat customers did exist. Of the nine rental units, one unit was suffering from a plumbing problem which would likely require replacing some flooring. The estimated cost for these repairs was \$2000. The four fishing boats and motor combinations were dated and would likely need to be replaced within the next few years at a total cost of \$24,000. For the first year however, repair costs of \$8,000 were anticipated. Comfortable boats and reliable motors are important to retain customers. The Renshaw family would use the house for their living quarters. Mrs. Renshaw's mother would occupy the double- wide mobile home. The undeveloped land had possibilities for the addition of one or two rental units or parking spaces for RVs. The estimated values for the assets to be purchased are listed in Exhibit 1. The Renshaws wanted to begin with a cash balance of \$10,000, but expected to maintain an average cash balance of \$5,000 through the year.

Exhibit 1. Values of Assets to be Purchased

Land	\$150,000
Buildings	\$325,000
Dock	\$7,000
Boats	\$20,000
Inventory	\$12,000
Furniture and Fixtures	\$30,000
Total	\$544,000

Next, the Renshaws wanted to estimate annual revenues. They learned that average occupancy rates for established resorts in this region ranged from 40 to 60% for the year. The business was seasonal with the spring and summer being the peak time. Assuming a 50% average occupancy rate, the following quarterly occupancy rates are normal: Quarters 1 & 4, 15% occupancy, Quarters 2 and 3, 85% occupancy. Total revenue receipts take on a similar pattern: 10% for each of quarters 1 and 2 and 40% for each of quarters 3 and 4. Revenue sources include room rentals, 60%, guided fishing trips, 20%, boat rentals, 10%, and retail sales, 10%.

Exhibit 2. Rate Schedule for Campbell's Resort, 2001

<u>Description</u>	<u>Number Of Units</u>	<u>Daily Rate</u>
2-Person Unit	4	\$60
4-Person Units	2	\$75
(in building)		
4-Person Units	2	\$100
(separate structures)		
6-Person Units	1	\$120
Boat Rentals	3	\$75
Guided Trip	1	\$190

To estimate first year total revenue for the resort, the Renshaws decided to assume a conservative occupancy rate of 35%. This rate would be applied evenly to rooms, boat rentals and guided trips. They also would use the existing rate structure as found in Exhibit 2. Although some resorts close during the off season of December – February, Campbell's would remain open the entire year. Based on information from the seller, store sales were projected at \$25,000.

Second year revenues were projected using the following assumptions: the average occupancy rate would increase to 40% and rates on rental units would increase 10%, as would store sales. Boat rental and guide rates would remain constant. For the third year, the occupancy rate was projected to be 45% and all rates were projected to rise by 5% as would store sales. For subsequent years, revenues were projected to increase at a rate of 5% due to a combination of increased occupancy and rate increases.

To estimate operating expenses, the Renshaws first looked at industry data from Bizstat.com and RMA Annual Statement Studies. After looking at this information, the Renshaws felt that not all of the expense ratios reported fit their situation. For example, Cost of Goods Sold was reported industry-wide as being 12.3% of revenues. However, many in the industry sample would provide food service (Bizstat.com). Because Campbell's did not, they estimated a CGS percent of 8%. Similarly, because of the liability issues attached to boat rentals, they felt the insurance expense would be close to 6% of revenues, higher than the industry average of 2.1%. Key expenses as a percent of sales can be found in Exhibit 3.

Exhibit 3. Selected Expenses as Percentages Of Revenue, 2002

<u>Expense</u>	<u>Percentage</u>
Cost of Goods Sold	8.0%
Salaries and Wages	10.7
Repairs	4.6
Supplies	4.0
Insurance	8.5
Utilities	11.0

Also, as new owners of the resort, they felt they needed to spend considerably more than the 2% of revenues indicated for the industry for advertising. They planned on a \$15,000 advertising budget for the first year, decreasing to \$10,000 for the second year and then \$7,000 each year thereafter. Specific marketing decisions still needed to be made.

Non-income taxes, including payroll and property taxes were determined using the standard rates on payroll for social security and medicare (7.25%), and by looking at last year's property taxes. Property taxes were projected to be \$2,000 for 2002, then increasing by 10% each year. Interest expense could be estimated from the bank loan arrangements as discussed below.

Using the estimated book value of assets in Exhibit 1, depreciation would be determined as follows: buildings and dock depreciated to a salvage value equal to 50% of their current value over a ten year period; boats and motors depreciated to a \$5000 salvage value over three years; furniture and fixtures depreciated to a \$15,000 salvage value over five years. Straight-line depreciation would be applied. Capital expenditures were projected to be zero for year one, \$10,000 for 2003, \$15,000 for 2004, and then \$5,000 per year for the foreseeable future. The expenditures would be used for boat and motor replacement and general renovation. Depreciation estimates are given in Exhibit 4.

Exhibit 4. Depreciation Expense

<u>Asset</u>	<u>Purchase Value</u>	<u>Salvage Value</u>	<u>Years</u>	<u>Annual Depreciation</u>
Buildings	\$325,000	\$162,500	10	\$16,250
Dock	7,000	3,500	10	350
Boats	20,000	5,000	3	5,000
Furniture	30,000	15,000	5	3,000

Total Annual Depreciation Expense: \$24,600

Bank financing for resort purchases was available in this region. Although the exact terms would depend on the personal balance sheet of the buyer and the bank's assessment of the likelihood of their success, a minimum down payment of 30% is common. Interest charged would likely be at a 3 or 4 percent premium over the 6% prime rate. The loan could be amortized over a 20 year period. A likely covenant of the loan would be a compensating balance equal to three monthly payments. If the new owners demonstrate the ability to produce profits and cash flows, the loan can often be renegotiated after 2 or 3 years for a lower interest rate.

Revolving lines of credit also become available to assist in expansion or remodeling. The first four years of the loan amortization are in Exhibit 5.

Exhibit 5. Loan Amortization: First Four Years

	<u>Payment</u>	<u>Interest</u>	<u>Principle</u>	<u>Balance</u>
Year 1	\$55,206	\$47,000	\$8,206	\$ 461,794
Year 2	\$55,206	\$46,179	\$9,027	\$ 452,767
Year 3	\$55,206	\$45,277	\$9,929	\$ 442,838
Year 4	\$55,206	\$44,284	\$10,922	\$ 431,916

The asking price for the resort was \$650,000. The Renshaws would be able to pay a down payment in cash of \$200,000 and finance the remainder through a local bank. They anticipated some immediate expenditures such as plumbing and new bathroom flooring to make the ninth unit rentable and repairs of boats would require an additional \$10,000, plus \$10,000 would be held as cash. Thus the amount borrowed would total \$470,000. The bank would charge 10%. The bank recognized the potential cash flow problems associated with fixed monthly payments due to the seasonal aspect of the business. It was therefore willing to forego a monthly payment and require a total amount for the year based on an annual payment calculation. The exact timing of the payment was up to the borrower. The only other debt would be some trade payables amounting to around \$5,000.

After the down payment, the Renshaws would have \$50,000 in liquid assets for living expenses, if necessary. They estimated their annual needs for personal living expenses to be \$30,000.

The venture was not without risk. First, although staffing needs would be minimal, a dependable, honest person who would handle the housekeeping chores was important. Because such a position usually would be paid close to minimum wage, turnover was a real possibility. Second, two new river location resorts had opened in the past two years. New competition was a threat, especially as the new resorts offered newly built facilities.

Third, the fishability of the river is dependent on water flow release from the dams on the two lakes. The dam at Bull Shoals, for example, contained eight generators. If more than two are running, the river is very difficult and dangerous for wade fishing. If more than 6 generators are running, boat fishing becomes problematic. A spring season with heavy rainfall would raise lake levels to where water would be released until normal levels were achieved. This activity can discourage fishermen from the area and make revenue projections difficult.

Although the Renshaws were determined to be diligent in their analysis of the opportunity to purchase Campbell's Resort, they knew an expression of strong interest needed to be conveyed to Mr. Wilson within the next few weeks. As they started their analysis of the opportunity, a number of questions arose.

Student Questions

1. Although owning a resort sounds romantic and fun, how well prepared were they to go into the venture and what were their chances of success?
2. Is the \$650,000 asking price reasonable?
3. What annual rate of return on their investment would they be willing to accept? Although some owners buy resorts for short-term investments (five years), the Renshaws hoped to make this their home and a long term venture.
4. What would a beginning balance sheet look like?
5. What would the projected statements of profit and loss and cash flow look like for the next four years?
6. How should they spend the estimated marketing budget of \$15,000?
7. Excluding occupancy and rate considerations, what other means might exist for increasing annual revenues?
8. Would there be sufficient cash flow to pay expenses, service the debt, and provide \$30,000 in annual income to the Renshaws?
9. Should they purchase the resort?

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AN INVESTMENT MANAGER'S DILEMMA: SHOULD SHE RECOMMEND SELLING TALISMAN ENERGY

**Dorothee Feils, University of Alberta
Grace C. Allen, Western Carolina University
Kevin Roseke, University of Alberta**

The foreign direct investment by a Canadian oil and gas company in the politically sensitive country of Sudan provides a situation to explore an investment decision of a mutual fund manager. The case emphasizes the impact of ethical issues on a company's stock price and the appropriateness of holding the company in a mutual fund.

THE CHARGE

In February of 2001, Laura Johnson, an investment manager for a large mutual fund company, was faced with the decision whether to recommend the sale of Talisman Energy, a stock in the company's diversified international fund. The fund's objective was to seek out companies that were of higher risk with the potential to generate higher capital returns. Laura was extremely proud of the performance that her fund had generated over the past five years. Its five year average return was in the top five percent of all international equity funds. Laura worked with a team of other portfolio managers and they were meeting the next day to review the portfolio and consider the sale of any of the current holdings. Several months prior, Talisman Energy had been placed on the fund's priority watch-list and it seemed that Laura and the other managers were spending a disproportionate amount of time monitoring events in Sudan as they related to Talisman. At tomorrow's meeting, Talisman would be at the top of the list for discussion. All four managers were researching Talisman; however, it would be Laura's responsibility to lead the discussion since she recommended Talisman's purchase more than three years ago.

Laura felt that there were three factors most relevant in her decision process. The first factor was Talisman's future growth potential. Production had grown significantly over the past four years and she would need to determine if this growth could continue. A second factor was the riskiness of the stock compared to the expected return. Since its purchase several years ago, Talisman's stock price had increased; however, Laura was wondering if the increase in the stock price was enough to compensate for its volatility and political risk. A third factor was the ethical choice of holding Talisman in the fund. In the past year, the claims of human rights violations against Talisman had intensified. Several managed funds had sold their shares of Talisman as a result of these allegations. Although Laura's fund was not classified as a socially responsible fund, she contemplated if it were morally right to profit from a company such as Talisman.

At the meeting tomorrow Laura would present to the other managers a recommendation based on all three factors. To help make her recommendation she gathered the background

information on Talisman Energy, the Canadian and US Oil and Gas Industry as well as the current role Talisman was accused of playing in the Sudan crisis.

COMPANY BACKGROUND

A spin-off from British Petroleum PLC in 1992, Talisman Energy is an oil and gas company based out of Calgary, Canada. As a newly independent company it announced that it would strive to increase its oil and natural gas production by 20%. This goal led Talisman's push into politically risky ventures in regions of unrest such as Indonesia and Algeria. In 1998, the company found and pursued another high-risk high return foreign direct investment in the country of Sudan.

From Talisman's 1997 – 2000 Annual Reports, Laura collected information on Talisman's stock price performance, net income and growth potential, as well as, information on oil and gas production and reserves to help her make a recommendation on the stock.

Exhibit 1: Stock Price History.

		2000		1999		1998		1997	
		TSE	NYSE	TSE	NYSE	TSE	NYSE	TSE	NYSE
		(C\$)	(US\$)	(C\$)	(US\$)	(C\$)	(US\$)	(C\$)	(US\$)
Share Price (dollars)	High	58.85	39.75	49.15	32.56	45.6	32.13	55.25	37.125
	Low	34.4	23.88	22.1	15.67	22.5	14.63	37.05	28.75
	Close	55.65	37.06	36.9	25.92	26.95	17.5	43.75	30.375
Yr. end shares outstanding (million)		135.3		138.3		118.9		109.6	

TSE (Toronto Stock Exchange); NYSE (New York Stock Exchange)

Exhibit 2. Financial Highlights (millions of Canadian dollars).

	2000	1999	1998	1997
Cash flow	2,413	1,111	631	797
Net Income (loss)	906	177	(259)	77
EBITDAX	2,902	1,352	813	902
Exploration and Development Expenditures	1,179	996	1,145	951
Total Assets	8,676	7,808	5,457	5,031
Long-term debt	1,733	2,195	2,086	1,739
Shareholder's Equity	3,665	3,623	2,214	2,187

Exhibit 3. Consolidated Statement of Income (years ended December 31).

(mil. of Canadian dollars except per share amounts)	2000	1999	1998
Revenue			
Gross Sales	4835.9	2317.6	1533.6
Less Royalties	945.8	389	213.5
Net Sales	3890.1	1928.6	1320.1
Other	98.8	46.2	50.6
Total Revenues	3988.9	1974.8	1370.7
Expenses			
Operating	826.9	603.5	581
General and Administrative	94.9	70.1	58.9
Depreciation, depletion and amortization	1152.6	746.6	614.8
Dry hole	77.3	50.6	91.2
Exploration	99.6	79.5	102.4
Interest on long-term debt	135.9	119.6	91
Other	15.8	-60.6	143.7
Total Expenses	2403	1609.3	1683
Income(loss) before taxes	1585.9	365.5	-312.3
Taxes			
Current income tax	333.5	48.8	14.6
Future income tax	196.5	109.2	-87.9
Petroleum Revenue Tax	149.6	30.7	19.8
	679.6	188.7	-53.5
Net Income (loss)	906.3	176.8	-258.8
Preferred security charges, net of tax	22.5	13.3	
Net Income (loss) avail. to common stockholders	883.8	163.5	-258.8
Per common share (Canadian dollars)			
Net Income (loss) available to c. stockholders	6.41	1.31	-2.31
Diluted net income (loss) available to c. stockholders	6.32	1.3	-2.31
Average number of c. shares outstanding (millions)	137.8	124.6	111.9

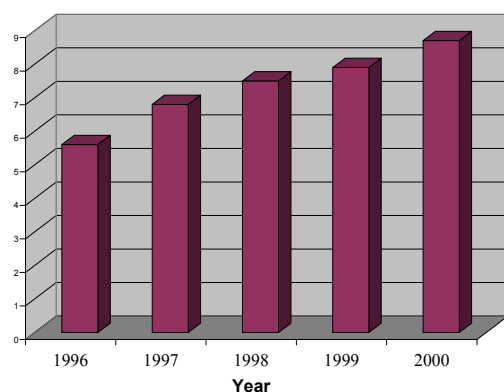
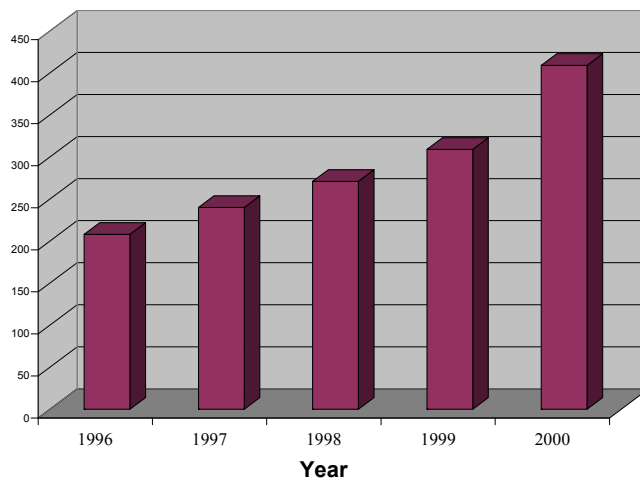
Figure 1. Proved Reserves (bpe/share at year end)

Figure 2. Oil and Gas Production (mboe/d)

The decision on whether to keep Talisman in the portfolio depended not only on the financial performance and future potential of Talisman, but also on the ethical issues of holding a company with involvement in Sudan. In order to better understand the ethical issues involved, Laura gathered the following information on the conflict in Sudan and Talisman's involvement in the conflict.

OVERVIEW OF THE SUDANESE CONFLICT

The conflict in the country of Sudan, the largest country in Africa, has its roots in colonial British rule, the rise of nationalism, and tribal and regional tensions. In the early 19th Century, the controlling British divided northern and southern Sudan into two separate areas with two separate administrations, regardless of tribal divisions. In 1956, Sudan gained independence from Britain but quickly became a country torn by civil war. Southern Sudan is mainly populated by indigenous people and Christians. The Sudan People's Liberation Army (SPLA) is located in the south. Northern Sudan, mainly Arab and Muslim, is the seat of the government. Over the decades the government has become increasingly dictatorial, supporting the Islamization of Sudan, and has been eroding the power of the south to govern itself.

In 1977, Chevron, a US oil company, began drilling for oil in southern Sudan and made significant discoveries between 1979 and 1982. The government made efforts to ensure that Sudan's oil revenues would benefit the North and not the South, where the oil fields actually are located. Tensions escalated until 1983, when drastic measures were taken by the government to end the constitutional rights of the South. Chevron halted its operations after the murder of three expatriate workers in 1984. It attempted to resume its work in 1988, given the potential of the Sudanese oil fields, but withdrew two years later. Then in 1997 the civil war escalated when foreign oil companies returned to the oil-rich region. The western companies asked the government to protect them from the SPLA. The government complied allowing human rights violations, from looting and burning villages and crops to rape, abduction and torture in the name of petroleum concession protection. Arakis Energy, a small Canadian energy company, developed a good connection to the government of Sudan and was able to purchase the Chevron

holdings for a small amount. But developing the oil fields proved to be beyond Arakis' financial ability.

THE FOREIGN DIRECT INVESTMENT

Since its inception in 1992, as a spin-off of British Petroleum PLC, Talisman had pursued successfully politically risky ventures in regions such as Indonesia and Algeria. Talisman Energy saw another potentially lucrative investment opportunity in Sudan and purchased Arakis Energy in August 1998. This purchase gave Talisman a 25% ownership in the Greater Nile Petroleum Operation Company (GNPOC), a partnership between four companies seeking to drill and pump oil through a 1500-km pipeline to Port Sudan on the Red Sea. Talisman would provide the needed cash flow to develop this venture. Within months, Talisman was criticized by the anti-Sudanese government rebels for supporting the government by the exploration of oil that did not promise to benefit the Sudanese people leading only to an escalation in the countries' civil war. Also questioning Talisman's Sudan operations was one of Talisman's shareholders, The United Church of Canada, who suspected that royalties from the project would be used to fund the civil war.

In response to the criticisms Talisman's CEO, James Buckee, defended the Sudan project saying the project benefited the Sudanese people by providing much needed infrastructure, jobs and royalties. As Chief Executive Officer James W. Buckee put it "...development is good and stagnation is bad. Lack of investment won't help anyone." (*Oil & Gas Journal*, 1999a). Unable to convince shareholders of ethical behavior, the Texas Teachers Retirement Fund sold 100,000 shares of Talisman Energy in November 1999. A month later TIAA-CREF, a college teacher's fund, sold 261,000 shares. In late 1999, The United Nations claimed that the oil development in Sudan was worsening the human rights situation there. Several months later, the US Government imposed unilateral sanctions against GNPOC as Sudan was deemed to be a sponsor of terrorism.

Figures 3 and 4 show the relative importance of the Sudanese operations for Talisman.

Figure 3. Oil Production by Region (bbls/d).

