

# **JOURNAL OF FINANCE CASE RESEARCH**

**Volume 11**

**2009**

**Number 1**

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AT HARVARD AND DARDEN MBA PROGRAMS:**

**QUALITIES OF A SUCCESSFUL  
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Rachel Smith

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INSTITUTE OF FINANCE CASE RESEARCH**

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# **JOURNAL OF FINANCE CASE RESEARCH**

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*Robert Stretcher, Executive Editor*  
*Sam Houston State University*

*Jonathan Breazeale, Managing Editor*  
*Sam Houston State University*

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**Huntsville, Texas**

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**Dr. Robert Stretcher, Executive Editor  
Journal of Finance Case Research  
Department of General Business and Finance  
Sam Houston State University  
Huntsville, Texas 77341  
(936) 294-3308**

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## Letter From the Editor

We are pleased to present the Spring 2009 issue of the *Journal of Finance Case Research*, the official journal of *The Institute of Finance Case Research* (IFCR). 2009 has been a year of transition for the IFCR. Our structure has changed to more effectively handle the inflow of quality case manuscript submissions. I am pleased to announce that Jonathan Breazeale has assumed duties as Managing Editor of the Journal beginning January 2009. I have been honored to serve as Executive Editor for the past four years and will continue to carry out those duties, assist in the *Journal's* production and promote the mission of the *Institute*.

The IFCR provides an avenue for the writing of cases and their submission for peer review. Cases accepted for publication in the *Journal* have met the quality 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*.

The *Institute* will continue to promote the interaction of casewriters in conference settings. Cases submitted for conference presentation are eligible for the review process for the *Journal*. The overall objective of this activity is to create an outlet for casewriters, and a source of high quality cases for case users.

I would like to personally invite casewriters and case users to participate in the activities of the *Institute*. Our case sessions are held at a variety of finance conferences in colorful, interesting locales and provide the opportunity for interaction with others with a similar interest. Our recent conference activities have taken place in Jacksonville, Florida, Denver Colorado, Dallas, Texas, Maui, Hawaii; Biloxi, Mississippi; Nashville, Tennessee, Las Vegas, Nevada, Denver, Colorado, Chicago, Illinois and Pensacola Beach, Florida and other great destinations.

We are sponsoring IFCR case sessions at the *Financial Management Association* (FMA) in Reno, Nevada in October 2009, the *Academy of Economics and Finance* in Houston, Texas in February 2010, and a variety of other conferences in the near future. All full manuscripts presented at the conferences may be entered in the review process for the *Journal*. We find that cases presented at our conferences, having had the advantage of being exposed to the scrutiny of experienced casewriters, have a better chance of final acceptance for journal publication.

Our acceptance rate is 20-25%. The *Journal* is listed in *Cabell's Directory of Publishing Opportunities in Economics and Finance*, and is listed in many other quality informational references.

This issue of the *Journal of Finance Case Research* contains six quality cases, and an excellent article by Rachel Smith on case discussion at Harvard and Darden (University of Virginia). We hope you find these useful. Please visit our website often for updates and conference information. We encourage all parties interested in the production, promotion, and use of cases in finance to become active participants in the IFCR.

**Robert Stretcher, Executive Editor**  
*Journal of Finance Case Research*  
**www.jfcr.org**



## THE PRO-COOKING COMPANY

David C. Porter, University of Wisconsin-Whitewater

*This case concerns a capital budgeting decision in a private company that manufactures high quality cookware for the direct sales market. The student must reconsider adding a product to its cookware line, a product that was rejected twice in the past. The decision is complicated by (1) the company may lose one of its major customers if the production is denied for the third time; (2) possible externalities exist through increased sales of other products; and, (3) a possible conflict of interest exists since the decision maker receives a commission for every product accepted for development. The case contains sufficient information about the cookware industry, direct sales market, product history and costing for the student to develop an informed NPV analysis with support for a go – no go decision.*

### INTRODUCTION

In mid 2007, Karen Jackson, one of the product managers at the Pro-Cooking Company (Pro-Cooking), received a new product request from David Evans of Quality Cookware Ltd. (Quality Cookware). Quality Cookware was a major distributor in the direct sales area of high quality stainless steel cookware and one of Pro-Cooking's major customers. Pro-Cooking had produced several hundred products for Quality Cookware and had developed a strong relationship with the company for almost three decades. This request was for a specialized pasta basket inset to fit into a stainless steel stockpot for cooking and draining pastas. It was the third time Quality Cookware had requested the product over the past several years but Pro-Cooking had been unable to fulfill the previous requests due to the difficulty of manufacturing the product. Karen had been working with R&D on a feasibility study for the past six months and knew that if Pro-Cooking was unable to find a way to produce the project for the third time, Quality Cookware may well take their business elsewhere. There was more at stake than the decision for a single product.

### THE COOKWARE INDUSTRY

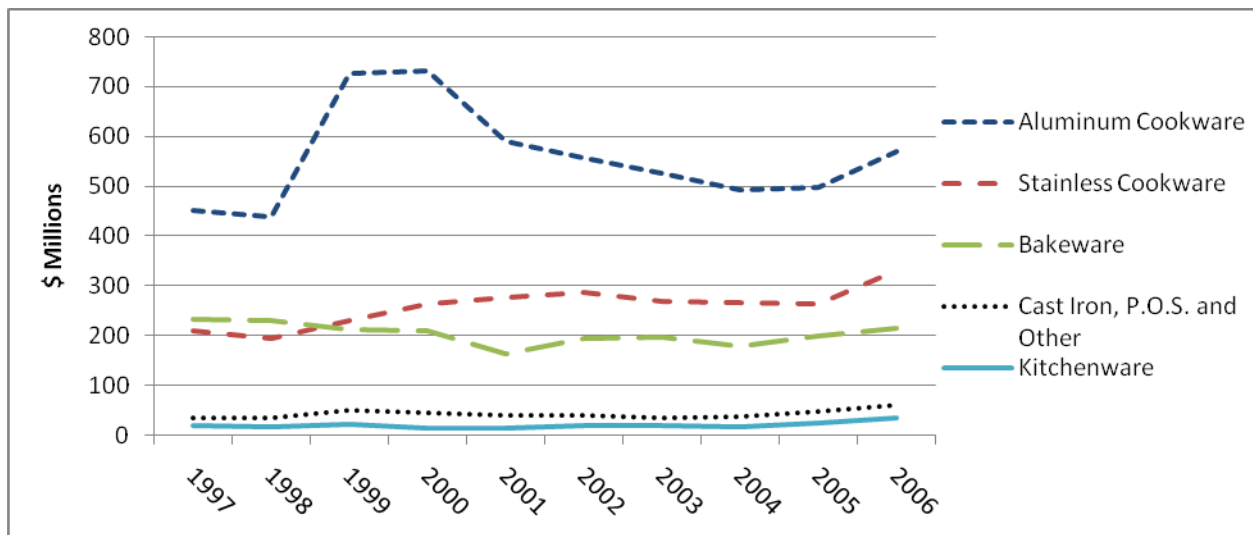
The Cookware Manufacturers Association (CMA) maintains substantial information on the United States cookware industry at <http://www.cookware.org/>. The CMA is a not-for-profit trade association representing the interests of U.S. and Canadian firms making cookware, bakeware and kitchenware. The CMA serves the public and its members with information, statistics and standards for the cookware industry and represents over 90% of the cookware, bakeware and kitchenware produced in the United States and Canada with its nineteen members. Exhibit 1 shows a breakdown of CMA member wholesale shipments by category for 2006 and demonstrates that aluminum cookware makes up almost 50% of total shipments with a total of \$569 million in sales. Stainless steel cookware makes up the second largest component with \$331 million in sales or 27.4% of total industry shipments.



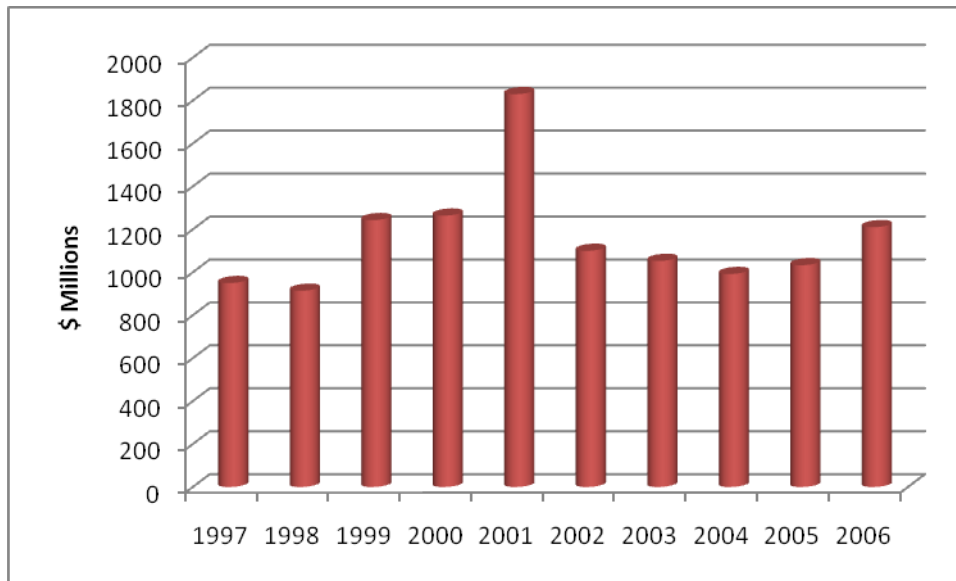
**Exhibit 1. CMA Industry Shipments 2006 (\$ Millions)**

	<b>Sales</b>	<b>Percent of Total</b>
Aluminum Cookware	\$569	47.0%
Stainless Steel Cookware	\$331	27.4%
Cast Iron, Other	\$60	5.0%
Bakeware	\$214	17.7%
Kitchenware	\$36	3.0%
Total	\$1,210	100%

Exhibit 2 shows that although cast iron, bakeware and kitchenware shipments have remained relatively stable over the last decade, aluminum cookware shipments have fluctuated considerably, while stainless steel cookware shipments have shown a general increase across the 1997-2006 period. Given the dominance of the aluminum cookware sector it is not surprising that Exhibit 3 shows total shipments are highly correlated with aluminum cookware shipments.

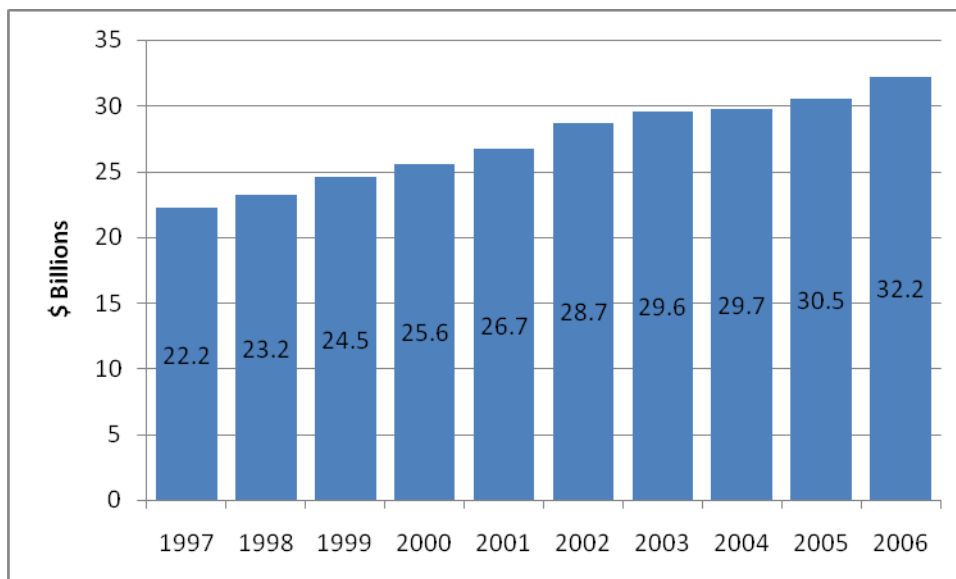
**Exhibit 2. CMA Shipments by Category**

The cookware industry can be further broken down by price point and distribution channel. Some cookware companies manufacture products to be sold through retail channels, while other manufacturers, like Pro-Cooking, focus on the high quality direct sales channel. The retail channel includes low price point cookware sold by mass merchandisers such as Wal-mart and K-mart, as well as medium price point cookware sold through department or specialty stores like Macy's and Williams Sonoma. At the high price point, high quality stainless steel cookware is sold through the direct sales channel through independent distributors. Some of the brand names sold in direct sales include Lifetime, Saladmaster, Kitchen Craft and Vitacraft; as well as multinational direct-selling companies like Amway and Tupperware.

**Exhibit 3. CMA Total Shipments**

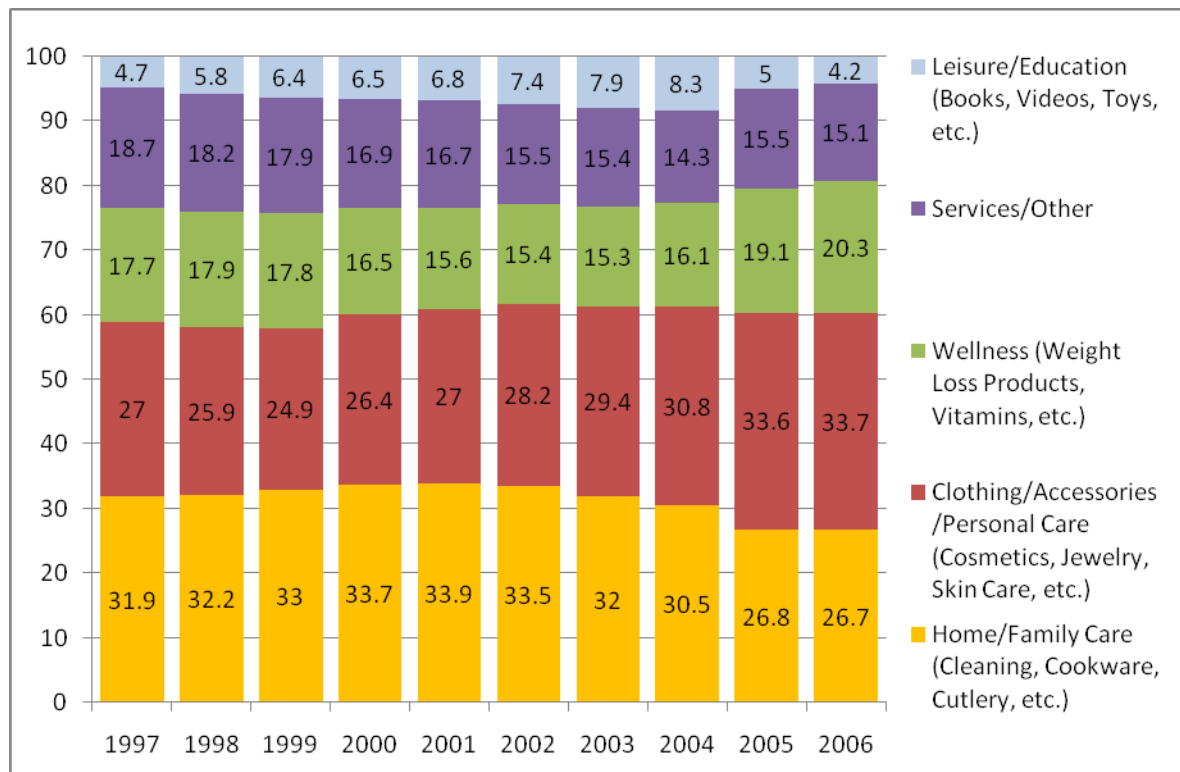
### DIRECT SELLING CHANNEL

Direct selling is a dynamic and growing global business. U.S. data is tracked by the Direct Selling Association (<http://www.dsa.org>). Exhibit 4 shows that U.S. sales through direct selling increased by 45% over the 1997-2006 period with sales exceeding \$32 billion in 2006.

**Exhibit 4. Direct Selling Total U.S. Sales**

Over 50% of the U.S. population has purchased a product from a direct seller. Tupperware (plastic food containers), Pampered Chef (cooking aids and accessories), Creative Memories (scrapbook supplies), Party Light (candles & candle holders), and Jafra International (skin care & cosmetics) are examples of direct selling companies. Exhibit 5 breaks U.S. direct selling down by category and shows Clothing/Accessories/Personal Care products have been gaining market share mostly at the expense of Home/Family Care products.

**Exhibit 5. Direct Sales by Category**



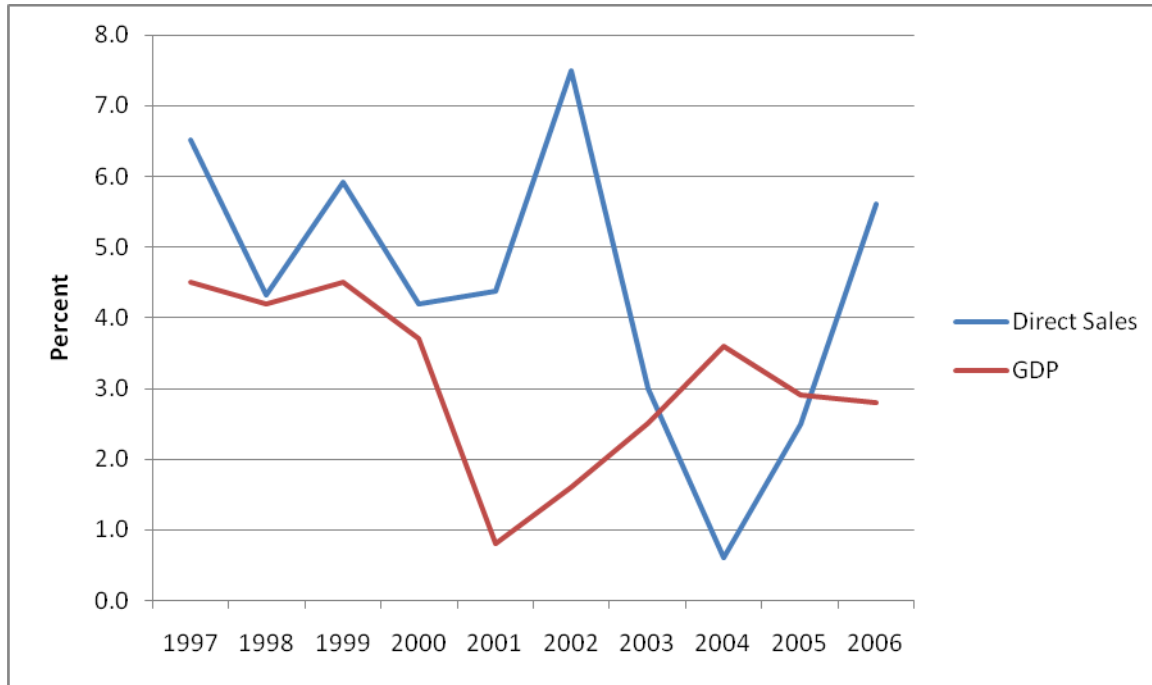
The growth of the direct selling industry is supported by new product introductions and a greater acceptance of direct selling, as evidenced by the continued growth in the number of direct sellers. By 2006 the number of sales persons selling direct sales products had increased to 15.2 million from 9.2 million in 1997. The Direct Selling Association advertises the benefits of direct selling as having flexible work schedules, a good way to meet and socialize with people, and a way to earn extra income. Direct selling also provides a way for individuals to own their own business where earnings can be more proportional to effort.

Exhibit 6 demonstrates the historical relationship between direct sales and growth in real GDP. In general, sales growth increases during economic slowdowns when more people turn to direct sales to increase income. With a larger number of salespeople knocking on doors and demonstrating products, more sales are consummated resulting in direct sales companies showing growth even in poor economic times.

Direct marketers believe that the benefit of personal interaction, product uniqueness, high quality and long warranties support the higher sales price and margins received on direct sales products. Because consumers perceive direct sales products as high quality, the salesperson can

focus on fully explaining the features and benefits of their products and work one-on-one with customers to demonstrate how to use the product, instead of having to justify the quality.

### Exhibit 6. Percent Change in U.S. Direct Sales Versus Real GDP



## COOKWARE DIRECT SELLING

Selling cookware in the direct sales channel includes door-to-door selling, in-home dinner parties, and small group demonstrations at a fair or show. Whichever method the salesperson uses to show the cookware to the consumer, the sales pitch will include a demonstration of the cookware by preparing a meal and telling “the story” of how the cookware will make the consumers life better. The story highlights the product’s advantages and benefits of a lifetime of healthy and fun cooking.

The features that make the direct sell cookware industry unique are the technology and design of the products. One of the newer advancements in cookware is a “clad” or “sandwich bottom” design. This design in cookware is a combination of stainless steel with more conductive metals to enable foods to cook quickly and evenly. To create this style of cookware, the manufacturing process uses tremendous pressure (impact bonding) or heat (brazing) to bond the materials together. Conductive metal, such as aluminum or copper, are sandwiched between two pieces of stainless steel and bonded together. Cookware with aluminum sandwiched between layers of stainless steel are so conductive that pans are designed to stack on top of each other so several dishes can be cooked at once using a single burner on the stovetop. The conductive metal turns a piece of cookware and its cover into a mini oven that will even bake a cake. This design can be a great selling feature for the energy conscious consumer.

There can be as many as 9 layers of metal in a piece of cookware, with the most common being 3 ply, 5 ply or 7 ply. More layers allow the cookware to cook better because heat is more

evenly distributed throughout the piece of cookware but the additional layers also result in higher cost.

### **MARKET TRENDS**

Based on an increased focus on healthy lifestyles and changing trends in America, growth in the cookware industry appears favorable. The baby boomer generation has realized the beneficial effect of diet and healthy eating on aging and quality of life, and in response are demanding quality cookware to fulfill these needs. The demand for cookware products from specific ethnic markets with large families and varied cooking needs is another growth opportunity as these ethnic populations increase in America. Trends in American pastimes, according to statistics gathered by *The Food Network*, list cooking as the favorite pastime for 43% of Americans, second only to watching TV.

Significant increases in gas prices and strong signs of a declining economy in early 2008 also suggested that more families would be tightening their budgets. The RPI (Restaurant Performance Index provided by the National Restaurant Association) had already moved from expansion to contraction in the latter part of 2007 confirming that families were preparing more meals at home. As a result, Quality Cookware believed this was an ideal time to introduce additional products.

Historically, the direct selling channel thrived on new products because salespeople had a new item to show, demonstrate and offer to customers. The popularity of pasta products, created the need for pasta insets to compliment a set of cookware. A pasta inset or basket is designed to fit perfectly in a stockpot or Dutch oven. The basket has holes punched through the bottom and sides of the pan to allow water to flow into the basket to cook pasta. When the pasta has cooked, the basket is lifted from the pan and placed in a sink to drain. The baskets are designed for optimal clearance from the bottom of the basket and the pan bottom to maintain a precise cooking temperature. Since these baskets can also be used for steaming vegetables and seafood, Quality Cookware's research showed the pasta basket should be a very popular addition to a set of cookware.

### **PRO-COOKING COMPANY BACKGROUND**

Pro-Cooking has been a leading manufacturer of high quality direct sales cookware for over 50 years. The high quality stainless steel cookware products are sold to distributor customers, who in turn sell the cookware to the final consumer through individual one-on-one selling, in-home dinner cooking party demonstrations to several couples, small group presentations at fairs or home/bridal shows, and direct selling at cooking schools. The cookware products are generally sold as sets, which can range from a minimum of three pieces to a maximum of 27 pieces with retail prices ranging from \$500 to \$2,500.

Pro-Cooking considers itself a global company, and has several established customer relationships outside the U.S. Exhibit 7 shows a breakdown of sales by country or region and although the U.S. is their primary area with 64% of sales, 36% of sales were outside the U.S. Japan had the second largest market share at 15%.

