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981K15

ROSA'S PALAS FRANCHISE

Harshini Ansari, entrepreneur, was investigating the feasibility of opening a Rosa's Palas (Rosa's) franchise, a well-known Italian chain restaurant, in Denver, Colorado. In the fall of 2003, Ansari had spoken with the franchiser, Latrelle Waller, about the financial investment and the income Ansari could expect from this investment. Ansari had also toured and spoken with other owners of the present Rosa's franchises in Des Moines, Iowa; Sioux City, Iowa; St. Paul, Minnesota and Omaha, Nebraska to see if their estimates of sales and costs were similar to those of the franchiser.

Rosa's was a pizza and pasta, sit-down, chain restaurant. Several franchises had been opened in the past five years and considerable success had been experienced by all. Rosa's was particularly recognized for its "Papa's Deep Dish" pizza with triple bacon and mozzarella cheese and for its "Mama's Premium" lasagna with special cheese egg noodles and a secret sauce, layered seven times, between the noodles. The amount of carry-out business varied with each franchise.

Waller had been looking for a franchisee in Denver for about one year before Ansari approached him in late 2003.

Waller estimated that the new franchise, if located on the potential site available at the corner of Base Avenue and Tail Road, would produce a sales volume of $1,600,000 in the first year with annual increases in sales of $150,000 for the next two years, at which time he felt the restaurant would reach its peak annual sales volume. These estimates were based on historical sales generated from other franchises, adjusted for the additional traffic that would surround the Denver store. It was expected that sales would be evenly distributed through the year. Waller recommended that Ansari spend $75,000 on advertising in each of the first three years to help achieve these sales goals and to establish the restaurant in its new location.

Waller explained to Ansari that many of the costs were based on the sales volume, and that Ansari could project food costs to be 31 per cent of sales and the payroll costs 17 per cent of sales. He explained that it was normal to have a large percentage of the dollar sales go towards payroll since long hours combined with efficient service were among the franchise's key success factors. Furthermore, Waller reasoned that the flexible nature of restaurant labour reduced the risk to Ansari since no fixed salaries, other than her own, would be carried by the business. Government payroll taxes were roughly 10 per cent of the payroll figure.

As he did with all potential franchisees, Waller had his accountant prepare a list of the franchise's depreciable fixed assets and the corresponding depreciation schedule for the next seven years. See Exhibit 1 for this schedule. At the same time, Waller informed Ansari of other investments she would have to make. One of these was a $50,000 franchise fee[1] which was a flat fee and had to be paid on the first day of the franchise opening. This fee did not include the additional annual franchise fee, four per cent of sales, which was in actuality a royalty on sales volume. A liquor license would cost $1,000 to obtain initially; additional payments of $1,200 would be required to maintain the license in each year of operations. These payments would be made each March. An on-going inventory of $15,000 would be required to maintain the minimum operational level. As well, in order to take advantage of purchase and/or cash discounts and other short-term needs, Waller recommended that Ansari retain an additional $20,000 cash float to meet emergency working capital at all times.

The building available to Ansari, if she were to go ahead with the franchise, was 3,500 square feet in size. Ansari thought she could rent the building for $20 per square foot per year for a three-year period. Due to the open-ended nature of the lease agreement, a month's deposit would not be required. Payment would be due at the beginning of each month.

Ansari was also informed that paper goods, such as serviettes, glasses, pizza boxes, etc., would be roughly 1.5 per cent of sales, with laundry and maintenance being 0.6 per cent of sales, and cash short being 0.5 per cent of sales.

Waller was unable to provide exact figures on utilities, repairs, etc. because each franchise was different; however, Ansari spoke with some of the other franchise managers and found out the following:

	DES MOINES FRANCHISE	SIOUX CITY FRANCHISE	ST. PAUL FRANCHISE
Sales	$1,560,000	$1,200,000	$960,000[2]
Utilities	21,600	42,000[3]	9,600
Repairs	4,800	12,000	15,600
Insurance	6,000	12,000	8,000
Telephone	4,800	10,000	14,400

From this information, Ansari "guesstimated" her utilities to be 70 per cent of Sioux City's bill since electricity costs were running about 30 per cent higher than gas costs. Ansari thought an increase of $2,000 in each successive year was reasonable. Regular maintenance and repairs expense on the building, fixtures, and equipment were estimated by Ansari to be $14,000 annually. Recent inquiries into insurance and telephone expenses indicated these costs would be similar to Sioux City's costs. These expenses were expected to be incurred evenly throughout the year.