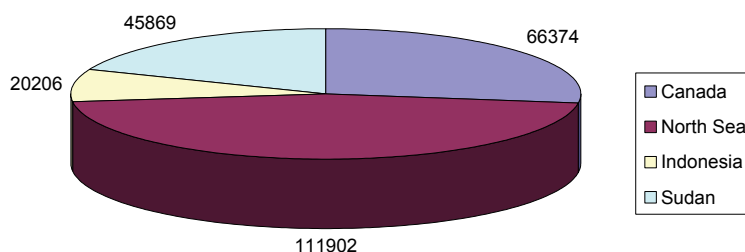
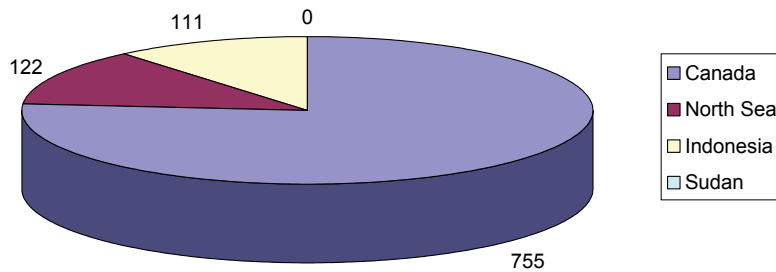
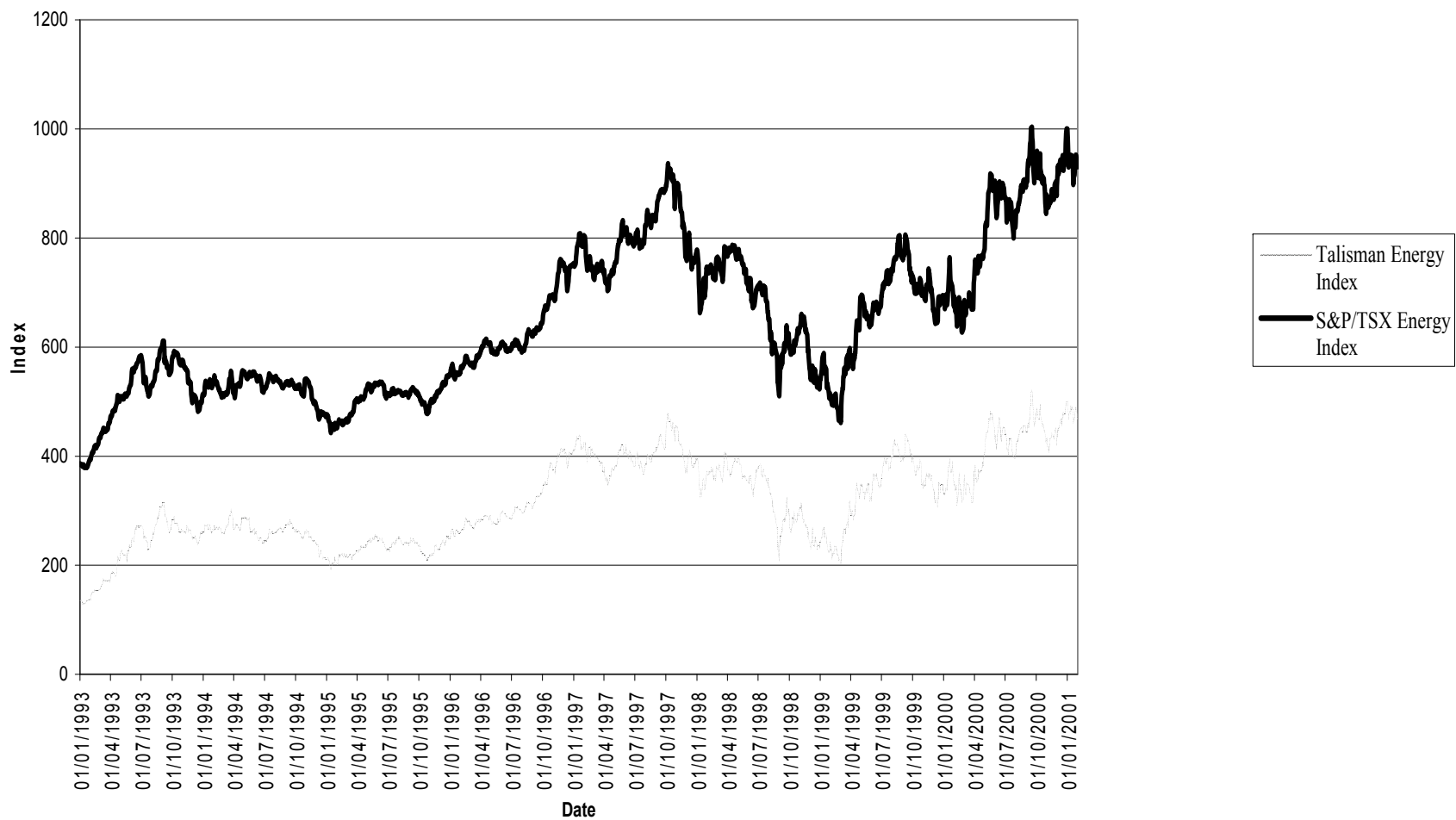


Figure 4. Natural Gas Production by Region (mmcf/d).

As expected, the Sudan investment was an operationally very successful venture for Talisman. The rate of return from the Sudan oil fields was a phenomenal 30%. Approximately 20% of Talisman's oil production came from Sudan contributing to the firm's profits of \$906 million in 2000; however, the stock price languished at levels much lower than appropriate for the earnings level. Evidence of a depressed stock price can be seen in Figure 5 where Talisman is compared to the industry (Datastream).

Figure 5. Talisman and Energy Index Performance.



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PERDUE FARMS

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Perdue Farms Inc., most widely recognized for their chicken products, is a vertically integrated agribusiness with annual revenue of \$2.8 billion. As the fifth largest poultry producer in the country in terms of sales, the company is poised for a period of explosive growth. Founded in 1920 by Arthur Perdue, the company has remained privately-held and family-run for three generations. With the passing in 2005 of the legendary Frank Perdue (made famous with his, "It takes a tough man to make a tender chicken" advertising campaigns), the responsibility of managing this growth has fallen squarely on the shoulders of CEO Jim Perdue. Will the company be able to remain privately-held and family-run while achieving stated sales targets of \$20 billion? Or, will external equity be required to fund the rapid expansion of the enterprise?

COMPANY HISTORY

The Early Years

In 1920, Arthur Perdue left his job as a railroad worker and started the family business. What has since become the fifth largest poultry production enterprise in the United States had its humble beginnings with Arthur, joined later by his son Frank, selling table eggs. Until the early 1940's, the company, at that time named A.W Perdue & Son, focused solely on the production and sale of eggs. After World War II, Arthur and Frank Perdue expanded the business to include selling commercial chicken feed to other poultry producers. As the feed business expanded, Frank began to research and develop his own feed combinations.

Frank Perdue expanded the family business further in the 1960's with the purchase of the company's first chicken processing plant. The preparation of chicken for market had not been part of the business before that time, but significantly higher margins made processing a natural extension of existing operations. Around the same time, the company also entered the turkey market to compliment existing chicken-focused operations. It is during this period of expansion that the company began to become recognized for its commitment to quality products. In a market saturated with competitors' products, the only way to improve the margins on processed

* Please note: This case and accompanying teaching notes were composed using only publicly available data. No privileged data was made available by Perdue Farms and there was no collaboration between the authors or the affiliated institution with any employee (past or present) of Perdue Farms. The analysis and conclusions offered in this case are those of the authors and in no way represent the views or opinions of Perdue Farms, its employees, or the Perdue School of Business at Salisbury University. The authors are solely responsible for any and all errors or omissions contained within the text of both the case and accompanying teaching notes.

poultry parts was to gain a reputation for quality. With a loyal customer base of quality-minded butchers on the Eastern Shore of Maryland, it was time to expand into bigger markets. To avoid direct competition with more established poultry producers in the South, Perdue initially bypassed the mid-Atlantic markets of Washington D.C., Baltimore, and Philadelphia and aimed for a much bigger prize: New York.

Advertising was a key factor in the successful introduction of Perdue poultry products into markets throughout the Northeast during the 1970's and 1980's. A prominent advertising agency hired by the company to develop the campaign suggested that Frank himself should appear in the TV commercials. There is perhaps no better example in marketing history of a company and their product being so closely identified with the company owner as spokesperson. Frank eventually made almost 200 different commercials stressing the quality of Perdue products and his personal commitment to customer satisfaction. This strategy was hugely successful and eventually led to expansion to virtually every major market east of the Mississippi River. (Perdue, Frank 2003)

Transition

For the rapidly growing and still family-owned Perdue Farms, it was natural that the reins would eventually be passed from Frank to his only son, Jim Perdue. While Jim knew he would eventually return to the family business, he initially considered becoming a marine biologist. In what was perhaps a way to distance himself from the family business and his legendary father, Jim left Maryland, moved to the West coast, and earned a Ph.D. in fisheries science. This move was actually strongly encouraged by Frank. As Jim recalled when discussing his need to establish himself as a success before assuming a visible role in the company, "When someone pats you on the back you need to know it's because you're doing a good job and not because your Frank's son." (Perdue, James 2005)

Jim returned to the family business in 1983 as an entry-level management trainee. As part of the training program, Jim earned his stripes by holding basic managerial positions in virtually every area of the company. In 1991, Jim Perdue became the third CEO and Chairman of the Board. Jim assumed the role of advertising spokesman and public face of Perdue Farms in 1994. During the 1990's, Jim led the company through a period of explosive growth. Building on existing operations through acquisitions and expansion, Perdue farms became a fully vertically integrated agribusiness. Perdue now controls the supply chain from the farm to the plate of the consumer. The operation begins with processing of grains and oilseed for feed, continues with egg production, hatchery operations, poultry processing, and culminates with fully-cooked products and deli meats. It is also during this period that Perdue Farms expanded globally with operations in over 40 countries including a joint venture in China.

Frank Perdue's generosity was legendary, especially on the Eastern Shore of Maryland where the company maintains its corporate headquarters. He was active in the community and was deeply involved with improving the community in which his business thrived. The company and its colorful front man, however, have not always been viewed favorably. During testimony before Congress in the 1980's, Frank Perdue admitted that he approached individuals with strong ties to organized crime for advice on how to handle an emerging union movement among the company's poultry workers. Allegations of anti-labor practices within Perdue Farms followed. In 1989, Perdue Farms was found negligent and fined for unsafe worker conditions at poultry processing plants in North Carolina. (Reuben 2005)

Jim Perdue has spent much of the past decade improving the company's corporate image. While the company and the Perdue family have always been recognized for philanthropy, more recent corporate focus seems to place heavy emphasis on improving corporate citizenship. Conditions for workers have improved dramatically with increased focus on health and safety best exemplified by on-site medical clinics in virtually every major Perdue Farms facility. The company routinely recognizes the valuable contributions made by Perdue Farms employees and offers some of the most competitive employee benefits packages in the industry. Perhaps as a result of the influence of Jim's training in marine biology, the company has focused significant resources on environmentally friendly projects. These projects include the investment in machinery to recycle chicken litter into fertilizer and convert soybean byproducts into bio-diesel fuel as well as wastewater treatment facilities aimed at reducing pollution in the sensitive Chesapeake Bay.

CROSSROADS

The Corporate Strategy

On March 31, 2005, Frank Perdue passed away leaving the company, with his son at the helm, at the beginning of a period of planned exponential growth. Jim has spoken on several occasions of the corporate goal called "*The 2020 Vision*" of growing sales from the current level of \$2.8 billion to \$20 billion annually by the year 2020. To realize the planned growth in sales, the company plans a major structural change in operations. In describing the strategy, Jim uses the analogy of a pipeline for the existing vertically integrated operations. In his vision of the future for Perdue Farms, Jim sees less of a pipeline and more of a "dumbbell." This strategy will involve dramatically expanding operations at either end of the pipeline and focusing less on intermediate operations.

On one end of the "dumbbell" are grain and oilseed operations; at the other end are value-added poultry products such as deli meats and fully cooked poultry. While the company plans to expand in these two areas, they will maintain or even curtail operations involving hatchery operations and chicken processing. Perdue Farms already contracts with local farmers who act as "growers." Hatchlings are delivered to contract growers who feed the chicks Perdue feed, maintain Perdue-approved growing conditions, and then deliver fully grown broiler chickens to Perdue processing plants. Presumably, this strategy could effectively be applied to the equally capital and labor intensive hatchery and processing operations.

Through a series of acquisitions and internal development, the Grain and Oil Seed Division of Perdue Farms has grown to be a formidable participant in the commodities markets. Operations within this division include processing grains for feed, pet food, and vegetable oil. While the most visible operations involve grain processing, protein products made from byproducts of the poultry processing operations are made into livestock feed and pet foods. Further, this division has recently entered the fertilizer markets with a pelletized fertilizer product made from recycled chicken waste.

The other business area where the company plans to expand operations involves further processed poultry products. The obvious reason for expansion in this area is the substantially higher margins that can be charged for "ready-to-eat" products such as deli meats and fully cooked or microwavable poultry dishes. The company believes that, as society moves at an even more frantic pace, demand for such products is sure to increase. The company hopes that the

brand loyalty and reputation for quality already associated with products such as “Oven Stuffer Roasters” can be transferred to these further processed products. (Perdue, James 2004)

The Family Strategy

The transition from Arthur Perdue to his only son Frank was straight forward: Frank was the only child and deeply involved in the business from a very early age. The transition from Frank Perdue to his only son Jim could potentially be far more complicated. While Jim has assumed the role of CEO and Chairman, he is not the only child as was the case with his father. Frank Perdue was married three times and is survived by four children, two stepchildren, and twelve grandchildren. For the company to remain privately-held and family-run, there will necessarily need to be consensus, at least among Jim and his sisters. The Perdue family is acutely aware of these issues and has taken proactive steps to address them. These steps include the establishment of a Family Advisory Council and the appointment of outside Directors to the corporate Board of Directors.

The future direction of the company and issue of succession after Jim Perdue’s tenure as CEO and Chairman could become even more problematic as the fourth generation of Perdues (collectively known as “G-4”) comes of age. With the members of G-4, the family actively supports the tradition of encouraging independence and self-discovery best exemplified by Jim’s pursuit of a career in Marine Biology. While no clear “heir apparent” is being publicly groomed to take over, Jim remains confident that G-4 will produce capable leaders for the family business. In one of the many testimonials that followed Frank Perdue’s passing, one of his grandsons stated that “the family would honor Frank Perdue by ensuring that Perdue Farms remained family-owned and continued its financial success.” (Fisher 2005)

ANALYSIS ISSUES

Perdue Farms remains a privately-held company that has a reputation for being fiercely protective of the corporate and family privacy. As such, there is very little publicly available information about the company financial condition, corporate strategy, or ownership arrangements. Some insight, however, can be gained through examination of the financial condition of the owners. Frank Perdue was mentioned often over the last two decades in the Forbes Magazine annual survey of the 400 wealthiest Americans. In 1997, he peaked at the rank of 214 and had an estimated personal net worth of \$825 million. Meaningful estimations of corporate financial condition can also be made through comparison with competitors. Key data for the industry and primary competitors is provided in Exhibits 1 – 4.

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Exhibit 1: Industry and Direct Competitor Comparisons

	ConAgra Foods	Tyson Foods	Pilgrim's Pride	Major Food Industry	Meat Products Industry
Market Capitalization:	13.59B	6.56B	2.33B	16.23B	932.00M
Employees:	39,000	114,000	40,300	37.50K	9.53K
Quarterly Rev. Growth (yoy):	1.30%	3.30%	-0.70%	5.40%	20.00%
Revenue (ttm):	15.14B	26.59B	5.68B	15.14B	2.08B
Gross Margin (ttm):	21.19%	6.76%	12.02%	40.22%	22.45%
EBITDA (ttm):	1.82B	1.34B	538.39M	2.29B	234.92M
Operating Margins (ttm):	9.68%	3.15%	7.40%	14.80%	8.06%
Net Income (ttm):	696.60M	351.00M	190.00M	745.84M	119.45M
EPS (ttm):	1.359	0.982	2.858	1.65	2.1
P/E (ttm):	19.31	18.88	12.23	19.17	10.3
PEG (5 yr expected):	2.26	1.69	1.19	2.13	1.19

Exhibit 2: Direct Competitor Income Statements

	ConAgra Foods		Tyson Foods		Pilgrim's Pride	
	2004	2003	2004	2003	2004	2003
Net Sales	\$ 14,522	\$ 16,939	\$ 26,441	\$ 24,549	\$ 5,364	\$ 2,619
Cost of Sales	11,315	13,569	24,550	22,805	4,854	2,419
Gross Profit	3,207	3,370	1,891	1,744	510	200
Operating Expenses						
SG&A	1,823	1,909	880	831	237	137
Other Expenses	0	0	86	76	0	0
Total Operating Expenses	1,823	1,909	966	907	237	137
Operating Income or Loss	1,384	1,461	925	837	273	63
Other Income and Expenses						
Interest Expense	275	275	275	296	52	38
Other Adjustments	(130)	(14)	15	18	13	(38)
Total Other Expenses	145	261	290	314	65	0
Income Before Income Taxes	1,239	1,200	635	523	208	63
Income Tax Expense	428	436	232	186	80	7
Net Income Available to Common	\$ 811	\$ 764	\$ 403	\$ 337	\$ 128	\$ 56

Exhibit 3: Direct Competitor Balance Sheets

	ConAgra Foods		Tyson Foods		Pilgrim's Pride	
	2004	2003	2004	2003	2004	2003
Assets						
Current Assets						
Cash and Cash Equivalents	\$609	\$688	\$33	\$25	\$38	\$17
Accounts Receivable	1,324	800	1,240	1,280	324	127
Inventory	2,581	2,581	2,063	1,994	610	341
Other	635	2,040	196	72	45	6
Total Current Assets	5,149	6,109	3,532	3,371	1,017	491
Long-term Assets						
Net Property Plant and Equipment	2,880	2,678	3,964	4,039	1,179	735
Goodwill	3,797	3,805	2,558	2,652	0	0
Intangibles	827	824	149	182	0	0
Other	1,569	1,703	261	242	49	31
Total Long-term Assets	9,073	9,010	6,932	7,115	1,228	766
Total Assets	\$14,222	\$15,119	\$10,464	\$10,486	\$2,245	\$1,257
Liabilities and Shareholder Equity						
Liabilities						
Current Liabilities						
Notes Payable	\$31	\$2	\$0	\$0	\$0	\$0
Current Portion of Long-term Debt	382	509	338	490	8	3
Accounts payable	941	788	945	838	315	159
Other	1,651	2,548	1,010	1,147	311	118
Total Current Liabilities	3,005	3,847	2,293	2,475	634	280
Long-term Liabilities						
Long-term Debt	4,878	4,632	3,024	3,114	536	416
Subordinated Debt	402	763	0	0	0	0
Other	1,143	1,232	855	943	152	114
Total Long-term Liabilities	6,423	6,627	3,879	4,057	688	530
Total Liabilities	\$9,428	\$10,474	\$6,172	\$6,532	\$1,322	\$810
Shareholder Equity						
Common Stock	2,829	2,828	37	37	1	1
Paid-in Capital in Excess of Par	756	737	1,849	1,861	432	80
Retained Earnings	2,349	2,104	2,728	2,380	493	368
Treasury Stock	(1,124)	(686)	(264)	(252)	2	2
Other	(16)	(338)	(58)	(72)	(5)	(4)
Total Shareholder Equity	\$4,794	\$4,645	\$4,292	\$3,954	\$923	\$447
Total Liabilities and Shareholder Equity	\$14,222	\$15,119	\$10,464	\$10,486	\$2,245	\$1,257

Exhibit 4: Direct Competitor Stock Price, Ownership and Dividend Information

	ConAgra Foods	Tyson Foods	Pilgrim's Pride
Beta	0.177	0.396	0.739
Stock Price (as of 6/1/05)	\$26.17	\$18.50	\$34.94
52-Week High	\$30.24	\$21.28	\$39.85
52-Week Low	\$25.38	\$12.50	\$23.02
Shares Outstanding	517.89M	353.6M	66.56M
Float	503.13M	228.32M	15.01M
Inside Ownership (%)	2.30%	31.05%	39.22%
Dividend Yield	4.03%	0.85%	0.17%

OLYMPIC OPTICAL COMPANY: VALUING A BUSINESS

Colene L. Coldwell, Baylor University
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This case focuses on a two part dilemma faced by Memphis entrepreneur, Winston Wolfe, in the spring of 2005. Wolfe had begun a sunglass-importing business 30 years earlier, and was now trying to decide if he should sell his very profitable business. He also wondered if he decided to sell the business, what value should he place on the firm. The company, Olympic Optical, had begun operations by selling sunglasses imported from Taiwan. Later, it began imprinting the glasses with the Olympic Optical brand. This transition had been fairly successful. However, when the company began importing sporting glasses—and later safety glasses—that it had redesigned to be more functional and attractive than those that were available at the time, sales increased dramatically. The primary reasons for the increase in sales were twofold: (1) The more attractive styles of glasses; and (2) the licensing and printing of well-know names on its products (Jack Daniel's on the company's sporting glasses, and Remington and Smith & Wesson on its safety glasses). This case looks at the issues associated with assessing the value of a company, as well as the factors affecting the timing of its sale.

INTRODUCTION

As Winston Wolfe passed by the silver coat of arms displayed on a stand in the upper hall of Loxley Hall, his English Tudor style home in Memphis, Tennessee, he found himself mentally listing the pros and cons of the decision he had to make. Lost in thought, he gazed over the balcony to the first floor and the great hall below. The walls of the room, covered with the majestic horns of wild beasts killed in England centuries before, had no advice to offer. He considered how nice it would be to spend more time here, at Loxley Hall, and at the cottage in the country that meant so much to him.

Long ago—at the beginning of his career—Winston had made a promise to himself that he would not continue working until he died. Instead he intended to retire at a reasonable age. Then he could spend more time on the pursuits that now only occupied his weekends. It was now the spring of 2005, and he would turn 60 this year. Olympic Optical, the business he had started from scratch in 1975, had experienced remarkable growth in both sales and profitability since 1997. As he closed the front door of his home and walked slowly to his car, Wolfe thought about the three companies that had expressed an interest in buying his business. He wondered if this was the right time to sell; and if so, what value he should place on the company. He also wondered what the process should be for valuing the firm.

Background on Winston Wolfe

Winston Wolfe was born in Grenada, Mississippi. However, when he was two years old, his parents divorced and he moved to Memphis with his Mother. Except for the years when he was away at college, Winston had spent every year since that move in Memphis.

Wolfe had attended Central High School in Memphis and participated in the school's track and field team. In fact, he had excelled in the decathlon event and had become the State Decathlon Champion. He had even broken the old state record for that sport.

After finishing high school, Wolfe had gone to Baylor University in Waco, Texas, where he pursued a degree in Psychology and a minor in business. During his years at Baylor, he developed the philosophy that to become an educated businessperson, he needed to have some knowledge of many different fields. Perhaps that is why the courses that he most enjoyed were economics, accounting, statistics and psychology. Wolfe believed that the psychology major would help him understand the human psyche better, and the business courses would help him in whatever business endeavor he pursued.