Pro-Cooking's mission statement is given to all employees:

*One Cookware Manufacturer is Not the Same as Another:*

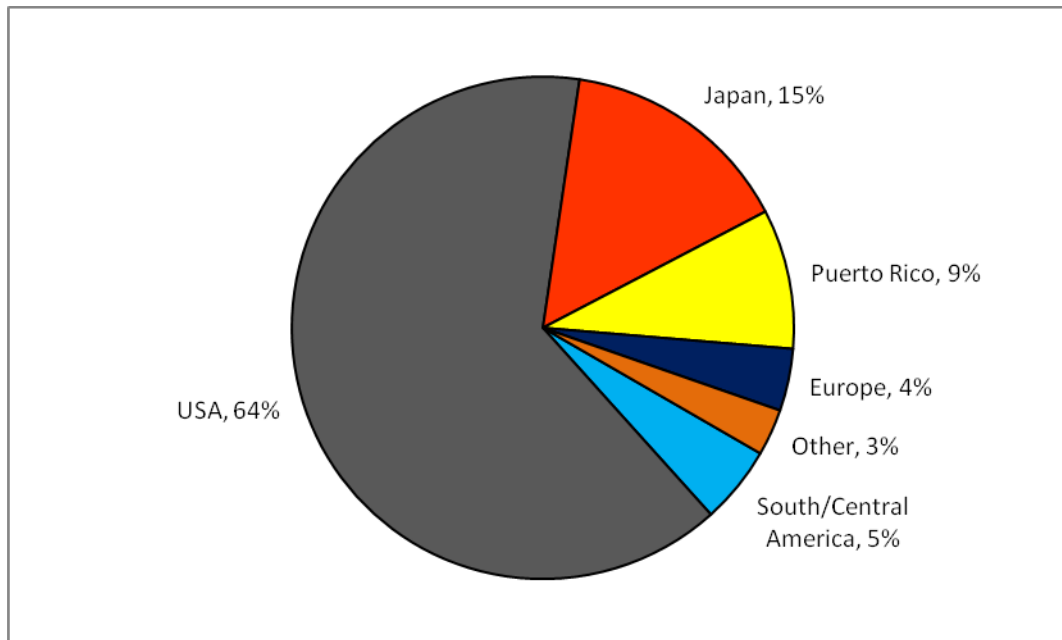
*At the Pro-Cooking Company our Mission is to inspire a better way of life for all, by creating wealth for entrepreneurial business people and the Pro-Cooking Company, using our direct sales expertise to provide a healthy cooking experience to consumers with high quality cookware.*

*Guiding Principles:*

- *Leading Supplier in the Markets we choose to Participate in*
- *Continuous Improvement by All*
- *Produce World Class Quality Products*
- *All Employees are part of the TEAM*
- *Focus on (Major) Customers' Needs*

The mission statement demonstrates the company's commitment to quality products and customer focus.

### Exhibit 7. Sales by Country



### **STAINLESS STEEL PRODUCTS AT PRO-COOKING**

The stainless steel cookware manufactured at Pro-Cooking promotes a waterless/greaseless method of cooking through unique features such as water-seal weighted covers, gentle even-heat distribution and minimum-moisture cooking. Pro-Cooking considers the waterless/greaseless method to be the healthiest cooking method available. Cooking without grease lowers the fat intake consumed with food promoting a low-fat diet. Cooking vegetables in boiling water cooks the vegetables to desired doneness but it also releases the vitamins, minerals and color into the water. Prior to serving, the water, along with all the vitamins, minerals and color are poured down the drain. Cooking without water maintains the vibrant color of foods and keeps needed vitamins and minerals in the food.

It is also important in the direct selling business to have a strong warranty. Pro-Cooking provides a “free from failures in material and workmanship” lifetime warranty on cookware products. This warranty guarantees product complaints regarding material and workmanship failures will be replaced to the consumer free of charge, for the lifetime of the product.

### **PASTA BASKET PROJECT DETAILS**

Quality Cookware had requested a 7-ply 6.5 quart saucepan with a pasta basket two other times over the past several years. In the first case, there was insufficient lead time to develop the product and Quality agreed to drop the request. On the second occasion, Pro-Cooking had investigated three options: (1) a Chinese made model; (2) outsourcing the product manufacturing to a U.S. company but packaging in house; and, (3) manufacturing and packaging the product totally in house. None of the methods were considered viable at the time. Quality Cookware rejected the first option, the U.S. outsourcing costs were too high and the quality did not meet standards and the complete in house option was far too costly.

From the beginning of this request, many months were spent trying to find a cost effective, quality method of perfin the holes in the side of the pasta basket. In house tooling costs were estimated at over \$300,000 and there were significant concerns that even if the money was spent, manufacturing would not be successful in making the product. Perfin the tiny holes in the bottom and sides of the unit was a difficult labor intense process and very hard on the tooling equipment. There was a risk that the tooling, at the very least, would need frequent repair and maintenance and at worst would breakdown beyond repair. Two sets of perfin tools were included in the \$300,000 quote, but due to the difficulty of the process there was a possibility that both tools would need repairs simultaneously and Pro-Cooking would temporarily be unable to make the product. Emergency repairs would be expensive and create a backlog of customer orders. Manufacturing was not in favor of making the pasta basket in-house due to the risk and cost associated with maintaining the perfin tools. Having an outside company draw and perf the basket and assume most of the risk appeared to be a more viable option depending on the quotes and quality of the product. There was considerable hope that outsourcing would be possible this time around due to technology improvements at companies specializing in this type of production and the declining economy may result in better pricing.

Outsourcing quotes were requested from several companies and one of the companies, Vollperf Inc., quoted a tooling cost of \$108,500 along with a per piece price of \$25.00. The per piece price was a total cost including miscellaneous costs such as scrap and freight. Product

samples showed the company could provide the necessary quality at the quoted prices. Additional startup expenses of \$7,750 would be generated in-house.

The life span of most cookware products was short and three years was a typical project length used to determine the viability of a new product. Pro-Cooking depreciated all tooling costs over the project life using the IRS double declining balance method of depreciation. None of the tooling costs would be recoverable (there would be no terminal value). Other costs associated with the project included working capital, sales commission, distribution, and warranty costs. If the project was approved, Karen would receive a commission of 0.5% of sales over the life of the project. Distribution costs (shipping supplies and other expenses required in preparing an order for shipment) were estimated at 2% of sales value. Historically, warranty costs averaged 1.75% of sales.

The accounting department provided a cost estimate of \$40.613 per piece, for material, labor and overhead costs. This estimate included the per piece price of \$25.00 from Vollperf plus additional material, packaging, labor and overhead added to the process in-house. Exhibit 8 shows the full costing detail of the pasta basket product. Only costs specifically associated with the pasta basket project were included in the projection.

#### **Exhibit 8. Pasta Basket Cost Detail Sheet – as of 1/10/08**

<b>Description</b>	<b>Qty</b>	<b>Cost*</b>	<b>Labor</b>	<b>VOH</b>	<b>FOH</b>	<b>Total</b>
Shell	1	25.000		2.497	4.494	31.991
Handles	2	3.018		0.301	0.544	3.863
Accessories	1	0.108		0.011	0.020	0.139
Carton	1	1.454		0.145	0.262	1.861
Packing	0.25	1.498		0.150	0.269	1.917
Labor			0.658	0.066	0.118	0.842
Total Cost						40.613

\*Costs include scrap, freight, etc., where applicable.

VOH and FOH refer to variable and fixed overhead expenses.

Pro-Cooking's marketing department recommended a selling price of \$54.50 to Quality Cookware. A price higher than \$54.50 could make it difficult for Quality Cookware to sell the marked up product at what were considered reasonable margins. Quality Cookware forecast an annual purchase of at least 5,000 pieces of the pasta basket. Although Quality's forecasts had been reliable in the past, Karen believed that this estimate was quite conservative as other new products manufactured for Quality Cookware, although not as specialized as the pasta basket, had annual sales exceeding 10,000 units.

Quality Cookware had payment terms of 1% 10, net 60 days. They had always paid within these terms and 80% of the time paid within the discount period. Pro-Cooking used a 39% tax rate on all project analyses and an 18% discount rate for this type of cookware. Company financial statements for year-end 2007 are provided in Exhibits 9 and 10.

In efforts to keep inventory levels around 60 days, Quality Cookware was required to order with a 90 day lead-time and provide forecasts 3 months beyond orders. The lead-time on a coil of stainless steel was about 60 days, so for items made with unique steel, like the pasta basket, a 90-day lead-time was essential to keep inventory costs down.



Karen believed that the launch of the pasta basket may also help boost sales of the existing cookware line. Consumers interested in the pasta basket would typically see a demonstration of the entire cookware line and may be inclined to purchase additional products. At the least, volume on stockpots should increase since one matching stockpot would be necessary for the optimal use of the pasta basket. Karen expected at least half the people buying a pasta basket would also purchase a stock pot since people buying the Quality Cookware line were less concerned about price and more concerned about superior cooking. Those not already owning the correct size stock pot could probably be persuaded on the importance of having the optimal stock pot. The other product managers were not convinced. They argued that trying to estimate sales increases in one product based on sales of another product would be virtually impossible since you could never determine if someone would have bought the stock pot on its own even if there was no pasta basket. Their position was that sales of other products should not be included in the stock pot project evaluation. Even if some additional stock pots were sold, they believed that there would be minimal incremental cash flow since stockpot sales only generated about half the cash flow of the pasta basket.

### THE DECISION

Karen knew the importance of this decision given Pro-Cooking's desire to maintain strong relationships with their major customers. With a lead-time of 4-5 months on the tooling equipment she also knew management approval needed to happen quickly if they were to meet Quality Cookware's target launch date of June 2008. With all the information in hand, she requested her assistant schedule a meeting time early in the next week for the presentation.

#### **Exhibit 9. Income Statement Year Ended 2007 (\$ 000)**

Net Sales	\$102,929
Variable Cost of Sales	\$56,679
Period Costs	\$17,998
Total Cost of Sales	\$74,677
Gross Profit	\$28,252
GP% of Sales	27.4%
SG&A	\$12,170
Operating Profit	\$16,082
ROS%	15.6%
Tax	\$6,271
NPAT	\$9,811

**Exhibit 10. Balance Sheet as of December 31, 2007 (\$ 000)**

Cash & Securities	4
Net Receivables	12,629
Net Inventory	7,995
Prepaid & Other Current Assets	197
Total Current Assets	20,817
Total Other Non Current Assets	2,523
Net Property, Plant & Equipment	22,253
<b>Total Assets</b>	<b>\$45,601</b>
Total Current Liabilities	27,657
Total Non-Current Liabilities	134
Total Liabilities	27,790
Total Shareholder's Equity	17,811
<b>Total Liabilities &amp; Equity</b>	<b>\$45,601</b>



## **BANKING AND REAL ESTATE ASSET DEFLATION: FRANKLIN BANK, SSB**

**Danielle Agnew and Robert Stretcher**  
**Sam Houston State University**

*This case explores the situation faced by Franklin Bank (FB), S.S.B. as of January 2009. The institution is presented in light of the 2008 mortgage market crisis, especially given its risk exposure to real estate. The student is tasked with analyzing the bank's public record in light of numerous news stories concerning the bank. The student's objective is to determine if steps could have been taken beforehand to defuse the situation, or whether the bank was operating in a sound manner, in accordance with recommended capital adequacy and loan quality guidelines established by its regulatory agencies (Texas Department of Savings and Mortgage Lending, FDIC, and SEC).*

### **BACKGROUND**

At the end of 2007, the five-year-old Franklin Bank, S.S.B. began to experience the effects of the real estate crash. Anthony Nocella, president and chief executive officer (CEO) of Franklin Bank, reported the fourth-quarter 2007 net loss resulted from credit losses. A portion of the loss was due to a \$23.5 million loan-loss allowance increase (HBJ, 2008a). Nocella disclosed, "While this increase obviously had a negative impact on our quarterly and yearly earnings, it was necessary and prudent given the turmoil in the housing markets nationwide, which has negatively impacted our homebuilder customers and many single-family borrowers" (HBJ, 2008a).

In February of 2008, Franklin Bank announced it was delaying its 10-K report due to possible accounting and disclosure issues related to its mortgage portfolio, specifically single-family residential mortgages and residential real estate. The bank reported an audit committee had been formed in order to investigate these issues (HBJ, 2008b).

By May of 2008, the audit committee completed their independent investigation and made various recommendations to the Board of Directors regarding Franklin Bank's leadership, finance and accounting functions, public disclosure process, as well as policies, procedures and controls (PrimeNewswire, 2008). The Chairman of the Board, Lewis Ranieri, reported that Franklin Bank's Board of Directors fully accepted the findings of the independent review and would take the steps necessary to implement the recommendations immediately (PrimeNewswire, 2008).

**Table 1. Changes in ALLL\*, PLLL\*\*, and Net Income/Loss**

	9/30/2007	12/31/2007	3/31/2008	6/30/2008	9/30/2008
<b>ALLL*</b>	\$22,630,000	\$54,256,000	\$69,810,000	\$61,981,000	\$145,368,000
<b>As % of Total Assets</b>	0.39%	0.95%	1.18%	1.11%	2.86%
<b>Horizontal Analysis</b>	100%	240%	308%	274%	642%
<b>PLLL**</b>	\$10,888,000	\$49,854,000	\$20,921,000	\$65,743,000	\$213,127,000
<b>As % of Total Income</b>	4.24%	14.81%	27.22%	44.20%	113.88%
<b>Horizontal Analysis</b>	100%	458%	192%	604%	1957%
<b>Net Income/Loss</b>	\$19,230,000	(\$53,562,000)	(\$35,702,000)	(\$137,226,000)	(\$383,326,000)
<b>As % of Total Income</b>	7.49%	-16%	-46.46%	-92.27%	-204.82%
<b>Horizontal Analysis</b>	100%	-279%	-186%	-714%	-1993%

<b>Calculation Figures</b>	9/30/2007	12/31/2007	3/31/2008	6/30/2008	9/30/2008
<b>Total Assets</b>	\$5,730,051,000	\$5,702,461,000	\$5,922,782,000	\$5,572,332,000	\$5,089,260,000
<b>Total Income</b>	\$256,793,000	\$336,547,000	\$76,850,000	\$148,725,000	\$187,151,000

\*ALLL = Allowance for Loan and Lease Losses

\*\*PLLL = Provision for Loan and Lease Losses

One of the steps Franklin Bank took was accelerating Nocella's personal plans to retire from his position of president and chief executive officer (PrimeNewswire, 2008). In addition, Franklin Bank was in the process of restating third- and fourth-quarter 2007 results due to the findings of the investigation (Barr 2008a). Throughout the investigation process, Franklin Bank had been in communication with regulatory agencies such as the Federal Deposit Insurance Corporation (FDIC) and the Texas Department of Savings and Mortgage Lending (TDSML) and reported they would continue to cooperate with these and other such agencies (PrimeNewswire, 2008).

Although Franklin Bank did not participate in the subprime lending business to a great extent, their lending activity was heavily centered in California, Arizona, Nevada, and Florida markets (Steffy, 2008 and HBJ, 2008c). Even non-subprime loans in those markets were devastated by real estate asset deflation and the economic downturn, causing foreclosures to become very problematic for Franklin Bank (Steffy, 2008 and HBJ, 2008c). Other risks faced by Franklin Bank, which were reported in May of 2008, include Franklin Bank's limited operating

history, possible fraud and negligence by loan applicants and others with whom Franklin Bank does business, and the bank's reliance on brokered deposits (PrimeNewswire, 2008). Franklin Bank also faces the risk of the potential unavailability of external financing, including advances from the Federal Home Loan Bank (FHLB), upon which Franklin Bank relies heavily (PrimeNewswire, 2008 and UBPR, 2008). As of September 30, 2008, Franklin Bank had FHLB advances in the amount of \$1,127,500,000, which represented 29.32 percent of Average Assets, more than twice that of Franklin Bank's peer group (UBPR, 2008).

**Table 2. Capitalization as of September 30, 2008.**

Regulatory Ratios	Franklin Bank	Significantly Undercapitalized?	
Tier 1 Leverage ratio	2.11%	< 3% or	Yes
Tier 1 Risk-Based capital ratio	3.37%	< 3% or	
Total Risk-Based capital ratio	5.11%	< 6%	Yes

**Prompt Corrective Action Categories**

Regulatory Designations	Leverage	Tier 1 Risk-Based	Total Risk-Based
Well Capitalized	> 5% and	> 6% and	> 10%
Adequately Capitalized	> 4% and	> 4% and	> 8%
Undercapitalized	< 4% or	< 4% or	< 8%
Significantly Undercapitalized	< 3% or	< 3% or	< 6%

**Tier 1 Leverage ratio:**

Tier 1 Capital	\$	113,169,000	
Adjusted Average Assets =	\$	5,369,889,000	= 2.11%

**Tier 1 Risk-Based capital ratio:**

Tier 1 Capital	\$	113,169,000	
Total Risk-Weighted Assets =	\$	3,355,880,000	= 3.37%

**Total Risk-Based capital ratio:**

Total Risk-Based Capital	\$	171,394,000	
Total Risk-Weighted Assets =	\$	3,355,880,000	= 5.11%

On October 1, 2008, the Securities and Exchange Commission (SEC) issued a stay in suspension of trading until October 24, 2008 due to the bank's inability to regain compliance. On that date Franklin Bank was required to make an argument for continued listing of its shares.

Franklin Bank had been working on a refinancing plan, but remained under scrutiny from regulators (Barr, 2008c).

On November 4, 2008, Franklin Bank admitted to being "significantly undercapitalized" as of September 30, 2008 (Barr, 2008d). Prompt Corrective Action (PCA) Categories designate a significantly undercapitalized institution as one which maintains a Tier 1 Leverage Capital Ratio of less than 3 percent, or a Tier 1 Risk-based Capital Ratio of less than 3 percent, or a Total Risk-based Capital Ratio of less than 6 percent (FDIC Risk Management Manual, 2008). Franklin Bank was highly leveraged, and this was indicated by a Tier 1 Leverage Capital Ratio of 2.11 percent, a Tier 1 Risk-based Capital Ratio of 3.37 percent, and a Total Risk-based Capital Ratio of 5.11 percent (FFIEC 041 2008, pg. 34).

**Table 3. Federal Home Loan Bank (FHLB) Advances as of September 30, 2008.**

	Franklin Bank	Peer Group
Total FHLB Advances	\$1,127,500,000	na
As a % of Average Assets	29.32%	13.28%

### FRANKLIN BANK MANAGEMENT

Ranieri, Franklin Bank's Chairman of the Board, was one of the first in the financial industry to bundle mortgages into securities as a trader with Solomon Bros. in the 1980's (Steffy, 2008 and Barr, 2008b). In 1987, after Ranieri was forced out of Solomon Bros., he organized an investment firm called Bank United. Bank United was formed from the assets of the failed United Savings and was later sold to Washington Mutual in 2001. In 2002, Ranieri and other members of his management team founded Franklin Bank (Steffy, 2008). Due to Nocella's accelerated retirement, Ranieri was named interim CEO as of May 23, 2008 (Barr, 2008b).

Nocella was the president and CEO of Franklin Bank until May 23, 2008 (Barr, 2008b). Prior to his tenure at Franklin Bank, Nocella worked with Ranieri at Bank United. According to Barr, ". . . Ranieri and Nocella had great success in the past working together in the 1990s at Bank United . . ." (Barr, 2008b).

### THE BANK'S FAILURE

Franklin Bank, SSB was closed on Friday, November 7, 2008 by the TDSML, and the FDIC was named receiver (FDIC Press Release, 2008). Prosperity Bank assumed all of Franklin Bank's deposits, including those that exceeded the insurance limit, and all 46 of Franklin Bank's branches reopened as branches of Prosperity Bank under normal operating hours (FDIC Press Release, 2008). According to the Houston Chronicle, "Franklin had struggled most of the year under bad real estate loans, and by last week its failure seemed inevitable. Houston-based Prosperity Bank assumed Franklin's branches, \$3.7 billion in deposits and about \$850 million of its more than \$5 billion assets" (Steffy, 2008).

The FDIC assumed the remainder of Franklin Bank's assets and estimated that the Franklin Bank failure would cost the Deposit Insurance Fund between \$1.4 and \$1.6 billion (Steffy, 2008 and FDIC Press Release, 2008). The FDIC disclosed in a press release, "Prosperity Bank's acquisition of all deposits was the 'least costly' resolution for the FDIC's Deposit Insurance Fund compared to [other] alternatives" (Thiruvengadam, 2008 and FDIC Press Release, 2008).

As a result of the closing and acquisition, Franklin Bank Corp., Franklin Bank's holding company, stated it had very limited remaining tangible assets of less than \$500,000 (Barr, 2008e). Four days after Franklin Bank's failure, Franklin Bank Corp. voluntarily declared bankruptcy (Chapter 7, Title 11) in the District of Delaware, the state of incorporation (SEC, 2008).

### **OTHER POINTS OF INTEREST**

The volatility surrounding coverage of Fannie Mae and Freddie Mac was very stressful to mortgage lenders. Mortgage lenders are highly dependent on the two quasi-government entities for the quick securitization of loans originated by the lenders. According to David Zugheri, of First Houston Mortgage, Fannie Mae and Freddie Mac are ". . . like air. If they shut down, within 15 minutes I go and release my whole staff. That's how vital they are to the mortgage industry" (Patel, 2008). Securitization of loans, which results in continuously available loanable funds, was also a standard practice of Franklin Bank. This practice is evidenced by Franklin Bank's large share of mortgage servicing assets (FFIEC 041 2008, pg. 28).

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# FINANCIAL EFFECTS OF CHANGING ACCOUNTING METHODS FOR LEASES: SMITH MANUFACTURING

Kurt R. Jesswein, Sam Houston State University

*A small but growing company is concerned about how its use of operating leases might affect its future financing opportunities as the reporting rules for those leases are changed.*

## A LEASE ACCOUNTING CONUNDRUM

Smith Manufacturing is a small, but growing, machine shop located in the Midwest. Because of its growth, it has been heavily dependent on local banking institutions for operating funds. The company also extensively uses lease financing that enables it to use cutting-edge equipment in its operations without having to finance such acquisitions directly. Given the company's extensive tax credits carried forward from losses in earlier years of operation, leasing is viewed in a very favorable light because the company does not have much use for the depreciation expenses associated with additional capital acquisitions.

Smith has been very successful as its business has grown both in size and profitability. Copies of its balance sheet and income statement for the past three years are found in Exhibits 1 and 2, respectively.

### Exhibit 1. Smith Manufacturing Balance Sheet

	2008	2007	2006
Cash	\$ 37.2	\$ 25.8	\$ 24.0
Receivables	415.1	378.7	278.8
Inventory	261.8	297.3	225.4
Other current assets	<u>53.5</u>	<u>58.2</u>	<u>47.8</u>
Total current assets	767.6	760.0	576.0
Net fixed assets	671.1	637.2	556.9
Other assets	<u>476.0</u>	<u>377.5</u>	<u>159.8</u>
Total assets	\$1,914.7	\$1,774.7	\$1,292.7
Notes payable	\$ 54.8	\$ 26.9	\$ 6.9
Accounts payable	187.3	168.6	105.1
Accrued salaries & wages	<u>151.4</u>	<u>143.8</u>	<u>95.6</u>
Total current liabilities	393.5	339.3	207.6
Long-term debt	178.7	229.0	212.4
Other long-term liabilities	<u>137.0</u>	<u>215.9</u>	<u>109.8</u>
Total liabilities	709.2	784.2	529.8
Common stock and paid-in capital	108.1	101.8	93.4
Retained earnings	<u>1,097.4</u>	<u>888.7</u>	<u>669.5</u>
Total equity	1,205.5	990.5	762.9
Total liabilities and equity	\$1,914.7	\$1,774.7	\$1,292.7

**Exhibit 2. Smith Manufacturing Income Statement**

	<b>2008</b>	<b>2007</b>	<b>2006</b>
Sales	\$2,312.1	\$2,161.3	\$1,689.2
Cost of sales	<u>1,531.2</u>	<u>1,436.5</u>	<u>1,084.4</u>
Gross profit	\$780.9	\$724.8	\$604.8
Operating expenses	<u>460.5</u>	<u>424.9</u>	<u>334.6</u>
Earnings before interest and taxes	\$320.4	\$299.9	\$270.2
Interest expense	<u>50.5</u>	<u>35.1</u>	<u>31.5</u>
Earnings before income taxes	\$269.9	\$264.8	\$238.7
Tax expense*	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>
Net earnings	\$269.9	\$264.8	\$238.7
Common shares outstanding	30.6	30.4	29.7
Earnings per share	\$8.82	\$8.71	\$8.04
Dividend per share	\$2.00	\$1.50	\$1.00
Year-end stock price	\$30.88	\$25.76	\$18.65

\*The company suffered extensive losses in earlier years and has had the use of significant amounts of tax loss carryforwards. Its marginal tax rate without the tax credits was 40 percent.