Income taxes were calculated at the corporate tax rate of 20 per cent on the first $50,000 of income, 22 per cent on the next $50,000 and 48 per cent on any income over $100,000.

[1] All fees and licenses were to be amortized over five years.
[2] 2,400 square feet, 60 per cent carry-out business.
[3] All utilities were electric.

Ansari had recently spoken to a college alumnus who practised law and who was willing to provide her professional services on a retainer for $300 each month.

After discussion with other Rosa's managers, Ansari was warned that Waller tended to be slightly optimistic in his sales predictions. Using information from the other franchisees, Ansari figured that she should discount Waller's annual sales estimates by 20 per cent when projecting statements. Furthermore, Ansari was told that it would be more realistic to project the cost of food at 35 per cent of sales and the payroll at 20 per cent of sales.

Ansari also found out that many sales were made on credit card. According to other franchises, about 60 per cent of all sales were made on credit. Sales made on bank credit cards such as *Visa* and *MasterCard* would be treated like a discounted cash sale since the signed credit card drafts could be deposited directly in the company bank account; however, sales made on non-bank cards such as *EnRoute* and *Diner's Club* would involve receivables. From her interviews, Ansari deduced that five per cent of all credit card sales were made with such non-bank cards. From previous experience, Ansari knew that the monies from sales made on these cards would be collected about a month after the sale. Ansari also deduced that given Rosa's proposed sales mix, service charges levied by all credit card companies, payable in the month of the sale, would average 2.1 per cent of total sales.

Like most restaurants, which tend to operate on a cash basis, accounts payable would be minimal. Wages and government payroll taxes would all be paid in the year in which they were incurred. All other expenses would also be paid for in cash in the month that they were incurred with the exception of the utilities, telephone, repairs and insurance bills. These four expenses would be paid in the month following their use. In order to conserve cash, the entire income tax payment would be made in one lump sum in April of the following fiscal year.

Under the franchise agreement, Ansari, as manager, could be paid a salary of $40,000 minimum plus 1.5 per cent of sales in excess of a $1,600,000 sales level. The salary and bonus could be written off as an expense. Bonus payments would be disbursed after the books were completed (probably a month and a half after the fiscal year ended). If she went ahead, Ansari hoped to open the franchise on March 1, 2004.

Ansari knew the analysis would be fairly straightforward with the information she had gathered. She wanted to project an income statement, cash budget and statement of financial position for the first three years of operations under her more conservative assumptions. Furthermore, Ansari was sincerely interested in the results Waller's assumptions would produce. She thought both sets of estimates would provide the complete spectrum of results she could expect.

Ansari realized that she would require additional financing to fund the venture since she only had $50,000 of her own money to invest in the franchise.[4] She hoped to obtain a bank loan for the additional financing requirements. She wondered whether the bank would extend financing. For her estimates, Ansari decided she would calculate interest, estimated at an annual rate of eight per cent, based on the opening outstanding balance of the loan. All funds would be borrowed at the beginning of the year and interest payments would be made on a monthly basis. She would pay off as much of the loan as possible only at year-end.

Harshini Ansari thought, after projecting these statements, that she could analyze the results, assess the risk of the franchise by looking at her margin of safety and return on investment, and make a decision.

[4] *Ansari's investment represents 100 shares of common stock.*

EXHIBIT 1: FIXED ASSET DEPRECIATION SCHEDULE[1]

Year	Investment Tax Credit	Double Declining Balance	Sum of Years Digits[2]	Total Depreciation for the Year	Book Value at Year-end
1	$ 39,000[3]	$ 100,286		$139,286[4]	$ 250,714
2		$ 71,633		$ 71,633	$ 179,081
3			$59,694	$ 59,694	$ 119,387
4			$47,755	$ 47,755	$ 71,632
5			$35,816	$ 35,816	$ 35,816
6			$23,877	$ 23,877	$ 11,939
7			$11,939	$ 11,939	$ 0

[1] *Fixed assets cost is expected to be $390,000. Asset purchase is the responsibility of the franchisee.*
[2] *An accelerated depreciation method.*
[3] *This is an additional write-off in the first year allowed under U.S. tax laws (investment tax credit)*
[4] *Under U.S. tax laws, a firm may choose whichever depreciation method produces the greatest depreciation expense for that particular year.*