It was during this time of his life that Wolfe discovered he had a keen interest in product design. He noticed that many common products were created with awkward and dysfunctional designs, and it was then that he began tinkering with the idea of redesigning products to improve their functionality.

After leaving Baylor in 1964, Winston entered a management training program at the First National Bank in Memphis. He worked at the bank for the next four years; however, in 1968, he left the bank to accept a position in marketing with Great Southern Corporation. His new employer was in the import business. The company imported a variety of products, including sunglasses, from the Far East. One of Wolfe's responsibilities at the firm was to select the styles of sunglasses that the firm would offer for sale. This was his first opportunity to exercise an interest in product design. After he had been with Great Southern Corporation for seven years, Winston decided that it was time to risk going out on his own and becoming an entrepreneur.

History of Olympic Optical Company

In 1975, Winston Wolfe started his own firm which he named Olympic Optical Company. The firm's operations were similar to those of the company he had just left—importing sunglasses from Taiwan. As the firm's single employee, Wolfe had to choose the glasses that he would sell. Once more, he was in a position to pursue his interest in product design. Wolfe believed that the design of a pair of sunglasses should combine ergonomics and a more fashionable style.

By 2005, the company had experienced three distinct segments of growth. Interestingly, during each phase Olympic had focused on a different market segment: The advertising specialties business from 1975 to 1982; the licensing of sporting glasses from 1982 to 1997; and the licensing of safety glasses from 1997 to 2005.

Ad specialty business from 1975 to 1982

During this phase of the business operation, Olympic sold sunglasses to candy and tobacco jobbers (often called “rack jobbers”) who would then sell the glasses to convenience stores. Most of the glasses were sold in bulk, and he would supply the jobbers with card racks on which to display the glasses. Olympic sold to that market for about two years, and Wolfe found that the company’s highest sales were for the Christmas season. The customers liked the fact that they were given 60 days to pay for the goods. Typically this allowed the jobbers to sell their inventory before the payment was due.

When Wolfe started working for Great Southern Corporation, he had signed an employment contract. The contract contained a five year non-compete clause. However, when he left the company, he forgot that this clause had been in his employment contract. Soon after he began to import sunglasses to sell in his fledgling business, Great Southern Corporation filed a law suit against Wolfe for breach of contract. The firm was able to get a temporary restraining order against him to cease and desist from selling imported sunglasses. This dispute was later settled, and Wolfe continued to sell sunglasses. Despite his former employer’s fears, Wolfe never sold products to any of the companies that had been customers of Great Southern Corporation.

When Wolfe first founded Olympic Optical Company, it was a one-man business. It remained that way for approximately a year. During this time, Winston lived in a modest two-bedroom apartment off Lamar Avenue in Memphis. His office was housed in his second bedroom, and he built a desk to use in his operations. Years before, he had purchased an old green Remington typewriter. The old machine, which sat on his homemade desk, was used to type the invoices and address labels to accompany the sunglasses that he sent to his clients. Across the street from his apartment was a storage building where he rented a 10 foot x 30 foot space for storing his inventory.

To efficiently manage this one-man operation, Wolfe had worked out a regular routine. First, he received the sunglasses from Taiwan. Next he repacked and labeled the sunglasses. Finally, with the glasses ready for shipping, he pulled a plastic lawn chair out of the storage unit. And there he sat, waiting for the United Parcel Service (UPS) delivery truck to pick up his shipment. Because of these arrangements, he was able to begin his operation with very low overhead.

After the first year of operation, Wolfe had made enough money to move his business to an office building in a business park on Lamb’s Place near the Airport. Later, he relocated the firm again. This third move brought Olympic to an office building across from a large mall in the Western section of the city. It was after this change that Wolfe hired Jane Ely, his first employee. Jane joined the business as an administrative assistant, and she helped with the typing of invoices and shipping labels. Wolfe next hire was found in a somewhat unconventional manner. While at the J.C. Penney’s Company trying to secure an order for sunglasses, he met Dick Lyon. Wolfe was immediately impressed with Lyon, and hired him to work for Olympic Optical. Dick took over the next phase of the business—selling to police uniform and supply shops.

One day it had occurred to Wolfe that since police officers wear sunglasses, stores that catered to law enforcement personnel might also be a good market for his sunglasses. To test his theory, he purchased a carrying case, added his nicest glasses, and began calling on police uniform and equipment companies. Clearly he could only reach a limited number of shops this way. To expand this business, he needed to find more outlets for his product. And to do this, he needed to know where additional shops were located. Wolfe went to the downtown Memphis library. There he began searching through the telephone directories from many cities in the U.S.

From these efforts, Wolfe was able to compile a list of various police uniform shops in a number of different cities. To get his foot in the door with these firms, he sent each company an assortment of 12 types of sunglasses. Included in the shipment was a straightforward request: If the recipients liked the sunglasses and wanted to stock them in their stores, they could send him a check for \$54. Many of the store managers kept the glasses and soon Olympic began receiving payments from these companies. Ultimately, Olympic Optical Company sold several thousand dollars worth of merchandise to these specialty stores.

Licensing of sporting glasses from 1982 to 1997

In 1982, Wolfe was first able to get Olympic Optical's sporting glasses into sporting goods stores. The Taiwanese vendors who made the products would send samples of their sport glasses to Wolfe, and he would pick a style. He would also suggest certain changes in the color, lens and frame. He was again able to exercise his interest and further develop his skills in the area of product design. After receiving the design changes from Wolfe, the vendor would send the finished goods to Olympic Optical, Olympic would package the glasses and sell them to the distributors.

In 1984, Olympic began imprinting the sunglasses with specialty designs. The first glasses that the firm engraved had acrylic lenses. Olympic's employees would first make a template of the logo that was to be added and then engrave it on the glasses. Since all of the work was done by hand, the process was painstakingly slow and, therefore, very labor intensive.

The first company to become an important name in Olympic's engraving efforts was the Jack Daniel's Distillery. The chance event that started the relationship between Olympic Optical and Jack Daniel's would become an important turning point in the operations of the business. One of Olympic's salesmen, Jim McCarty, had taken over the company's specialty business in 1984, and he decided to make a call on the Brown/Foreman Company that owned the Jack Daniel's Distillery. The woman with whom he spoke at Brown/Foreman asked if Olympic would be interested in licensing the Jack Daniel's name. Her idea was to engrave Olympic sunglasses with the Jack Daniel's name and sell these items in the company's distillery gift shop in Lynchburg, Tennessee. Wolfe decided that this was a good opportunity for Olympic, and therefore he entered into a licensing agreement with Brown/Foreman.

At the time, he had envisioned that the Jack Daniel's glasses would also sell well in independent liquor stores. Unfortunately, he found out later that most states have laws that prohibited proprietors of liquor stores from selling anything except alcoholic beverages.

The licensing agreement required Olympic to provide a quarterly report to Jack Daniel's, stating the number of glasses that had been sold in the period. Olympic would send a check to Jack Daniel's to cover the royalty fee on these sales. The agreement also stipulated that Olympic would pay a minimum royalty amount each quarter, regardless of the number of sales that had accrued to Olympic. In most cases, Olympic found that the check sent to Jack Daniel's was nothing more than the minimum amount.

While using the hand-engraving process, Olympic's employees could only imprint five glasses each hour. Not only was the engraving time consuming, but the process increased the price for each pair of glasses from \$1.50 to \$2.00. Olympic never completed a cost analysis to see if the firm was actually making money with the engraving. However, it was around this time that Olympic Optical began to pursue a different market for its products; the firm began to attend Ad Specialty Shows and sell sunglasses to other companies.

In 1985, Olympic began using a process called pad printing. This offered a much less labor-intensive way to engrave sunglasses. Using this method, the firm was able to print around 1,200 glasses an hour. Orders for as many as 10,000 products could be sent out in one shipment. Though the Jack Daniel's experience was less than ideal, it gave Olympic the knowledge to enter the next phase of its licensing business. This new venture proved to be the most lucrative that the firm had pursued to date.

Harold Tidwell, an Olympic employee, suggested to Wolfe that in addition to the Jack Daniel's business, the firm should also try to license the Remington and Smith & Wesson names to use on their glasses. Wolfe thought that the firm needed to build the Olympic name, so he decided against the additional licensing at that time. He also believed that if Olympic did license the additional names, he would have to choose between the two or risk a possible conflict of interest.

Eventually, Wolfe thought the time was right to proceed with further licensing. He chose Remington first because the company had historically been closely associated with sporting activities. However, a few months later, he discovered that Olympic could also license the Smith & Wesson name without creating any legal issues.

It was the Remington glasses that first gave Olympic access to Wal-Mart. Clearly, this was another milestone for the firm. John Hardison, the General Manager of Olympic, suggested: "If you can get any product into Wal-Mart, you are set." Remington and Smith & Wesson had different reputations. Remington was a name associated with shotguns and rifles. Smith & Wesson, on the other hand, was known for pistols. By licensing the Smith & Wesson name, Olympic was able to sell more products to Wal-Mart. Some of the Wal-Mart stores sold only pistols, and these stores clamored for the Smith & Wesson sporting glasses.

Before long, the Smith & Wesson product line became the company's bread and butter. It was because of this success that Wolfe made the decision not to renew the licensing with Jack Daniel's and Remington. Olympic found that "name recognition works for a wide variety of products."

In 1986, Wolfe ventured into the mail order business by placing ads in selected magazines. One of Olympic's competitors, U.S. Optics, advertised its products in magazines. This had proved to be a successful way for the firm to sell its glasses. It was U.S. Optic's success in this area that had first caused Olympic to consider this form of selling. To manage the new mail order business, Wolfe hired Dana Lynn. Dana was given a budget of about \$1.0 million a year to work on ads with advertising agencies to develop and purchase ads in leading magazines. In the past, most of Olympic's sales had been through jobbers and distributors to stores. With this new marketing effort, the firm went directly to the end user of their product.

The company continued its mail order business for about three years. Ultimately it was dropped because it was so labor intensive. Olympic had to hire extra people just to answer the phones and take orders that resulted from its advertising efforts. On average, the ads generated about 200 calls a day, but each of the orders might be no more than \$15. In addition, the products had to be shipped, and Olympic employees did this as well. By 1988, the firm's sales from mail order were \$315,000, but the cost of ads was very high. Some of the magazines in which Olympic Optical placed ads were:

Popular Science
Guns & Rifles
American Rifleman

Playboy
Hunting & Fishing

Of these, Popular Science was by far the best source of sales, and Playboy was the least effective. One of the products that sold best in the magazine ads were the company's "Air Force" glasses. This style was very similar to the official U.S. Air Force sunglasses, but Olympic's products were less expensive. The glasses had smaller lenses and a straight temple, but other than these minor differences, they were much like aviator glasses.

Safety glasses from 1997 to 2005

In 1997, Olympic Optical began producing safety glasses. Michelle Wilhite, Manager of Quality Control, said of the glasses: "We had a quality product, and Winston made sure it met the highest standards. You can have the salespeople out front; but if you don't have people in the back putting together a quality shipment, you won't succeed."

All Olympic Optical safety glasses used polycarbonate¹ lenses. This gave the glasses a high level of impact resistance. Olympic received testimonials from some customers whose eyesight was saved by the polycarbonate lens. The company began buying the lens and frames separately and then assembling the glasses. Soon, the safety eyewear business generated the highest level of product sales that the company had ever experienced. (See Figure 2 entitled "Olympic Optical Company, Sales of Safety Glasses 1997-2000.")

In 1991, Olympic had tried to sell safety glasses under the Remington name with little success. The safety eyewear available at that time was primarily created for industrial use and it tended to be heavy and unfashionable. Wolfe began designing more attractive safety glasses in 1997, and the glasses began selling rapidly. The clunky, unattractive safety glasses were called the "Engineer Style." Each pair featured thick glass lenses, and was so heavy that they tended to ride down on the wearer's face. The glasses that Wolfe had designed included a one-piece lens that wrapped around the wearer's face. This meant that, rather than being a separate piece, the side shield was a part of the glasses. This style soon became the bread and butter product of the company.

Unfortunately, Olympic found that it could not legally sell the Remington safety glasses after all because another company, "Remington Shaver," had the rights to all safety products imprinted with the name "Remington." Ultimately, this did not matter because the Smith & Wesson eyewear line quickly grew to become Olympic's most popular product. The rapid rise in popularity of the Smith & Wesson safety eyewear was largely because the company's name was associated with safety (and thus safety glasses). Not only did many police officers use Smith & Wesson pistols, but also movies, such as "Dirty Harry," had propelled the company's products into popular culture. The Smith and Wesson name was synonymous with safety and machismo.

When Olympic Optical first licensed the Smith & Wesson name, the firearms company had already trademarked the "Magnum" name. However, when Olympic began engraving the name on its safety glasses, one of the firm's competitors contacted Wolfe, and stated that it had a prior right to use that name. Wolfe responded by stating that Smith & Wesson had licensed the "Magnum" name to Olympic Optical, and Smith & Wesson had trademarked the name. He

¹ A synthetic thermoplastic resin (a linear polymer of carbonic acid) used for molded products, films, and non-breakable windows. The substance is characterized by high-impact strength, light weight, and flexibility. Often used as shatter-resistant substitute for glass.

further suggested to the complainant that it might actually be in violation of Smith & Wesson's trademark. He never heard from the company's representatives again.

Wolfe eventually got nine patents on various glass designs. However, obtaining a patent did not stop other companies from trying to copy the Olympic designs. The "Magnum" safety glass made the best impression with customers. Unfortunately, this was the style that was most frequently copied, which meant that Olympic had to incur legal costs while defending itself from infringement. Usually, a letter from Olympic's lawyer, informing the offending company that Olympic already had a patent on the design, was enough to prevent the infringing firm from copying the design.

Company Operations

From the beginning of the company, Olympic Optical did not use budgets. Winston and John Hardison, the General Manager, would produce budget numbers for the company's sales people, but because the firm made such high gross profits, Wolfe did not believe that it was necessary to follow a budget in order to contain costs. John Hardison suggested that Winston was conservative and kept a close eye on costs, but he would approve of equipment that was needed for the business. The company would pay its bills before they were due and in this way Olympic developed an excellent credit status with its vendors. Because of this pattern of paying early, the firm was able to get the best prices from its vendors.

To minimize costs, the company tried to keep very little inventory on hand. At times, this meant that glasses had to be flown from Taiwan because the company did not have enough glasses on hand to fill an order. This was especially true when an order from Wal-Mart or K-Mart was due. The large size of Wal-Mart orders often meant that Olympic would have to run extra shifts to ensure that the product was shipped on time. Due to Olympic's inventory control policies, this also often meant that products had to be sent by air from Taiwan rather than by ship. In these instances, the shipping costs rose from \$.02 to \$.25 per pair of glasses. However, even with the higher freight costs, Olympic was still making money. (See Exhibit 3 entitled "Olympic Optical Company Balance Sheets 1998-2004; Exhibit 4 entitled "Olympic Optical Company Income Statements 1998-2004; and Exhibit 5 entitled "Olympic Optical Company Schedule of Operating Expenses 2000-2004.")

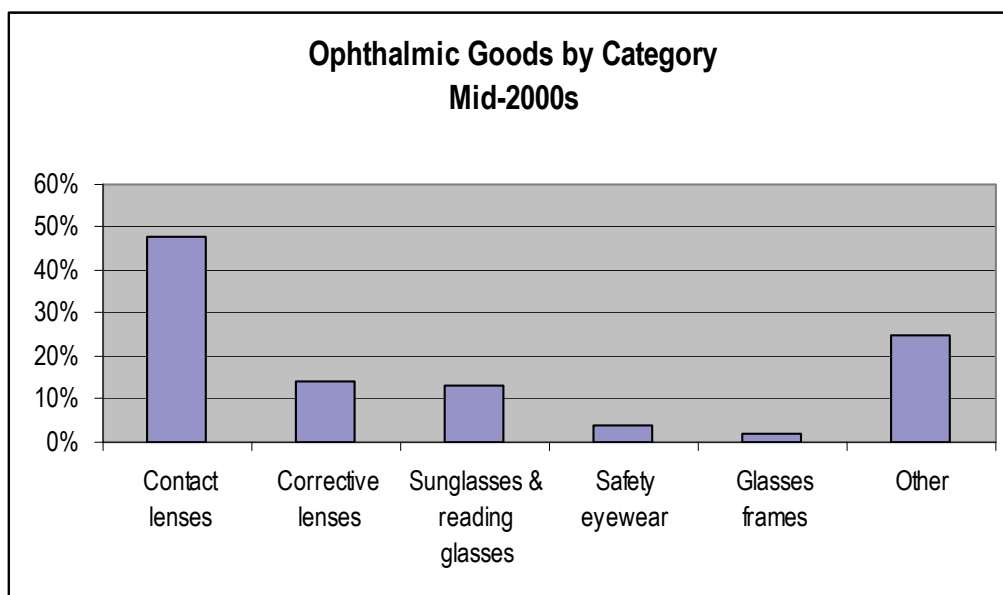
Olympic had a policy of shipping in a "timely manner." This meant that the company turned 95 percent of its orders around in 48 hours. Normally orders that were placed by 10:00 A.M. were shipped before 4:00 P.M. the same day.

The firm's warehouse operations were very primitive. Olympic did not have a forklift—just a hand-pumped lift. In addition, all invoices were handwritten, and then hand-delivered to the person in charge of billing after each order was shipped. However, this did not interfere with the firm's ability to meet customer demands; the firm rarely made an incorrect or untimely shipment. Indeed, Olympic's customers service was adjudged by to be "impeccable."

THE SAFETY EYEWEAR INDUSTRY

The ophthalmic goods industry—corrective eyeglasses, contact lenses, safety eyewear, and the like—had been significant for some time. In 2003, total industry sales reached approximately \$4.55 billion. Throughout the later part of the twentieth century, sales of ophthalmic goods grew at a rate that outpaced population growth. This growth was primarily fueled by two factors: Increasing appetites for fashionable eyeglass frames and designer sunglasses, as well as crucial innovations in soft contact lens technology. At just 4 percent of total industry sales in 2003, safety eyewear represented a small slice of the ophthalmic goods business. (See Exhibit 1. “Ophthalmic Goods by Category.”) Still, this seemingly insignificant share of the market translated to safety eyeglass sales around \$182 million (Gale, 2006).

Exhibit 1



Anecdotal evidence suggested that, in keeping with sales of ophthalmic goods in general, consumer purchases of safety eyewear had grown steadily over the past three decades. This growth appeared to mirror that seen in the safety products overall.

A number of factors may have contributed to the expanding use and corresponding sales growth of safety products and safety glasses. These included:²

- Improved education regarding workplace hazards
- Increased government regulation in the workplace
- Tougher enforcement of government standards
- Changed employer attitudes about safety
- Better product selection
- Superior marketing techniques
- Shifting societal attitudes about personal responsibility

² Conversation with Dan Ship, President of International Safety Equipment Association (ISEA), September 24, 2007.

In the latter half of the twentieth century, the U.S. Federal government stepped up its involvement in industrial safety issues. Efforts to protect the nation's workforce seemed to culminate in December 1970 when Congress enacted the Occupational Safety and Health Act of 1970 (OSHA). Unlike previous laws, which had left the primary responsibility for worker safety in the hands of state governments, this act gave the Federal government the power "to set and enforce safety and health standards for most of the country's workers" (MacLaury, 1981).

In order to comply with new safety standards, to protect employees, and perhaps to prevent related lawsuits or fines, companies became increasingly vigilant about monitoring and maintaining a safe workplace environment. One direct outcome of this stepped-up focus on safety was the expanded use of safety wear. If workers were to be protected from industrial safety accidents, they would require a wide range of safety products. This naturally resulted in a growing demand for new and better products.

Although it is unclear which came first—better education, new government regulations, a more cautious employer approach to safety, (the classic chicken and egg debate)—it is clear that there had been a change in the way society viewed safety. It was also clear that these changing societal attitudes played a pivotal role in the expanded use of safety wear.

Safety eyewear

The use of safety eyewear began in the workplace as one aspect of safety. However, safety eyeglasses eventually had many applications in American life. They were used at work, in school, at home, and even in sporting activities. Welding a steel girder, conducting a science experiment, mowing a lawn, or playing baseball: These were all activities that might involve the wearing of safety glasses.

As the use of safety eyewear became commonplace, end-users began to demand comfortable stylish products. The result was a new generation of safety glasses. And, rather than being clunky and painful to wear, these new products were both functional and attractive. For some, safety glasses became an accessory that made a fashion statement about the user.

New products were also being designed to protect employees from particular types of work-related accidents. For instance, a worker assembling computer products would need one style of safety glasses, a power tool operator might use another style, and a deer hunter might require a third model.

The makers of protective eyewear had to meet certain safety standards. These were driven primarily by the two agencies that regulated workplace safety. First, the National Institute for Occupational Safety and Health (NIOSH) identified potential safety hazards. Next, safety goals were defined and later enforced by OSHA. Finally, private organizations such as American National Standards Institute (ANSI)³—whose members were drawn from the safety products industry—developed and oversaw standards that were designed to help the makers of safety products support these goals.⁴ Guidelines developed by ANSI included parameters for shape, construction materials, impact resistance, and the like.

³"The American National Standards Institute (ANSI) coordinates development and use of voluntary consensus standards in the United States and represents the needs and views of U.S. stakeholders in standardization forums around the globe. www.ansi.org/about_ansi/overview. Accessed October 3, 2007.