However, the financing situation of the company is precarious. Although it leases much of its capital equipment, it still relies heavily on its local bank, the First National Bank of Springfield, to finance other aspects of its operations. A key component of the funding arrangement with the bank is the maintenance of satisfactory financial ratios. For example, Smith Manufacturing is expected to maintain an interest coverage (times interest earned) ratio, defined as the ratio of earnings before interest and taxes (EBIT) to interest expense, above 4.0 and a debt ratio, defined as the ratio of total liabilities to total assets, below 45 percent. In addition, Smith is expected to maintain an Altman Z-score of greater than 3.0 before putting its current lending agreement in danger. The Altman Z-score is being defined as the weighted sum of five individual ratios: working capital to total assets ( $X_1$ ); retained earnings to total assets ( $X_2$ ); EBIT to total assets ( $X_3$ ); market value of equity to book value of liabilities ( $X_4$ ); and sales to total assets ( $X_5$ ), using the formula  $Z\text{-score} = 1.2X_1 + 1.4X_2 + 3.3X_3 + 0.6X_4 + 0.999X_5$ .

Smith has not had serious concerns about meeting these ratio requirements because it has consistently met them in the past. However, a recent review of the company's financial statements by a newly-hired CPA firm has produced some possibly distressing results. The CPA firm has determined that the vast majority of the company's leasing arrangements do not in fact meet the requirements set forth in Statement of Financial Accounting Standard (SFAS) 13 to have them be reported as operating leases. The CPA firm has recommended that the leases instead be reclassified as capital leases. A brief summary of SFAS 13 is found in Exhibit 3, and a summary of the operating lease information reported in the footnotes to Smith Manufacturing's financial statements is found in Exhibit 4.

**Exhibit 3. Summary of SFAS 13 "Accounting for Leases"**

*Capital leases* are contractual arrangements that transfer most of the benefits and responsibilities of ownership to the party using the asset. The user of the asset (lessee) records an asset and a related liability on its balance sheet in an amount equal to the present value of the required lease payments, with periodic write-offs incorporating the depreciation (amortization) of the asset and associated operating expenses and the implicit financing charges. **Operating leases** are contractual arrangements that are accounted for as rental contracts. To be accounted for as such, the agreement must not 1) transfer ownership to the lessee by the end of the lease term or through a bargain purchase option, 2) have an initial lease term greater than 75 percent of the estimated economic life of the leased property, nor 3) have minimum lease payments that exceed 90 percent of the present value of the fair value of the leased asset. The lessee does not record any asset or liability for the future contractual rental payments on its balance sheet, instead documenting the future commitments under leasing agreements as a footnote to the financial statements. Only the periodic rental expense is recorded.

**Exhibit 4. Footnote Disclosure from Smith Manufacturing's Annual Report**

**Operating lease (rental) expenses (\$000) reported in 2008** \$213

<b>Future operating lease obligations (\$000)</b>	<b>2009</b>	\$114
	<b>2010</b>	\$79
	<b>2011</b>	\$55
	<b>2012</b>	\$31
	<b>2013</b>	\$24
	<b>Beyond 2013</b>	\$96

**Your Task**

You have recently been hired as a credit and financial analyst for the First National Bank of Springfield. The management of Smith Manufacturing has come to you for help in determining how the reclassification of the company's operating leases as capital leases might affect its debt covenants.

You have been provided with information on various approaches suggested for reclassifying operating leases as capital leases. One method involves calculating the present value of the future lease obligations, and then assuming this amount would be reported as additional liabilities (the lease obligations) and additional assets (the lease benefits) on the company's balance sheet. This approach is complicated by the fact that future lease obligations are only estimated for the first five years beyond the balance sheet date with a lump-sum reported for those periods beyond the initial five years. One solution to this problem is to convert the lump-sum amount into an annuity based on the amount owed in the fifth year. For example, the \$96,000 reported for the periods beyond 2013 (as found in Exhibit 4) could be converted to a four-year annuity of \$24,000 per year beginning in 2014, based on the \$24,000 amount owed in

2013. Thus, the total amount of additional assets and liabilities from reclassifying the leases would be estimated as the present value of the five years of lease data reported Exhibit 4 plus the subsequent four-year annuity of \$24,000 per year. The company's current cost of debt is eight percent.

Capitalizing the operating leases would also involve reclassifying a portion of the lease expense, which is currently reported as an operating expense, as a financing expense. This financing expense could be estimated by multiplying the total amount of lease payments (the sum of the present value of the future obligations plus the amount already paid in 2008) by the company's cost of debt. Note that this reclassification of expenses would not change the total expenses for the company or its reported net earnings. It simply reduces the company's operating expenses (and increases its operating income) by an amount that is offset by the increased amount of interest expense.

A second heuristic, or rule-of-thumb, approach to reclassifying the leases is often used in securities filings with the Securities and Exchange Commission simplifies the calculations yet can provide similar results. In this approach one simply assumes that two-thirds of the company's total *future* operating lease obligations would be the amount capitalized and reported as additional assets and liabilities on the balance sheet with no present value calculations needed. The reclassified interest expense is simply assumed to be one-third of the *current* year's total operating lease expenses.

No matter which approach is chosen, both the balance sheet and income statement are restated or reclassified to account for the necessary adjustments. This in turn would require a recalculation of the company's interest coverage and debt ratios, as well as its Altman Z-score. For example, both total liabilities and total assets would be increased by the inclusion of the newly-capitalized leases with some of the liabilities reported as current liabilities that would represent the amount of lease obligations due within the next year. In addition, the financing ratios would be affected by shifting a portion of the operating expenses to interest expense.

An additional complication with recalculating the company's Z-score would be the potential change in the market value of the company's equity. Although the number of shares outstanding will not change, the company's stock price could be affected by changes in investor' perceptions about the company due to the reclassification of the leases.

Again, there are alternative approaches to handling this issue. One could assume that the company's stock is priced in a very efficient market, and that the existence of the operating leases has already been factored in to the investors' valuation models. If this were so, the stock price would not be affected by the reclassification of the leases.

You have been provided with the beta for the company's common stock, which is 1.30. Coupled with a current risk-free interest rate of four percent and a market risk premium of six percent, the Capital Asset Pricing Model (CAPM) would estimate an 11.8 percent required return for the company's shareholders. Furthermore, given the company's recent dividend payment of \$2.00 per share and an estimate of future dividends growing at a constant rate of five percent per year, the constant-dividend-growth-rate model would value the company's stock at \$30.88 per share.

On the other hand, if one assumes that the operating leases have not been properly evaluated by investors, one could estimate the potential reduction in the company's stock price from reclassifying the leases. Because Smith Manufacturing would now report an increased amount of leverage on its balance sheet, this could lead to higher perceptions of risk by current and potential investors. This change in risk perception would put upward pressure on the

company's beta and the returns required by investors and consequently place downward pressure on the company's stock price. In this set of circumstances, a model, such as the one developed by Robert Hamada, could be used to estimate the potential change in the company's beta for a given change in leverage. With a higher estimate of beta, the higher required return demanded by the company's shareholders could be estimated along with the reduction in the company's stock price that would be a likely result from the higher required return.

To summarize the advice that the management of Smith Manufacturing is seeking from you, you will need to complete the following tasks. You should first determine how well Smith has met its debt covenants in the past by calculating the interest coverage ratio, the debt ratio, and the Altman Z-score for each of the past three years. Next, you should reclassify the operating leases as capital leases and determine the additional amounts of debt, of assets, and of interest expense that would result from reclassifying the leases. This calculation should be made using both approaches (the present value method and the 1/3-2/3 method) discussed above. Third, you should recalculate the interest coverage ratio, the debt ratio, and the Altman Z-score based on your adjusted amounts of liabilities, assets, and interest expense. This would form the basis of your discussion of how serious of an issue reclassifying the operating leases could be for Smith Manufacturing. Finally, you should write a short report to Smith's top management in which you describe your calculations and analysis and provide a summary of the potential implications that reclassifying the operating leases might have on future financial arrangements between the company and the bank.



## BUSINESS VALUATION: FILTER FABRICATION, LTD.

Edward Blackburne and Robert Stretcher  
Sam Houston State University

*This case examines a decision facing the managers of Filter Fabrication, Ltd. (FFL), a manufacturer of various perforated filters for industrial and consumer use. The analysis involves an assessment of cashflow estimates using forecasted sales and expense figures. The reader is tasked with determining a distribution of present values of these cashflows given simulated inputs of sales and expense categories. The case is appropriate for intermediate level financial management courses, and may have applications in other subject areas as well. The case should take readers approximately 3 hours of outside preparation and should occupy one hour of classroom review of the results.*

### BACKGROUND

Filter Fabrication, Ltd. was founded in 1992 by Richard Connors, who had developed a revolutionary process for making custom, spiral-welded, metal tubing.

The process, which incorporated specially designed mills and proprietary techniques, gave FFL unprecedented flexibility in handling various product sizes and features. It also provided the consistent quality, production speed, and cost-efficiency FFL needed to earn a loyal customer base in a variety of industries.

This innovative production technology, along with an unwavering commitment to responsive service, launched an era of steady growth and success for FFL. Expanded plant facilities, additional production lines, and continually refined manufacturing methods have since kept FFL at the forefront of the industry.

Today, FFL serves a global marketplace. A recognized leader in producing components for oilfield screen assemblies, FFL recently developed a proprietary line of patented *VeriFilm* sand control screen products. FFL also is a key supplier of cores and shrouds for manufacturers of filters and strainers in water treatment, food processing, pulp and paper, nuclear energy, and other industrial applications.

FFL remains a privately held company under the direction of Connors, who serves as President. The company boasts a highly trained and experienced team of employees, many with a decade or more of service at FFL. Administrative and manufacturing facilities are located in Shreveport, Louisiana.

### CAPABILITIES

FFL produces a wide range of product sizes and designs to meet the demands of some of the largest firms in the oil industry. The production lines are modular, each of which can be reconfigured and quickly retooled to handle large volumes or special requirements. FFL



produces diameters from .625 inch OD (outside diameter) to 15 inches. Wall thicknesses range from .025 inches to .1875 inches. The possible lengths are essentially unlimited. Metric specifications can be easily handled as well as American standard specifications. The materials used are stainless steel and mild carbon steel, as well as titanium, nickel, *HASTELLOY*, and other exotic alloys. Perforation patterns range from custom hole shapes, sizes, and patterns as well as standard staggered and inline patterns held in inventory by FFL. *Verifilm* is patented in the US, UK, and Norway.

### FINANCIAL SUMMARY

Although steel prices have increased dramatically in recent years, actual Cost of Goods Sold (COGS) has not increased as quickly as sales. Accordingly, the gross profit margin has increased even in the face of rising materials cost. EBITDA for fiscal year 2007 was \$3.7 million on sales of \$15.2 million (24.38%). From fiscal year 2005 through fiscal year 2007, gross sales have increased from \$6.8 million to more than \$15 million, an average annual rate of over 30%. Table 1 lists actual sales, COGS, gross profit, expenses and EBITDA for 2005-2007.

**Table 1. Financial Summary.**

	2005		2006		2007	
<b>Sales</b>	\$6,795,322	100%	\$9,440,551	100%	\$15,220,806	100%
<b>COGS</b>	\$3,778,020	55.60%	\$5,948,204	63.01%	\$8,340,311	54.80%
<b>Gross profit</b>	\$3,017,303	44.40%	\$3,492,347	36.99%	\$6,880,495	45.20%
<b>Total Expenses</b>	\$1,930,205	28.40%	\$2,115,213	22.41%	\$3,170,246	20.83%
<b>EBITDA</b>	\$1,807,098	16%	\$1,337,134	14.59%	\$3,710,249	24.38%

### THE TASK

FFL is at a crossroad in its brief history. A variety of possibilities for future direction of the firm are available to Richard Connors at this point in time. Necessary for any of these alternatives, however, is some representation of the overall value of the firm. The following information (Table 2) should be used to carry out a valuation using the present value of future expected EBITDA. Since the firm is not a corporation, taxes are not of consequence. Since all equipment is provided via lease, no depreciation accrues to the firm, and all lease expenses are reflected in total expenses. Cost of good sold (COGS) is broken out separately from total expenses (not included in the total expenses figures).

To estimate the value of the firm, a Monte Carlo simulation model should be used. This allows for the uncertainty of the inputs into a model by explicitly allowing for stochastic, rather than deterministic, inputs. This simulation replicates many iterations of the financial model so that a distribution of outcomes is generated, providing both a point estimate and a confidence interval for the resulting present value of future benefits. The simulation requires certain parameters and assumptions, outlined in Table 2.

**Table 2. Analytical Inputs.**Methodology:

Each iteration of the simulation will proceed as follows:

1. Values for Annual Sales Growth, Cost of Goods Sold, and Expense Rates will be randomly selected from a specified normal distribution for each of the 10 years of the forecast horizon.
2. These values will be used to calculate an annual forecast of the Earnings Before Interest, Taxes, and Depreciation and Amortization (EBITDA).
3. The Present Value of the future stream of earnings is calculated using an appropriate discount rate.

This process is repeated 1,000 times.

Model Assumptions:

- \* Beginning 2007 Sales of \$15,220,806
- \* Annual sales growth will be normally distributed. During the first 5 years, average annual sales is expected to grow at a rate of 25.00% per year; Management estimates that 95% of the annual growth rates bound between 5.40% and 44.60%. During the remaining 5 years, sales growth is modeled to grow at a 15.00% rate with the 95% confidence lower bound of -4.60% and upper bound of 34.60%.
- \* Cost of Goods Sold will be normally distributed with mean 55.00%; Management indicates that 95% of draws will be between 51.08% and 58.92%.
- \* Expense Ratio will be normally distributed with mean 20.00% of Gross Sales: Management estimates that 95% of draws will be between 18.04% and 21.96%.
- \* Annual Earnings before Interest, Taxes, and Depreciation (EBITDA) is calculated as Gross Sales - COGS - Expenses.
- \* A Discount Factor of 20.00% is used for all Present Value calculations.



## STARBUCKS CORPORATION

Armand Gilinski, Jr., and Raymond Lopez  
Pace University

*“I’ve been in the finance business my entire career and I have studied finance history,” said Michael Casey, Starbucks chief financial officer. “Howard, yields on most corporate bonds are at 40 year lows and investors are very receptive to quality corporate debt instruments. This is a great time to take on debt, funds that will surely be needed to support our growth strategies.”*

*Could Mr. Casey convince Howard Schultz, chairman and chief global strategist of Starbucks? He had just returned to Seattle from an investment banking conference in N.Y.C. and was sharing some of his findings with Mr. Schultz. “Mike, you know how successful we have been at developing and expanding the “Starbucks Experience” on a global basis. We have accomplished these goals with primarily a debt-free capital structure which has eliminated the financial risks of paying interest on bonds. Sure we sold some convertible debt years ago, but we converted it quickly to add to our equity. I’m just not sure this is the time to change our capital structure.”*

In addition to meeting the financial needs of global business expansion, Starbucks recently announced an extension and expansion of its stock buyback activities.<sup>(1)</sup> Ten million shares had just been added to the program with 3.6 million shares already purchased under the June 2002 plan. The primary purpose of this plan was to offset dilution from the firm’s long-standing employee compensation program.

Mr. Casey’s proposal could radically alter the capital structure of the firm. Based on presentations at the conference and discussions with other CFOs, he was preparing three scenarios for evaluation by Mr. Schultz and the board, moving from a no-debt structure to either 20 percent, 35 percent or 50 percent debt based on book values for debt and equity. Introducing low cost debt into the capital structure would reduce the firm’s weighted average cost of capital (WACC) contributing to growth and enhancing profit margins.

“Mike”, questioned Howard, “while our WACC will decline, what about the additional financial risks of debt? How will equity investors who have owned the shares of a growing debt-free company react to such a change? And our business risks are growing as we expand internationally. Maybe an all-equity capital structure will be optimum over the next 5 to 10 years. Although I’m not convinced, I think your proposals are worth bringing to the board. Put some details together for the May meeting.”

### THE STARBUCKS STORY <sup>(2)</sup>

The firm began operations in 1971 by opening its first retail store in Seattle’s Pike Place Market. Starbucks was named after the first mate in Herman Melville’s Moby Dick and by 2003 had grown to its position as the world’s leading retailer, roaster and brand of specialty coffee.

The company operated coffeehouses in North America, Europe, the Middle East, Latin America and the Pacific Rim. Worldwide, more than 22 million customers visited Starbucks coffeehouses weekly in early 2003, up from 20 million in 2002 <sup>(3)</sup> and 9 million in 1999. <sup>(4)</sup>

Howard Schultz joined the company in the early 1980s. Starbucks had already become a highly respected roaster and retailer of whole bean and ground coffees in the local Seattle area. A business trip to Italy opened Schultz's eyes to the rich traditions of the espresso beverage. Upon his return to Seattle, Schultz introduced espresso drinks into the retail stores and they became an essential element of the firm's vision. In addition to its well-situated coffeehouses, Starbucks sold coffee and tea products through its specialty operations including Starbucks.com. (Exhibit 1 – Historical Time Line)

Coffee aficionados could also find Starbucks in a variety of carefully chosen venues including United Airlines, Horizon Air, Seattle's Key Arena, Chicago's Wrigley Field, University of Washington athletic facilities, Experience Music Project interactive museum, Hyatt Hotels, Barnes & Noble bookstores throughout North America and Chapters, Inc. bookstores in Canada.

Since 1991, Starbucks coffee had been available at licensed airport locations and travel plazas operated by HMS Host in the U.S. Licensed locations were also found on college campuses through a licensing with ARAMACK Corp., SYSCO and Sodexo. The firm also licensed locations in select supermarkets across the U.S.

Howard Schultz established what came to be known as the "Starbucks Experience". "You get more than the finest coffee when you visit a Starbucks – you get great people, first-rate music and a comfortable and upbeat meeting place", said Schultz. "We establish the value of buying a product at Starbucks by our uncompromising quality and by building a personal relationship with each of our customers. Starbucks is rekindling America's love affair with coffee, bringing romance and fresh flavor back to the brew."

Mr. Schultz had instituted a "passion for quality" into every aspect of company operations. Starbucks offered coffee lovers a selection of coffees from around the world. Company coffee buyers personally traveled to the coffee-growing regions of Central America, Africa and Indonesia in order to select the finest Arabic beans. After these quality beans arrive at one of the firm's three roasting facilities, Starbucks professional roasters pursue the art of creating the rich signature Starbucks Roast.<sup>®</sup> This dark roast was not just a color – it was the cumulative result of expert roasters knowing coffee and bringing balance to all of its flavor attributes.

In addition to quality coffee, Starbucks featured a variety of handcrafted beverages, Tazo<sup>®</sup> teas, freshly baked pastries and in some markets a selection of high quality sandwiches and salads. Starbucks merchandise included exclusive espresso machines and coffee brewers, unique confections and other coffee and tea related items.

Music had been important to Starbucks since the company was founded. In 1995 the firm began selling compilations covering a wide range of tastes including jazz, blues, folk and world music. Since 1999, Hear Music had been the voice of music at Starbucks, increasing the complexity of Starbucks musical selections.

In the spring of 1995, Frappuccino<sup>®</sup> blended beverage, a low fat creamy iced coffee drink, was introduced to the Starbucks line of beverages. The next year (1996) a joint venture between the company and Pepsi – Cola Co., the North American Coffee Partnership, began selling Frappuccino<sup>®</sup> as a bottled coffee drink. Five flavors were available in grocery channels

nationwide by 2003, as well as in select Starbucks coffeehouses. In 2002, Starbucks Double Shot<sup>™</sup> joined the ready-to-drink product lineup as part of the joint venture.

Another product extension initiative commenced in October, 1995 between the company and Dreyers' Grand Ice Cream. This joint venture was formed to supply a premium line of coffee ice creams to both the grocery channel and the coffeehouses. By July, 1996, Starbucks had become the number one brand of coffee ice cream in the United States. In 2003, consumers could enjoy seven delectable flavors including Java Chip and Coffee Almond Fudge.

Starbucks early success in grocery channels led to the test sale of coffee in supermarkets in Portland, Oregon in 1996 and Chicago in 1997. In 1998, the company and Kraft Foods entered into a licensing agreement to accelerate the growth of Starbucks products in grocery channels nationwide. This deal blended Kraft's extensive knowledge of selling, marketing and distributing packaged foods directly to grocery customers with Starbucks premium product line.

In 1996, the first overseas location for a Starbucks coffeehouse was opened in Tokyo, Japan. By early 2003, there were more than 400 retail outlets in Japan. "It will continue to be imperative for us to build roots in local communities and establish strong alliances with local companies if we are to be successful in international markets", said Peter Maslen, president of Starbucks Coffee International. "Therefore we will seek opportunities with companies that have expertise in the marketplace and, more importantly, share similar values, vision and business philosophy."

In addition to Japan, Starbucks had opened coffeehouses in the following locations: Hawaii and Singapore in 1996, the Philippines in 1997, the U.K., Taiwan, Thailand, New Zealand and Malaysia in 1998, Beijing, Kuwait, South Korea and Lebanon in 1999, United Arab Emirates, Hong Kong, Shanghai, Australia, Qatar, Saudi Arabia and Bahrain in 2000, Switzerland and Austria in 2001, and Oman, Germany, Spain, Mexico, Puerto Rico, Southern China Macau and Shenzhen, Greece and Indonesia in 2002.

Also in 2003 Starbucks Coffee International, a wholly owned subsidiary of the company, announced plans to acquire its licensed operations in Switzerland and Austria from its partner, Bon Appetit Group. "As Starbucks continues to expand its presence worldwide, one of our key long term global strategies is to establish a larger equity position in our international business", said Howard Schultz. "The opportunity to convert the Swiss and Austrian operations to company operated markets is consistent with this strategy. In the past few years, we have pursued similar opportunities by acquiring our licensed operations in Thailand and Australia as well as increasing our equity position in our South Korean business."

While details of the transaction were not made public, it would be treated as a cash purchase. The first Starbucks locations opened in Zurich, Switzerland on March 7, 2001 and Vienna, Austria on December 7, 2001. Upon completion of this acquisition, Starbucks will company-operate 14 stores in Switzerland and 7 stores in Austria, and will continue to expand the business in both markets.

Another recent initiative in the Starbucks story was the introduction of in-store wireless hot spots, allowing customers to browse the Internet while sipping their Cappuccino. The first such Wi Fi "hot spot" was installed in the fall of 2001 on a trial basis. The company integrated this hot spot with its corporate VPN on the network to access applications and databases that streamline such functions as hiring, sales, inventory and a host of other business tasks. According to James Shook, Starbucks vice president of Information Technology, this double duty network served more than 2,000 stores in North America, with a goal of 2,500 stores by year-end 2003. By adding this technology to its stores, the company expected to attract more

customers and keep them in the store longer, thus increasing purchases of coffee and other beverages.<sup>(5)</sup>

In November, 2001, the company launched its original re-loadable stored value Starbucks Card which allowed customers to purchase company beverages and other merchandise. Like a prepaid debit card, it provided frequent customers with a convenient and secure payment method. It also provided the company with the benefits of float, since the card is purchased for cash and then used at a future time (perhaps days or weeks later).

In February of 2003, Starbucks, in conjunction with Bank One and Visa U.S.A., announced a strategic relationship to develop innovative new consumer payment products that would enable Starbucks to enhance consumer convenience and reward customer loyalty. The first payment product to be launched later in the year would combine the benefits and convenience of a re-loadable stored value Starbucks Card and a VISA credit card all in one. With more than 11 million original Starbucks Cards activated to date, these new features were expected to be embraced enthusiastically by Starbucks customers.

“The Starbucks Card has redefined the stored value card market by becoming the ideal payment solution for a high-volume, low-ticket retail environment”, said Howard Schultz. “By partnering with Bank One and VISA to offer a dual function card, we can provide customers with a choice of convenient payment products that both enhances and rewards the “Starbucks Experience” they enjoy every day.”