⁴www.asse.org/publications/standards/docs/Dembystan. Accessed December 11, 2007.

Safety standards often varied across function, in accordance with the specific requirements of the intended user. For instance, a hunter would most likely not be exposed to the same eye dangers as a construction worker or a baseball player. Hence, safety eyewear designed for a particular application might be superficially or dramatically different from a pair created for another purpose to accommodate each safety threat.

Competitive landscape

Safety eyewear had been primarily a commodity product. Aside from superficial differences in product design, one pair of glasses was usually an acceptable substitute for another. As mentioned previously, there were certain safety standards that had to be met. However, once these safety issues had been addressed, firms had to find a way to differentiate their products from equally reliable, competitive products. Efforts to distinguish one type or brand of safety eyewear from another were often made through form, fashion, and fit. Still other differentiation efforts included celebrity endorsements or branding with a well known name, such as the Smith & Wesson® name, licensed to Olympic Optical, or Aearo Corporation's *Orange County Chopper* series.

With more than 480 firms in the U.S. that manufactured or sold protective eyewear, the industry was very fragmented.⁵ The majority of these firms sold inexpensive products that were mass produced in Asia. Conversely, only a few firms marketed the type of premium priced safety eyewear that was comparable to Olympic Optical's Smith & Wesson line. Such firms included UVEX, AEARO, and MCR.

Winston Faces a Decision

As Winston drove through Germantown on the way to his favorite restaurant for lunch, he admired the dogwood trees and the azaleas bushes that were beginning to bloom beside the road. His mind returned to the questions that had been keeping him awake at night lately. The primary question was: Should he sell Olympic Optical at this time; and if so, to whom? A secondary question was valuing the business if he did decide to sell it. (See the Appendix, entitled "Valuing a Business.") He thought about the people who had become more like family than employees and wondered what would happen to them if he sold the business.

⁵ "Industry Reports," Online at www.zapdata.com.

Exhibit 2

**Olympic Optical Company
SALES OF SAFETY GLASSES 1997-2000**

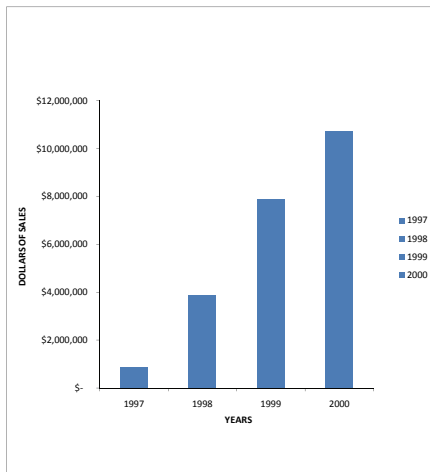


EXHIBIT 3. Olympic Optical Company Balance Sheets 1998 - 2004

	Fiscal Year Ended 5/31		Fiscal Year Ended 12/31				
	1998	1999	2000	2001	2002	2003	2004
Assets							
Cash & Equivalents	150,980	2,547,557	653,612	441,738	743,663	864,929	207,267
Accounts Receivable	885,802	\$1,334,090	1,528,811	1,560,232	1,383,593	1,146,544	1,103,871
Inventories	367,963	1,318,758	1,434,093	1,469,096	1,286,368	1,288,776	1,123,476
Prepaid Expenses	9,397	6,625	33,423	9,928	9,246	37,733	24,149
<i>Total Current Assets</i>	1,414,142	5,207,030	3,649,939	3,480,994	3,422,870	3,337,982	2,458,763
Property & Equipment	160,610	214,532	178,812	294,390	306,047	343,613	347,042
Accumulated Depreciation	91,339	123,957	98,565	132,565	139,481	164,030	213,063
<i>Net Fixed Assets</i>	69,271	90,575	80,247	161,825	166,566	179,583	133,979
Intangibles (Includes Goodwill)	-	-	-	-	-	-	-
Other Assets (Deferred Taxes)	-	-	-	-	-	1,775	1,775
TOTAL ASSETS	\$ 1,483,413	\$ 5,297,605	\$ 3,730,186	\$ 3,642,819	\$ 3,589,436	\$ 3,519,340	\$ 2,594,517
Liabilities							
Notes Payable	-	-	-	-	-	-	-
Accounts Payable	96,206	77,349	1,571,866	1,632,219	1,199,865	1,299,176	454,451
Current Portion of Long-Term Debt	-	-	-	-	-	-	-
Income Taxes Payable	-	-	-	-	-	-	-
Accrued Expenses & Other	641,518	284,787	129,425	135,683	273,466	119,467	109,086
<i>Total Current Liabilities</i>	737,724	362,136	1,701,291	1,767,902	1,473,331	1,418,643	563,537
Long-Term Debt	-	-	-	-	-	-	-
Deferred Income Taxes	-	-	-	-	-	-	-
Other Liabilities	-	-	-	-	-	-	-
<i>Total Liabilities</i>	737,724	362,136	1,701,291	1,767,902	1,473,331	1,418,643	563,537
Shareholder Equity							
Common Stock	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Paid-In Capital	-	-	-	-	-	-	-
Retained Earnings	735,689	4,925,469	2,018,895	1,864,917	2,106,105	2,090,697	2,020,980
Treasury Stock	-	-	-	-	-	-	-
<i>Total Shareholder Equity</i>	745,689	4,935,469	2,028,895	1,874,917	2,116,105	2,100,697	2,030,980
TOTAL LIABILITIES & SHAREHOLDER EQUITY	\$ 1,483,413	\$ 5,297,605	\$ 3,730,186	\$ 3,642,819	\$ 3,589,436	\$ 3,519,340	\$ 2,594,517

EXHIBIT 4. Olympic Optical Company Income Statements 1998 - 2004

Olympic Optical Company
Historical Income Statements

	Fiscal Year Ended 5/31			Fiscal Year Ended 12/31			
	1998	1999	2000	2001	2002	2003	2004
Net Sales^a	\$ 4,694,081	\$ 8,783,428	\$ 14,809,775	\$ 14,695,042	\$ 14,185,932	\$ 12,329,350	\$ 12,178,018
Cost of sales	2,107,860	3,371,138	5,596,283	5,423,906	5,468,006	4,696,450	4,597,729
Gross Profit	2,586,221	5,412,290	9,213,492	9,271,136	8,717,926	7,632,900	7,580,289
Operating Expenses ^b	2,416,027	2,966,909	9,572,314	9,483,438	8,377,434	7,658,170	7,684,398
Gross Operating Income (Loss)	170,194	2,445,381	(358,822)	(212,302)	340,492	(25,270)	(104,109)
Other Income/(Expenses)							
Interest Income	59	12,819	131,391	59,240	16,775	9,229	34,361
Interest Expense	(21,941)	(1,338)	(6,659)	(916)	(508)	-	-
Other (Net)	-	-	515	-	9,256	-	-
Total Other Income (Expenses)	(21,882)	11,481	125,247	58,324	25,523	9,229	34,361
Income (Loss) Before income Taxes	148,312	2,456,862	(233,575)	(153,978)	366,015	(16,041)	(69,748)
Income Taxes		934,881	-	-	124,827	(633)	(31)
Net Income (Loss)	\$ 148,312	\$ 1,521,981	\$ (233,575)	\$ (153,978)	\$ 241,188	\$ (15,408)	\$ (69,717)

a. Sales related to Smith & Wesson safety glasses \$ 6,133,506 \$ 12,526,833 \$ 12,209,201 \$ 12,802,600 \$ 10,841,216 \$ 10,060,840

EXHIBIT 5. Olympic Optical Company Schedule of Operating Expenses 2000 - 2004

	1999	2000	2001	2002	2003	2004
Officers' Salaries ^a	\$ 190,305	\$ 6,404,161	\$ 5,900,008	\$ 4,680,170	\$ 3,824,192	\$ 3,838,842
Salaries & Wages	498,858	912,131	1,083,197	1,228,147	1,230,827	1,269,006
Payroll Taxes & Employee Benefits	100,346	267,342	282,453	313,484	318,298	335,744
Sales Commission	289,156	592,901	578,615	561,305	497,955	545,108
Rent	81,014	162,103	170,030	167,726	167,922	181,426
Office Supplies & Expense	24,740	50,947	49,811	56,449	44,140	59,908
Utilities	3,993	7,809	8,498	7,562	7,656	8,496
Telephone	12,533	17,450	18,365	21,260	22,755	20,813
Insurance	12,246	14,879	38,027	27,227	31,132	35,599
Travel	65,345	97,108	84,291	146,006	154,153	199,416
Advertising, Brochures, & Promotion	115,267	194,806	287,533	298,773	506,830	353,377
Professional Fees	22,975	109,604	120,321	156,926	262,921	270,120
Bad Debts	479	32,588	1,452	33,559	7,233	2,076
Warehouse Supplies	5,863	11,896	9,116	9,103	8,302	6,716
Production Supplies	3,929	3,951	3,078	2,843	1,643	1,819
Samples	-	5,565	6,359	23,641	4,199	2,723
Contributions [to charitable organizations]	15,400	131,035	306,480	62,358	24,880	2,380
Taxes & Licenses	8,983	11,312	9,454	10,965	9,742	11,136
Interest	825	6,659	916	508	538	767
Repairs & Maintenance	-	373	-	-	-	-
Depreciation	16,798	28,607	34,000	43,138	48,402	49,033
Contract Labor	-	900	1,397	395	70	-
Dues & Subscriptions	1,977	7,455	5,465	9,041	6,198	6,486
Royalties	285,252	507,391	485,488	517,356	478,182	485,407
TOTAL	\$ 1,756,284	\$ 9,578,973	\$ 9,484,354	\$ 8,377,942	\$ 7,658,170	\$ 7,686,398

a. Includes Bonus Paid to President

\$ 6,000,000

\$ 5,650,000

\$ 4,330,170

\$ 3,574,192

\$ 3,486,842

APPENDIX

Valuing a Business

Business valuation refers to the process of establishing a fair market value for a firm.⁶ This process could be compared to the appraisal of a single piece of property, such as a rental house. Despite the specialized nature of firm appraisal, there are actually many common situations that might require the valuation of a company. Some of these reasons include the:

- Determination of value prior to the sale or purchase of a company,
- Establishment of an employee stock ownership plan (ESOP),
- Estimation of stock value for an initial public offering (IPO),
- Dissolution of a marriage or a partnership, or the
- Solicitation of a potential investor for capital.

Assessing the situation

Prior to beginning the appraisal process, there should be a clear understanding of the purpose for the valuation and for whom it is being prepared. The nature of the subject business should also be considered. Every business has unique characteristics that set it apart from others in its industry. These characteristics often play a critical role in the valuation process. The industry and the firm's position in the industry should be also be researched. The outlook for the industry should be factored into the process. Finally, an awareness of any macroeconomic factors that might impact the firm's will ultimately lead to a more accurate assessment of value.

Selecting the valuation method

There are a number of techniques that can be used to estimate the value of a company. The choice of valuation method is influenced by the condition and character of the subject firm, as well as the industry in which it operates. The purpose of the valuation and the type of firm conducting the valuation will also play an important part. For instance, accounting and consulting companies often rely on the discounted cash flow method. On the other hand, firms considering merging with or acquiring another firm, frequently prefer one of the multiplier methods. Since no perfect technique for estimating a company's value currently exists (short of a crystal ball), valuation experts must rely on more than one method.

Most of these methods fall within one of three categories: The income approach, the market approach, and asset approach. A legitimate valuation professional will utilize some form of each approach. Firm value is then derived by assigning a weight to each method. However, when valuing a viable profitable business, the income and market approaches are typically given the most weight.⁷

⁶ Many of the complexities associated with valuing a business in the real world have been omitted from this case in respect of the constraints that exist in the classroom.

⁷ Bill Baker, Partner, KPMG LLP - Transaction Services. Email November 9, 2007.

The income approach

The income approach to firm valuation is an application of fundamental finance theory. The value of any company is nothing more than the present value of any future benefits created by the firm. This approach could take several variations, such as the discounting of future cash flows or of future earnings. In each case, future economic benefits are projected over a predetermined time period, a discount rate is selected, and the future economic benefits are discounted to arrive at firm value.

Estimating Firm Value (Income Approach): Discounted Free-Cash Flow Method

One method included in the income approach is discounted free-cash flow valuation. In the simplest sense, the discounted free cash flow method defines firm value as the present value of its expected future free cash flows.⁸ That is, value of a firm is the present value of cash flows in the planning period (the period before the firm has reached a constant growth rate) plus the present value of all cash flows that occur beyond that point.

$$\text{Intrinsic or Economic Value of the Firm} = \text{Present Value} \left(\begin{array}{c} \text{Cash Flows} \\ \text{Explicit Planning Period} \end{array} \right) + \text{Present Value} \left(\begin{array}{c} \text{Residual} \\ \text{Value} \end{array} \right)$$

More precisely, a firm's value is the present value of all future free cash flows generated by the firm, plus the value of any non-operating assets, such as excess investment in working capital. Determining value using the discounted free cash flow method involves:

- (i) Selecting the forecast duration (often five years but should be of sufficient length for the firm to achieve a constant rate of growth).
- (ii) Determine the sales growth rate, both in the explicit planning period and the period beyond, in which the firm is expected to grow at a constant rate.
- (iii) Forecasting free cash flows (FCF), which includes normalizing the financial statements, examining important income statement—balance sheet relationships (such as operating profit margin, net fixed assets to sales).

⁸ Free cash flows are typically defined as the funds available to reward both debt and equity holders after funding new investments (Jensen 1986).

One method for calculating free cash flows is as follows:⁹

Operating Income

Less: Cash taxes¹⁰

Equals: → After-tax cash flows from operations

Less: Operating working capital investment¹¹ ($\Delta CA - \Delta \text{spontaneous liabilities}^{12}$)

Less: Capital expenditures (Net new investment in fixed & other assets)

Equals: → Free Cash Flows (FCF)

- (iv) Estimating the appropriate discount rate (often the weighted average cost of capital) and then,
- (v) Discounting the projected free cash flows and summing to obtain the value of the firm.

The market approach

The market approach is based on the assumption that the market value of the subject company will be similar to the selling price of similar businesses. To determine firm value using this approach, past sales transaction of similar businesses are examined. From this assessment, certain ratios or multipliers that relate to sales, earnings, or assets are developed. The multiplier is then used in conjunction with some measure of earnings—such as earnings before interest and taxes (EBIT), or earnings before interest, taxes, depreciation, and amortization (EBITDA)—to estimate firm value.

Estimating Firm Value (Market Approach): EBITDA-Multiplier Method

Finding firm value using this market approach method is considerably more straightforward than the previous technique. First the income statement is normalized (adjusted to remove or replace any unusual operating expenses), EBITDA is calculated, and an appropriate multiplier is calculated (this is the difficult aspect of the process). Now the value of the firm can then easily be found as follows:

⁹ Alternate methods for calculating FCFs exist.

¹⁰ Cash taxes represent the actual amount of cash that is actually paid to various governments each year.

¹¹ Operating working capital is defined as current assets less spontaneous liabilities.

¹² Spontaneous liabilities: Short-term liabilities that automatically change as sales change (non-interest bearing).

Operating Income

Plus: Depreciation & amortization

Equals: → EBITDA

Times: Multiplier

Equals: → Value of the Firm

Less: Value of outstanding long-term debt

Equals: → Value of the equity

If the firm has outstanding debt, then the market value of the debt can be deducted to arrive at the value of equity.

The asset or cost approach

In situations where valuing the future earnings of a business does not yield a value that is greater than the value of a firm's assets, the best estimate for firm value is the value of its tangible assets. Under these circumstances, the book value or the replacement cost of the firm's assets is determined. This is then used as an estimate for firm value. The approach is primarily reserved for firms that are difficult to value, such as those in financial difficulty or that have not established a consistent pattern of cash flows. A potential buyer or investor might want to know that if the investment goes badly, the firm's assets could be sold to recoup a portion of his or her investment.

Estimating Firm Value (Cost Approach): Net Book Value of the Assets

Finding firm value using the Net Book Value of Assets method is a straightforward process. After any necessary adjustments to the balance sheet are complete, the value of the firm's liabilities is deducted from *Total Assets*. This value represents the net book value of the firm.

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MULTINATIONAL CAPITAL BUDGETING USING MONTE CARLO SIMULATION: INTRAWEST EVALUATES THE CLEARWATER BEACH PROJECT

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Modeling risk in multinational capital budgeting projects requires an examination of both the uncertainty of the project cash flows and the uncertainty of the exchange rate used to convert the project cash flows to domestic currency for the parent company. Under conditions when the parity conditions are violated or risky market fundamentals create uncertainty in future exchange rates, the net present value from project and parent perspective can differ. Students are asked to make a decision when the net present value differs between the project perspective and various parent perspectives. Insight into the impact of exchange rate estimation and its importance in determining net present value from the parent perspective is demonstrated. This example facilitates the discussion of scenario analysis, sensitivity analysis, and Monte Carlo simulation to examine the risk of a multinational capital budgeting project.

BACKGROUND

This example provides an interesting way for students to take international capital budgeting issues one step further. The typical approach in most International Finance text books is to simply use the traditional net present value (NPV) analysis from both the parent and project perspective. Although this allows students to get a good feel for exchange rate risk, one drawback to the traditional method of capital budgeting is the difficulty to change many of the key assumptions without totally reconstructing the analysis many times. One major argument of the traditional NPV analysis is the accuracy and static nature of the cash flows, allowing key variables to fluctuate over time gives enables us with the ability to measure the variability of cash flows.

In order to fluctuate many variables at the same time, Monte Carlo simulation using Crystal Ball® software is implemented which provides a detailed sensitivity of each variable. This allows the ability to figure out which of the variables have the biggest influence on the NPV. Further, it allows students to discuss how they might mitigate the risk of particular key variables over the time period of the project. This example provides the instructor with numerous different possibilities to test the students' knowledge on NPV, scenario analysis, sensitivity analysis, exchange rate risk, and capital budgeting of real estate investments. Also, this example provides the opportunity to implement a Monte Carlo simulation to better address the risk of a project as the typical NPV analysis often falls short in measuring the risks of a project.

The example provides a hypothetical cross-border project for a Canadian firm, Intrawest. Intrawest is a Canadian corporation that develops and operates destination resorts throughout the world. In January of 2008, assume that Intrawest is considering the development and future operation of a resort in Clearwater Beach, Florida. The riskiness of the foreign cash flows and the future exchange rates needs to be considered when evaluating the project. All future cash flows from the Clearwater Beach project must be converted back into Canadian dollars for Intrawest. Intrawest uses NPV to make their capital budgeting decisions. Intrawest applies a discount rate of twenty-two percent to projects of similar risk in Canada and a discount rate of twenty-five percent for projects of similar risk in the United States.

THE CLEARWATER BEACH PROJECT

The real estate market in Clearwater Beach is depressed and Intrawest believes that the timing is right to purchase and develop real estate. Intrawest has located a distressed property in Clearwater Beach, Florida that provides an interesting investment opportunity. On top of the depreciated market in Clearwater, Intrawest is also interested in this property as they feel that the U.S. is a prime target due to the weakened U.S. dollar. Given that Intrawest must convert all income from properties to Canadian dollars the project will bring about exchange rate risk from Intrawest and this must be accounted for when examining the project from the perspective of Intrawest. The current exchange rate between the United States dollar (US\$) and Canadian dollar (C\$) is 1.02874 C\$/US\$ which is the exchange rate to be used for all cash flows in 2008. Several different estimates for the future spot rates exist complicating the decision for Intrawest.

One estimate for future exchange rates is that changes in the exchange rates are random and could appreciate or depreciate up to 8 percent annually with each year's appreciation or depreciation being independent of each other. Another estimate for future spot rates is based on interest rate parity. The current one year nominal interest rate in Canada is 7.25 percent. The future nominal interest rates in Canada for 2009 through 2018 are expected to be normally distributed with a mean of 7.50 percent and a standard deviation of 2.25 percent. In the United States the current nominal one year interest rate is 8.75 percent and the interest rates for 2009 through 2018 are expected to be normally distributed with a mean of 9.25 percent and a standard deviation of 3.05 percent. Future expected spot rates can also be estimated using relative purchasing power parity. In Canada the expectations for inflation are equally likely to be anywhere from three to five percent each year, and in the United States inflation is expected to be six percent most likely but could be as low as two percent or as high as nine percent. Each year from now through 2018 the nominal interest rate, expected inflation, and expected exchange rate can differ and are not related to the nominal interest rate, expected inflation, and expected exchange rate in any other year.

The current location that is being considered offers 5.5 acres of beach front property and is listed for US\$20,000,000. Intrawest views US\$20,000,000 as the maximum price for the property and believes that they will most likely be able to purchase the property for US\$18,500,000. The minimum price for the property that Intrawest believes they can purchase the property is US\$16,000,000 which is the amount that is owed to Bank of America on the property. Intrawest would like to purchase the property for development. Intrawest will be able to include the construction costs, permitting costs and design costs in the depreciable base of the resort. The resort will be depreciated using straight line depreciation and a 39 year estimated life.

Depreciation of the asset cannot begin until the asset is put into service. The property will take two years to develop once construction begins and the estimated costs are uncertain. In the first year permitting and design costs will cost US\$3,000,000. Construction cannot begin until permitting is complete. Intrawest believes there is eighty percent chance that permitting will be completed this year and construction will begin in January, 2009. If permitting is delayed an additional US\$750,000 in permitting costs will be incurred in 2009 and construction will not begin until January, 2010. Construction costs are hard to determine as labor and material costs are likely to vary. Material costs in the first year are estimated to be US\$30,000,000 but could vary and are just as likely to be anywhere between US\$28,000,000 and US\$32,000,000. Labor costs in the first year are most likely going to be US\$20,000,000 but could be as low as US\$19,000,000 or as high as US\$23,000,000. The materials costs in the second year of construction are most likely going to be US\$14,000,000 but could be as high as US\$15,000,000 or as low as US\$13,500,000. The labor costs in the second year of construction are expected to be somewhere between US\$10,000,000 and US\$13,000,000. If construction is delayed a year then labor and material costs are expected to increase by fifteen percent each year. Intrawest believes that the market value of the developed property at the end of 2018 will be between US\$100,000,000 and US\$170,000,000.

Intrawest will operate the property once developed and have the following estimated the operating costs and revenues. Operating costs include management, sales, service, maintenance, utilities, and taxes. The cost for management include the resort manager with an initial annual salary of \$800,000 plus a bonus of three percent of gross income, a banquet and dining manager with an initial annual salary of \$300,000 plus a bonus of three percent of gross revenue from banquet and dining services, and ten assistant managers with an average initial annual salary of \$120,000 each. These values assume that they begin operation in 2011. If the permitting delay prevents operations from beginning until 2012, the base salary for each manager will be eight percent higher initially. The base pay for all managers automatically increases eight percent every year.

Sales costs average five percent of gross revenue each year, and service costs are estimated to be thirty percent of gross revenue. The utilities for the resort are estimated to cost \$8,000,000 in the first year of operation and are expected to increase by nine percent annually. The average tax rate for Intrawest is thirty-five percent. Maintenance costs have a fixed and variable component: the fixed costs are \$4,000,000 in the first year operations and are expected to grow between nine and thirteen percent annually, the variable maintenance costs are estimated to be between seven and ten percent of gross revenue.

The resort will have a total of 800 revenue generating rooms which consists of 100 beach front suites, 150 beach view suites, 250 beach view rooms, 100 garden view suites, and 200 garden view rooms. After 2011, the average daily prices are expected to grow with rate of inflation in the United States. The expected rates for 2011 for each room are as follows: US\$450 for beach front suites, US\$375 for beach view suites, US\$300 for beach view rooms, US\$400 for garden view suites, and US\$250 for garden view rooms. The utilization rate for the rooms is expected be ninety-five percent each year but the utilization rate has a maximum value of one hundred percent and a standard deviation of five percent.

Banquet and dining services sales are most likely going to be US\$6,000,000 in the first year but could be as low as US\$4,500,000 or as high as US\$7,500,000. The profit margin on banquet and dining services are normally distributed with a mean of eighty percent and a standard deviation of eight percent. The growth in banquet and dining services is expected to

grow at ten percent annually for the foreseeable future, but the variation in the growth rate is normally distributed with a standard deviation of four percent.

Questions for Students

To analyze the project the following questions should be answered by students:

- 1) Construct a pro-forma statement of cash flows through 2018 for the most likely scenario and determine the NPV from both the project and parent perspective using the most likely values for each of the variables provided in the exercise. Would you accept the project? Why?
- 2) Using the pro-forma statement of cash flows calculate the best and worst case scenario NPV from both the parent and project perspective. Does this change your accept/reject decision? Why
- 3) Conduct sensitivity analysis for the five variables you think are most important. What are the implications of your results?
- 4) Apply the proper distributions to your random variables and conduct a Monte Carlo simulation. Forecast the NPV from both the parent and project perspective for each of the three future exchange rate estimates. Would you change your decision to accept/reject the project? Why? What are the most important factors influencing your decision?

USING THE EXAMPLE IN THE CLASSROOM¹

Students are asked to initially look at the base case scenario for the project perspective and three different possible exchange rate options for the parent perspective and then calculate the NPV of the project from these four perspectives. They will find that all four of the different NPVs are positive and suggest that Intrawest should go forth with the project. Here the instructor should caution students on making such a hasty decision without further evaluating the uncertainty involved in these forecasts. It is very unlikely that the actual cash flows will equal the projected cash flows, in fact they almost never will. Next we need to make some additional estimates of future cash flows. We can get a range of NPVs by estimating the highest and lowest NPVs possible under the assumptions given in the exercise. Students will have to evaluate the relationship of each variable has with the NPV. Students are then asked to conduct a scenario analysis to determine the NPV for the best case and worst case to add to their most likely case scenario.

This is an introduction to the riskiness of the cash flows for students. Students will find negative NPVs for the worst case scenario and positive values for the best case scenarios. Now the decision to accept or reject the project is unclear as it is dependent on the key variables. The instructor can point out that likelihood of actually getting the cash flows of any of these three estimates is indistinguishable from zero. Students might suggest that they estimate the cash flows from a variety of different scenarios. Here the instructor should warn students about “the paralyses of analysis” in which computing a large number different estimated cash flows for the

¹ Editor’s Note: For this case, I felt it was appropriate to include the authors’ notes on teaching the case because of the potential complexity of the assignment.

project prevents them from making any decisions because of the difficulty of interpreting the results in this format. It is very difficult to remember the results from thirty or forty different spreadsheets and make an informed decision.

Students are then asked to identify which variables they think have the biggest impact on the NPVs determined in the model. Here students are introduced to sensitivity analysis. The sensitivity analysis allows students to change each variable one at a time to determine its impact on the NPV of the project. With the large number variables that involve uncertainty students will realize that conducting sensitivity analysis on all of the variables would be very time consuming. They are asked to select which variables they think are most important and conduct a sensitivity analysis on those variables only. Different students will select different variables which allows for a discussion on which variables should be most important. After having gone through the process of conducting a scenario analysis and sensitivity analysis by hand students are ready to discuss the benefits of Monte Carlo simulation in modeling the riskiness of the cash flows.

An introduction to Crystal Ball® followed by a discussion of the distributions that can be applied to the assumptions facilitates the Monte Carlo simulation exercise. Margetis (2009) provides an introduction to the use of Crystal Ball® for simulation analysis. Selecting the four different NPVs computed as the forecasted variables allows Crystal Ball® to generate distributions and sensitivity analysis for the various NPVs. The sensitivity analysis under the four different forecasts will identify the variables that have the largest impact on NPV. Students are able to see firsthand how Monte Carlo simulation provides more timely and complete information about the riskiness of the cash flows than the standard sensitivity analysis and scenario analysis computed manually.

RESULTS FOR PROJECTED CASH FLOW ANALYSIS AND MONTE CARLO SIMULATION

Exhibit 1 illustrates the spreadsheet estimating the cash flows for the project and the NPV for the four different exchange rate scenarios. This spreadsheet illustrates the base case NPV for this project under those four different scenarios. These variables are indicated in bold at the bottom of the spreadsheet. The top of the spreadsheet identifies the assumptions made in the case. The results from this spreadsheet provide the various NPVs calculated according to the traditional NPV analysis indicates that management should accept the project as all NPVs are positive. The assumptions that are filled with light gray identify the variables that can vary over time as described in the case analysis. These variables are given different distributions that have been defined earlier in the paper. The completion of the base case NPVs gives the instructor the chance to test student's ability to solve a capital budgeting project using NPV as well provides the opportunity for discussion about potential weaknesses in the traditional NPV analysis. Some issues that may arise when using traditional NPV are the fact that cash flows are static. This means that key variables used to generate cash flows are not allowed to change over the cash flow prediction time period. To address these issues the Monte Carlo simulation using Crystal Ball software is used. This allows a detailed NPV distribution and shows the importance of different variables on NPV.

Exhibit 2 shows the NPV distribution for the different assumptions on exchange rates and the variables that have the largest impact on the NPV. Panel A shows the NPV distribution and the essential variables when assuming that the exchange rate will vary randomly over time as

discussed in the case descriptions. Under these assumptions the NPV distribution looks favorable as many trials have positive NPVs. Looking at the NPV distribution it appears that accepting the project would be a good idea. The key variables impacting NPV are utilization rate (occupancy), changing exchange rates over time, and terminal value. Occupancy is a key when evaluating a hotel/resort project as it is the primary driver impacting income and cash flow for these projects. It is not a surprise that occupancy plays a large role in the calculation of NPV. Exchange rate fluctuation is also important. Finally, terminal value is important as it measures the how much the resort will be worth at the end of the investment period. This variable has added importance do range in possible values. These ranges make as real estate values can be extremely volatile as shown over the past five years especially in the Clearwater Beach area.

Panel B illustrates the NPV distribution and the essential variables when assuming that the future exchange rates will follow the interest rate parity as defined in the assumptions. The NPV distribution shows that the project appears to be acceptable under these conditions. This time the decision is a little closer than the one made using the random approach to calculating exchange rates as positive and negative NPVs are close to even. The essential variables affecting NPV are occupancy, terminal value, changing exchange rates over time, and resort maintenance costs. These variables are similar to the ones found before, but this time maintenance costs shows up and exchange rates appear slightly less important. Maintenance cost is definitely one that should be further investigated by the firm as it could greatly impact cash flows for the project. Panel C demonstrates the NPV distribution and the essential variables when assuming that the exchange rate will follow relative purchasing power parity as defined in the assumptions. The NPV distribution illustrates that the project is similar to that shown in under the assumption of interest rate parity. The same variables from the interest rate parity assumption are also important when examining NPV this way.

Panel D illustrates the NPV distribution and the essential variables when examining the NPV from the project prospective. This time, exchange rate risk is not an important factor. Examining the project this way focuses how the project performs without the impact of foreign exchange fluctuation. The NPV distribution illustrates the inherent risk of the project as many of the NPV trails are negative. This result directly disagrees with the previous ones, with the project appearing less beneficial when ignoring the potential gains from exchange rate fluctuation due to a weaker dollar. With this in mind, Intrawest should carefully consider this project before accepting it. Investors of Intrawest could make their own speculations on exchange rates without having Intrawest speculate on the United States dollar for them. The project should be acceptable without depending on exchange rate appreciation. The variables which greatly affect NPV from the project prospective are occupancy, terminal value, maintenance value, inflation, and start-up costs including purchase price and material costs. If Intrawest plans on investing in the project, they would definitely want to take a great deal of time focusing on these variables and perhaps tighten up the ranges before thinking about accepting the project as there appears to be a large probability of a negative NPV.

CONCLUSION

This hypothetical project offers the instructor a variety of options in format and delivery. Instructors can also choose on whether to focus on the impact of exchange rates, revenues driven by occupancy, expenses, or the terminal value in determining the NPV of the project. This also sets up well for a complicated real estate problem as the decision is directly impacted by

occupancy which can be analyzed in the Clearwater Beach area more closely. The time frame can also be adjusted. The instructor could speed up the project by providing the students the pro-forma statement of cash flows for the project for the year 2008 through 2018 if the material is intended to be covered in one class session. For a longer team type assignment, the instructor can assign the project to students and allow them to create the pro-forma statement cash flows. Of course any of the assumptions can be allowed to change over time with any different distributions. This provides the ability to scale the complexity of the analysis to any desired level of difficulty.

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Exhibit 1

Intrawest ULC Clearwater Beach Resort - Pro Forma Statement of Cash Flows

Assumptions		Room Types	Price	Utilization	Rooms		
Property Price	\$18,500,000	Beach front suite	\$400	346.75	100	United States Discount Rate	25%
Permitting delay (years)	0	Beach view suite	\$325	346.75	150	Canadian Discount Rate	22%
Year 1 permitting costs	\$3,000,000	Beach view room	\$275	346.75	250		
Year 2 permitting costs	\$2,000,000					Growth in construction costs if delayed	15%
Year 1 material costs	\$30,000,000	Garden view suite	\$300	346.75	200		
Year 2 material costs	\$14,000,000	Garden view room	\$225	346.75	300		
Year 1 labor costs	\$20,000,000	Utilization Rate	95.00%				
Year 2 labor costs	\$11,500,000	Banquet Sales Year 1	\$6,000,000				
Resort Manager salary	\$800,000	Banquet sales growth rate	8%	Banquet Margin	80.00%	Exchange Rate (C\$/US\$)	1.02874
Resort Manager bonus	3%	Depreciation expected life (years)			39		
Banquet Manager salary	\$300,000	Utilities in first year of operation		\$8,000,000			
Banquet Manager bonus	3%	growth in utilities expense		9%			
Assistant Manager salary	\$1,800,000	Tax rate		35%			
Salary growth rate	10%	maintenance costs (fixed)		\$4,000,000			
Sales cost percentage	5%	growth in fixed maintenance costs		11.00%			
Service costs percentage	30%	Maintenance costs percentage (variable)		8.50%			

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue											
Beach front suite				\$13,870,000	\$14,424,800	\$15,001,792	\$15,601,864	\$16,225,938	\$16,874,976	\$17,549,975	\$18,251,974
Beach view suite				\$16,904,063	\$17,580,225	\$18,283,434	\$19,014,771	\$19,775,362	\$20,566,377	\$21,389,032	\$22,244,593
Beach view room				\$23,839,063	\$24,792,625	\$25,784,330	\$26,815,703	\$27,888,331	\$29,003,865	\$30,164,019	\$31,370,580
Garden view suite				\$20,805,000	\$21,637,200	\$22,502,688	\$23,402,796	\$24,338,907	\$25,312,464	\$26,324,962	\$27,377,961
Garden view room				\$23,405,625	\$24,341,850	\$25,315,524	\$26,328,145	\$27,381,271	\$28,476,522	\$29,615,582	\$30,800,206
Banquet sales				\$6,000,000	\$6,480,000	\$6,998,400	\$7,558,272	\$8,162,934	\$8,815,968	\$9,521,246	\$10,282,946
gross revenue				\$104,823,750	\$109,256,700	\$113,886,168	\$118,721,551	\$123,772,744	\$129,050,171	\$134,564,816	\$140,328,259
Expenses											
Property	\$18,500,000										
Permitting	\$3,000,000	\$0									
Materials		\$30,000,000	\$14,000,000	\$0							
Labor		\$20,000,000	\$11,500,000	\$0							
Resort Manager Salary				\$800,000	\$880,000	\$968,000	\$1,064,800	\$1,171,280	\$1,288,408	\$1,417,249	\$1,558,974
Resort Manager Bonus				\$3,144,713	\$3,277,701	\$3,416,585	\$3,561,647	\$3,713,182	\$3,871,505	\$4,036,944	\$4,209,848
Banquet Manager Salary				\$300,000	\$330,000	\$363,000	\$399,300	\$439,230	\$483,153	\$531,468	\$584,615
Banquet Manager Bonus				\$180,000	\$194,400	\$209,952	\$226,748	\$244,888	\$264,479	\$285,637	\$308,488
Banquet Variable Costs				\$1,200,000	\$1,296,000	\$1,399,680	\$1,511,654	\$1,632,587	\$1,763,194	\$1,904,249	\$2,056,589
Assistant Manager Salary				\$1,800,000	\$1,980,000	\$2,178,000	\$2,395,800	\$2,635,380	\$2,898,918	\$3,188,810	\$3,507,691
Sales Cost				\$5,241,188	\$5,462,835	\$5,694,308	\$5,936,078	\$6,188,637	\$6,452,509	\$6,728,241	\$7,016,413
Service Cost				\$31,447,125	\$32,777,010	\$34,165,850	\$35,616,465	\$37,131,823	\$38,715,051	\$40,369,445	\$42,098,478
Utilities				\$8,000,000	\$8,720,000	\$9,504,800	\$10,360,232	\$11,292,653	\$12,308,992	\$13,416,801	\$14,624,313
Maintenance (fixed)				\$4,000,000	\$4,440,000	\$4,928,400	\$5,470,524	\$6,072,282	\$6,740,233	\$7,481,658	\$8,304,641
Maintenance (variable)				\$8,910,019	\$9,286,820	\$9,680,324	\$10,091,332	\$10,520,683	\$10,969,265	\$11,438,009	\$11,927,902
Depreciation				\$2,012,821	\$2,012,821	\$2,012,821	\$2,012,821	\$2,012,821	\$2,012,821	\$2,012,821	\$2,012,821
EBT				\$37,787,886	\$38,599,114	\$39,364,447	\$40,074,151	\$40,717,298	\$41,281,645	\$41,753,484	\$42,117,487
Taxes				\$13,225,760	\$13,509,690	\$13,777,557	\$14,025,953	\$14,251,054	\$14,448,576	\$14,613,719	\$14,741,121
Net Income				\$24,562,126	\$25,089,424	\$25,586,891	\$26,048,198	\$26,466,244	\$26,833,069	\$27,139,764	\$27,376,367

Exhibit 1 (continued)

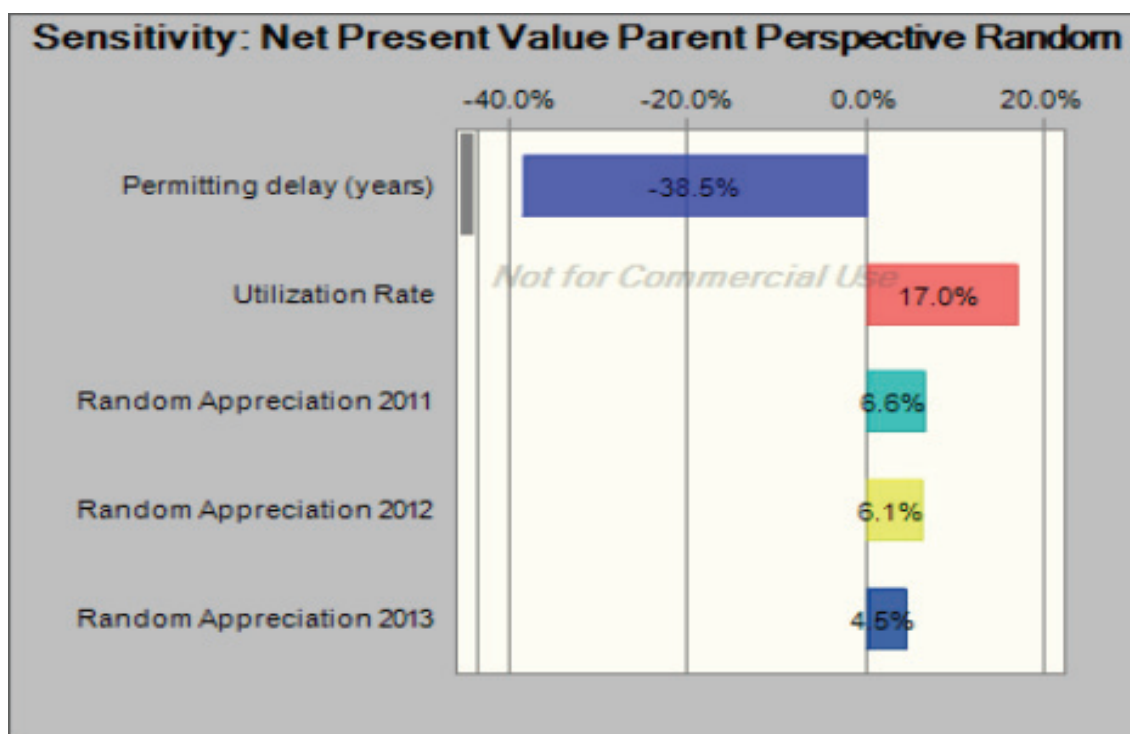
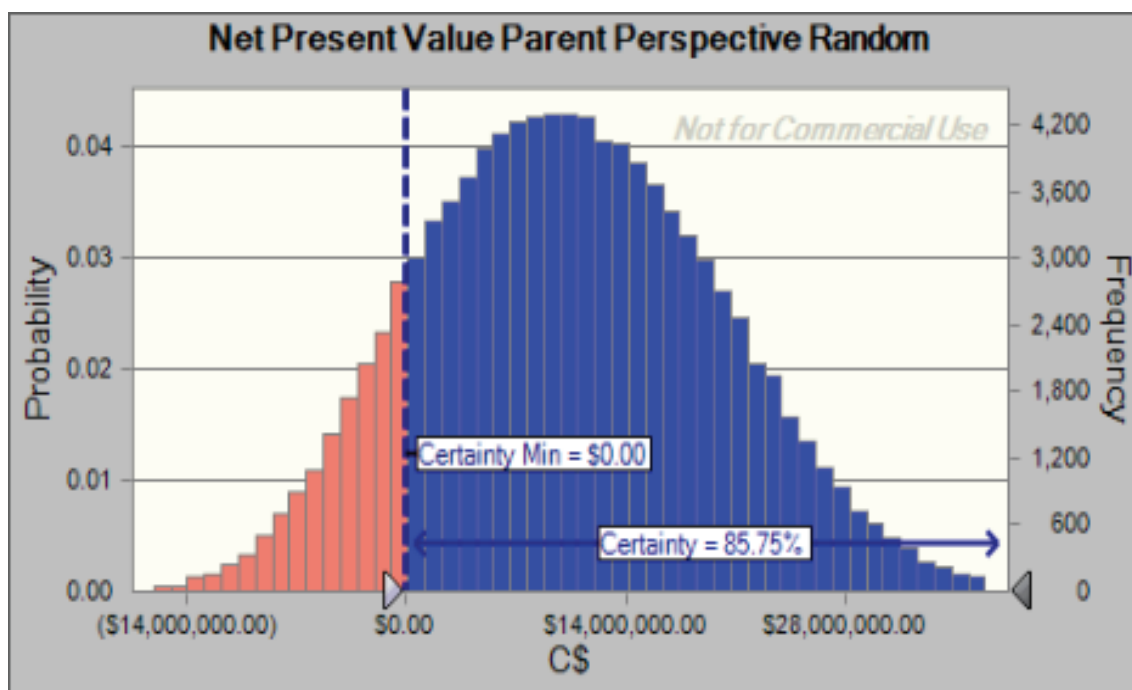
Cash Flows