### **STARBUCKS BUSINESS<sup>(6)</sup>**

Starbucks Corporation, together with its subsidiaries, purchased and roasted high quality whole bean coffees and sold them along with fresh, rich brewed coffees, Italian-style espresso beverages, cold blended beverages, a variety of pastries and confections, coffee-related accessories and equipment, a selection of premium teas and a line of compact discs primarily through company-operated retail stores. The company also sold coffee and tea products through other channels of distribution. Starbucks also sold these items through certain of its equity investees, as well as bottled Frappuccino<sup>®</sup> and Starbucks Doubleshot<sup>™</sup> coffee drinks and a line of premium ice creams. These non-retail channels were collectively categorized as “Specialty Operations” within the Starbucks organization.

The firm’s objective was to establish Starbucks as the most recognized and respected brand in the world. In order to achieve this goal, the company planned to continue rapid expansion of its retail operations within as well as outside North America. In addition, plans called for expansion of Specialty Operations as well as selective pursuit of other opportunities to leverage the Starbucks brand through introduction of new products and the development of new distribution channels.

#### **Company-operated Retail Stores**

The core of Starbucks’ business and its largest operating division in terms of net revenues was the company-operated retail stores. The firm’s retail goal was to become the leading retailer and brand of coffee in each of its target markets by selling the finest quality coffee and related products and by providing superior customer service. The result of these initiatives would be a high degree of customer loyalty contributing to sustained growth in net revenues, profits and cash flow.

Starbucks strategy for expanding its retail business was to increase market share in existing markets and open stores in new markets where opportunities existed to become the leading specialty coffee retailer. In 1992 and 1993 the firm developed a three-year geographic expansion plan that targeted areas that had favorable demographic profiles for a Starbucks “customer”, as well as being able to be serviced and supported by the company’s operations infrastructure. Within each target region a large city was selected to serve as a “hub”, with a goal of opening at least 20 stores in that hub within two years. Teams of Starbucks’ managers and other personnel would be located in the hub city to support the growth institutions. Once the stores in the hub city were operating efficiently, additional stores would be opened in smaller, surrounding “spoke” areas within the region. To manage the expansion process, Starbucks created zone vice presidents to direct the development of each region and to implant the firms’ culture in the newly opened stores. All of the new zone vice presidents had extensive operating and marketing experience in chain store retailing.

In major metropolitan cities Starbucks’s strategy was to blanket the area with retail outlets, even if some stores cannibalized sales of another store. Some new stores might draw as much as 30 percent of the business of an existing store only a few blocks away, in the first year or two. Management believed that its “Starbucks everywhere” approach would ultimately benefit the firm. Delivery and management costs would be reduced, customer lines would be shorter at each store and increased foot traffic at all stores would enhance the firms’ competitive position.<sup>(7)</sup>

As a firm with global ambitions, Starbucks had a two-pronged approach to store expansion outside of the United States. They would either open company-owned and company-operated stores or license a reputable and capable local firm with retailing expertise in the target host country to develop and operate new retail outlets. In most countries, Starbucks chose a local partner/licensee to assist in recruiting individuals, setting up supplier relationships, locating suitable store sites and catering to local market conditions. These partners/licensees should have strong retail/restaurant experience, share values and a corporate culture comparable with Starbucks, and be committed to good customer service.

In addition they had to possess talented management and strong financial resources and have demonstrated brand-building skills. In order to efficiently manage and coordinate these growing activities, the firm created a new subsidiary, Starbucks Coffee International to orchestrate overseas expansion and build the Starbucks brand globally via licensees. Though only marginally profitable in fiscal year 2002, Mr. Schultz and his top management team were convinced that this corporate structure would facilitate strong operating performance and growing cash flows as the global expansion increased in scale and scope.

In support of these strategies, the firm opened 614 new company-operated stores during fiscal year 2002, net of store closures. At year-end, Starbucks had 3,496 company-operated stores in 43 states, the District of Columbia and five Canadian provinces (these stores comprised the firm’s North American retail operating segment). Under the company’s International Retail business unit, there were 322 stores in the United Kingdom, 33 stores in Australia and 29 stores in Thailand. Company-operated retail stores accounted for approximately 85 percent of net revenues during fiscal 2002, up slightly from 84 percent during fiscal 2001. (Exhibits 2, 3 and 4)

Starbucks retail stores were typically located in high-traffic, high-visibility locations. Since the company could vary the size and format of its stores, they could be located in a variety of settings, from central city urban areas to suburban retail centers, office buildings and



university campuses. While the firm selectively located its stores in suburban malls, it focused on sites that had convenient access for pedestrians and drivers.

The firm's overall growth rate in net revenues has generally declined from 1995 through 2001, before rising in 2002. Exhibit 5 shows the components of growth between comparable (same store) sales and growth from net new store outlets. While store growth has trended downward from levels above 50 percent in 1995, same store sales have generally been between 5 and 9 percent per year. Both growth avenues are expected to continue expanding in the next few years.

All Starbucks stores offered a choice of regular and decaffeinated coffee beverages, including at least one "coffee of the day", a broad selection of Italian-style espresso beverages, cold blended beverages, a selection of teas and distinctively packaged roasted whole bean coffees.

Stores also offered a selection of fresh pastries and other food items including sodas and juices. However, the growth driver was coffee and other beverages. "Food is a vehicle for us to sell more coffee", said John Richards, head of Starbucks North America Retail Division. "The last thing we want is to go into fast food."<sup>(8)</sup>

While this philosophy was prevalent in the mid-1990s, a few years later Starbucks was hoping to support its growth objectives with more sales of food and other non-coffee items through its retail outlets. Howard Behar, who came out of retirement in 2001 to head North American operations, had a goal of improving these sales levels.<sup>(9)</sup>

Other store selections included coffee-making equipment and accessories, a selection of compact discs, games and seasonal novelty items. Each store varied its product mix depending upon the size of the store and its location. Larger stores carried a broad selection of the firm's whole bean coffees in various sizes and types of packaging as well as an assortment of coffee and making-making equipment and accessories. These included coffee grinders, coffee makers, espresso machines, coffee filters, storage containers, travel tumblers and mugs. Smaller Starbucks stores and kiosks typically sold a full line of coffee beverages but a more limited selection of whole bean coffees and a few accessories such as travel tumblers and logo mugs. Approximately 500 stores carried a selection of "grab and go" sandwiches and salads. The retail sales mix by product type during fiscal 2002 was 77 percent beverages, 13 percent food items, 6 percent whole bean coffees and 4 percent coffee-making equipment and accessories. Comparable data for fiscal 2001 were 75 percent, 14 percent, 7 percent and 4 percent respectively.

### **Specialty Operations**

This division of the company was structured to develop the Starbucks brand outside of the company-owned retail store environment through a multitude of channels. Starbucks strategy was to reach customers where they work, travel, shop and dine by establishing relationships with prominent third parties that shared the company's values and commitment to quality. These relationships could take a variety of forms, some of which were arrangements through business alliances, international retail store licensing agreements, grocery channel licensing agreements, warehouse club accounts, interactive operations, equity investors and other initiatives related to the firm's core business. In certain situations, Starbucks had an equity ownership interest in license operations. During fiscal 2002, specialty operations revenues (which included royalties and fees from licenses as well as product sales) accounted for 15

percent of company net revenues compared with 16 percent of net revenues in fiscal 2001 (see Exhibits 2 and 3 for revenue breakdowns in dollars and percentages). These net revenues reached \$2.79 billion in fiscal 2002, up 25.3 percent from \$2.23 billion in fiscal 2001.

### **Business Alliances**

This operating segment included two divisions that together accounted for 45 percent of specialty revenues in fiscal 2002, down slightly from 46 percent in fiscal 2001. The largest was the North American Food Service Accounts while the other was the North American Retail Store Licensing group.

The Foodservice Accounts division sold whole bean and ground coffees to office coffee distributors, hotels, airlines, retailers and restaurants as well as institutional foodservice companies that supplied business, industry, education and healthcare accounts. In fiscal 2002, the company had approximately 5,600 foodservice accounts, up from approximately 5,500 accounts in fiscal 2001. Net revenues grew to \$133.9 million in fiscal 2002, up 3 percent from the \$130.0 million in fiscal 2001.

The Retail Store Licensing group complimented the firm's company-owned retail store operation. Although the company did not generally relinquish operational control of its stores in North America, in situations in which a master concessionaire or other company controlled or could provide improved access to desirable retail space, the company would license its operations. As part of these arrangements, Starbucks received license fees and royalties and sold coffee and related products for resale in the licensed locations. Employees working in these licensed locations had to follow Starbucks detailed store-operating procedures and attend training sessions similar to those given to Starbucks store managers and employees. As of fiscal year-end 2002, the company had 1,078 licensed stores in continental North America, up from 809 stores at the end of fiscal 2001. Revenues from these stores were \$89.3 million in fiscal 2002, up 42 percent from the \$62.9 million generated in fiscal 2001. Since the number of stores grew by 33.3 percent, average store revenues collected by Starbucks grew from \$77,750 to \$82,839.

Another segment of Specialty Operations was the International Retail Store Licensing group. Retail stores located outside of North America, the United Kingdom, Thailand and Australia were operated through a number of licensing arrangements with prominent retailers. During fiscal 2002, the firm opened 294 new international licensed stores, up from 282 stores opened in fiscal 2001. At fiscal year end 2002, the company operated 928 licensed international retail stores, up from 634 stores at year-end 2001. Net revenues to Starbucks from these business units grew by 54.7 percent in fiscal 2002 and accounted for 17 percent of division net revenues, up from 13 percent in fiscal 2001.

Grocery channel licensing with Kraft Foods, Inc. had net revenues of \$64.5 million in fiscal 2002, up 9.9 percent from the \$58.7 million in fiscal 2001. Pursuant to the agreement with Kraft, that firm managed all distribution, marketing, advertising and promotions for Starbucks whole bean and ground coffee in grocery and mass merchandise stores. Starbucks earned royalties based on a percentage of total net sales. At the end of fiscal 2002, the firm's whole bean and ground coffees were available throughout the United States in approximately 18,000 supermarkets.

Another outlet for Starbucks products was the Warehouse Club. These accounts purchased whole bean and ground coffees in North America. As part of its agreement with

Kraft, they also distributed Starbucks products to warehouse club stores; a distribution fee was paid to Kraft for these services. Net revenues from this business unit were \$64.5 million in fiscal 2002, up 18.3 percent from the \$54.5 million generated in fiscal 2001.

Starbucks coffee and coffee-related products were also conveniently available via mail order and online. The company maintained a web site, [www.starbucks.com](http://www.starbucks.com), since 1998 where an online store allowed customers to purchase coffee, gifts and other items via the Internet. The company also published and distributed a catalog of business gifts that offered coffees, certain food items and select coffee-making equipment and accessories. At fiscal year end 2002, approximately 1,650 company-operated retail stores offered customers high-speed wireless Internet access.

Management believed that its interactive operations supported its retail store expansion into new markets and reinforced brand recognition and the “Starbucks Experience” for customers in existing markets. Growth in the last few years certainly supported these beliefs. In fiscal 2002, this division produced \$34.7 million in net revenues, up 65.2 percent from the \$21 million in fiscal 2001.

The company had two non-retail domestic 50-50 joint ventures which produced and distributed Starbucks branded products. The North American Coffee Partnership, a joint venture with the Pepsi-Cola Company, a division of PepsiCo, Inc., developed and distributed ready-to-drink coffee-based products such as Frappuccino and Starbucks Double Shot coffee drinks. These products were available in approximately 200,000 supermarkets, convenience and drug stores and other locations throughout the United States and Canada.

The Starbucks Ice Cream Partnership with Dreyers Grand Ice Cream, Inc. developed and distributed premium ice creams through over 20,000 supermarkets throughout the United States. Starbucks sold roasted coffee for use by both of these partnerships with net revenues of \$8.4 million in fiscal 2001 and \$9.9 million in fiscal 2002.

The company had several other initiatives related to its core businesses that were intended to enhance the customers’ experience at Starbucks retail stores. One example was the marketing of a selection of premium tea products since the acquisition of Tazo, L.L.C. in 1999. Collectively, these net revenues were \$14.9 million in fiscal 2002, down from \$29.4 million in fiscal 2001.

## **Product Supply**

Starbucks was committed to selling only the finest whole bean coffees and coffee beverages. To ensure compliance with its rigorous coffee standards, the firm controlled its coffee purchasing, roasting and packaging as well as distribution of coffee to its retail stores. Starbucks purchased green coffee beans from coffee-producing regions around the world and custom roasted them to its exacting standards for its many blends and single origin coffees.

The supply and price of coffee were subject to significant volatility. While most coffee trades in the commodity market, coffee of the quality sought by Starbucks tended to trade on a negotiated basis at a substantial premium above commodity coffee prices. Supply of and demand for high quality beans determined its final price. Many factors influenced supply and price including weather, political and economic conditions in growing areas. In addition, green coffee prices had been affected and could continue to be affected by certain organizations and associations that had historically attempted to influence prices through agreements establishing export quotas or restricting coffee supplies.

In order to secure adequate supplies, Starbucks routinely entered into fixed-price purchase commitments for future delivery of coffee. While the prices paid might be higher, secure supplies of quality beans was of prime concern. The company believed that its policies would continue to be successful and that premium coffee beans would be available to meet anticipated needs.

Starbucks also purchased significant quantities of fluid milk from multiple suppliers whose processing facilities were concentrated near company retail stores. They also purchased large quantities of paper and plastic products from several companies to supply retail stores as well as manufacturing and distribution operations.

### **BEVERAGE CONSUMPTION IN THE UNITED STATES**

The volume of alcoholic and non-alcoholic beverages consumed by Americans had been growing modestly over the last seven years. By far, the largest category was soft drinks which in 2002 was almost double the next largest category - - coffee (Exhibit 6). It may be observed that coffee volumes have actually been declining in this period from 7.9 billion gallons in 1996 to 7.7 billion gallons in 2002. Almost all other beverage categories had experienced some growth in this period with bottled water growing at a remarkable 10.8 percent per year.

Although coffee consumption has declined modestly in recent years, the U.S. market accounts for 20 percent of the world's coffee, solidly in first place. The market is actually composed of three segments, each of which has experienced its own unique characteristics and growth record. The largest segment was coffee packaged for brewing or mixing by the consumer usually in the home. Most of the decline in total industry volume has been in this market.

Ready to drink packaged coffee beverages have performed in a stable fashion over the last few years. These products are consumed in the home as well as at the workplace. The category of freshly brewed coffee for immediate consumption has been the growth engine of the industry. While still small in terms of volume, its revenue share is considerably higher due to the trend towards specialty coffees served in restaurants as well as in coffee houses. The well-known "Starbucks Effect" has been felt most strongly in this segment.

On a per capita basis coffee consumption has lagged behind most of the beverage industry categories although still remaining in second place behind soft drinks. (Exhibit 7). Bottled water once again has exhibited the most rapid growth record almost doubling its per capita consumption in just seven years. With coffee's declining trend, it could be expected to lose its second place position to bottled water in the next few years.

Coffee tends to be one of the cheapest categories while the alcoholic beverages (beer, distilled spirits and wine) are generally more expensive. The result is that, based on retail sales data (Exhibit 8), coffee is in seventh place with sales of soft drinks greater than coffee by more than nine times! However, the trend in retail sales of coffee has been up if only modestly over this period. So, higher prices have more than made up for the declining trend in volume.

Based on retail sales, on a percent of market basis, coffee has experienced an even greater decline over the last few years (Exhibit 9). From 3.8 percent of the beverage marketplace in 1996, coffee's percentage has declined steadily to only 3.1 percent in 2002. Even with the trend towards specialty coffee consumption at higher price points, the overall position of the industry continued to decline.

The National Coffee Association of USA, Inc. surveys consumers on an annual basis to identify trends in consumption patterns. Most coffee categories are experiencing declining consumption (regular, soluble [instant] and decaffeinated) while the only growing component of the market is gourmet (Exhibits 10, 11 and 12).

## **COMPETITION**

Starbucks operated in the specialty coffee segment of the overall coffee-consuming marketplace. Its prime competitors for coffee beverage sales were coffee shops, restaurants and street carts. Tangentially, the company's coffee products also competed with the traditional commercial-grade coffee industry, where demand, sales and consumption had been relatively stable for at least two decades. In contrast, the specialty coffee industry segment had expanded exponentially, with strong growth supported by the ready-to-drink market. This increase was attributed to growing consumer awareness of and appreciation for fine coffee. Other factors were the emergence of coffee bars, featuring an expanding array of premium coffee beverages, as well as the adoption of a healthier lifestyle that prompted some consumers to substitute coffee for alcoholic beverages. The image of coffee consumption had evolved from a breakfast or after-dinner beverage to a drink that could be enjoyed at any time of the day. Coffee bars fostered the idea that a high quality coffee beverage could be enjoyed with family and friends or business associates, creating a relaxing yet productive experience. No doubt Starbucks operating performance over the last decade has made a major contribution to the growth of this market!

### **Retail Coffee Houses**

In this segment of the specialty coffee market place none of its competitors had achieved the national and international exposure and scope of Starbucks. Firms such as Diedrich's Coffee, Peets's Coffee & Tea, Inc. Tully's Coffee Corporation, Caribou Coffee, Green Mountain Coffee, Barnie's Coffee and Tea, Coffee Beanery, Café Appassionato and Second cup coffee were regional in scope while growing sales at very different rates with a wide variety of corporate strategies. Currently, Starbucks U.S. specialty coffee house sales were greater than all the others, combined!

#### **Diedrich Coffee, Inc.**

This firm operated three retail chain brands and had a combined total of 417 retail outlets, both company owned and franchised, located in 36 states and 10 foreign countries. Headquartered in Irvine, California, it operated 35 Diedrich Coffee outlets, 360 worldwide Gloria Jean outlets (313 in the U.S.) and 22 Coffee People outlets.

The Diedrich Coffee outlets were located primarily in California, Colorado and Texas. The Gloria Jean brand, established in 1979, had developed into the flagship of the firm, selling cappuccino, latté and other Italian-style beverages as well as selected food items, whole bean coffees and coffee accessories. The brand had become internationally renowned as a leader in gourmet specialty flavored coffees. Retail sales in 2002 were \$133.5 million yet revenues to parent company Dietrich were down for 2002, even though there was a net increase in franchise

locations. Lower royalty rates from growing international franchise outlets could not compensate for lower retail sales at the Diedrich outlets in 2002.

The Coffee People chain was started in 1983 and currently operated 22 units in Oregon. Together, the entire Diedrich operation also sold coffee products to 390 wholesale accounts including restaurants, specialty retailers, food service operators and office coffee service distributors as well as via mail and the Internet.

### **Peet's Coffee & Tea, Inc.**

One of the older coffee house chains in the U.S. was Peet's Coffee & Tea, Inc., headquartered in Emeryville, California. With 72 company-owned outlets, the firm had shifted from a strategy focused on store expansion to one concentrating on other distribution channels including grocery stores, food service and mail order/on-line/specialty stores. Although Peet's continued to expand its coffee house business, that division's revenues were diminishing as a percentage of total company sales as the firm grew other distribution channels. Currently, coffee houses accounted for about 80 percent of total company sales, with 60 percent of total revenue from the sale of whole bean coffee and tea. Approximately two-thirds of each Peet's store was devoted to the whole-bean counter.

### **Tully's Coffee Corp.**

A more recent restaurant into the coffee house industry this firm opened its first store in 1992, with a goal of creating a coffee oasis. Besides brewing a variety of custom-roasted, 100 percent Arabic whole bean coffees, Tully's coffee houses served an array of specialty coffee beverages, teas, juices and other beverages. There also was a large selection of pastries, sweets and baked goods for purchase. In addition, they sold a variety of high-quality coffee accessories.

Tully's operated 99 coffee house locations in four western states (California, Idaho, Oregon and Washington) as of late 2002. The company also had licensed outlets in Japan and South Korea. Royalties were collected on international sales as well as profits from supplying goods to the Asian outlets. Tully's also operated a wholesale division selling branded coffee and related products to supermarkets and food service operators.

The firm was privately owned with its founder and chairman, Tom O'Keefe, owning 32 percent of the company. Revenues for its latest fiscal year ending March, 2003 were \$50.8 million, down 1.3 percent from the previous period. The firm experienced a loss of \$9.9 million for fiscal 2003.

A new president, CEO Tony Gioia, was hired in May 2002 with the task of enhancing the company's operating performance. Same store sales (stores opened at least one year) had recently turned up and increased wholesale grocery sales were being generated. While outlets expanded from 80 supermarkets carrying Tully's coffee in the Western U.S., they were currently reaching 1,150 stores. However, their retail business continued to shrink slowly as underperforming outlets were closed with no plans to open new ones.

### **Other Coffee House Industry Firms**

Other companies selling specialty coffee were primary small local or regional chains that that may have aspired to compete against Starbucks but were finding it quite difficult and

challenging. A few of the names include New World Coffee (30 outlets). Brew Hatta (15 outlets in Delaware and Pennsylvania), Caribon Coffee 241 locations in 9 states, Second Cup Coffee (the largest change based in Canada), and Bad Ass Coffee (30 outlets in 10 States and Canada).

From this brief summary of the history of some Starbucks competitors, strategies and performance, one may conclude that it has been increasingly difficult to compete with them successfully. Many have tried while few have succeeded. For example, Brothers Coffee actually discontinued its retail coffee business in 1996, focusing instead on the wholesale market. After filing for bankruptcy in 1998, they subsequently sold most of their assets to Proctor and Gamble.

Pasqua Coffee agreed to be absorbed by Starbucks at a bargain-basement price. New World Coffee shifted focus to the bagel market – and the list goes on. “Going up against Starbucks is just not a wise strategy”, opined an unnamed former rival. “Everybody who tried it is in trouble”.<sup>(10)</sup>

### **Donut Shops**

A more rapidly growing group of competitors that could provide increased competition in the next few years were the donut shops that also sold coffee, some of it of the specialty variety. Dunkin Donuts was the largest firm, with approximately 5000 worldwide retail outlets, second to the Starbucks total of 5,886. As the number one donut marketer, it was interesting that donuts were not the largest revenue generator for the firm. This Randolph, Massachusetts Company, a wholly owned subsidiary of Allied Domecq PLC generated more revenue from selling coffee than donuts! In fact, the firm was the world’s largest coffee and baked goods chain, selling approximately 4.4 million donuts and 2.5 million cups of coffee every day. They were also the largest retailer of coffee-by-the-cup. More than 40 percent of the company’s sales come from coffee, with some individual store actually exceeding the 50 percent level.

Two other rapidly growing brands were also expanding store locations rapidly in major U.S.markets. Krispy Kreme and Tim Horton’s each with less than 200 outlets currently had their sites on continued rapid expansion, especially in their coffee sales categories. The ready-to-drink market continued to increase market share both domestically and in international locations. Yet from the data in Exhibits 13, 14 and 15, one could conclude that Starbucks had been quite successful in this market segment.<sup>(11)</sup>

### **Whole Bean Coffee- Retail**

The second and much smaller market segment for the company was whole bean coffees sold at retail through supermarkets, specialty retailers and a growing number of specialty coffeehouses. Starbucks whole bean coffees and its coffee beverages competed indirectly against all other coffees on the market. The company believed that its customers choose among retail products primarily on the basis of quality, service and convenience and, to a lesser extent, on price.

The supermarket segment of the marketplace was believed to be the most competitive distribution channel for specialty whole bean coffee, in part because supermarkets offered customers a broad variety of choices without having to make a separate trip to a specialty coffee store. A number of nationwide coffee manufacturers as well as regional specialty coffee

companies sold whole bean coffees in supermarkets. Kraft General Foods (the parent of Maxwell House), Proctor & Gamble (the marketer of Folgers and Millstone brands) and Nestle, all distribute their coffee products through supermarkets.

Regional specialty coffee companies selling whole-bean coffees in supermarkets include brands such as Green Mountain, Allegro, Brothers, and Peaberry. With such a broad variety of brands literally at their fingertips, consumers in supermarkets could easily substitute one of them for Starbucks, especially if they were a few dollars per pound less than Starbucks.