Operating cash flows	-\$21,500,000	-\$50,000,000	-\$25,500,000	\$26,574,946	\$27,102,245	\$27,599,711	\$28,061,018	\$28,479,064	\$28,845,890	\$29,152,585	\$29,389,187
Terminal value											\$200,000,000
Net cash flows	-\$21,500,000	-\$50,000,000	-\$25,500,000	\$26,574,946	\$27,102,245	\$27,599,711	\$28,061,018	\$28,479,064	\$28,845,890	\$29,152,585	\$229,389,187
Random Appreciation/Depreciation	1.00000	1.00000	1.00000	1.00000	1.00000	1.00000	1.00000	1.00000	1.00000	1.00000	1.00000
Canadian Nominal Interest Rate	6.5000%	6.5000%	6.5000%	6.5000%	6.5000%	6.5000%	6.5000%	6.5000%	6.5000%	6.5000%	6.5000%
American Nominal Interest Rate	6.7500%	7.2500%	7.2500%	7.2500%	7.2500%	7.2500%	7.2500%	7.2500%	7.2500%	7.2500%	7.2500%
Canadian Expected Inflation	3.0000%	3.0000%	3.0000%	3.0000%	3.0000%	3.0000%	3.0000%	3.0000%	3.0000%	3.0000%	3.0000%
American Expected Inflation	4.0000%	4.0000%	4.0000%	4.0000%	4.0000%	4.0000%	4.0000%	4.0000%	4.0000%	4.0000%	4.0000%
Exchange Rate Random	\$1.02874	\$1.02874	\$1.02874	\$1.02874	\$1.02874	\$1.02874	\$1.02874	\$1.02874	\$1.02874	\$1.02874	\$1.02874
Exchange Rate IRP	\$1.02874	\$1.02155	\$1.01440	\$1.00731	\$1.00026	\$0.99327	\$0.98632	\$0.97943	\$0.97258	\$0.96578	\$0.95902
Exchange Rate RPP	\$1.02874	\$1.01885	\$1.00905	\$0.99935	\$0.98974	\$0.98022	\$0.97080	\$0.96146	\$0.95222	\$0.94306	\$0.93399
Canadian Cash Flow Random	-\$22,117,910	-\$51,437,000	-\$26,232,870	\$27,338,710	\$27,881,163	\$28,392,927	\$28,867,492	\$29,297,553	\$29,674,921	\$29,990,430	\$235,981,832
Canadian Cash Flow IRP	-\$22,117,910	-\$51,077,301	-\$25,867,260	\$26,769,172	\$27,109,413	\$27,413,955	\$27,677,247	\$27,893,145	\$28,054,854	\$28,154,866	\$219,989,341
Canadian Cash Flow RPP	-\$22,117,910	-\$50,942,413	-\$25,730,817	\$26,557,652	\$26,824,178	\$27,053,882	\$27,241,585	\$27,381,582	\$27,467,596	\$27,492,717	\$214,248,319

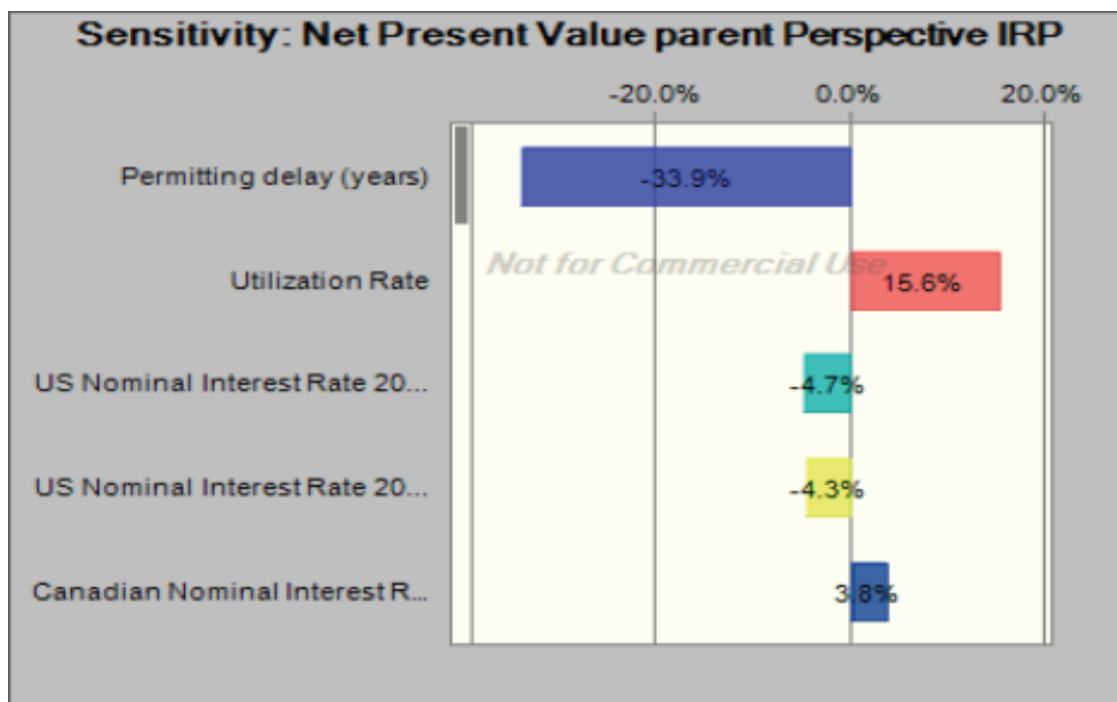
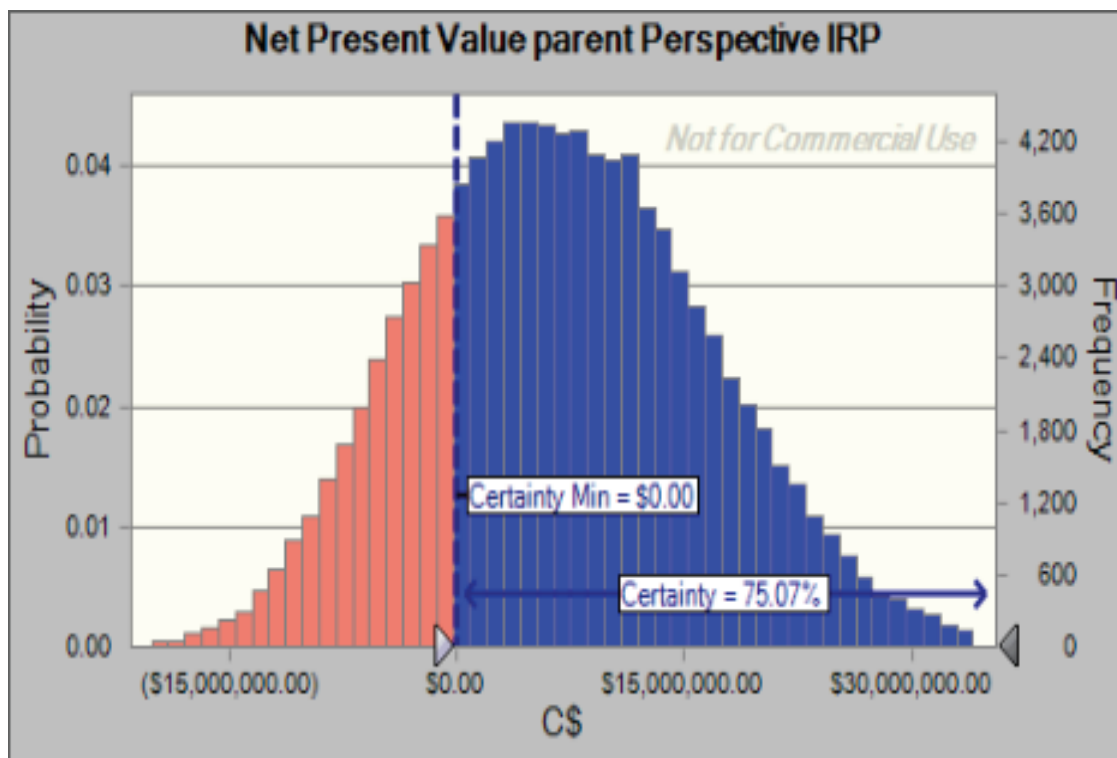
NPV Project Perspective	\$2,718,602.72
NPV Parent Perspective Random	\$15,641,458.80
NPV parent Perspective IRP	\$11,621,564.11
NPV Parent Perspective RPP	\$10,169,841.72

Exhibit 2
NPV Distribution and Variable Sensitivity

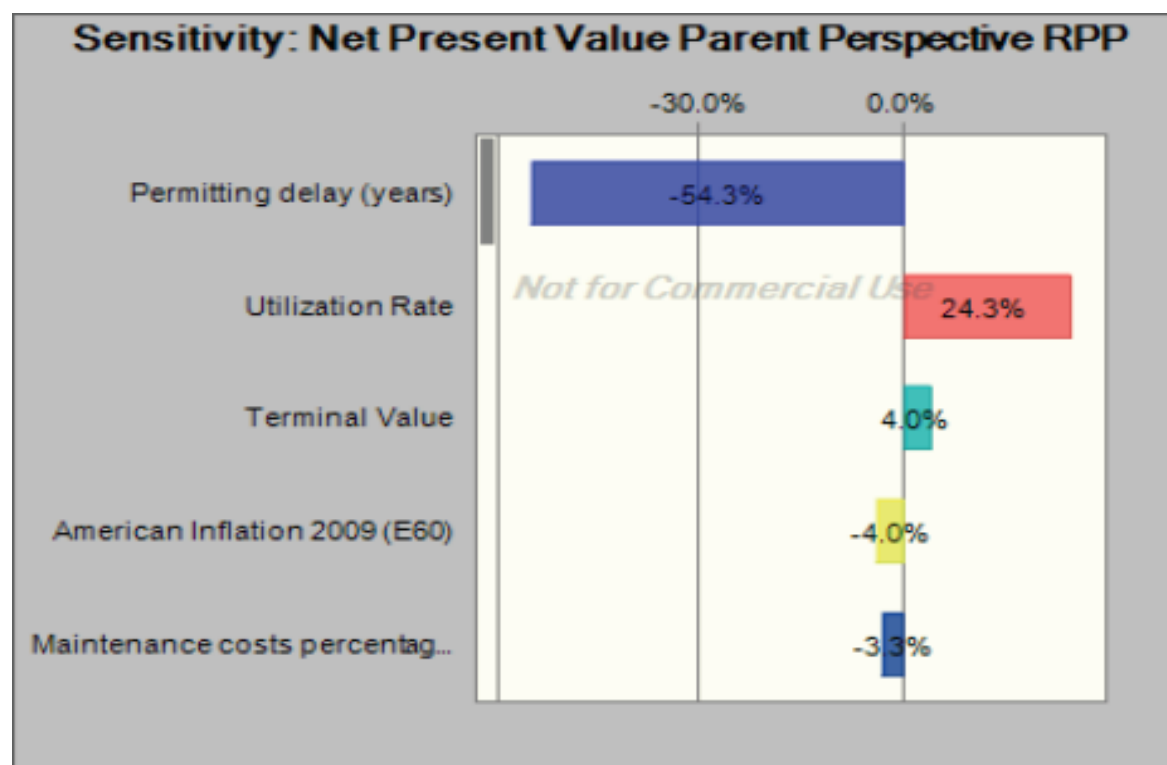
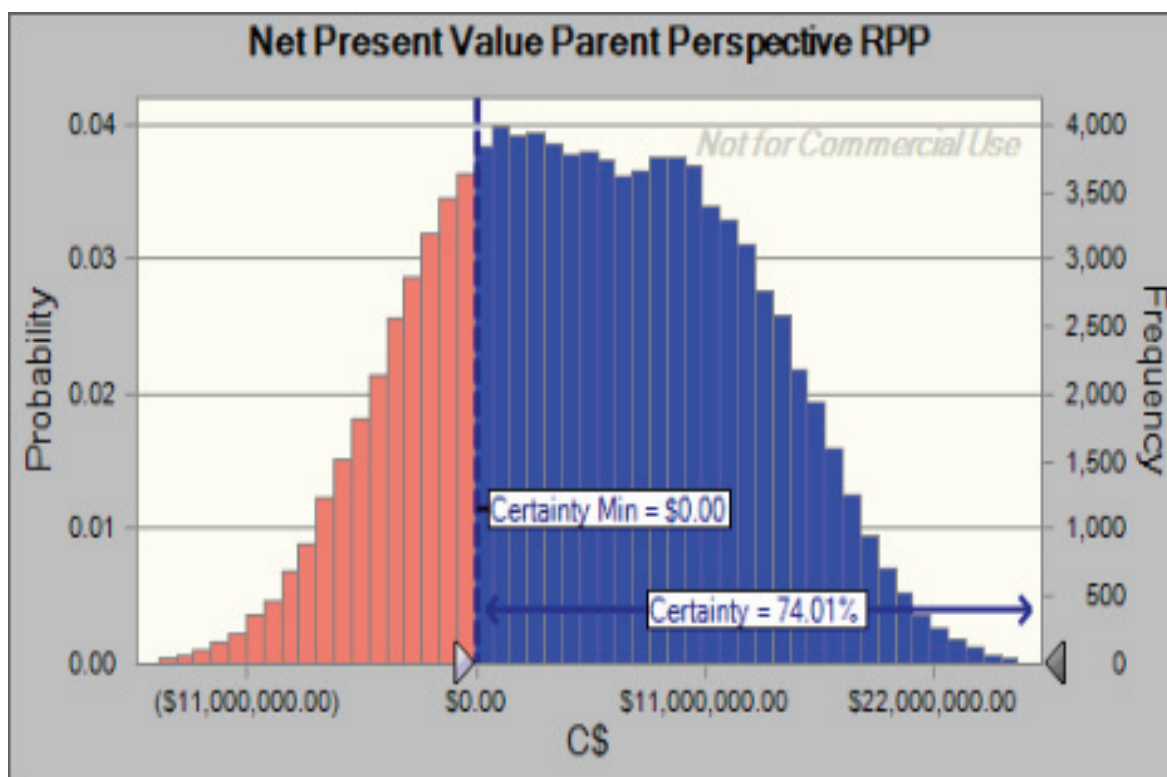
Panel A: Shows the NPV distribution using the Monte Carlo simulation with 100,000 different trails and the sensitivity of highest impact variables when using a randomly chosen percentage to estimate the currency exchange rates over the project life.



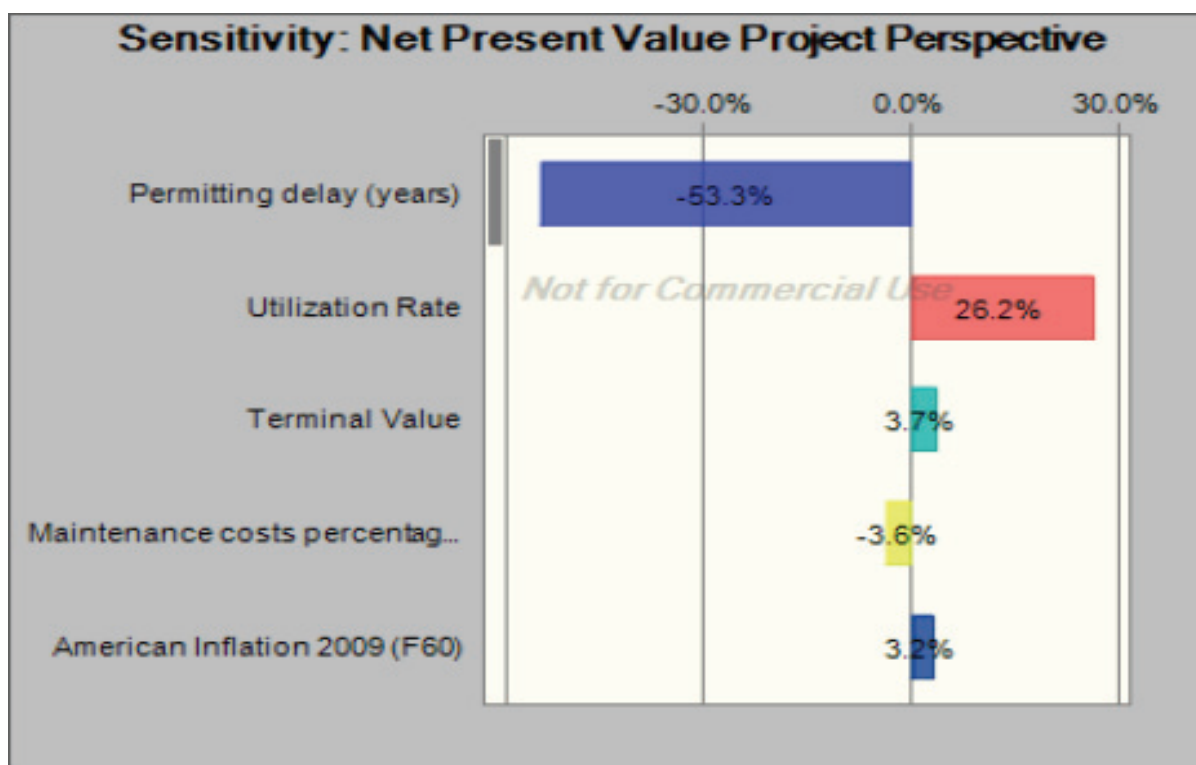
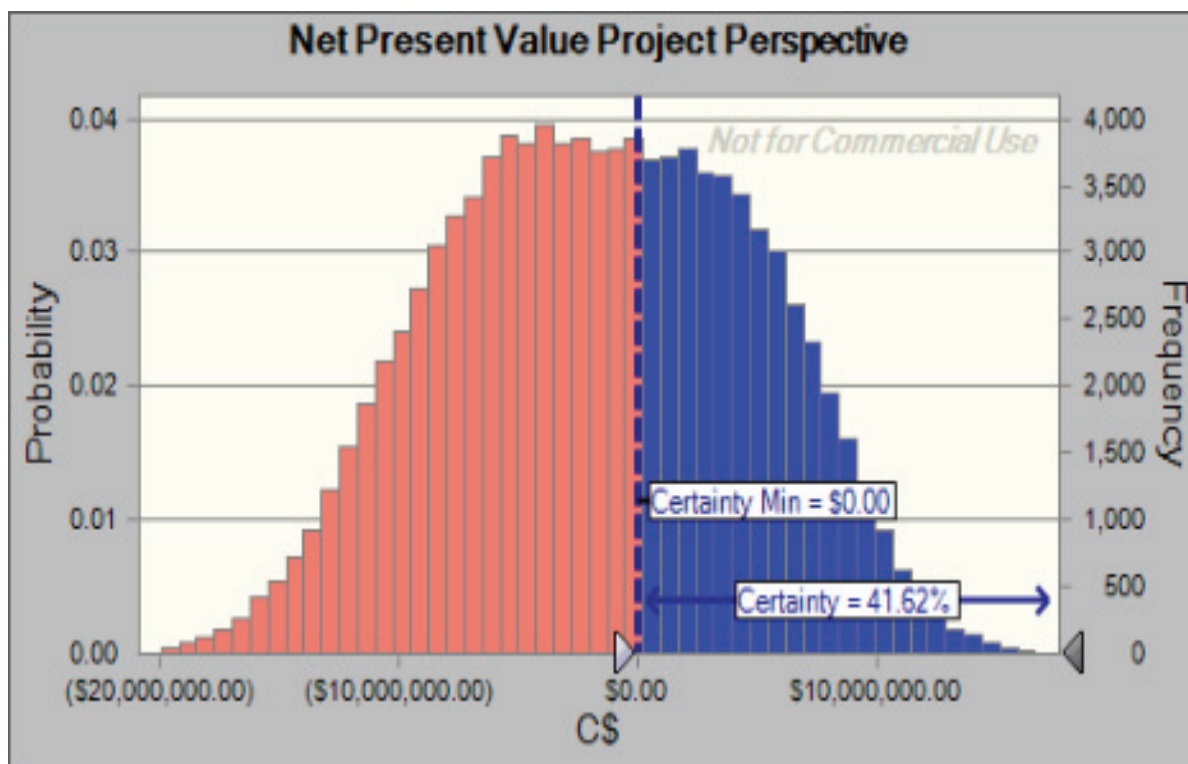
Panel B: Shows the NPV distribution using the Monte Carlo simulation with 100,000 different trails and the sensitivity of highest impact variables when using interest rate parity to estimate the varying currency exchange rate over the project life.



Panel C: Shows the NPV distribution using the Monte Carlo simulation with 100,000 different trails and the sensitivity of highest impact variables when using relative purchase power parity to estimate the varying currency exchange rate over the project life.



Panel D: Shows the NPV distribution using the Monte Carlo simulation with 100,000 different trails and the sensitivity of highest impact variables when considering no exchange rate fluctuations, looking at the project prospective.