To put the growth of specialty coffee into perspective, data from the National Coffee Association showed that regular coffee still accounted for 87 percent of all coffee consumed in the United States in 2002. Data in Tables 10, 11 and 12 show that, while average consumption of regular coffee per day has declined in recent years, the specialty coffee market segment has been strengthening. It would seem that gourmet coffee sales still have room for rapid growth in the foreseeable future.

### **FINANCIAL HISTORY**

The company has been “public” since 1992 when it sold shares in an IPO. Upon completion of that sale, the firm’s market cap reached \$273 million. The stock, listed on the NASDAQ, had now been trading for just over a decade. In 1993 a convertible debenture was sold bringing the company \$80.5 million at an interest rate of 4.5 percent. In 1995 another convertible debenture was sold with a coupon rate of 4.25 percent netting the company \$165 million.

Both of the offerings served as deferred equity issues rather than more permanent debt offerings. Consequently, the 4.5 percent debentures were converted to common stock in 1996 while the 4.25 percent issue was converted in 1997. Since that time the firm has financed its longer-term asset needs with internally generated cash flow. The number of common shares outstanding has grown nominally each year due to the issuance of options.

Since the public offering in 1992, there have been four 2 for 1 stock splits, the latest one occurring in April of 2001. The resulting capital account of the firm shows literally no long term debt and equity at market value of approximately \$9.4 billion in April 2003. See Exhibit 13 for the performance of Starbucks common stock since its IPO in 1992. Recently, the firm’s beta (B) coefficient had been 0.74.

### **FINANCIAL PERFORMANCE**

Within the perspective of the overall performance of the coffee industry over the last decade, management strategies and execution of Starbucks Company had been quite remarkable. Its growth by almost any measure of operating and financial performance has resulted in excellent returns for all company stakeholders and especially their shareholders. Balance sheets for the last four years (presented in Exhibit 14) show a decidedly conservative organization with almost no long-term debt and the book value of stockholders equity exceeding \$1.7 billion, supporting assets of \$2.3 billion at year-end 2002.

Income statements for the last five years show significant yet balanced growth with exceptional control of expenses (Exhibit 15). Statements of cash flows (Exhibit 16) clarify details of operations, investing and financing activities.



Although the firm was expanding its outlets through wholly owned stores as well as joint ventures, asset growth had been in line with sales. Yet there were financial commitments that do not necessarily show up on a firm's balance sheet. Leasehold improvements (Exhibit 17) and future rentals under non-callable lease obligations (Exhibit 18) represent financial commitments that contribute to business risk. These data must be incorporated into any evaluation of a firm's debt capacity.

### **STARBUCKS MANAGEMENT EXPECTATIONS <sup>(12)</sup>**

In October of 2002, the company hosted its fourth biennial Analyst Conference at its worldwide headquarters in Seattle. Feature presentations were made by the management team responsible for leading Starbucks global growth strategy.

The North American leadership team highlighted Starbucks strengths in extending the brand into complementary channels and products outside the retail store business as well as continued focus on the core retail business. Key drivers of the company's retail business include continuous product innovation, speed of service initiatives and leading edge store development. Mark Wesley, senior vice president, Store Development and Asset Management, reiterated the firm's long-term global store target of more than 25,000 stores. "We believe that North America alone can support at least 10,000 company-owned and licensed Starbucks locations" stated Mr. Wesley. "We are experiencing tremendous early success with the opening of stores in non-traditional locations, such as off-highway and other unique real estate sites, with innovative and flexible new store designs."

Starbucks Coffee International managers identified an even larger target for stores outside of North America. They expect to be able to operate more than 15,000 locations as a long-term goal. "We are in the very early stages of development in international markets," stated Peter Maslen, president, Starbucks Coffee International. "With a presence now in 30 countries across the globe, we have been able to demonstrate that the Starbucks business model can be extremely successful in many diverse communities around the world. In addition to retail stores, we look forward to launching our consumer products business internationally with the introduction of a ready-to-drink coffee-based beverage in one international market in the next 18 months. We are building infrastructure to ultimately support the potential for at least 6,000 stores in Asia Pacific, 7,500 stores in Europe, the Middle East and Africa, 1,500 stores in Latin America and a robust consumer products business in each region."

Company representatives also highlighted financial goals for the next 3 to 5 years that would be the result of global retail store expansion and growing specialty businesses. They projected revenue growth of approximately 20 percent per year with earnings per share growth of approximately 20-25 percent per year. By the end of fiscal 2005 (September), they expected to be operating 10,000 stores worldwide in 60 countries. More specifically, for fiscal 2003 they expected to open at least 1,200 stores worldwide and achieve comparable store sales growth of 3 to 7 percent with monthly anomalies.

### **THE FINAL CHALLENGE**

In preparing for his board presentation, Mike Casey contacted a few of the investment bankers he had met at the conference. The results were three specific scenarios for moving Starbucks to a more balanced capital structure either immediately with three different sized debt

issues or a phase in to the target debt levels over a five-year time frame. He also prepared financial statements to show how the company could maintain its agreed upon debt level. With growing cash flows, the firm would need to be much more active in the bond markets than it had been in recent years. Without continued bond sales, growing retained earnings and net worth would reduce the firm's debt ratio.

By the end of April, Mr. Casey was ready with his ideas. He called Mr. Schultz to arrange a briefing before the board meeting. "Howard, I have the information we spoke about in March. If we go through with any debt offering, the rating will be critical and affect our interest rate and cash flows. I have provided a table showing Standard and Poors' Ratings (Exhibit 19) and criteria, with ratios (Exhibit 20). So estimates can be made of our expected situation. Security yields in the corporate markets as of April should allow us to firm up a tight range for each proposal (Exhibit 21). Can we get together for review?" "Sure" said Mr. Schultz, "I will see you tomorrow in my office."

### End Notes

- (1) Press Release, Starbucks Corporation, March 31, 2003
- (2) Company Profile, Starbucks Corporation, April, 2003
- (3) Interview with Howard Schultz by Nick Cottam, “Starbucks drinks to success”, NASDAQ, September, October 2002, pp. 18-21
- (4) Schwartz, Nelson D., “Still Perking After All These Years”, *Fortune*, May 24, 1999, pp. 203-210
- (5) Greene, Tim, “Starbucks gets win-win from Wi Fi”, *Network World*, July 14, 2003
- (6) Annual Report 2002, Starbucks Corporation, Form 10K
- (7) Daniels, Cora, “Mr. Coffee”, *Fortune*, April 14, 2003, P.139-140
- (8) Schwartz, Nelson D., “Still Perking After All These Years”, *Fortune*, May 24, 1999, p. 210
- (9) Holmes, Stanley, Drake Bennett, Kate Carlisle and Chester Dawson, “Starbucks Coffee – To keep up the growth it must go global quickly”. *Business Week*, September 9, 2002 pp. 100-110
- (10) “The U.S. Coffee & Tea Market, Packaged Facts, September, 1999 and September, 2002
- (11) Press Release, Starbucks Corporation, October 24, 2002
- (12) Ibid.

## Exhibit 1. Starbucks

### Time Line of Historical Developments

- 1971** Starbucks opens its first location in Seattle's Pike Place Market.
- 
- 1982** Howard Schultz joins Starbucks as director of retail operations and marketing. Starbucks begins providing coffee to fine restaurants and espresso bars.
- 
- 1983** Schultz travels to Italy, where he's impressed with the popularity of espresso bars in Milan. He sees the potential in Seattle to develop a similar coffee bar culture.
- 
- 1984** Schultz convinces the founders of Starbucks to test the coffee bar concept in a new location in downtown Seattle. This successful experiment is the genesis for a company that Schultz founds in 1985.
- 
- Starbucks introduces Christmas Blend.
- 
- 1985** Schultz founds Il Giornale, offering brewed coffee and espresso beverages made from Starbucks coffee beans.
- 
- 1987** With the backing of local investors, Il Giornale acquires Starbucks assets and changes its name to Starbucks Corporation.
- 
- Opens in Chicago and Vancouver, B.C.
- 
- Starbucks location total = 17
- 
- 1988** Starbucks introduces mail order catalog with service to all 50 states.
- 
- Starbucks location total = 33
- 
- 1989** Opens in Portland, Oregon.
- 
- Starbucks location total = 55
- 
- 1990** Starbucks expands headquarters in Seattle and builds a new roasting plant.
- 
- Awarded Horizon Air account.
- 
- Starbucks location total = 84
- 
- 1991** Establishes a relationship with CARE, the international relief and development organization, and introduces the CARE coffee sampler.
- 
- Becomes the first privately owned U.S. company to offer a stock option program that includes part-time employees.
- 
- Opens first licensed airport location with HMS Host at Sea-Tac International Airport.
- 
- Opens in Los Angeles.
- 
- Starbucks location total = 116
- 
- 1992** Completes initial public offering with Common Stock being traded on the Nasdaq National Market under the trading symbol "SBUX."

- Awarded Nordstrom account.
- Opens in San Francisco; San Diego; Orange County, California; and Denver.
- Starbucks location total = 165

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**1993** Begins Barnes & Noble, Inc. relationship.

- Completes \$80.5 million convertible debenture offering.
- Opens second roasting plant in Kent, Washington.

— Opens in Washington, D.C.

- Starbucks location total = 272

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**1994** Awarded ITT/Sheraton (now Starwood Hotel) account.

- Completes offering of additional Common Stock.
- Opens in Minneapolis; Boston; New York; Atlanta; Dallas; and Houston.
- Starbucks location total = 425

---

**1995** Based on an extremely popular in-house music program, Starbucks begins selling compact discs.

- Awarded United Airlines account.
- Begins serving Frappuccino® blended beverages, a line of low-fat, creamy, iced coffee beverages.
- Opens state-of-the-art roasting facility in York, Pennsylvania.
- Forms alliance with Canadian bookstore Chapters Inc.
- Completes \$165 million convertible debenture offering.
- Starbucks Coffee International forms joint venture with SAZABY Inc., to open Starbucks coffeehouses in Japan.
- Opens in Philadelphia; Pittsburgh; Las Vegas; Cincinnati; Baltimore; San Antonio; and Austin, Texas.
- Starbucks location total = 676

---

**1996** Starbucks Coffee International opens locations in Japan, Hawaii, and Singapore.

- Awarded Westin (now Starwood Hotel) account.
- Starbucks and Dreyer's Grand Ice Cream, Inc. introduce Starbucks® Ice Cream and Starbucks Ice Cream bars. Starbucks Ice Cream quickly becomes the number one brand of coffee ice cream in the U.S.
- North American Coffee Partnership (Starbucks and Pepsi-Cola Company business venture) begins selling a bottled version of Starbucks Frappuccino® blended beverage.
- Successfully converts approximately \$80.5 million of its 4.5 percent convertible subordinated debentures to Common Stock.

— Opens in Rhode Island; Idaho; North Carolina; Arizona; Utah; and Ontario, Canada.

— Starbucks location total = 1,015

---

**1997**    Awarded Canadian Airlines account.

— Successfully converts approximately \$165 million of its 4.25 percent convertible subordinated debentures to common stock.

— Forms alliance with eight companies to enable the gift of more than 320,000 new books for children through the All Books for Children first annual book drive.

— Establishes The Starbucks Foundation, benefiting local literacy programs in communities where Starbucks has coffeehouses.

— Opens in Florida, Michigan, and Wisconsin.

— Starbucks Coffee International opens in the Philippines.

— Starbucks location total = 1,412

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**1998**    Starbucks Coffee International opens locations in Taiwan, Thailand, New Zealand, and Malaysia.

— Introduces Milder Dimensions® a lighter and milder tasting line of premium coffee blends.

— Introduces Tiazzì® blended juice tea, a refreshing mixture of tea, fruit juice and ice.

— Acquires Seattle Coffee Company in the United Kingdom with more than 60 retail locations.

— Acquires Pasqua Inc., a San Francisco based coffee retailer.

— Forms Urban Coffee Opportunities, a joint venture with Earvin "Magic" Johnson's Johnson Development Corp., to develop Starbucks Coffee locations in under-served, urban neighborhoods throughout the U.S.

— Signs a licensing agreement with Kraft Foods Inc. to extend the Starbucks brand into grocery channels across the U.S.

— Launches Starbucks.com.

— Opens two new coffeehouse concepts, Cafe Starbucks in Seattle and Circadia® Coffee House in San Francisco.

— Begins offering the Doonesbury® Starbucks line of products with all net proceeds donated to local literacy organizations.

— Opens in New Orleans; St. Louis; Kansas City, Missouri; and Portland, Maine.

— Starbucks location total = 1,886

---

**1999**    Starbucks Coffee International opens locations in China, Kuwait, Korea, and Lebanon.

— Acquires Tazo®, a Portland, Oregon based tea company.

— Forms the "Out of the Park, Into the Books" partnership with homerun king Mark McGwire.

— Partners with Conservation International to promote environmentally sound methods of growing coffee.

Introduces Shade Grown Mexico Coffee.

— Acquires Hear Music, a San Francisco based music company.

— Enters agreement with Albertson's, Inc. to open more than 100 Starbucks locations in their supermarkets in the year 2000.

— Opens in Memphis, and Nashville, Tennessee; and Saskatchewan, Canada.

— Starbucks location total = 2,135

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## 2000

Howard Schultz transitions from chairman and ceo to chairman and chief global strategist.

— Orin Smith promoted to president and ceo.

— Enters into licensing agreement with TransFair USA to market and sell Fair Trade Certified<sup>SM</sup> coffee.

— Introduces a Commitment to Origins<sup>TM</sup> coffee category that includes shade grown, organic and Fair Trade Certified selections.

— Expands contribution to Conservation International to establish conservation efforts in five new sites.

— Enters agreement with Host Marriott International to open locations in select properties.

— Starbucks Coffee International opens in Dubai; Hong Kong; Shanghai; Qatar; Bahrain; Saudi Arabia and Australia.

— Starbucks current location total = 3,501

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## 2001

Introduces coffee sourcing guidelines developed in partnership with The Center for Environmental Leadership in Business, a division of Conservation International.

— Commits to the purchase of one million pounds of Fair Trade Certified<sup>SM</sup> coffee.

— Offers \$1 million in financial support to coffee farmers through Calvert Community Investments.

— Begins to offer high-speed wireless internet access in stores.

— The Starbucks Foundation awards more than 450 grants totaling \$4.2 million to literacy, schools and community-based organizations across North America.

— Announces a four-year, \$1 million philanthropic partnership with Jumpstart, a national organization which pairs college student tutors with Head Start children.

— Begins offering the Starbucks Card, a stored value card for customers to use and reload.

— Enters agreement with Hyatt Hotels Corp.

— Starbucks Coffee Japan introduces a stock option program for eligible full and part-time partners and successfully implements IPO.

— Breaks ground for Starbucks third roasting plant located in Carson Valley, NV.

— Starbucks and international business partners seed Starbucks Cares Fund with \$1.2 million contribution to benefit September 11th Fund. Customers and partners contribute more than \$1.4 million to Starbucks Cares.

— Starbucks Board of Directors authorizes stock repurchase plan of up to \$60 million of stock.

Announces the fourth 2-for-1 stock split effective on April 27.

Starbucks opens 300th location in Japan and celebrates fifth year of business in Japan.

Starbucks Coffee International opens in Switzerland, Israel, and Austria.

Starbucks location total = 4,709

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## 2002

Signs memorandum of understanding with Fairtrade Labeling Organizations International (FLO) enabling Starbucks to enter into licensing agreements with national Fair-Trade organizations to sell Fair-Trade certified coffee in the countries where Starbucks does business.

Publishes its first Corporate Social Responsibility Annual Report.

Introduces Starbucks Barista Quattro™ thermal coffeemaker, a 4-cup version of its popular Barista Aroma™, and Saeco Italia™, a fully automated home espresso machine.

Celebrates 10-year anniversary of Starbucks IPO.

Introduces Starbucks DoubleShot™, to the ready-to-drink coffee category.

Signs licensing agreement with TransFair Canada to bring Fair Trade Certified<sup>SM</sup> coffee to more than 270 retail locations in Canada.

The Starbucks Foundation awards more than 500 grants totaling \$5.9 million to literacy, schools and community-based organizations across North America since 1997.

Reinforces its dedication to coffee origin countries and the farmers who produce Starbucks coffee through an expanded line of Commitment to Origins™ Coffees.

Extends the Frappuccino line to include non coffee options, Chai, Vanilla and Coconut Crème Frappuccino ice blended beverages.

Launches its high-speed wireless internet service branded T-Mobile® HotSpot™ in more than 1,200 Starbucks stores.

Tazo and Mercy Corps establish Collaboration for Hope and Advancement in India (CHAI), a project to build strong communities in the tea growing district of Darjeeling where Tazo purchases some of the finest teas available in the world.

Organizes more than 35,000 volunteer hours in the month of September and contributes more than \$275,000 through the Starbucks *Make Your Mark* program to charitable organizations across North America.

Starbucks Board of Directors authorizes stock repurchase plan of up to 10 million shares.

Establishes Seattle Coffee Trading Company (SCTC) in the Canton of Vaud, Lausanne, Switzerland.

Starbucks Coffee International opens in Oman; Indonesia; Germany; Spain; Puerto Rico; Mexico; Greece and Southern China.

Current location total=5,886

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Source: Starbucks Corporation. All rights reserved. Website: [www.starbucks.com](http://www.starbucks.com)



**Exhibit 2.**

**Starbucks Corporation**  
**Net Revenue Breakdown**  
**Fiscal 2001 and 2002**  
**(in millions)**

Business Units	Business Unit Divisions	Net Revenues		Business Unit Division Net Revenues	
		Fiscal 2002	Fiscal 2001	Fiscal 2002	Fiscal 2001
Company-Operated Retail Stores  Specialty Operations					
		\$2,792.9	\$2,229.6		
		<u>\$ 496.0</u>	<u>\$419.4</u>		
	North American Foodservice Accounts			\$133.9	\$130.0
	North American Retail Store Licensing			89.3	62.9
	International Retail Store Licensing			84.3	54.5
	Grocery Channel Licensing			64.5	58.7
	Warehouse Club Accounts			64.5	54.5
	Interactive Operations			34.7	21.0
	Equity Investors			9.9	8.4
	Other Institutions			<u>14.9</u>	<u>29.4</u>
	Totals	<u>\$3,288.9</u>	<u>\$2,649.0</u>	<u>\$496.0</u>	<u>\$419.4</u>

Source: Starbucks Coffee Company, Form 10K, 2002 and 2001

**Exhibit 3.**

**Starbucks Corporation  
Net Revenue Breakdown  
Fiscal 2001 and 2002  
(in percents)**

Business Units	Business Unit Divisions	Percent of Net Revenue		Percent of Business Net Division Revenue	
Company-Operated Retail Stores  Specialty Operations	North American Foodservice Accounts  North American Retail Store Licensing  International Retail Store Licensing  Grocery Channel Licensing  Warehouse Club Accounts  Interactive Operations  Equity Investors  Other Institutions  Totals	Fiscal 2002	Fiscal 2001	Fiscal 2002	Fiscal 2001
		85%	84%		
		<u>15</u>	<u>16</u>		
				27%	31%
				18	15
				17	13
				13	14
				13	13
				7	5
				2	2
		<u>3</u>	<u>7</u>		
		<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

Source: Starbucks Coffee Company, Form 10K, 2002 and 2001

**Exhibit 4.**

**Starbucks Coffee Company  
Systemwide Retail Stores  
(September)**

	2002 (52 Weeks)	2001 (52 Weeks)	2000 (52 Weeks)	1999 (53 Weeks)	1998 (52 Weeks)
Stores opened during the year					
Continental North America					
Company Operated Stores	525	525	408	416	352
Licensed Stores	<u>269</u>	<u>279</u>	<u>351</u>	<u>46</u>	<u>39</u>
Total North America	794	804	759	462	391
International					
Company Operated Stores	89	122	76	31	35
Licensed Stores	<u>294</u>	<u>282</u>	<u>168</u>	<u>119</u>	<u>48</u>
Total International	<u>383</u>	<u>404</u>	<u>244</u>	<u>150</u>	<u>83</u>
Total Stores Opened	1,177	1,208	1,003	612	474
System wide Stores open at year end					
Continental North America					
Company Operated Stores	3,496	2,971	2,446	2,038	1,622
Licensed Stores	<u>1,078</u>	<u>809</u>	<u>530</u>	<u>179</u>	<u>133</u>
Total North America	4,574	3,780	2,976	2,217	1,755
International					
Company Operated Stores	384	295	173	97	66
Licensed Stores	<u>928</u>	<u>634</u>	<u>352</u>	<u>184</u>	<u>65</u>
Total International	1,312	929	525	281	131
Total Stores Open at Year End	5,886	4,709	3,501	2,498	1,886

Source: Starbucks Coffee Company, Annual Reports and 10Ks

**Exhibit 5.**

**Starbucks Coffee Company  
Revenue Growth Breakdown  
1995 –2002**

Year	Comparable Store Sales Growth	Store Growth	Total Net Revenue Growth
2002	6%	18.2%	24.2%
2001	5	16.6	21.6
2000	9	20.1	29.1
1999	6	22.9	28.9
1998	5	29.2	34.2
1997	5	34.8	39.8
1996	7	43.0	50.0
1995	9	54.3	63.3

Note: Fiscal Year ends in September.

Comparable store sales growth includes only company-operated stores open 13 months or longer.

Source: Starbucks Coffee Company, Annual Reports and 10Ks.