CREATION OF WEALTH WITHOUT DEBT

William P. Dukes, Texas Tech University

Paul R. Goebel, Texas Tech University

This case relates to the use of wisdom, knowledge, skill to provide an approach or approaches to create or enhance wealth without the use of recourse leverage. In this case, the entrepreneur applied skills developed through the receipt of an excellent education in a first class university, and the application of the education received coupled with the work ethic of a Trojan horse over an extended period of time. The resulting creation of wealth provides proof that what you do is important, but even more important is how you go about doing it and with whom you select as partners. This case has a difficulty level appropriate for senior undergraduate and master level graduate students. It is designed to be taught in a single class period, with approximately two hours of student preparation time, depending on their level of proficiency.

INTRODUCTION

Scott Allen is a 1965 graduate of Wendell University. While attending Wendell, Scott's major field was accounting, but he took sufficient classes in finance to graduate with a double major. Scott was an excellent student and put his heart into all classes. Thanks to his professors and the strong desire to be successful, Scott was selected for induction by Beta Gamma Sigma and Phi Kappa Phi in his junior year. Being in the top seven percent of his class was important to him. Scott's first job after graduation was in a small accounting firm, but more importantly within the first month of employment he sat for and passed all four parts of the CPA examination. After a year of hard work, Scott sensed that his accounting degree and CPA designation were not enough. He came to realize that while accounting and finance provided him with an excellent base of knowledge, most businesses wanted someone with a better rounding of their education. With his CPA and tax work, Scott realized that he could afford to go back to Wendell University for an MBA. Through hard work and the ability to waive some of the required leveling courses, Scott was able to complete the MBA degree requirements in 1967. Along the way, Scott married his college sweetheart, a union that ultimately produced two daughters and one son.

After 10 years of working in the same accounting firm, Scott Allen left to work exclusively with two oil and gas businesses. During this time he learned 'how to put deals together'. This ultimately led to Scott concentrating on the management of businesses. To expand his horizons beyond accounting, in 1981 Scott formed the Scott Allen Professional Corporation (PC), which permitted him to expand his CPA work into business management. As sole owner of his PC, Scott had control but there were new horizons to be tapped. He convinced one of his consultants to join him as a partner in his PC. The new partner had a real estate and geology background.

When the accounting workload increased he went back to his first love, Wendell University, and hired as he needed more employees. This gave Scott more time to consider the larger goals for his most successful business. The CPA practice was going great, and Scott had been able to hire experienced money managers to permit expansion of his very successful money management business.

Scott and his executive team began to dream and plan new activities in the state of Texas. Various phases of the oil business intrigued him, so he began to make use of various skills available within his organization. Scott Allen had a special talent in being able to raise money for any project deemed worthy of consideration. He was of the opinion that various phases of the oil business needed more investigation. Rather than borrowing money, which he disliked intensely, Scott would raise money to finance various projects. Scott found that he could sell equity positions to friends, family, acquaintances, or investors desiring to participate in one or more of the projects. Projects put into play were drilling for oil and gas, reworking existing wells, and oil and gas production projects. His geologist partner helped greatly in judgment calls on the nature, location and expected production of oil and gas projects. He and his partner took equity positions along with other interested investors. When the time was ripe the entire project was sold, reaping significant profits in the millions of dollars for the equity positions. Big money was earned without borrowing anything, greatly pleasing his equity investors.

Some of the off-shoots of the equity funded projects included the establishment of Sight Seeing Systems in the colorful mountains in the western part of the country, office building development in the Dallas-Fort Worth metroplex, and the purchase and development of a ranch in the Possum Kingdom area where some of the best deer hunting in the state exists.

Scott's other interests include church related activities, memberships on the Wendell University Endowment Fund Board, and service on several bank Board of Directors along with other graduates of Wendell University.

STEPS TO BUILD WEALTH WITHOUT RECOURSE DEBT

Over the years, Scott Allen developed a series of steps that he believed are the keys to creating wealth without the use of recourse debt. These steps include:

1. Establish a cash-flow business in a major city to 'make a living' while building up future wealth. It can be a CPA firm, as in the case of Scott Allen, or a real estate brokerage firm, law practice, small business, etc. Alternative positions could be working in money management or with a hedge fund, although these types of positions typically require long hours, taking time away from wealth building activities.
2. Get to know potential qualified investors, i.e. people with money. It is typically easier to cultivate individuals rather than institutions, and will save significant travel time. Possible avenues to meeting investors are:
 - a) be active at your children's school, serving on Boards and Committees
 - b) join influential service clubs
 - c) become active at a University, serving on committees or in the Alumni Association
 - d) be active at church
 - e) join social clubs.

3. Gain qualified investor's confidence by being around them. Strive to demonstrate integrity and good judgment in your chosen profession. Resist greediness. Be humble. One way to demonstrate good judgment is to learn about 'diversified' investments and then use it in conversation around investors.
4. Save your cash!
5. Look for promoters (i.e. 'money makers') with integrity to invest with, or to raise money for. Examples are oil operators, real estate developers, people who buy companies, etc.
6. Decide which promoters one can offer to raise money for. Since the fundraiser and promoters typically charge carried interests to compensate them for 'promoting' the proposed project to outside investors, the fundraiser can potentially raise as much as 20-25% of the promotion charges. As an example, assume there is a 20% charge by the fundraiser out of the total promotion charges, taken as 10% up front and 10% on the back end. If \$2 million is raised for a project, and a total promotion charge of 10%, then the fundraiser can take 10% on each end of the total amount raised, equaling \$40,000 in this example.
7. Try to do business only with promoters who have integrity and humbleness. This person possibly should only be starting out or barely be getting started. Encourage the promoter to abstain from greediness!
8. Don't enter into a legal partnership with the operator. Let it be a contractual arrangement, preferably in writing. However, an informal 'verbal deal' in the oil and gas business can lead to successive deals. Let the promoter be the operator. Stay out of it. Perhaps the best way to form a legal arrangement with the promoter is to form one's own limited partnership to invest in a limited partnership that the operator forms, with the fundraiser's limited partnership being the only investor in the operator's limited partnership. Each deal should be structured independently of all others, allowing the fundraiser and the operator to 'quit' after each deal. Again, the operator must be a money maker with integrity and humbleness.
9. An example of an actual oil and gas deal consisted of \$30 million of cash and debt to buy producing oil and gas properties. In this case, 65% non-recourse bank debt was obtained and cash of 35% (about \$10 million) was raised. Of the \$10 million cash raised, only about \$4 million came from individuals, with 'non-promoted' industry partners investing the difference. Clearly the fundraiser will be better off raising equity from individuals rather than industry partners, but this will take a 'track-record' before this will be possible. In all subsequent deals with this particular promoter, 100% of the necessary cash was raised from individuals because the operator and fundraiser had 'proven' themselves, and investors were willing to put more money with them. As more equity is able to be raised, less non-recourse debt will be required, dropping to around 50% for each of the eight subsequent deals between Scott Allen and his operator.
10. An example of an actual real estate deal started with a client who owned \$3 million worth of raw land in a growing area of a major Texas city. The fundraiser approached a home builder

who wanted to get into single family lot development. A 50/50 deal was proposed, where the client would contribute the land and \$1 million to develop (streets, utilities, etc.) the first phase (30 - 60 acres). The home builder built the houses at his risk (debt and equity) and was the only builder. The profits on lot sales and all homes were split 50/50 between the home builder and land owner. Ultimately, the \$3 million property was converted into \$12 million cash, with the fundraiser receiving about 10% of the profit.

11. Invest in 'people, not deals'. Never forget that! Also, in the oil and gas business, buy production and resist the temptation of exploration.

12. The fundraiser's role will be to raise money in return for a percentage of the carry (hopefully 20-25%). However, the fundraiser's cash-flow business could also be involved in providing appropriate services for a fee (e.g. accounting, legal, etc.).

13. Invest some of one's own money with the operator on a 'heads-up basis', while the fundraiser and operator are 'promoting' the investors.

In summary, Scott Allen believes the keys to building wealth without the use of recourse debt are to:

- a. Get to know potential investors and gain their confidence
- b. Find a money maker with integrity and humility, and who is not greedy
- c. Conduct your business and fundraising activities with integrity, and without greed
- d. Recognize that the process may take time, so don't try to 'get rich quick'
- e. Refrain from borrowing recourse debt, except for a house and a car
- f. Raise enough cash (usually 35%-50%) so that banks are willing to provide non-recourse financing for the rest.

Just as acquiring wealth is important, Scott has also come to realize that maintaining this wealth is just as important. Scott is a big advocate of practicing 'modern portfolio theory' through the diversification of his investments. An example of a diversified portfolio might include:

- a. 10% in bonds
- b. 15% in diversified US equities (large, mid, and small cap, both value and growth)
- c. 15% in diversified international and emerging market equities
- d. 10% in hedge funds or comparable alternative investments
- e. 50% in other alternative investments, such as real estate, oil and gas, private equity placements, venture capital, etc.

SCOTT'S CONCERNS

Having achieved financial success, Scott is now faced with the question of how he can give back to Wendell University and pass his wealth on to his family, with minimal tax consequences. Issues raised in these considerations include, but are not limited to:

1. Is the use of a Charitable Remainder Uni-Trust (CRUT) the best way to give to Wendell University?
2. How can a CRUT be structured to provide funding to the College of Business at Wendell University and show support for his three children at the same time?
3. Would the establishment of a Professorship or Chair be in the best interests of the College of Business, or would the funding of scholarships provide the most benefit?
4. Would other instruments, such as Private Annuity Trusts, be beneficial in transferring some of Scott's sizable real estate and oil and gas holdings to his family?

PROMAX: A CASE ON TRANSACTION EXPOSURE

Merouane Lakehal-Ayat, St. John Fisher College

Promax, manufacturer of a new PDA, has narrowed its expansion choice to an Irish supplier requiring payment in Euros and a Chinese supplier requiring payment in yuan (with a pass-through clause for potential currency related cost increases from an Australian sub-contractor.) The suppliers are equivalent in every way except for foreign exchange considerations. The challenge facing Promax is that the payable they will incur with whomever they select will be subject to transaction exposure. If the rates change in a favorable way, then Promax's costs for the PDA will decline. However, the rates could move unfavorably, and Promax's COGS could rise to unacceptable levels.

BACKGROUND

Promax, Inc. manufactures high-end accessory products for the rapidly expanding Personal Digital Assistant (PDA) market. Promax has designed and developed a new interface for digital cameras that allows display on a 5 x 7 screen. This new hand-held device allows owners of digital cameras to show pictures directly from the camera. It will be marketed at an inexpensive price of \$125. Promax has completed the prototype and is preparing for production. Currently, Promax assembles and ships its products from a small manufacturing facility in Arkansas. This plant would require expansion to meet the new production requirements. Promax has decided, instead, to produce this product offshore by contracting with another manufacturer.

There are two choices for this 18-month contract. The first choice is to use a Chinese firm that Promax has had successful business dealings before. The Chinese firm has both the capability and a solid track record of fulfilling contracts. Although they refuse to contract for payment in U.S. dollars, their quotation is reasonable and meets the pricing requirements for the product. There is one variable, however; they are dependent upon materials from Australia and their quotation has a materials increase provision based on the appreciation of the Australian dollar.

Recently, a new Irish firm that has expanded into Kosovo solicited Promax's purchasing department. This Irish firm, while new, has a strong reputation. The new plant in Kosovo has an inexpensive skilled-labor pool and an adequate source of materials. While they also will not contract for payment in U.S. dollars, their quotation, in Euros, is competitive with the Chinese firm's.

Key Principle

Promax's future profits may vary due to changes in FX rates. This is because they have a commitment to pay either supplier they choose in the supplier's currency. Thus, a transaction

exposure exists. If the dollar depreciates relative to the supplier's foreign currency, then Promax's COGS will increase. This could result in a combination of lower revenue (due to the need to increase price,) and lower profits depending on how Promax handles pass-through and hedging. Of course there is a potential upside if the USD appreciates relative to the currency of the supplier's if Promax chooses not to hedge.

Key Factors and Assumptions

- The product will be marketed at a price of \$125
- All variables between the two supplier alternatives are equal besides FX rate considerations
- The Chinese contractor invoices in foreign currency. They also have a pass-through provision for FX related price increase from their Australian materials supplier.
- The Ireland contractor, with operations in Kosovo, will invoice in Euros.
- Offshore production will be under an 18 month contract.
- The key concern for Promax was a 75% payment due 12 months from acceptance of the contracts with the remainder (25%) due at the end of the contractual period.
- The contract is assumed to be executed immediately upon selection of a supplier.

REQUIRED

Prepare a proposal analyzing the choice of one of the two competitive suppliers for Promax's contract. The proposal should focus on the expected currency exchange rates for the next 18 months. Assume for this project that all other variables between the two manufacturers are equal. Your proposal should include an executive summary, the data and analysis supporting your decision, and the proper citations documenting your sources.

The content should address parity conditions, asset approach, and balance of payments. This contract will pose transaction exposure for Promax. Regardless of which supplier you chose you will need to develop a hedging strategy with pricing. This pricing should be documented with quotations from sources. Additionally, you should address pass-through rates.

1. Verify/Forecast the FX rates for China, Australia, and the Euro for the next 12 and 18 months (using the FX determinants - Balance of Payments, International Parity Conditions, and Asset Analysis).
2. Select a supplier based on the FX forecast.
3. Develop a hedging strategy considering the forward, option, money market, and un-hedged alternatives for both pay periods.
4. Evaluate the performance of selected strategy by looking at the actual FX market rates.

Exhibit 1. Balance of Payment (BOP) Information***China***

Since China is a fixed regime, we will first focus on the reserves. The risk of inadequate reserves to maintain a net zero balance is judged to be very low. According to the People's Daily, "Trade and capital account surpluses in recent years brought China's foreign exchange reserves to US\$403.3 billion at the end of last year, the second-largest amount in the world following Japan."¹

However, there is some risk of revaluation. In Morris Goldstein's testimony before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, he makes the point that the RMB is currently considered undervalued by at least 15 to 20%, as evidenced by surpluses on both the overall current and capital accounts in its balance of payments, and accumulated international reserves in large amounts.² The testimony goes on to make the case the US should urge China to revalue their currency. For it is not only in the interest of the US, but also in the self-interest of China as well.³

If China were to revalue, the USD would become weaker and the payable that Promax is obligated for would cost the company at least 15 to 20% more.

Australia

The country's recent gains in trade are not considered sustainable.⁴ The forecasted Current Account balance deficit is expected to increase over 100% in the coming year. This is true for both the Goods and Services and the Net Investment Income sub-accounts. The Capital and Financial Account is not expected to increase enough to offset the increasing trade account deficit, resulting in an increasing overall BOP imbalance of 3.3B USD.

The BOP indicates that a depreciation the Australian dollar would be more likely than an appreciation. And depreciation would result in a weaker AUS dollar, which would avoid the Chinese supplier passing through increases in price for what they would have to pay the Australian sub-contractor.

Eurozone

The BBC points out that the EUR is not dependent on any one country, "The strength of the euro will ultimately depend on the strength of the eurozone economy."⁵ The EUR is going to be most influenced by the economies of the most influential member countries, which happen to be Germany and France. These two countries account for more than 50% of GDP, according to

¹ http://english.peopledaily.com.cn/200402/27/eng20040227_136006.shtml

² <http://www.iie.com/publications/papers/goldstein1003.htm>

³ Ibid

⁴ Country Watch Database, http://80-www.countrywatch.com.ezproxy.rit.edu/cw_topic.asp?vCOUNTRY=9&SECTION=SUB&TOPIC=MAOVR&TYPE=TEXT

⁵ <http://news.bbc.co.uk/1/hi/business/1740131.stm>

global statistics.⁶ A good source for signals for the direction of the EUR is the European Central Bank because it has the single objective for price stability of the currency.

The forecast for Germany is a strengthening of the Current Accounts, the Capital and Financial Account and the overall BOP. France is forecasting an overall strengthening in the BOP as well. In contrast, the US's BOP forecast is for a very large increase in the trade deficit. The BOP analysis for the Eurozone suggests a weakening of the USD relative to the EUR. This would result in an effective increase in costs for what Promax would have to pay for the PDA's.

Ireland and Kosovo's economies were not considered major factors in the analysis because their impact on the EUR would be small compared to that of France and Germany.

⁶ www.globalbritain.org/Statistics/Eurozone.doc

Exhibit 2. Asset Approach Information

Factor		China	Australia	US	EU
Real Interest Rates = Nominal IR – Inflation		5.31 – (-0.8) = 5.39	7.81 – 2.8 = 5.01	4.68 – 1.6 = 3.08	4.8 – 1.9 = 2.9 ⁷⁸
Growth Prospects	Real GDP Growth %	8	3.7	2.4	1.3
	Net Financial Acct (\$B)	15	14	394	
Liquidity		Medium	High	High	High
Shock Survival		High	Medium	High	High
Political Risk Premium		Medium CSFB 225 - 325 ⁹	Low CSFB 0	Low CSFB 0	Low
Corporate Governance		Low	Medium	Medium	High
Contagion		Low	Medium	Low	Low
% Unemployment		3.1	6.6	5.7	8%

⁷ <http://www.fxclub.org/tools/archfund/euro/forecastspolicyanalysis.doc>

⁸ <http://archives.tcm.ie/businesspost/2002/06/30/story323477.asp>

⁹ <http://www.som.yale.edu/faculty/jmg93/Intl/notes/Lect%2014%20Ccap.pdf>

CHAD MYERS: THE DIARY OF A DEBT ADDICT¹

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Since the appearance of the first credit card in the 1950s, credit card companies have been aggressively offering credit to increasingly riskier borrowers. In an attempt to broaden their markets, credit card issuers have targeted their marketing toward college students with little or no experience with managing credit. Students receive applications through direct mail campaigns, find applications for credit cards posted in class rooms and receive them with their purchases at campus bookstores. Too often, students succumb to these offers, incurring high levels of debt they cannot repay. This case challenges students to find ways to exit the financial morass presented by access to easy, yet costly credit card debt.

This case opens with Chad Myers being confronted by a collection agency to pay an overdue balance on a Visa card. In addition, he suddenly finds he is not able to pay the minimum payment on his remaining cards. Students are given Chad's assets, liabilities, income and expenses and asked to help Chad solve his financial dilemma.

COLLEGE STUDENTS AND CREDIT CARD DEBT

Excessive credit card debt is epidemic among college students. The consequences of heavy marketing by card issuers combined with the lack of discipline and financial sophistication of most college students, not surprisingly, have resulted in a huge expansion in credit card debt among this population. Eighty-four percent of college undergraduates have credit cards. Half of all college students have four or more credit cards. The average college student's credit card balance is over \$3,173. Twenty-one percent of students owe between than \$3,000 and \$7,000.² These heavy debt loads can seriously penalize students both before and after graduation. Students might be forced to file for bankruptcy, to work part-time jobs while still in school or even drop out of school entirely. High debt loads can induce anxiety and, in rare cases lead to suicide.³ After graduation, overdue credit card debt can result in damaged credit histories just at the time students need debt to purchase a car, professional clothing for work or a home. The unpaid balances can also hinder a student's ability to invest for retirement at a time in life when this type of investment can provide its greatest rewards. Clearly, the consequences of misusing credit card debt during college last well beyond graduation.

¹ Disclaimer: Chad Myers, the central figure in this case, is fictional and serves only as a metaphor for an average college student dealing with problems associated with excessive credit card debt.

² "How Undergraduate Students Use Credit Cards" Sallie Mae's National Study of Usage Rates and Trends 2009, http://www.salliemae.com/about/news_info/research/credit_card_study/.

³ "The Credit Card Binge." U.S. News and World Report.

Until very recently, credit card companies intensified their efforts to market credit cards to college students as more secure markets have matured. The marketing strategies employed include sending setting up booths in dining halls,⁴ E-mails, and offering free t-shirts for filling out an application, stuffing applications into bookstore sacks⁵ and stapling applications in college classrooms. Colleges and universities implicitly approve of credit card use by accepting them for tuition payments. To soften college administrations, the firms help fund college activities or forward part of the “take” to the university⁶. However, there is a recent trend among universities to restrict the marketing of credit cards on college campuses.⁷

Common sense would suggest marketing debt to college students would not be viable for card issuers. However, while most students are unemployed, they do have some disposable income and many are initially debt free. Many students are financially unsophisticated and are impulsive spenders unfazed by high the interest rates charged.⁸ What’s more, they tend to max out their cards and pay the minimum required payment, which allows the card issuers to earn maximum interest.⁹ Also, the card companies know that Americans form an allegiance to their first card.¹⁰

A RUDE AWAKENING

The case begins early one morning as Chad Myers is forced to confront problems presented by his burgeoning credit card balances. It is 6:00 a.m. as Chad Myers awakens to the ringing of his new Apple iPhone.

“Hello?” Chad answered sleepily.

“Is this Chad Myers?”

“Speaking.”

“Mr. Myers, this is John Jenkins with the Speedy Collection Agency. I’m calling about the \$1,000 balance you owe on your Visa card. This amount is over 90 days past due. **WHEN ARE YOU GOING TO PAY US???**”

Chad was now wide awake. His heart and mind raced as he struggled for a response. He was both broke and jobless and there was no way he could come close to paying the balance on this debt. His parents knew nothing of his financial problems, were of very modest means and

⁴ “Students Start Early, and Charge Often,” by David L. Marcus, U.S. News and World Report, March 19, 2001 (Vol. 130, issue 11), p. 58.

⁵ “The Credit Card Binge,” by Margaret Mannix, U.S. News and World Report, September 6, 1999 (Vol. 127, Issue 9), p. 89.

⁶ “Students Start Early and Charge Often,” U.S. News and World Report.

⁷ Ibid.

⁸ Ibid.

⁹ “Congratulations Grads – You’re Bankrupt,” Business Week, May 21, 2001 (Issue 3733), p.48.

¹⁰ “Students Start Early and Charge Often,” U.S. News and World Report, March 19, 2001 (Vol. 130, issue 11), p. 58.

certainly would not be able pay the debt. What would happen to him? Would he be arrested? Would he go to jail? What could he possibly do to resolve this problem?

Regaining his composure, Chad responded angrily, "This is the 10th time you guys have called me. Just as I told you before, I'll pay you when I can."

"When might that be Mr. Myers?" Jenkins asked sarcastically

"I don't know. I just don't have much money right now. Can I pay you \$50 per month until the debt is repaid?" Chad asked hopefully.

"That is totally unacceptable Mr. Myers. **THE ENTIRE BALANCE IS DUE RIGHT NOW!** You know Mr. Myers, #@%\$ like you are responsible for the credit crisis we have in this country right now. If you don't pay Speedy Collection Agency at once, I'll be forced to contact your family to obtain payment. Is that what you want Chad?"

In frustration, Chad slammed down the phone. He didn't know what to do. He didn't have the \$1,000 needed to pay off the Visa Card, and he certainly didn't want his family to find out about his excessive debt. As he pondered his predicament, he began to review how he had arrived at this state of affairs.

Chad had arrived at Oxford State University two years ago to major in industrial technology. He planned to finance his education with a small savings account, a little help from his parents, a scholarship paying half his tuition, Stafford loans, and a part-time job.

On his first trip to the campus bookstore during his freshman year, the checker placed a Visa credit-card application in the bag with his books. Although this went unnoticed by Chad at the time, his eyes were drawn to the colorful application when he emptied the bag back at his apartment. The application was short and easy to fill out. The application offered a credit card with a \$1,000 credit limit available at an 18% interest rate. On a whim, Chad decided to fill out the application and send it in.

When his card arrived, Chad initially made small purchases for meals and entertainment. Using the card was so easy. Soon, he started obtaining cash advances with the card at ATM machines. Chad quickly maxed out his Visa card which led him to apply for a MasterCard and a Discover card. With these, he purchased a mountain bike, an Apple iPhone, a 22" flat screen TV for his off-campus apartment and a Nintendo Wii console.

Midway through his first semester, Chad began dating Dixie, whom he had met at a social hosted by his fraternity. As their romance blossomed, he began charging his share of their frequent dates on his credit cards.¹¹ When Spring break arrived, Chad and Dixie decided to spend it at Panama City, Florida. Again, Chad charged his share on his credit cards. By the end of the spring semester, Chad's credit card debt had increased to \$3,000 but he was not overly concerned since he was able to make the minimum payments each month. Also, he planned to take a full-time summer job near his parent's home and pay off the balance by the next fall.

As it turned out, Chad decided to keep his part-time job and go to summer school instead. This had the added advantage of allowing him to continue seeing Dixie through the summer.

¹¹ Chad and Dixie decided early in their relationship not to follow traditional gender roles. Each paid half the cost of these dates.

Again, Chad charged his share of their dates using his credit cards. Curiously, neither Chad nor Dixie had any knowledge of the other's financial affairs.

By September, Chad's credit card balances totaled \$4,500. Unfortunately, just before registration, Chad lost his part-time job and decided to pay for his tuition and books using his credit cards. To make matters worse, Chad now had to bear the full cost of his tuition having lost his scholarship due to poor grades during the previous semester.

By October, Chad's credit-card debt totaled \$7,150. Chad realized he was unable to pay even the minimum monthly payments on this debt. Soon he began receiving letters and ever more urgent phone calls demanding payment.

Chad wondered how he could possibly solve his financial problems. Should he ignore the problem and simply stop answering his phone? Could he somehow resolve his credit card debt and still remain in school? Would it be more expedient to drop out of school for a year or two so he could earn the money needed to pay off his credit card debt? Should he declare bankruptcy? Should he inform Dixie and his parents of the financial crisis he had created for himself? As Chad considered these alternatives, he knew his decision would affect his ability to pay off his debt, his credit rating, his ability to continue college, and perhaps even his relationship with Dixie.

Chad's Financial Information

Chad's Assets

Item	Estimated Market Value
1992 F150 Ford Pickup	\$2,000
Dell Pentium IV PC (Gift from Grandparents)	\$400
Mountain Bike	\$150
Apple iPhone	\$150
22" Samsung flat-screen television	\$300
Nintendo Wii console with 5 games	\$200

Chad's Debt

Credit-card debt:

	<u>Balance</u>	<u>APR</u>	<u>Minimum Monthly Payment</u> ¹²	<u>Number of Months To Payoff</u>	<u>Total Interest Paid</u> ¹³
Visa card	\$1,000	18%	Default	Balance Due Now	
MasterCard	\$2,500	22%	\$100	34	\$875
Discover	<u>\$3,650</u>	22%	<u>\$146</u>	33	<u>\$1,192</u>
Total	\$7,150		\$246		\$2,067

¹² Computed as 4% of the outstanding balance.

¹³ Assumes minimum monthly payment.

Stafford Loan:

<u>Balance</u>	<u>APR</u>	<u>Minimum Monthly Payment</u>
\$2,500	6.8%	None while attending college at least half-time. Payments commence six months after discontinuing college.

Chad's Income

Parents \$500 per month (Parents have stated this is an absolute maximum).

Job Currently unemployed but might potentially earn \$8.00 an hour and work 30 hours per week while enrolled full-time in school. Alternatively, Chad could work full-time (\$8.00 per hour over a 40 hour week) and go to school part-time. Finally, Chad could discontinue college temporarily and work a 50-hour week (\$8.00 per hour with time-and-a-half for the 10 hours worked over the 40-hour workweek).

Chad's Expenses

Tuition	\$2,400/semester
Books (used from bookstore) and supplies	500/semester
Apartment rent	500/month
Meals - mostly restaurants	500/month
Entertainment/dates (excluding food)	400/month
Fraternity Dues	275/month
Insurance on truck	150/month
Gym Membership	40/month

Chad's FICO¹⁴ Scores:

Experian: 415
Equifax: 455
Transunion: 435

¹⁴ FICO (Fair Isaac Corporation) scores are issued by each of the three credit reporting agencies (Equifax, Experian and Transunion) and are a measure of the default risk presented by a borrower. The scores range from a low of 300 (very high default risk) to 850 (very low default risk).

REVERSING ACQUISITIONS: THE CASE OF CITIGROUP

Natalya Delcoure, University of St. Thomas
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INTRODUCTION

In early 2007, Citigroup announced its intention to sell the "umbrella" symbol acquired through the purchase of Travelers eight years prior. In 2002, the business units from the same acquisition were spun off, drawing attention to Citigroup's merger/acquisition and divestiture/spinoff activity during the past ten years.

The history of Citigroup is primarily the history of two separate organizations, Citicorp – multinational banking behemoth with operations in over 100 countries – and Travelers Insurance – a combination of many different companies beginning with Commercial Credit in Baltimore and gradually expanding with purchases of Primerica (consumer finance), Smith Barney (brokerage), and Travelers (Insurance).

At the time of the merger between Citicorp and Travelers, Sandy Weill was the Chairman of Travelers and John Reed was the Chairman of Citicorp. The merger was aimed to create a one-stop shop for banking, insurance, brokerage, and investment banking services under common umbrella. The two CEO candidates for the combined firm could not have been more different in management style and their career backgrounds.

The merger took place in April 1998. At first, the merger did not receive regulatory approval because the remaining provisions of the Glass-Steagall Act did not allow banks to merge with insurance underwriters and offer investment and banking services. However, Chuck Prince, Citicorp CEO, and his team of lawyers found a loophole in the Law – the Federal Reserve could grant the companies a conditional two years trial before Citigroup would have to divest the insurance underwriting business. Curiously enough, in 1999, the Glass-Steagall Act was invalidated by the passing of the Gramm-Leach-Bliley Act. Ironically, Citigroup still divested its insurance underwriting business in December 2002, presumably due to the lack of synergies from the two companies' merger.

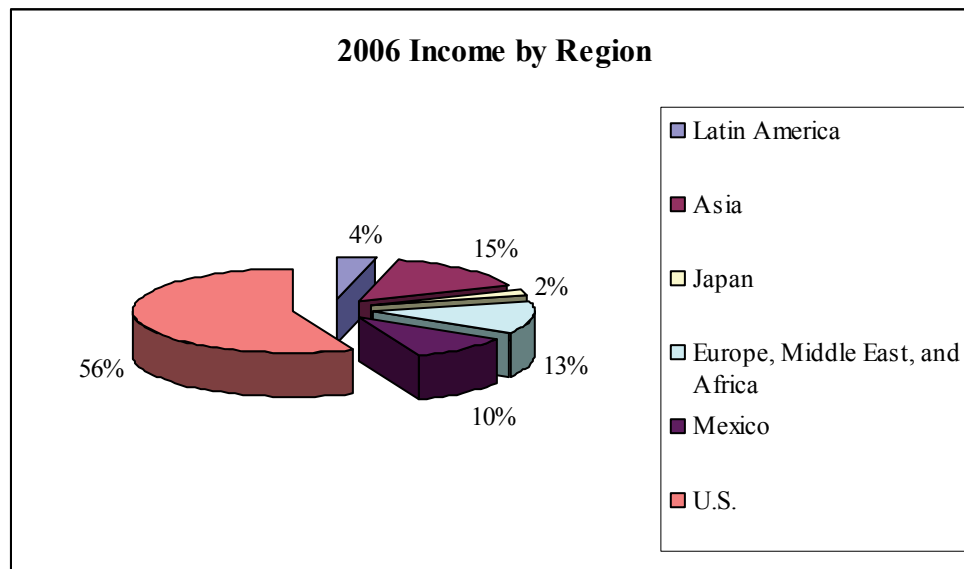
BACKGROUND

Citigroup (NYSE:C) is a major U.S. financial services company based in New York City. The company is the product of the Citicorp and Travelers Insurance 1998 merger. The merger combined insurance, commercial and investment banking for the first time in the U.S. since 1933 under the "red" umbrella symbol of Travelers. The combined entities were envisioned to offer a

“financial services supermarket” to consumers, and economies of scale paired with operations efficiency to the company.

Citigroup is organized into three major business groups – Global Consumer, Corporate and Investment Banking, and Global Wealth Management. Exhibit 1 shows Citigroup geographical presence and income by region in 2006.

Exhibit 1. Citigroup Income



Source: <http://www.edgar-online.gov>

Skeptics noted that the “financial supermarket” idea was not new. Historical evidence demonstrates mixed performance results of these entities. On one side, European universal banks (including Deutsche Bank and BNP Paribas), had lower profitability compared to their specialized counterparts. However, Loyds TSB and MBNA enjoyed success in focusing on retail banking and credit cards, respectively. For Citigroup, it was hard to overestimate the complexity of blending two companies with different corporate cultures and managing such a giant effectively. Nevertheless, the merger was announced in April 1998 and effectively completed over the next two years. Table 1 presents segment, product and regional net income for 1998 and 2006. Table 2 summarizes Citigroup mergers’ and spinoffs’ timeline.

Table 1. Segment, product and regional net income for 1998 and 2006, in \$ millions.

	1998	2006
Global consumer		
U.S. Cards	\$709	\$3,890
U.S. Retail Distribution	\$113	\$2,027
U.S. Consumer Lending	\$175	\$1,912
U.S. Commercial Business	-	\$561
Total U.S. Consumer	\$997	\$8,390
International Cards	\$982	\$1,137
International Consumer Finance	-	\$40
International Retail Banking	-	\$2,840
Total International	\$982	\$4,017
Total Global Consumer	\$1,979	\$12,407
Corporate and Investment		
Capital Markets and Banking	-	\$5,763
Transaction Services	\$910	\$1,426
Total Corporate and	\$910	\$7,189
Global Wealth Management	\$22	\$1,444
Total Global Wealth	\$22	\$1,444
Net Income	\$2,911	\$21,040

Source: <http://www.edgar-online.gov>

Table 2. Citigroup mergers' and spinoffs' timeline

Date	Company	Description
April-98	Travelers Group	In April 1998 Citicorp and Travelers Group merge to become Citigroup. Citigroup issued 1.698 billion shares adjusted to reflect 3-for-2 stock split in Citigroup's common stock.
March-99	Financiero Atlas	Citigroup adds No. 2 consumer finance company in Chile to its portfolio.
March-00		Citigroup qualifies as a financial holding company (FHC) under Gramm-Leach-Bliley Act of 1999.
May-00	Schroders PLC	Salomon Smith Barney, investment banking wing of Citigroup, establishes Schroder Salomon Smith Barney in European market.
May-00	Bank Hadlowy w Warszawie SA	The merger offers investment and retail banking services to its clients and creates Poland's leading financial institution (stock transaction).
July-00	Grupo Siembra	Citigroup acquires 100% of shares in Argentina's retirement-services group \$280 million).
October-00	The Geneva Group, Inc.	Salomon Smith Barney purchases the Geneva Group, Inc., owner and operator of the Geneva Companies.
November-00	First Capital Corporation	Citigroup acquires the fifth-largest consumer finance company in Japan (\$31.1 billion).
July-01	European American Bank	Citigroup strengthens its presence in metropolitan New York and Long Island markets by purchasing European American Bank (\$1.6 billion in common and \$350 million in preferred stock).
August-01	Grupo Financiero Banamex-Accival	Citigroup executes the largest ever US-Mexico merger (\$12.5 billion) to increase its presence in Latin America.
November-01	ABN AMRO Bank	Citibank establishes its presence in Kenya through purchase of ABN AMRO Bank (\$224 billion).
November-02	Golden State Bancorp	Citibank expands its retail services in California and Nevada markets through the acquisition of Golden State Bancorp, second-largest US thrift (\$2.3 billion and 795 million shares of common stock).
December-02	Citigroup	Citigroup spins off Travelers Insurance in \$5 billion IPO.
December-03	Forum Financial Group	Citigroup purchases Forum Financial Group, a leading service provide in the global mutual fund, hedge fund, and offshore fund industries.
December-06	Grupo Cuscatlan	Citigroup extends its overseas presence by acquiring the units of Grupo Cuscatlan for \$1.5 billion in cash-and-stock.
February-07	Citigroup	Citigroup sells its red umbrella logo to St Paul Travelers Co for an undisclosed amount.

Table 3 shows combined net written Travelers's premiums and deposits, a non-GAAP financial measure, by product line, for the three years ended December 31, 2003.

Table 3. Net written premiums and deposits for term ended December 31, 2003 (\$ millions).

	2003	2002	2001
Individual annuities			
Fixed	\$544	\$1,294	\$1,148
Variable	\$4,002	\$4,081	\$4,972
Individual payout	\$56	\$58	\$59
Total individual annuities	\$4,602	\$5,433	\$6,179
GICs and other group annuities	\$7,402	\$6,292	\$7,068
 Individual life insurance			
Direct periodic premiums and deposits	\$826	\$771	\$652
Single premium deposits	\$405	\$285	\$208
Reinsurance	(\$139)	(\$113)	(\$96)
Total individual life insurance	\$1,092	\$943	\$764
Total	\$13,096	\$12,688	\$14,011

Source: <http://www.edgar-online.gov>

RESTRUCTURING JUSTIFICATIONS

Mergers are combinations of two firms into one, with the acquirer integrating the assets and liabilities of the target firm. Typically, mergers must be approved by at least fifty percent of the shareholders of each firm. Acquisition is a takeover of a firm by purchase of that firm's common stock or assets.

Mergers are often categorized as

- Horizontal – merger that takes place between two firms in the same line of business where the merged firms may have been former competitors. These mergers may be blocked by the regulators if they are thought to be anticompetitive or create too much monopoly power.
- Vertical – merger of two companies at different stages of production. For example, the buyer expands toward the source of raw materials or forward in the direction of the ultimate consumer.
- Conglomerate – merger of companies in unrelated lines of business.

Merger motives:	Dubious reasons for mergers:
1. To replace the existing management team.	1. Diversification – it is easier achieved and cheaper for an individual than for a corporation.
2. To gain efficiency from combined operations – creation of synergy.	2. The bootstrap game – mergers with no economic gains.
3. To spread the fixed costs across larger volume of output – economies of scale.	
4. To gain control and coordination over the production process by expanding back toward the output of the raw material and forward to the ultimate consumer – economies of vertical integration.	
5. To combine complementary resources.	
6. To use surplus funds.	

Merger Valuation

Three questions are typically addressed by analysts evaluating mergers

1. Is the proposed merger value-enhancing? Are the two firms worth more together than apart?
2. Do the terms of the merger increase the wealth of my shareholders? There is no point to merger if the cost is too high and all economic gains go to the other company.
3. What is the payment method? If the merger is paid by cash, the cost of the merger is not affected by the size of the merger gains; however, if stock is offered, the cost depends on the merger gains because the gain is reflected in the postmerger share price, and these shares are used to pay for the target firm.

In the market, fusion – mergers and acquisitions – gets the most attention; however, fission – the divestiture of assets or entire business – is as important.

Fission includes

- Spin off – companies split a business by separating it from the parent firm and distributing the stock in the newly independent company to their shareholders. The most common motive for spin off is to improve company's efficiency and focus.

- Carve-out – similar to spin off; however, the stock of the newly independent company is sold in a public offering.

The U.S. merger history suggests that merger activity reflects some underlying economic, regulatory, and technological factors.

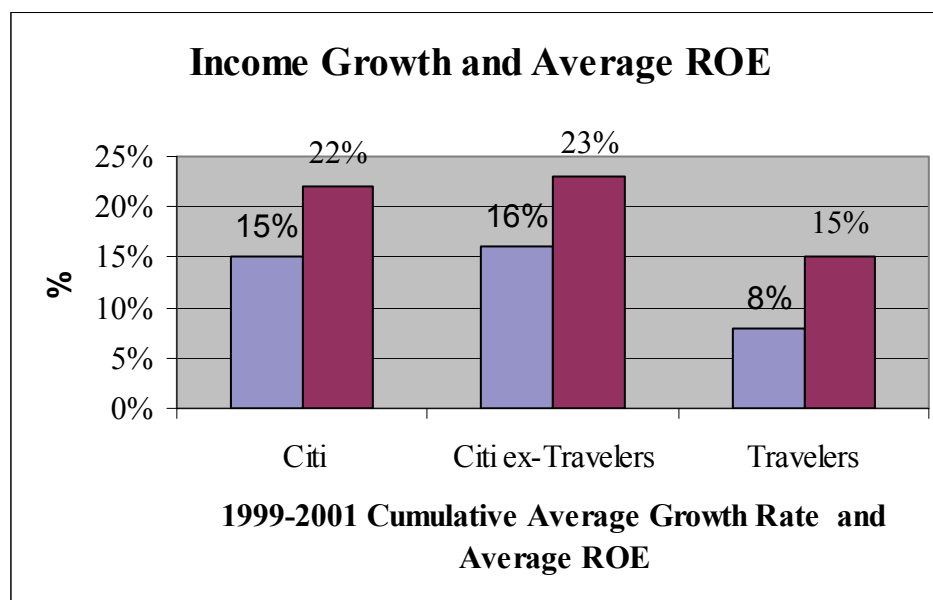
THE CURRENT DEBATE

Recently, Citigroup has been criticized by investors for poor market performance, despite its strong result in its investment and retail banking sectors (5.99% rate of return vs. 8.28% by S&P 500 Index in 2006). Some believe that the main weakness lies in corporate expenditures. Others urge the company to spin off various businesses to improve its market performance.

Exhibit 2 presents income growth rate and average return on equity (ROE) for Citigroup with and without Travelers Insurance. Exhibit 3 displays the impact of Travelers' Insurance on Citigroup financial performance.

The debate is intensified by the fact that Citigroup is the result of a large number of mergers with companies that still operate independently. For example, the subprime lending division business model (Citifinancial) involves expanding into new countries and essentially inventing or reinventing the consumer finance business model in that country. The division has been very profitable in some countries, but it has led to major problems in Japan and Argentina, where allegations of failed anti-money laundering procedures, deceptive sales tactics, and transactions which disrupted the financial markets and were fraudulent caused the resignation of senior executives and out-of-court settlement with the SEC.

Furthermore, the synergies between consumer finance and retail banking have been questioned by some. The retail banking franchise is different in each country it occupies. For example, in the U.S., Citibank has a relatively small branch network with mid-tier technological capabilities, and is actively engaged in cross selling investment and insurance products to all customer segments. On the other hand, Citibank in Mexico (Banamex) is the largest bank in Mexico with a growing customer base and unique product set.

Exhibit 2. Citigroup's Growth Rate and Returns

Note: Numbers exclude Traveler's losses related to the World Trade Center attacks of \$490 million after-tax and include after-tax realized gains and losses for Traveler's (\$70 million in 1999, \$31 million in 2000, and \$222 million in 2001).

Source: Citigroup 10-K and 10-Q Reports.

Exhibit 3. Citigroup Financial Impact, \$ millions

	<u>Full Year 2000</u>	<u>1-3Q 2001</u>
Citigroup Core Income	\$14,140	\$10,707
Traveler's		
Commercial Line	1,093	428
Personal Lines	307	155
Realized Gains/Losses	<u>31</u>	<u>222</u>
Total Traveler's Income	1,431	805
% of Citigroup	10%	8%

Source: Citigroup 10-K Report, 2000 and Citigroup 10-Q Report, 2001

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