**Exhibit 6.**

**United States Beverage Consumption  
Volume (millions of gallons)**

Beverage Category	2002P	2001	2000	1999	1998	1997	1996
Soft Drinks	15,153	15,023	14,925	14,895	14,820	14,385	13,940
<b>Coffee</b>	<b>7,770</b>	<b>7,710</b>	<b>7,700</b>	<b>7,750</b>	<b>7,800</b>	<b>7,854</b>	<b>7,901</b>
Milk	6,950	6,910	6,885	6,918	6,880	6,890	6,924
Beer	6,353	6,241	6,202	6,136	6,002	5,922	5,898
Bottled Water	6,000	5,400	4,950	4,570	4,070	3,730	3,100
Tea	1,940	1,910	1,870	1,850	1,825	1,788	1,744
Juices	1,830	1,790	1,750	1,720	1,710	1,702	1,692
Powdered Drinks	1,320	1,340	1,350	1,370	1,360	1,365	1,358
Wine	586	557	552	538	519	512	497
Distilled Spirits	365	357	354	343	334	320	329
Cider (Beverage Alcohol)	10	11	10	10	9	7	6
Totals	48,277	47,249	46,548	46,101	45,329	44,485	43,389

P = Preliminary

Source: Adams Wine Handbook 1999, 2003

**Exhibit 7.**

**United States Beverage Consumption**  
(gallons per person)

Beverage Category	2002P	2001	2000	1999	1998	1997	1996
Soft Drinks	52.5	52.7	52.9	53.4	53.7	52.8	51.7
<b>Coffee</b>	<b>26.9</b>	<b>27.0</b>	<b>27.3</b>	<b>27.8</b>	<b>28.3</b>	<b>28.8</b>	<b>29.3</b>
Milk	24.1	24.2	24.4	24.8	24.9	25.7	25.7
Beer	22.0	21.9	22.0	22.0	21.8	21.7	21.9
Bottled Water	20.8	18.9	17.5	16.4	14.8	13.7	11.5
Tea	6.7	6.7	6.6	6.6	6.6	6.6	6.5
Juices	6.3	6.3	6.2	6.2	6.2	6.2	6.3
Powdered	4.6	4.7	4.8	4.9	4.9	5.0	5.0
Drinks	2.0	2.0	2.0	1.9	1.9	1.9	1.8
Wine	1.3	1.3	1.3	1.2	1.2	1.2	1.2
Distilled Spirits							
Cider	.03	.04	.04	.04	.03	.03	.02
(Beverage Alcohol)							
Totals	167.4	165.6	164.9	165.2	164.3	163.2	161.1

Notes: P = Preliminary

Totals may not add up due to rounding

Source: Adams Wine Handbook, 1999, 2003

Statistical Abstract of the United States

**Exhibit 8.**

**United States Retail Sales by Beverage**  
**(millions of dollars)**  
**1996-2002**

Beverage Category	<u>2002P</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>
Soft Drinks	\$75,915	\$74,700	\$73,100	\$70,980	\$68,913	\$66,171	\$63,455
Beer	74,400	69,940	67,400	63,850	59,811	56,398	53,010
Distilled Spirits	42,150	39,502	37,317	35,770	34,033	33,600	33,328
Milk	18,765	18,400	17,700	17,495	17,153	17,166	17,181
Juices	14,360	14,000	13,400	13,140	13,066	13,002	12,920
Wine	20,500	19,135	18,120	16,600	14,535	13,718	12,848
<b>Coffee</b>	<b>8,150</b>	<b>8,040</b>	<b>8,050</b>	<b>8,165</b>	<b>8,112</b>	<b>8,050</b>	<b>7,972</b>
Bottled Water	7,100	6,210	5,545	5,120	4,664	4,587	4,560
Tea	1,340	1,300	1,280	1,265	1,252	1,225	1,195
Powdered Drinks	860	870	880	888	885	887	885
Cider (Beverage Alcohol)	110	120	110	95	85	66	56
Total	\$263,650	\$252,217	\$242,902	\$232,308	\$222,489	\$214,870	\$207,410

Notes: P = Preliminary

Retail sales estimates exclude sales tax

Source: Adams Wine Handbook, 1999, 2003

**Exhibit 9.**

**United States Beverage Market Shares  
Per Retail Dollar  
(in percents)**

Beverage	<u>2002P</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>
Soft Drinks	28.8%	29.6%	30.1%	30.4%	31.0%	30.8%	30.6%
Beer	28.2	27.7	27.7	27.4	26.9	26.2	25.6
Distilled Spirits	16.0	15.7	15.4	15.3	15.3	15.6	16.1
Wine	7.8	7.6	7.5	7.1	6.5	6.4	6.2
Milk	7.1	7.3	7.3	7.5	7.7	8.0	8.3
Juices	5.5	5.6	5.5	5.6	5.9	6.1	6.2
<b>Coffee</b>	<b>3.1</b>	<b>3.2</b>	<b>3.3</b>	<b>3.5</b>	<b>3.6</b>	<b>3.7</b>	<b>3.8</b>
Bottled Water	2.7	2.5	2.3	2.2	2.1	2.1	2.2
Tea	.5	.5	.5	.6	.6	.6	.6
Powdered Drinks	.3	.3	.4	.4	.4	.4	.4
Cider (Beverage Alcohol)	.0	.0	.0	.0	.0	.0	.0
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Note: P = Preliminary

Source: Adams Wine Handbook, 1999, 2003

**Exhibit 10.**

**Consumption of Coffee and Gourmet Coffee  
Beverages in the USA  
(Cups per person per day)**

Types	2002	2001	2000	1999	1998	1997	1996	1995
Regular	1.21	1.26	1.31	1.48	1.44	1.62	1.52	1.38
Soluble(Instant)	.11	.12	.14	.17	.18	.21	.17	.27
Decaffeinated	.19	.15	.20	.20	.24	.23	.25	.23
Gourmet Coffee Beverages	<u>.33</u>	<u>.33</u>	<u>.20</u>	<u>.22</u>	N/A	N/A	N/A	N/A
Total	1.64	1.72	1.66	1.89	1.63	1.84	1.69	1.67

Note: Population defined as adults 18+ years old.

Source: "National Coffee Drinking Trends, 2001, 2002, 2003"  
National Coffee Association of USA, Inc.

**Exhibit 11.**

**USA Trends in Consumption  
Cups per Drinker per Day**

Types	2002	2001	2000	1999	1998	1997	1996	1995
Coffee and Gourmet Coffee Beverages	3.15	3.27	3.06	3.49	3.02	3.32	3.43	3.52
Regular Coffee	2.90	2.99	2.98	3.42	3.16	3.48	3.69	3.58
Soluble Coffee (Instant)	1.60	1.73	1.77	1.98	1.77	2.00	1.84	2.61
Gourmet Coffee Beverages	2.49	2.45	2.33	2.24	N/A	N/A	N/A	N/A

Source: "National Coffee Drinking Trends, 2001, 2002, 2003", National  
Coffee Association of USA, Inc.



**Exhibit 12.**

**Percentage of Persons Drinking Coffee  
On the Previous Day**

Types	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>	<u>1995</u>
Coffee and Gourmet Coffee Beverages	52.2	52.4	54.1	54.3	54.1	55.5	49.3	47.4
Regular Coffee	41.6	42.2	44.1	43.3	45.6	46.5	41.2	38.6
Soluble Coffee (Instant)	6.7	7.0	8.2	8.6	10.2	10.3	9.4	10.4
Gourmet Coffee Beverages	13.1	13.5	8.6	9.0	N/A	N/A	N/A	N/A

Source: "National Coffee Drinking Trends, 2001, 2002, 2003", National Coffee Association of USA, Inc.

**Exhibit 13.**

**Starbucks Coffee Company  
Stock Prices and Earnings  
1992 – 2002**

<b>Year</b>	<u>Stock Prices</u>		<u>EPS</u>	<u>P/E Ratio</u>	
	<u>High</u>	<u>Low</u>	<u>(Fiscal Year)</u>	<u>High</u>	<u>Low</u>
2002	25.7	18.4	.60	42.8	30.7
2001	25 ¾	13.5	.46	60.0	29.3
2000	25.4	11.6	.36	70.6	32.2
1999	20 ½	6.9	.27	75.9	25.6
1998	15	7.2	.22	68.2	32.7
1997	11.2	6.5	.165	67.9	39.4
1996	10.1	3.6	.12	84.2	30.0
1995	5.6	2.8	.95	58.9	29.5
1994	4.1	2.4	.055	74.5	43.6
1993	3.5	2.0	.035	100.0	57.1
1992	2.4	1.3	.02	120.0	65.0

Notes: Fiscal Year ends September. Stock Price Range for calendar year. Prices and EPS adjusted for four 2 for 1 stock splits: September, 1993, December, 1995, March, 1999, April, 2001

Source: Standard & Poor's

**Exhibit 14.**

**Starbucks Coffee Company**  
**Balance Sheet**  
**(Fiscal Year ends September)**  
**(in millions)**

	Sept. 29, 2002	Sept. 30, 2001	Oct. 1, 2000	Oct. 3, 1999
<b>Assets</b>				
Current Assets:				
Cash and cash equivalents	\$174.6	\$113.2	\$70.8	\$66.4
Short-term investments-Available-for-sale				
Securities	217.3	101.4	57.6	51.4
Short-term investments – Trading securities	10.4	5.9	3.8	-
Accounts Receivable, net	97.6	90.4	76.4	47.6
Inventories	263.2	221.3	201.7	180.9
Prepaid Expenses and other current assets	42.4	29.8	18.7	19.0
Deferred Income Taxes, net	<u>42.2</u>	<u>31.9</u>	<u>29.3</u>	<u>21.1</u>
Total Current Assets	\$847.5	\$593.9	\$458.2	\$386.5
Equity and other investments	106.0	63.1	55.8	68.1
Property, plant and equipment, net	1,265.8	1,135.8	930.8	760.3
Other assets	53.6	31.9	25.4	23.5
Goodwill, net	<u>19.9</u>	<u>21.8</u>	<u>21.3</u>	<u>14.2</u>
Total Assets	\$2,292.7	\$1,846.5	\$1,491.5	\$1,252.5
<b>Liabilities and Stockholders Equity</b>				
Current Liabilities:				
Accounts Payable	\$136.0	\$127.1	73.7	\$56.1
Checks drawn in excess of bank balances	74.9	62.0	56.3	63.8
Accrued compensation and related costs	105.9	81.5	69.7	43.9
Accrued occupancy costs	51.2	35.8	29.1	23.0
Accrued taxes	54.1	70.3	35.8	30.8
Other accrued expenses	72.3	40.1	39.0	32.5
Deferred revenue	42.3	26.9	7.3	.5
Current portion of long-term debt	<u>.7</u>	<u>.7</u>	<u>.7</u>	<u>.7</u>
Total Current Liabilities	\$537.5	\$445.3	\$311.7	\$251.2
Deferred income taxes, net	22.5	19.1	21.4	32.9
Long term debt	5.1	5.8	6.5	7.0
Other long-term liabilities	1.0	.4	3.6	.4
Shareholders Equity:				
Common stock and additional paid-in capital	891.0	791.6	750.9	651.0
Other additional paid-in capital	39.4	-	-	-
Retained Earnings	804.8	589.7	408.5	313.9
Accumulated other comprehensive loss	<u>(8.6)</u>	<u>(5.4)</u>	<u>(11.0)</u>	<u>(3.9)</u>
Total Shareholders Equity	\$1,726.6	\$1,375.9	\$1,148.4	\$961.0
Total Liabilities and Shareholders Equity	\$2,292.7	\$1,846.5	\$1,491.5	\$1,252.5

Note: Totals may not add up due to rounding

Source: Company 10K and Annual Reports

**Exhibit 15.**

**Starbucks Coffee Company**  
**Income Statements**  
**(Fiscal year ends September)**  
**(in millions)**

	2002	2001	2000	1999	1998
<b>Net Revenues:</b>					
Retail	\$2,792.9	\$2,229.6	\$1,823.6	\$1,423.4	\$1,102.6
Specialty	<u>496.0</u>	<u>419.4</u>	<u>354.0</u>	<u>263.4</u>	<u>206.1</u>
<b>Total Net Revenues</b>	\$3,288.9	\$2,649.0	\$2,177.6	\$1,686.8	\$1,308.7
Cost of Sales and Related Occupancy Costs	1,350.0	1,112.8	961.9	747.6	578.5
Store Operating Expenses	1,121.1	875.5	704.9	543.6	418.5
Other Operating Expenses	127.2	93.3	78.4	54.6	44.5
Depreciation and Amortization Expenses	205.6	163.5	130.2	97.8	72.5
General and Administrative Expenses	202.2	151.4	110.2	89.7	77.6
Income From Equity Investors	35.8	<u>28.6</u>	<u>20.3</u>	<u>3.2</u>	<u>1.0</u>
Merger Expenses	-	-	-	-	<u>8.9</u>
Operating Income	\$318.7	\$281.1	\$212.3	\$156.7	\$109.2
Interest and Other Income, net	9.3	10.8	7.1	7.3	7.1
Interest –Related Investment Losses	-	<u>2.9</u>	<u>58.8</u>	-	-
Gain on Sale of Investment	<u>13.4</u>	-	-	-	-
Earnings Before Income Taxes	\$341.4	\$288.9	\$160.6	164.0	116.4
Income Taxes	<u>126.3</u>	<u>107.7</u>	<u>66.0</u>	<u>62.3</u>	<u>48.0</u>
Net Earnings	\$215.1	\$181.2	\$94.6	\$101.7	\$68.4
Net Earnings per share – basic	.56	.48	.25	.28	.19
Net Earnings per share – diluted	.54	.46	.24	.27	.18
Weighted Average Shares Outstanding (in millions)					
Basic	385.6	380.6	371.2	363.7	352.2
Diluted	397.5	394.4	386.0	377.1	367.5

Note: Totals may not add up due to rounding

Source: Company 10Ks and Annual Reports

**Exhibit 16.**

**Starbucks Coffee Company**  
**Consolidated Statement of Cash Flows**  
**(Fiscal Year ends September)**  
**(in millions)**

	Sept. 29, 2002	Sept. 30, 2001	Oct. 1, 2000	Oct. 3, 1999	Sept. 27, 1998
<b><u>Operating Activities:</u></b>					
Net Earnings	\$215.1	\$181.2	\$94.6	\$101.7	\$68.4
Adjustments to reconcile net earnings to net cash provided by operating activities:					
Depreciation and amortization	221.1	177.1	142.2	107.5	80.9
Gain on sale of investment	(13.4)	-	-	-	-
Interest-related investment losses	-	2.9	58.8	-	-
Provision for impairment and asset disposals	26.9	11.0	5.8	2.5	7.2
Deferred income taxes, net	(6.1)	(6.1)	(18.3)	.8	2.1
Equity in income of investors	(22.0)	(15.7)	(15.1)	(2.3)	0
Tax benefit from exercise of non-qualified stock options	44.2	30.9	31.1	18.6	9.3
Cash provided (used) by changes in operating assets and liabilities:					
Net purchases of trading securities	(5.7)	(4.0)	(1.4)	-	-
Accounts receivable	(6.7)	(20.4)	(25.0)	3.8	(19.8)
Inventories	(41.4)	(19.7)	(19.5)	(36.4)	(23.5)
Prepaid expenses and other current assets	(12.5)	(10.9)	.9	(7.6)	(2.5)
Accounts payable	5.5	54.1	15.6	4.7	4.6
Accrued compensation and related costs	24.1	12.1	25.4	7.6	9.9
Accrued occupancy costs	15.3	6.8	6.0	5.5	5.3
Accrued taxes	(16.2)	34.5	5.0	12.4	7.2
Deferred revenue	15.3	19.6	6.8	(.5)	.2
Other accrued expenses	<u>34.0</u>	<u>2.8</u>	<u>5.7</u>	<u>10.8</u>	<u>1.6</u>
Net cash provided by operating activities	\$477.7	\$456.3	\$318.6	\$229.6	\$152.2

## Exhibit 16 continued.

**Starbucks Coffee Company**  
**Consolidated Statement of Cash Flows**  
**(Fiscal Year ends September)**  
**(in millions)**

	Sept. 29, 2002	Sept. 30, 2001	Oct. 1, 2000	Oct. 3, 1999	Sept. 27, 1998
<b>Investing Activities:</b>					
Purchase of available-for-sale-securities	(340.0)	(184.2)	(118.5)	(122.8)	(51.4)
Maturity of available-for-sale-securities	78.3	93.5	58.8	85.1	112.1
Sale of available-for-sale-securities	144.8	46.9	49.2	3.6	5.1
Purchase of businesses, net of cash acquired	-	-	(13.5)	(15.7)	-
Additions to equity and other investments	(6.1)	(12.9)	(43.9)	(30.8)	(12.4)
Proceeds from sale of equity investment	14.8	-	-	-	-
Distributions from equity investors	22.8	16.9	14.3	9.0	2.8
Additions to property, plant and equipment	(375.5)	(384.2)	(316.5)	(257.9)	(201.9)
Additions to other assets	<u>(24.5)</u>	<u>(4.6)</u>	<u>(3.1)</u>	<u>(6.9)</u>	<u>(3.2)</u>
Net cash used by investing activities	(485.3)	(428.5)	(373.2)	(336.3)	(148.8)
<b>Financing Activities:</b>					
Increase/(decrease) in case provided by checks drawn in excess of bank balances	12.9	5.7	(7.5)	29.5	4.8
Proceeds from sale of common stock under employee stock purchase plan	16.2	13.0	10.3	9.4	4.6
Proceeds from exercise of stock options	91.3	46.7	58.5	33.8	20.8
Principal payments on long term debt	(.7)	(.7)	<u>(1.9)</u>	<u>(1.2)</u>	<u>(2.0)</u>
Repurchase of common stock	<u>(52.2)</u>	<u>(49.8)</u>	-	-	-
Net cash provided by financing activities	67.4	14.8	59.4	71.5	28.3
Effect of exchange rate charges on cash and cash equivalents	<u>1.6</u>	<u>(.2)</u>	<u>(.3)</u>	<u>(.1)</u>	<u>(.1)</u>
Net increase in cash and cash equivalents	61.3	42.4	4.4	(35.2)	31.5
Cash and cash equivalents:					
Beginning of the year	<u>113.2</u>	<u>70.8</u>	<u>66.4</u>	<u>101.7</u>	<u>70.1</u>
End of year	174.6	113.2	70.8	66.4	101.7

Source: Starbucks Coffee Company, Annual Reports and 10Ks

**Exhibit 17.**

**Starbucks Coffee Company  
Property, Plant & Equipment  
(in thousands)**

Item	Sept. 29 <u>2002</u>	Sept. 30 <u>2001</u>	Oct. 1, 2000	Oct. 3, 1999
Land	\$11,310	\$6,023	\$5,084	\$5,084
Buildings	30,961	19,795	19,795	19,795
Leasehold Improvements	1,131,382	960,732	754,132	591,640
Roasting and Store Equipment	516,129	421,150	354,806	273,612
Furniture, fixtures & other	<u>282,068</u>	<u>239,900</u>	<u>181,702</u>	<u>130,223</u>
Total	\$1,971,850	\$1,647,600	\$1,315,519	\$1,020,354
Less: Accumulated Depreciation and Amortization	<u>(814,427)</u>	<u>(605,247)</u>	<u>(446,403)</u>	<u>(320,982)</u>
	\$1,157,423	\$1,042,353	\$869,116	\$699,372
Work in Progress	<u>108,333</u>	<u>93,431</u>	<u>61,643</u>	<u>60,917</u>
Property, Plant & Equipment, net	\$1,265,756	\$1,135,784	\$930,759	\$760,289

Source: Starbucks Coffee Company, Annual Reports, 1999 to 2002

**Exhibit 18.**

**Starbucks Coffee Company**  
**Rental Expenses Under Operating Lease Agreements**  
**(in thousands)**

Fiscal Year Ended	Sept. 29 2002	Sept. 30 2001	Oct. 1 2000	Oct. 3 1999	Sept. 27 1998
Minimum Rentals – Retail	\$200,827	\$150,510	\$114,239	} \$95,613	\$75,912
Minimum Rentals – Other	19,143	16,033	12,910		
Contingent Rentals	<u>5,415</u>	<u>4,018</u>	<u>3,743</u>	<u>1,581</u>	<u>1,406</u>
Total Expenses	\$225,385	\$170,561	\$130,892	\$97,194	\$77,318

**Minimum Future Rentals Under Non-cancelable  
Lease Obligations as of September 29, 2002**  
**(in thousands)**

<u>Fiscal Year Ending</u>	<u>Amount</u>	
2003	\$248,026	
2004	243,519	
2005	232,641	
2006	219,384	
2007	203,394	
Thereafter		<u>863,874</u>
Total Minimum Lease Payments	\$2,101,829	

Source: Starbucks Coffee Company, Annual Reports, 1999-2002

**Exhibit 19.**

**Key Industrial Financial Ratios**  
**Adjusted Key Industrial Financial Ratios, Long Term Debt**  
**Three-year (2000-2002) Medians**

<i>Ratio</i>	<u>AAA</u>	<u>AA</u>	<u>A</u>	<u>BBB</u>	<u>BB</u>	<u>B</u>	<u>CCC</u>
EBIT interest coverage (x)	23.4	13.3	6.3	3.9	2.2	1.0	0.1
EBITDA interest coverage (x)	25.3	16.9	8.5	5.4	3.2	1.7	0.7
Funds from operations/ total debt (%)	214.2	65.7	42.2	30.6	19.7	10.4	3.2
Free operating cash flow/total debt (%)	156.6	33.6	22.3	12.8	7.3	1.5	(2.8)
Return on Capital (%)	35.0	26.6	18.1	13.1	11.5	8.0	1.2
Operating Income/ Sales (%)	23.4	24.0	18.1	15.5	15.4	14.7	8.8
Long Term Debt/ Capital (%)	(1.1)	21.1	33.8	40.3	53.6	72.6	78.3
Total Debt/Capital (%)	5.0	35.9	42.6	47.0	57.7	75.1	91.7
Number of Companies	6.0	20.0	121.0	224.0	279.0	264.0	56.0

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Source: "Corporate Ratings Criteria", Standard & Poor's



**Exhibit 20.****Formulas For Key Ratios**

1. EBIT interest coverage =	$\frac{\text{Earnings from continuing operations* before interest and taxes}}{\text{Gross interest incurred before subtracting capitalized interest and interest income}}$
2. EBITDA interest =	$\frac{\text{Adjusted earnings from continuing operations before interest taxes and D\&A coverage}}{\text{Gross interest incurred before subtracting capitalized interest and interest income}}$
3. Funds from operations = (FFP)/total debt	$\frac{\text{Net income from continuing operations + D\&A deferred income taxes and other non-cash items}}{\text{Long-term debt + current maturities, commercial paper, and other short-term borrowings}}$
4. Free operating cash = flow/total debt	$\frac{\text{FFO - capital expenditures - (+) increase (decrease) in working capital (excluding changes in cash, marketable securities, and short-term debt)}}{\text{Long-term debt + current maturities, commercial paper, and other short-term borrowings}}$
5. Return on capital =	$\frac{\text{EBIT}}{\text{Average of beginning of year and end of year capital, including short-term debt, current maturities, long-term debt, non-current deferred taxes, minority interest, and equity (common and preferred stock)}}$
6. Operating income/sales =	$\frac{\text{Sales - cost of goods manufactured (before D\&A), SG\&A costs, and R\&D costs}}{\text{Sales}}$
7. Long-term debt/capital =	$\frac{\text{Long Term debt}}{\text{Long-term debt + shareholders' equity (including preferred stock) + minority interest}}$
8. Total debt/capital =	$\frac{\text{Long-term debt + current maturities, commercial paper, and other short-term borrowings}}{\text{Long-term debt + current maturities, commercial paper and other short-term borrowings + shareholders' equity + shareholders' equity (including preferred stock) + minority interest}}$
9. Total debt/EBITDA =	$\frac{\text{Long-term debt + current maturities, commercial paper and other short-term borrowings}}{\text{Adjusted earnings from continuing operations before interest, taxes, and D\&A}}$
10. Discretionary cash flow/ total debt	$\frac{\text{FFO-capital expenditures - (+) increase (decrease) in working capital (excluding changes in cash, marketable securities and short-term debt) - common and preferred dividends}}{\text{Long-term debt + current maturities, commercial paper, and other short-term borrowings}}$

\*Including interest income and equity earnings; excluding nonrecurring items. Excludes interest income, equity earnings, and nonrecurring items; also excluded rental expense that exceeds the interest equivalent \$including amounts for operating lease debt equivalent and debt associated with accounts receivable sales securitization program.

Source: Standard & Poor's, "Corporate Ratings Criteria, Ratings and Ratios", 2003.

**Exhibit 21**

**Industrial Corporate Security Yields  
and Miscellaneous Financial Data  
April, 2003**

Maturity	Ratings					
	AAA	AA	A	BBB	BB+	BB/BB-
Five Years	3.59%	3.78%	4.13%	5.41%	7.73%	7.69%
Ten Years	4.76	4.95	5.29	6.56	8.56	9.40
Fifteen Years	5.11	5.30	5.64	6.90	8.72	NA
Twenty Years	5.44	5.62	5.96	7.22	NA	NA
Twenty-five Years	5.74	5.93	6.26	NA	NA	NA
Thirty Years	5.74					

Thirty Year Treasury Bonds – 4.83%

Diversified Equity Portfolio Expected Return – 11%

Equity Risk Premium over Company Long Term Debt Rate – 4.5%

Source: “The Outlook”, Standard and Poor’s

**Exhibit 22.**

**STARBUCKS COFFEE COMPANY  
Assumptions for  
Pro Forma Income Statements**

1. Total net revenues increase 20% per year for the next four years (2003 to 2006).
2. Cost of Goods Sold and related occupancy costs decline to 40.5% of sales in 2003, 40% in 2004, 39.5% in 2005 and 39% in 2006.
3. Gross margins increase from 59.5% in 2003 to 61% in 2006.
4. Store operating expenses are 34% of sales in 2003, declining .5% per year through 2006.
5. Other operating expenses are 4% of sales in 2003, declining .1% per year through 2006.
6. Depreciation and Amortization at 6.2% of sales each year.
7. General and Administrative expenses are 6.2% of sales in 2003, declining .1% per year through 2006.
8. Income from equity investees increases by 15% per year through 2006.
9. Interest and other income, net equals 2 ½% of the previous years balance total of cash and cash equivalents and short term investments.
10. Corporate income taxes at 37% per year.

**Exhibit 23.**

**STARBUCKS COFFEE COMPANY**  
**Assumptions for**  
**Pro Forma Balance Sheets**

1. Cash and Equivalents at 5.3% of sales
2. Short term investments – plug
3. Accounts receivable, net at 3% of sales
4. Inventories at 8% of sales
5. Prepaid expenses and other current assets at 1.3% of sales
6. Deferred income taxes, net at 1.2% of sales (an asset)
7. Property, plant and equipment, net at 38.5 % of sales
8. Other assets at 1.5% of sales
9. Accounts payable at 4% of sales
10. Cash drawn in excess of bank balances at 2.3% of sales
11. Accrued expenses and current portion of long term debt at 8.6% of sales
12. Deferred revenue at 1.3% of sales
13. Deferred income taxes, net at .7% of sales (a liability)
14. Common stock and paid-in-capital grows by 5 million shares per year sold at \$12 per share due to exercise of stock options

**Appendix I.**

Proposal from Allied Bankers For a 20 Percent  
Debt/Capital Ratio

Analysts at our firm have evaluated the Starbucks financial statements for the last four years as well as the company's strategic initiatives in its pursuit of global growth. We believe that continued financing of the firm with primarily equity funds is not in the best interests of your shareholder family. A more balanced capital structure will lower the firm's weighted average cost of capital (WACC) and contribute to profit margin expansion and enhanced stock valuations.

Allied Bankers proposes that Starbucks achieve a capital structure composed of 20 percent debt and 80 percent equity. We strongly believe we would be able to sell \$400 million worth of 20 year bonds and simultaneously repurchase a comparable amount of common stock. We estimate that with your shares currently selling for \$23 each, a 10 percent premium would be needed to attract the 15.8 million shares required to achieve this position. You should expect your firm's beta coefficient to rise modestly from its current .74 level.

Once this debt ratio is achieved, the firm may evaluate the impact on Starbucks stock valuation. If it has risen, the firm will need to continue to sell debt each year in order to maintain the 20 percent level since we expect continued growth in revenues, profits and retained earnings.

Our firm is also projecting an increase in interest rates of approximately 50 basis points on the long end (20 years plus) in each of the next two years. Therefore, this maintenance

strategy will require paying higher rates over the next few years. However, we estimate that the after-tax cost to Starbucks will not adversely affect operating or financial performance

If management is not satisfied with the stock market's reaction to this debt plan, the firm need not continue to sell debt (and/or repurchase shares). In such a case, the debt ratio will decline each year as retained earnings continue to grow.

The Allied Bankers organization stands ready to work with Starbucks management to implement these plans. We are convinced that they will result in enhanced shareholder values and complement other Starbucks strategies.

## **Appendix 2.**

### Proposal from Bailey Brothers For a 35 Percent Debt/Capital Ratio

The investment banking division of Bailey Brothers is convinced that current market conditions are quite attractive for the introduction of debt into the Starbucks capital structure. Treasury and corporate bond yields have been declining for a number of years and currently are at four decade lows. The long end of the market has been particularly receptive to quality corporate offerings and we believe that a Starbucks bond issue of \$700 million would be received enthusiastically by fixed income investors. An offering of this magnitude should receive at least an A rating from Standard and Poor's.

We propose a debt offering of at least 20 years with net proceeds used to repurchase 26.5 million shares of common stock at a premium of 15 percent to the current market price of \$23. This financial restructuring would lower Starbucks weighted average cost of capital (WACC) and contribute to shareholder valuations.

In order to maintain the desired debt ratio, the firm should be prepared to continue to sell debt over the next few years, even though we believe that interest rate levels have bottomed out. We expect rates to rise by approximately 50 basis points per year for long term debt of 20 to 30 year duration. The after-tax cost of debt to Starbucks should stay below 5 ½ percent over the next five years. In addition, if the markets react adversely to this plan, simply eliminating future bond sales will bring the firm's debt ratio down each year as retained earnings are expected to continue to increase.

Thank you for your interest in our firm. We are confident that, working together, our financial strategies will contribute to the growing valuation of Starbucks common stock in the next five years.

## **Appendix 3.**

### Proposal From Colonial Investors For a 50 Percent Debt/Capital Ratio

The Colonial Investors team of investment bankers and equity valuation specialists is pleased to present to Starbucks management a financial plan to enhance your shareholders value. We have followed the progress of your firm since its public offering in 1992 and have commented on more than one occasion that an all-equity capital structure is not an optimum

strategy in today's economic and financial environment. There are not many firms that resist the use of debt, especially with current interest rate levels.

Colonial's team proposes a debt offering of \$1 billion with proceeds to be used to repurchase common stock – a classic debt-for-equity restructuring. The net proceeds would allow Starbucks to purchase 36.2 million shares of its common stock at a 20 percent premium over the current price of \$23 per share. Your conservative equity beta of .74 can be expected to rise with additional debt but a decline in your WACC is still expected.

Upon completion of these offerings, the company will have to continue to sell debt periodically in order to maintain its proposed 50 percent debt ratio. Rates on the long end of the yield curve should be expected to rise steadily by 50 basis points per year for at least the next few years. Without these issues, the debt ratio will decline as the firm adds to retained earnings each year.

*Thank you for the opportunity to present our ideas. Colonial Investors would be pleased to partner with Starbucks in these strategies over the next five years and beyond.*

## GOURMET FOODS, INC: A CASE IN COMMERCIAL LENDING

**Lisa Poirot, CRC, The Risk Management Association**  
**Joe James, Sam Houston State University**  
**James B. Bexley, Sam Houston State University**

*Gourmet Foods, Inc. is the company that is the basis for this commercial lending case. The case has been built around a community bank's efforts to prospect for good commercial lending opportunities in a time of weakened economic news. Based on the fact that Gourmet Foods has expanded its business scope significantly during the 50 plus years of its existence, it appears to be a viable candidate for the bank to pursue. Community Bank also is aware of the company principals' dissatisfaction with the service they are receiving from their present financial institution and has received a request for a loan to be used to expand the borrower's physical plant.*

### CASE BACKGROUND

Fred Jackson had just returned to his office after Community Bank's regular loan committee meeting. In addition to the regular loan presentations, committee members spent some time reviewing the bank's lending situation in view of the economic environment. Members of the committee had been advised that although recent media reports had been focusing extensively on an economic slowdown or recession, Community Bank (CB) still needed to find some quality loans to add to its portfolio. Fred and the other loan officers were also reminded that CB's lending policy reflected management's conservative attitude toward acceptable risk levels for approving loans.

Since Fred was an experienced loan officer and had been with Community Bank for several years, he was well aware of the corporate culture regarding lending. He also knew that CB enjoyed a good reputation for service in the surrounding community in spite of such conservative loan decisions. Business owners in the community knew that loan requests that were well-supported and did not have excessive risk had always been approved in the past.

During the entire time of GFI's existence, First National Bank (FNB) had been the company's bank. Fred first encountered GFI when he worked at FNB at the beginning of his banking career. His first assignment as a credit analyst was to analyze a request GFI had submitted to FNB. When his supervisor retired Fred had already been promoted to a loan officer position and was assigned GFI as an account. In that capacity he had worked with first the Stone family and then that was expanded to include GFI's chief financial officer, Walt Frazier. Four years ago Fred moved to CB as a senior lender and has maintained contact with GFI's management team.

These thoughts were all running through Fred's mind as he began work on the next loan application that he had put on his checklist of things to accomplish for the day. Gourmet Foods, Inc. (GFI) was a prospect that CB has had on its list of potential desirable clients for some time. Fred had personally approached GFI's management several times during the past two years and

was anxious to determine if he had a request that he could approve and thus gain the company's financial business.

### **ABOUT GOURMET FOODS, INC.**

Gourmet Foods, Inc. (GFI) was started in 1950 by Paul Stone as a gourmet Italian sauce distributor. Under his guidance and that of his son Steve, the current Chief Executive Officer, the company expanded into all restaurant related food supplies.

GFI remained a small distributor for many years, starting with Italian sauces, then expanded into a gourmet line of Italian foods (olives, olive oils, specialty pastas, etc) for higher end restaurants. In 1990, the company diversified its offerings even further and entered into all levels of Italian foods to help improve its profitability. Five years ago, the company expanded into all types of restaurant foods in an attempt to further diversify their offerings. GFI covered several states including Texas, Oklahoma, and New Mexico. Revenues tripled between 2003 and 2008. The company took pride in their line of gourmet Italian foods and did not plan to discontinue the line, even though sale of these products has become only a small percentage of total sales.

Although it had grown over the years, GFI was still a family owned business. Steve Stone served as the company's Chief Executive Officer while his son, Jay (52), was the President and ran the day-to-day operations. As a result of the company's growth and the need for additional management skills, Walt Frazier was hired and became the Chief Financial Officer for GFI. Walt would be Fred's primary liaison in getting any additional financial details that might be needed to support the final determination about approving or disapproving the loan request.

GFI was legally classified as a sub-chapter S corporation with Steve and Jay each owning 50% of the company. The company used several suppliers and demonstrated a willingness to change when such action was warranted such as the 2006 change in one key supplier to obtain better pricing.

### **ABOUT THE LOAN REQUEST**

In 2004 GFI's growth created the need for GFI to acquire more space so they leased a 50,000 square foot warehouse. GFI's lease came up for renewal and they have been advised of a significant increase in the rental fee. Therefore, Steve and Jay started to explore the possibility of purchasing their own warehouse in the same area.

The warehouse building they found that was suitable for their needs contained 60,000 square feet. The building had a purchase price of \$1,000,000. GFI estimated they needed to spend an additional \$150,000 to build out the space for some offices and to add temperature controlled rooms for storage. Jay believed the building was worth \$1.4 million.

GFI's long-time loan officer had retired and left First National Bank, and the company was not completely satisfied with the level of service their new loan officer had been providing. The company had considered working with another bank on the building loan and approached Community Bank. Community Bank had been prospecting GFI for a few years and had met with Jay Stone several times. GFI also had a \$1 million line of credit with First National Bank and they were willing to discuss moving the line of credit to Community Bank.

### **THE LOAN ANALYSIS AND THE LOAN COMMITTEE**

Mr. Jackson requested that one of the bank's credit analysts review and process the following documents:

1. Balance Sheet of GFI (Exhibit 1)
2. Income Statement of GFI (Exhibit 2)
3. Personal Financial Statements of the Principals (Exhibits 3 and 4)

This review was expected to include:

1. Putting the financial statements into the bank's standard format
2. Prepare common size financial statements for the company
3. Prepare pro forma financial statements
4. Calculate projected cash flows
5. Calculate financial ratios based upon the financial statements
6. Provide preliminary analysis on the ratio calculations.
7. Justify a recommendation to approve or reject the loan request.



**Exhibit 1. Gourmet Foods, Inc. Balance Sheet**

	Dec. 31	Dec. 31	Dec. 31	Oct. 31
Amounts in \$1,000 U.S	2005	2006	2007	2008
<b>ASSETS</b>				
Cash	273	357	468	441
Marketable Securities	101	213	326	320
Accts. Receivable	1,421	1,550	1,725	1,801
Reserve for Bad Debt	(120.00)	(140.00)	(150.00)	(160.00)
Net A/R	1,301	1,410	1,575	1,641
Food Inventory	901	955	1,110	1,340
Gourmet Line Inventory	231	210	202	298
Total Inventory	1132	1165	1312	1638
<b>Total Current Assets</b>	<b>2,807</b>	<b>3,145</b>	<b>3,681</b>	<b>4,040</b>
 Machinery & Equipment	 190	 190	 240	 240
Trucks	300	300	380	380
Furniture & Fixtures	80	80	80	80
Leasehold Improvements	90	90	90	90
Gross Fixed Assets	660	660	790	790
Accumulated				
Depreciation	(78.00)	(118.00)	(164.00)	(189.00)
Net Fixed Assets	582	542	626	601
Pre-paid Expense	0	0	0	8
<b>Total Assets</b>	<b>3,389</b>	<b>3,687</b>	<b>4,307</b>	<b>4,649</b>
 <b>LIABILITIES</b>				
Notes Payable- Banks	850	657	737	567
Long-term Debt (Current)	66	51	0	0
Trade Accounts Payable	1,010	1,090	1,185	1,289
Accrued Payroll Taxes	51	49	50	98
Total Current Liabilities	1977	1847	1972	1954
Long-term Debt	66	0	0	0
Total Liabilities	2043	1847	1972	1954
Retained Earnings	1,346	1,840	2,335	2,695
<b>TOTAL LIABILITIES &amp; EQUITY</b>	<b>3389</b>	<b>3687</b>	<b>4307</b>	<b>4649</b>

**Exhibit 2. Gourmet Foods, Inc. Income Statement**

	Dec. 31 2005	Dec. 31 2006	Dec. 31 2007	Oct. 31 2008
Amounts in \$1,000 U.S				
<b>REVENUE</b>				
Sales - Food	10452	11455	11448	9541
Sales - Gourmet Italian	1038	1040	1124	651
<b>TOTAL SALES</b>	<b>11490</b>	<b>12495</b>	<b>12572</b>	<b>10192</b>
 Cost of Goods Sold - Food	 6872	 7231	 7301	 6294
Cost of Goods Sold - Gourmet	769	851	855	488
<b>GROSS PROFIT</b>	<b>3849</b>	<b>4413</b>	<b>4416</b>	<b>3410</b>
<b>OPERATION EXPENSES</b>				
Selling, General, & Admin. Exp.	2420	2736	2813	2192
Officers' Salaries	298	300	300	250
Lease/Rent Expense	84	94	94	78
Operating Leases	160	160	80	175
Other Operating Expenses	174	215	228	195
Depreciation	48	40	46	25
Bad Debt Expense	21	23	15	25
<b>TOTAL OPERATING EXP.</b>	<b>3205</b>	<b>3568</b>	<b>3576</b>	<b>2940</b>
<b>OPERATING PROFIT</b>	<b>644</b>	<b>845</b>	<b>840</b>	<b>470</b>
<b>OTHER REVENUE &amp; EXPENSE</b>				
Interest Income	15	18	21	12
Interest Expense	18	21	17	14
<b>PROFIT BEFORE TAXES</b>	<b>641</b>	<b>842</b>	<b>844</b>	<b>468</b>

**Exhibit 3. JAY AND SARAH STONE  
PERSONAL FINANCIALS**

	Oct. 31
Amounts in \$1,000 U.S	2008
<b>ASSETS</b>	
Cash	195
Marketable Securities	485
Cash Surrender Value of Life Insurance	450
Residential Real Estate	1100
Real Estate Investments	200
Partnership/PC/S Corp Interests	1250
Retirement Accounts	1485
Personal Property (Including Automobiles)	68
<b>TOTAL ASSETS</b>	<b>5233</b>
<b>LIABILITIES</b>	
Notes Payable to Others	610
Accounts Payable (Including Credit Cards)	6
Notes Due: Partnership	158
<b>TOTAL LIABILITIES</b>	<b>774</b>
<b>NET WORTH</b>	<b>4459</b>

**Exhibit 4. STEVE AND BARBARA STONE PERSONAL FINANCIALS**

	Oct. 31
Amounts in \$1,000 U.S	2008
<b>ASSETS</b>	
Cash	1195
Marketable Securities	485
Cash Surrender Value of Life Insurance	750
Residential Real Estate	1100
Real Estate Investments	
Partnership/PC/S Corp Interests	1250
Retirement Accounts	1985
Personal Property (Including Automobiles	95
<b>TOTAL ASSETS</b>	6860
<b>LIABILITIES</b>	
Notes Payable to Others	355
Accounts Payable (Including Credit Cards)	10
Taxes Payable	185
<b>TOTAL LIABILITIES</b>	550
<b>NET WORTH</b>	6310



# FINANCE PROFESSORS' USE OF CASE DISCUSSION LEADERSHIP AT HARVARD AND DARDEN MBA PROGRAMS: QUALITIES OF A SUCCESSFUL CASE DISCUSSION LEADER

Rachel A. Smith, University of Indianapolis

*(This article is also published in FMA Online)*

## ABSTRACT

*Although many business schools use the case method of instruction in their programs, a relatively small literature base exists to provide professors with practical steps for implementation in the classroom which is derived from the experience of multiple, seasoned practitioners. The participants of this field-based case study were finance professors from Harvard Business School and the University of Virginia's Darden Graduate School of Business Administration, two top-ranked MBA programs that have used case discussion leadership as their primary philosophy of teaching and learning for many years. The methodology employed was a qualitative field study which utilized interviews of the finance professors, observations of case discussion courses, and analyses of relevant program documents. This study provides a unique perspective of the recommendations and specific practices of seasoned practitioners of case discussion leadership. This article provides specific themes, narrative, and observations regarding the qualities of a successful case discussion leader which can assist educators in developing their abilities and skills to implement in the classroom.*

The purpose of this study was to discover how finance professors in two top-ranked MBA programs describe and implement case discussion leadership in the classroom. The participants of the study were finance professors from Harvard Business School and the University of Virginia's Darden Graduate School of Business Administration, two top-ranked MBA programs that have used case discussion leadership as their primary philosophy of teaching and learning for many years. The methodology employed was a qualitative field-based case study which utilized interviews of the finance professors, observations of case discussion courses, and analyses of relevant program documents.

There are several books that have been written which describe the overall methodology and process for using cases in the classroom. Barnes, Christensen, & Hansen (1994) use actual cases to illustrate the value and methodology of using cases in the classroom in their book, "Teaching and the Case Method". They discuss issues such as opportunities, dilemmas, & risks of teaching cases; roles & responsibilities of the case discussion leader; the teacher-student contract; questioning, listening, and responding; guidance vs. control; ethical dilemmas; and writing cases. These concepts are described through the use of cases in their book and are also taught via a faculty seminar. Lynn (1999) discusses principles, techniques, case writing, and curriculum planning recommendations for professors using cases in his book, "Teaching & Learning with Cases: A Guidebook". Wassermann (1993) describes the issues related to using

cases in the classroom by presenting her own cases that illuminate specific scenarios a case teacher must address such as the role of the teacher as a person, the teacher and student relationship, and the teacher's use of the curriculum in her book, "Getting Down to Cases: Learning to Teach with Case Studies". Bruner (2003) presents the philosophical underpinnings that are required for an effective case discussion leader in his book, "Socrates' Muse: Reflections on Effective Case Discussion Leadership". He discusses the core values of student-centered teaching, developing student-centered teaching skills, shaping the learning experience, and handling challenges from the student-centered point of view. Each of these seminal books provides instruction regarding the philosophy, methodology, and process of using cases in the classroom. However, these books do not provide specific practices and narrative identified and synthesized from the perspectives of multiple, experienced practitioners of the case method. This study attempts to integrate the specific practices and recommendations of professors that have used the case method for many years and synthesize them into common themes. The actual narratives from personal interviews and observations of actual case discussions in the classroom will provide educators with a unique perspective which could be replicated in their practices as case discussion leaders.

Specifically, this article will present the qualities revealed as vital to the success of a case discussion leader. It will provide the relevant responses from interviews with the professors as well as specific practices and themes that were identified during actual case discussions in the classroom. This article will address the twelve primary factors that Harvard and Darden MBA professors consider as vital for successful case discussion leaders. An effective case discussion leader must (a) listen; (b) create intellectual excitement; (c) be a performer; (d) learn from others but be yourself; (e) prepare; (f) establish rapport, respect, and relationships with students; (g) know the context of the class; (h) exhibit humble leadership; (i) value and believe in an emphasis on teaching and case discussion leadership; (j) emphasize simple language; (k) focus on student self-discovery – ask versus tell; and (l) relinquish control, accept ambiguity, and embrace the unknown. Each of these qualities will be discussed by integrating the specific insights gleaned from the interviews and observations of the case discussion leaders at Harvard Business School (HBS) and the Darden Graduate School of Business Administration.

## **Listen**

The interviews with the professors revealed that one of the qualities that is vital for a successful case discussion leader is the ability to listen effectively. Matthew McBrady feels that "listening is the #1 most important factor" for a case discussion leader. Sherwood Frey clarified the type of listening as "hearing what people are saying versus filtering it by what you want them to say." Mark Haskins stated regarding listening, "Don't filter student's comments based on your wants or expectations." Peter Tufano feels that a case discussion leader cannot be successful without effective listening skills. He feels that this is similar to the need to be a good listener in order to be an effective conversationalist in everyday life. Listening in a case discussion allows the professor to follow-up on comments and clarify what students are saying. The observations revealed that the professors spend the majority of the class time listening to the students speak rather than speaking themselves. One of the HBS students commented to me that the reason why the class likes the observed professor is because he listens and understands what the students are saying and then encapsulates it.

### **Create Intellectual Excitement**

The interviews and observations revealed that professors create intellectual excitement in students for the material in two ways. The first is by their own model of intellectual excitement for the material which is then conveyed to students. Matthew McBrady stated that the professors must display “genuine intellectual curiosity for the subject and must really enjoy the learning process.” Yiorgos Allayannis also believes that you must sincerely enjoy what you are doing in order for the students to enjoy the experience. He feels that you must enjoy the process so that students will too. Ken Froot stated that you must “be passionate and interested in the material and new knowledge of the subject.”

The second way for a professor to create intellectual excitement is to proactively craft this type of learning experience for the students during the case discussions. Robert Bruner stated that the case discussion leader “must create intellectual excitement or sizzle for the material.” Sherwood Frey stated, “You must make the classroom a fun place – learning and fun go hand in hand. This allows students to be relaxed, open to new ideas, and ready to learn.” Yiorgos Allayannis feels that a case discussion leader must inspire his students to enjoy the learning process.

### **Be a Performer**

Based on the interviews and observations of the professors, it became apparent that creating intellectual excitement for the material requires the case discussion leader to be a performer in the classroom. Sherwood Frey believes that it is often effective to either role-play or ask students to role-play as different individuals in the case. This allows the student to think from varying or opposing perspectives. The professor may also play the devil’s advocate if students are conforming to similar patterns of thinking. He stated that “teaching is showmanship.”

The observed professors made frequent use of humor throughout the case discussions. Matthew McBrady stated, “You must be a ham, a performer. You must frequently use humor.” Robert Bruner feels that case discussion leaders must take risks in expressing their ideas in order to stimulate intellectual excitement and interest in students. This may include “the use of humor, weird media, or unusual examples in class to create sizzle.” The use of humor was apparent in all of the class observations – however, the style of humor varied according to the individual professor. One professor made frequent use of humor through his contagious, hardy laugh and display of exuberant enthusiasm. Other professors used humor by subtly putting themselves down. As an example, when the class encountered a confusing part of the case facts, the professor stated, “Perhaps we just have a dumb case writer,” in which the class knows that the case was written by himself. Another professor inserted preplanned but humorous comments into his discussion. For example, the case discussed was about Scott Toilet Paper and he stated, “I am a frequent user of the product under discussion” and later “According to analysts, paper is paper – but home consumers don’t get confused (between coated paper and toilet paper).” Another professor used a sarcastic style of humor. He stated when examining financial statement appendices, “Just pick the highest number – we’re doing high level finance here.” Another professor responded to student comments in a humorous manner. When a student was rambling on in search of the right answer he stated, “OK, I’ll signal right or wrong with my eyebrows.”

The observations revealed that a case discussion leader effectively uses movement in the classroom to enhance the learning experience and increase student engagement. The professors



frequently walked up and down the aisles which created visual stimulation, walked close to a student when they were expressing their views in order to give them their full and personal attention, and sometimes stood in the back of the classroom and just observed the students engage in a discussion – as if a silent observer of student learning and self-discovery. The professors never stood behind a podium and also made infrequent references to their notes. They often used drama through the fluctuation of their voice inflection, volume, or intensity. They frequently used hand motions and gestures to express their views or reflect emotion. The professors exuded a significant level of emotional energy during the case discussion. At the end of class, it felt as if a performance had just concluded. In fact, the students clapped at the end of every case discussion – as if clapping for a grand performance.

### **Learn From Others but Be Yourself**

During the interviews, most of the faculty mentioned the need to find your own style as a case discussion leader. Yiorgos Allayannis stated, “You must find your own style, be yourself, don’t try to emulate others. You must figure out who you want to be in the classroom.” Mark Haskins stated, “You must find out what works for you.” He also stated that it is valuable to observe other experienced, master case discussion leaders and then filter and glean from these observations to create your own unique style. Ken Froot also emphasized the value of observing others teach in order to learn some of their tricks for case teaching and then, “You must be yourself, unique.” The professors explained that this emphasis on finding your own style allows the case discussion leader to enjoy themselves, feel comfortable in the classroom, and use their strengths which maximizes the learning experience for the students.

The observations revealed an interesting discovery regarding the unique nature of each professor. The observations of the eight different professors revealed varying styles. These included a practical, real world perspective; a more academic, theoretical style; a storytelling, humorous style; a style which placed heavy emphasis on using simple, real-world language for themselves and their students; an optimistic, encouraging, yet methodical style; a style which exuded energy and engagement; a style which allowed students to consider the case from a personal perspective and gave significant latitude in the discussion direction; and a style which integrated personal research and drew heavily on students’ practical experience. Each professor expressed their own unique style, but all possessed the same core case discussion leadership qualities as described in this article.

### **Prepare**

The interviews revealed the necessity for a case discussion leader to be thoroughly prepared in order to be effective. This preparation requires multiple layers and dimensions. The first level of preparation is mastery of the content or subject material, which in this study is in the area of finance. This includes both theoretical knowledge and practical knowledge of current events, research, and application of theory in the real-world. The professors stated during the interviews that a case discussion leader must “know the content” and have “command of the subject.”

The second layer of preparation requires knowing every detail of the case content. Yiorgos Allayannis stated, “You must know the case so well that you can go in different directions – like in a movie, an actor may change the lines to make it better.” Ron Wilcox stated,

“Effective case discussion leadership begins with preparation – knowing the case inside and out and knowing common mistakes.”

The third level of preparation is in leading the case discussion process. Sherwood Frey stated that this level of preparation requires the professor to “anticipate students’ comments and all the deviant ways people can go.” Mark Haskins stated that through preparation, case discussion leaders can develop the “ability to anticipate wrong, blind, dead alleys that students will take.” He stated that this preparation for the case discussion process allows the professor to be “knowledgeable and confident about what students will do or say.” Matthew McBrady stated that an effective case discussion leader “must prepare enough to be confident.” Due to the multiple layers of preparation required for a case discussion leader, Mark Haskins stated, “You must work harder preparing for a case class than a lecture class.” Willis Emmons discussed the two vital elements of preparation which include content and process. He stated, “Content knowledge by faculty is vital.” This content knowledge includes case knowledge, theoretical knowledge, and practical experience. He described process mastery as the ability to effectively lead the case discussion process in class. He stated that it is difficult for new professors because they are attempting to learn both content and process at the same time, as compared to a senior faculty member that has thorough content knowledge and can primarily focus on mastering the process of leadership in the classroom. He also stated that although content knowledge and practical experience may provide the case discussion leader with some additional credibility, the faculty member can still be a poor case discussion leader without process knowledge and practice.

The case discussion leader prepares and learns on an individual level and also through collaboration with others. This includes one-on-one collaboration with colleagues in the same discipline and through group collaboration via weekly, *teaching group* meetings. The one-on-one discussions are normally conducted on an informal basis between the professors as colleagues. These one-on-one discussions may be used to glean a new perspective or insight on teaching, feedback on class progress or group dynamics, research ideas, or to seek clarification of a technical or case issue. One of the professors expressed that this is done frequently on campus and that phone calls to other faculty colleagues are acceptable in the evening until 10:00 pm. These informal interactions aid the professor in effectively preparing for the case discussions.

The weekly teaching group meetings are scheduled, 3-hour sessions among the professors in that specific discipline and level, which in this study is MBA finance faculty. The observation of this teaching group meeting at HBS consisted of 7 finance faculty members and 2 finance teaching assistants on a Friday afternoon from 3:00-6:00 p.m. Three of the finance faculty members were senior faculty and 4 were junior faculty – 2 of whom had never taught the cases for the following week. Ken Froot, the chair of the first-year Finance Teaching Group, called FIN2, led the meeting. The meeting consisted of a review of the success of the case discussions from that week, ideas for improvement in all areas, and a thorough review of the following week’s case discussions. The 2 teaching assistants, who lead optional weekly practice sessions, also provided feedback on the areas of student progress and struggles.

There are several outcomes and benefits of this weekly teaching group meeting based on the observations and interviews with the faculty members of the FIN2 teaching group. The first is that it prepares all faculty with an understanding of the case, an explanation of technical calculations, major themes and emphases for the following week’s case discussion, suggestions on how to present the case, questions to ask students, appropriate responses to anticipated student responses, ideas for graphical presentation of the case discussion on the blackboard, and time

expectations for each section of the case discussion. Individual preparation time is reduced to some extent because the course is centrally designed and discussed (Ken Froot). It also ensures uniformity of purpose, understanding, and vision for the goals of the case discussion among the faculty. It provides the teaching assistants with understanding of the case content, goals, and areas on which to focus the weekly practice sessions. It provides an opportunity for experienced senior faculty to mentor and train junior faculty by providing them with personal perspectives and insights based on their previous case discussion experience including an explanation of questions that students may ask and challenges that may arise and how to handle them. It provides a formal opportunity for junior faculty to ask questions about process or case content. It also provides a venue for collaborating on the success of the previous week, ideas for improvement, evaluation of new ideas, and student progress in case discussions and quizzes. The discussion of the case during the teaching group meeting seemed to stimulate enthusiasm for the upcoming case discussion among the faculty members, based on their anticipation of the potential for deep learning and intellectual excitement by the students. Peter Tufano stated to the group, "This is a really fun case to teach. It gives the students confidence that they can understand and tackle this level of complexity and ambiguity and solve these problems." The members of the FIN2 Teaching Group are there to help each other increase student learning, learn from each other, and improve the program. They each have common areas of expertise and skills, speak the same language, and share one focus and goal. It is evident that the faculty members have deep knowledge and respect for their students that is based on their description of the students' anticipated responses, characteristics, needs, and the professors' positive attitude when discussing their students. They seem to display an intense commitment to achieving maximum student learning through the pursuit of enhanced case discussion leadership, as evidenced by their participation in a 3-hour, collaborative teaching group meeting on Friday afternoon.

### **Establish Rapport, Respect, and Relationships with Students**

Faculty interviews revealed the importance of developing relationships and rapport with students. Matthew McBrady stated that in order to develop rapport with the students a case discussion leader must, "Respect the value of the real world experience of the students and what these MBAs bring to the table." He also stated that rapport and relationships with students are established by seeking to engage in effective interpersonal communication with the students with the primary emphasis on listening rather than speaking. Ken Eades stated that a case discussion leader will gain the respect of the students based on their qualifications and opinions. He stated that the relationship with students requires a balance in which the professor does not seek to be their friend, but is also not intimidating. Mark Haskins feels that an effective case discussion leader must develop mutual trust with their students. Yiorgos Allayannis and Ron Wilcox expressed the need to develop relationships with students. Nabil El-Hage stated, "It is vital to establish chemistry with the students." He also revealed the importance of establishing the "trust and goodwill of the students." Ken Froot feels that the case discussion leader will develop the respect of the students based on their content mastery. Robert Bruner emphasized the importance of establishing interpersonal rapport with the students which requires warmth and respect for students' views.

The finance professors revealed several reasons and benefits of establishing rapport, respect, and relationships with students. Ron Wilcox and Nabil El-Hage both stated that a

relationship with students is important, because if the students are not prepared, they will feel that they are failing you personally. Nabil El-Hage stated that establishing a relationship and the goodwill of students is important because the students “will be willing to work with you and cut you some slack, because you will need it.” Specifically, this will be valuable when you want to take the students down a path that may initially be difficult for students to see the value in pursuing. He stated, “If you don’t have their goodwill, they will fight you, which is counterproductive. If you do have their goodwill, they will go with you and wait for the ‘aha’ and relevance.”

Professors show respect for the students by always concluding class on time, even if they feel there is a lingering issue to discuss. When this occurs, the professor tells the class that they will conclude this discussion at the beginning of the following class and then sometimes give them an issue to reflect on until the next class. An effective case discussion leader gains knowledge of the students’ backgrounds, professional experiences, prior degrees, and current specialization emphasis. This can be accomplished by talking with students to learn more about them. Both schools have an open door policy in their offices for student interaction. HBS and Darden also provide the professors with cards that describe the pertinent background information for each student. This knowledge of the students allows the professors to weave in the students’ practical experiences by asking them to contribute their knowledge during the case discussion and by calling on certain students with relevant experience or knowledge to answer technical questions. Willis Emmons stated that knowledge of the students allows the case discussion leader to develop rapport with the students and draw on their experiences during the case discussions, according to their varied backgrounds.

The observations revealed a high level of student respect and rapport for the professor and a strong relationship between the professor and the students. When the professor walked to the front of the room to begin class, the students immediately became silent. The professors always wore a suit and tie during class which fostered a feeling of professionalism and respect for the position of the professor. During class when one of the professors incorrectly wrote a calculation on the board, a student respectfully clarified the error for him. After class, there was always a group of students waiting to talk to the professor. These discussions included clarifying an issue they did not understand, providing additional insight into the case, asking a related question beyond the case content, or apologizing for not providing a strong answer to a question during the case discussion. The professors were patient and receptive to the students, referred to them by name, and obviously had a strong rapport and relationship with the students. There was never a display of disrespect, antagonism, or harshness displayed between students and professors. The professors were often seen talking with students in the hallways or around campus.

### **Know the Context of the Class**

An effective case discussion leader understands the context of the class. This includes a knowledge of the unique personality and demographic of each class. It also requires the professor to maintain an awareness of the external influences on the changing dynamics of the class. Mark Haskins stated that an effective case discussion leader “has an awareness of where students’ heads and hearts are.” This includes struggles in the previous class session, other classes they are currently taking, and the current cultural environment of the school. Sherwood Frey stated that a case discussion leader must “start where the students’ heads are – either in the

course or at the case level.” At the case level, a case discussion leader could ask students to take a vote on their recommendations for the case or ask one student to explain their position in order to recognize their current perspectives. At the course level, the professor should be aware of the backgrounds, experiences, and interests of the students.

Peter Tufano stated that the case discussion leader “must have empathy for their students – to know them and where they are coming from. You will have a much better conversation or discussion if you know what they are about.” Robert Bruner expressed the need for a case discussion leader to display intuitive empathy in the classroom. This requires them to be sensitive to what is happening in the classroom. This could include the professor’s knowledge that students are often more tired after dinner or lunch. The professor should be cognizant of a significant controversial issue occurring in the school which is affecting the overall demeanor and morale of the class atmosphere. The professor should be aware when significant illness exists among the students in the class or that students often experience apathy at the end of their program or semester. They should recognize significant personal, relational, or emotional problems among specific students. The professors should be cognizant that evening students may feel fatigue after working all day or experience burnout at the end of a long class. This intuitive empathy for the classroom context can provide the case discussion leader with additional insight and understanding for the current class dynamics and may stimulate some adjustments in delivery, style, or motivation of the students. This knowledge of the class context also pertains to knowing the difference in types of student demographics. For example, significant differences exist between full-time, part-time, and executive students which a case discussion leader must recognize and subsequently make adjustments for in the classroom.

### **Exhibit Humble Leadership**

The interviews identified that an effective case discussion leader displays humility in their leadership style. Ken Eades stated that the case discussion leader “must have a low ego. They must have the ability to say ‘I don’t know.’ They must acknowledge the experience and knowledge of the student. They must display vulnerability by admitting that they don’t know everything.” Ken also feels that the case discussion leader should be willing to honestly admit mistakes, personally or in the program, but in a firm manner which does not invite discontent. Sherwood Frey stated that the case discussion leader “doesn’t need to be perceived as the final authority.”

The classroom observations revealed an attitude of humility, rather than arrogance in the professors’ attitudes. The professors’ speech to their students was always kind. They treated their students as colleagues rather than students. They always thoughtfully considered and responded respectfully to students’ views. They did not act as the ‘sage on the stage’ in which they were the source of all knowledge. It was evident through the observations and interviews that case discussion leaders act as co-learners with the students and seek to gain new knowledge during class; glean additional practical understanding and application of theory, based on students’ descriptions of their personal experiences; and often develop research topics, based on students’ questions. They displayed an attitude of desiring to jointly discover truth, rather than serving as an authoritarian. However, this attitude of humility did not diminish their rapport, respect, and leadership in the classroom. Conversely, students displayed a deep respect for the professors as a result of the professors’ relationship and respect for the students, approachability, content

mastery, attitude of lifelong learning, and commitment to maximizing the students' learning experience.

### **Believe in the Value of Teaching and Case Discussion Leadership**

Faculty interviews indicated the need for case discussion leaders to believe in the priority of teaching and thus place significant emphasis and time into developing teaching skills. This requires professors to judiciously allocate their time between research and teaching, rather than spending the majority of their time on researching. Mark Haskins stated, "Case discussion leaders should take certain semesters to just focus on being a better teacher versus researching." This could include reading about student learning and case discussion leadership methods, observing master case discussion leaders, trying new techniques, and self-reflection and analysis. During interviews, faculty expressed their belief in the value and superiority of using case discussions rather than passive methods of teaching in order to maximize student learning. Nabil El-Hage stated, "I truly believe that students always learn more with case discussions than lecture. Students retain more with cases." Willis Emmons explained that Harvard Business School only recruits faculty that possess a strong belief in the value of using case discussions versus passive methods. This ensures a unified culture and commitment in pursuing this active, student-centered style of learning. The observations revealed the professors belief and commitment to pursuing excellence in teaching. This was apparent in their level of preparation and time spent on case review, process knowledge and training, group teaching meetings, developing relationships with students, and case writing. This level of preparation is an indicator of their value and emphasis on teaching. This teaching objective is pursued by the professors, despite the personal accolades and notoriety that are often garnished from a primary emphasis on producing research and writing.

### **Emphasize Simple Language**

Faculty expressed the need to encourage students to use simple, practical language and to also use this approach themselves during case discussions. Yiorgos Allayannis stated, "We must force the use of simple language rather than theoretical jargon. It makes finance easier." He feels that this helps even students without finance backgrounds to learn during case discussions. He feels this also allows students to communicate to all parts of the business such as marketing, operations, and sales when they reenter the corporate workplace. He also stated, "We must focus on the bottom line which would be addressed in the board room." Sherwood Frey emphasized the need for students to be "numerically articulate" in quantitative classes, like finance. This requires the use of simple language to describe the calculations, formulas, and theories. He emphasized the need for students to use "plain English" in their explanations and discussions. He believes that students must be able to explain the numbers to their colleagues in any area of the business and produce understanding and relevance of the data in their minds. He also stated that "an outside observer of a case discussion class should reasonably be able to understand what is going on in your class." Matthew McBrady emphasized the need for case discussion leaders to train students to "develop the ability to communicate in plain English." Mark Haskins stated that students must develop the ability to "speak clearly" during case discussions. Peter Tufano stated that case discussion leaders must teach students to "use plain English." He feels that it is important to prevent students from hiding behind technical language and instead emphasize

clarity and simple language. Case discussion leaders must model this in their own language by making the case discussions clear and easy to understand. This will encourage students to do the same.

The observations revealed a strong emphasis on forcing simple language in students and the use of simple language by the case discussion leaders. Yiorgos Allayannis stated to students during a case discussion, “Don’t go technical on me,” “Please restate that in plain English, rather than technical jargon,” “OK, now what does that mean?” and “Restate that in a couple of short sentences.” He used questions that were very clear, bottom line, simple to understand, practical, and to the point. His questions and language were often indicative of what a non-finance colleague would ask. For example, he stated, “I need money to finance this project, but I’m not so sure it is going to work. What rationale will you need to show the investment banker in order to get money?” Ken Eades used practical questions in simple English to keep the discussion focused on the vital issues and emphasized real-life decision making. He forced the students to bring the discussion down to simple language by stating, “Explain what you mean by market cap.” Matthew McBrady continually forced students to use simple language versus theoretical jargon. He stated, “Explain this. Don’t hide behind the language.” Matthew McBrady also used a practical example to simplify a difficult theoretical concept. For example, he compared a complex corporate valuation decision to buying a house. He stated, “How can you compare the value of one house to another?” The students derived the idea of “price per square foot” which McBrady then tied in to the theory of “multiples valuation.” Nabil El-Hage placed a strong emphasis on using clear, basic questions that were action-oriented, required critical thinking, and decision-making without clear information. Ken Froot often asked students to clarify or explain what they were saying and to avoid ambiguous language. Peter Tufano used a conversational style of language, addressed the students as colleagues, and avoided the use of lofty language. He often asked the students to “explain that in plain English.” He modeled the same use of clear, simple language. For example, he stated when explaining the output from a complex financial model, “In plain English, 10% means that once in a decade earnings will fall \$11.5M from projected earnings.” The observations of case discussion leaders unanimously revealed their emphasis on forcing the use of simple language in students and modeling the use of simple language during their case discussions with students.

### **Focus on Student Self-Discovery – Ask versus Tell**

Students develop deep, lasting meaning and knowledge by discovering ideas and relationships themselves. Robert Bruner stated, “One learns best that which one teaches oneself.” He stated that rote memorization does not make meaning and that students will make meaning to the extent that they discover ideas themselves.” Matthew McBrady stated that he knows students are acquiring true learning when “I see students get it on their own.” Nabil El-Hage stated that an emphasis on student self-discovery requires the case discussion leader to “be willing to wait for the ‘aha’ in students.” Ken Eades stated that an effective case discussion leader will encourage student self-discovery by “stimulating students to ‘bubble up’ and offer insight.” He encourages the students to contribute and invites them to engage in the case discussion. Yiorgos Allayannis stated that when a student answers, “I don’t know,” the case discussion leader must keep asking them questions to help them understand the issue themselves.

Sherwood Frey feels it is important to encourage students in the class to challenge other students’ views. He stated that although it may be humbling for a professor, students often learn

more from other students than the professor. He will sometimes allow a student to continue in their discussion with a wrong analysis and then ask questions to help them understand their errors or let other students step in to challenge them on their views or assumptions. Frey also emphasized the need for the case discussion leader to “trust the [case discussion] process” and be patient to wait for student learning through self-discovery.

The case discussion observations revealed that the majority of the discussion dialogue or “airtime” was conducted by students rather than the professor. Students possess a high level of knowledge in the classroom and made many of the significant points. They often challenged other students or provided the professor or students with an additional perspective or alternate assumptions. The students were not just passive observers and absorbers of the professor’s dissemination of information.

The learning model established in a case discussion school facilitates and develops students as active participants in their learning. The model begins with individual study by the student. This includes readings of theoretical material in textbooks, online tutorials, or technical notes provided by the schools and thorough reading and analysis of the case. The second stage of the model requires students to meet in study groups before class to test their opinions, thoughts, questions, and ideas in a small group before the in-class case discussion. The third stage of the model requires students to actively contribute to the in-class case discussion. The fourth stage requires students to reflect on, develop, and discover their own meaning and truth in the days following the case discussion. This learning model is built on the premise that “students learn best, that which they teach themselves” and thus requires them to conduct a significant amount of learning outside of class, both individually and in a small group and then contribute to other students’ learning during the case discussion (Robert Bruner). This is compared to passive learning where students enter class as empty vessels waiting to be filled with knowledge by the professor.

The professor encouraged the use of student self-discovery in class by asking questions rather than giving answers. This is a style of learning described as the Socratic method in which the teacher is a discussion leader or participant in the search for knowledge. According to this teaching style, the learning experience is active and is structured as a dialogue based on questions, rather than statements. Socrates stated that his greatest personal contribution was that “I taught men to question” (as cited by Bruner, 2003, p. 19). Mark Haskins stated that one of the important qualities of a case discussion leader is “the ability to make seamless transitions by knowing how to ask questions which take the students to the key topics.” Sherwood Frey stated that an effective case discussion leader “encourages and values articulate ‘questions’ rather than only articulate ‘answers’ by students.” He stated that students must recognize that “the key is in asking the right question” and then develop their ability to ask relevant questions. He also stated that case discussion leaders must be comfortable asking, rather than answering questions. He feels that students will still respect the professor’s knowledge and know that they are choosing not to participate. Nabil El-Hage stated that a case discussion leader “must ask enough leading questions without giving the answer.”

### **Relinquish Control, Accept Ambiguity, and Embrace the Unknown**

The interviews revealed that an effective case discussion leader makes the decision to relinquish control, accept ambiguity, and embrace the unknown. The case discussion leader must be willing to let go of their need to control the direction of the discussion and tell others the truth



they must believe. In contrast, they must be willing to allow them to discover it themselves. Mark Haskins stated that effective case discussion leaders “must let go of the need to control.” He feels that a case discussion leader must discern whether it is productive to allow a student to take a different direction with the discussion and then be effective at seamlessly bringing them back through the use of questions. Ron Wilcox stated that a case discussion leader must “know when to stay out of it versus saying no or giving their perspective of the answer” when a student makes a statement that seems incorrect. Some alternatives for a case discussion leader are to allow other students to challenge or correct the student, ask the student questions which cause them to recognize their errors, or sometimes the professor must simply recognize that the answer is not wrong, just different than they anticipated.

Sherwood Frey feels that a case discussion leader can use some directiveness, but “it shouldn’t be recognizable. It should be subtle guidance. You make things happen without the awareness of students.” Matthew McBrady stated that the case discussion leader must find equilibrium between covering the case material and allowing the findings to unfold naturally. Ken Froot stated that a case discussion leader should not be overly directive during the case discussions. However, there are varying degrees of low directiveness and the case discussion leader should adapt their style to their personality and what feels comfortable to them. Peter Tufano feels that a case discussion leader should have a low need to control. However, the case discussion leader can provide subtle direction during the case discussion. He used an analogy linked to changing lanes on the highway, which can either be sudden and jarring or gentle. The case discussion leader should be gentle in guiding students through a case discussion. Robert Bruner stated that case discussion leaders should frequently remind themselves that “the case discussion classroom belongs to the students.”

A case discussion leader must be willing to accept that at the end of the case discussion, there may not be a right answer, but rather a preferred decision based on the assumptions made and levels of ambiguity in the case. Mark Haskins stated, “Case discussions and case facts are messy.” The outcomes are not always black and white because case discussions attempt to emulate real-life decision-making in which the direction is not always unquestionably clear. Nabil El-Hage stated, “A case discussion leader must have a high tolerance for ambiguity.”

The case discussion leader must accept that they do not know what direction the case discussion may take, where it will end up, and what types of learning may occur in the process. However, Yiorgos Allayannis stated that “the beauty of case discussions is that they are always different – different people, different sequencing of questions, different reactions of students, different ideas.” An effective case discussion leader is willing to take some of the unknown paths in pursuit of deeper learning. Robert Bruner stated that an effective case discussion leader exploits spontaneity by taking paths that seem to spark energy with the students. Nabil El-Hage stated that effective case discussion leaders have the confidence to lead new avenues in pursuit of learning. He stated that this requires the case discussion leader to be able to think quickly.

Sherwood Frey stated that the case discussion leader must be flexible and willing to take new and different paths. Matthew McBrady stated that a case discussion leader must be able to think on their feet, consider new views, and synthesize ideas when dealing with the unknown. The observations of case discussion leaders at the two business schools revealed their minimal control of the case discussion direction and telling students what they must learn, acceptance of ambiguity by focusing on multiple perspectives and assumptions, and embracing the unknown by having the spontaneity and confidence to take paths that seemed relevant and sparked the energy of the students.

## CONCLUSION

This article provides findings based on the insights from interviews, document review, and observations of Harvard and Darden Business School professors regarding the necessary qualities of a successful case discussion leader. An effective case discussion leader should (a) listen; (b) create intellectual excitement; (c) be a performer; (d) learn from others but be yourself; (e) prepare; (f) establish rapport, respect, and relationships with students; (g) know the context of the class; (h) exhibit humble leadership; (i) value and believe in an emphasis on teaching and case discussion leadership; (j) emphasize simple language; (k) focus on student self-discovery – ask versus tell; and (l) relinquish control, accept ambiguity, and embrace the unknown. This knowledge should be considered as a valuable resource for educators as a means to begin or enhance the use of cases in the classroom

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### Recorded Personal Interviews with Professors:

Mr. Nabil El-Hage, Harvard Business School

Dr. Willis Emmons, Harvard Business School

Dr. Peter Tufano, Harvard Business School

Dr. Ken Froot, Harvard Business School

Dr. Stuart Gilson, Harvard Business School

Dr. Matthew McBrady, Darden Graduate School of Business Administration

Dr. Yiorgos Allayannis, Darden Graduate School of Business Administration

Dr. Ken Eades, Darden Graduate School of Business Administration

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