

# LAURENS STREET CAFÉ

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## CASE DESCRIPTION

*The primary subject matter of this case is business start-up valuation. Secondary issues examined include uncertainty and sensitivity analysis. This case has a difficulty level of four, senior or five, graduate level. This case is designed to be taught in 3.75 to 5.00 class hours and is expected to require 6-8 hours of outside preparation by students.*

## CASE SYNOPSIS

*This case illustrates the challenges facing two entrepreneurs. David Spencer and Thomas Media are two finance professionals who were going through the process of determining if they should start a coffee café. They hired Matson Consulting, a business consultation firm, to perform a feasibility study. The job of analyzing the data and compiling the feasibility study was assigned to Joan Walker, a junior analyst at Matson Consulting. The study should be based on traditional capital budgeting methods and techniques. This case shows that: (1) starting a coffee café isn't so simple, (2) determining project value is subjective and sensitive to assumptions and input estimates, and (3) starting a business requires a lot of work.*

## INTRODUCTION

David Spencer and Thomas Media were avid coffee drinkers who worked in the finance profession. They were going through the process of determining if they should become entrepreneurs and open-up a coffee shop in their home town of Aiken, SC. They planned on naming their shop Laurens Street Café. Usually they would get their daily coffee fix at The New Moon Café ([www.newmoondowntown.com](http://www.newmoondowntown.com)) where they enjoyed the friendly employees and patrons. Nevertheless, they believed they could provide a better product at a comparable price. They have collected data to help them make an informed decision but don't have time to perform the analysis. Therefore, they have hired Matson Consulting. Jim Matson, principal of Matson Consulting, has assigned Joan Walker to perform the work. After a preliminary conversation with David and Thomas, Joan started working.

David and Thomas gave Joan the data they have already collected during a preliminary discussion, then arranged for a few more meetings afterwards. From the beginning, it was apparent to Joan that David and Thomas needed assistance. Joan planned on using the next two weeks to analyze data and develop an action plan for the feasibility study.

## PRELIMINARY DISCUSSION—EXISTING DATA

Table 1 below shows proposed operating hours discussed with Joan. David and Thomas arrived at these hours after much thought and investigating operating hours of local competitors. For example, David said The New Moon Café was located downtown and was open from 7am to 4pm Monday thru Friday, 8am to 3pm on Saturday, and 9am to 2pm on Sunday. Starbucks was

located on the south side of town and was open from 6am to 9pm every day. Joan argued that the operating hours may change, but David and Thomas thought this was a good plan to implement.

Day	Open	Close	Total Daily Hours
Monday	7am	4pm	9
Tuesday	7am	4pm	9
Wednesday	7am	4pm	9
Thursday	7am	4pm	9
Friday	7am	4pm	9
Saturday	7am	4pm	9
Sunday	7am	4pm	9
Total expected weekly hours			63
Total expected monthly hours (30 days per month)			270

Table 2 shows a sample of cash register tape information from The New Moon Café given to Joan. While getting their daily coffee fix at The New Moon, David and Thomas noticed that New Moon employees frequently forgot to remove cash register tape from prior transactions, allowing it to eventually roll onto the floor. One day, David asked a New Moon employee who was operating the cash register, “Do you mind if I tear off the cash register tape?” The employee agreed so they removed the tape, sat down at a table, and began looking at the information as they drank their morning coffee. Each transaction on the tape included the following information: (1) date, (2) time of day, (3) item(s) purchased with price, (4) sales tax, and (5) total transaction amount.

Table 2 This Table shows actual cash register tape information from The New Moon Café for selected dates. The sales amount is the total amount including sales tax.						
Day	1	2	3	4	5	6
Day of week	Tuesday	Saturday	Friday	Tuesday	Monday	Monday
Transaction	Sales Amount	Sales Amount	Sales Amount	Sales Amount	Sales Amount	Sales Amount
1	\$5.62	\$9.10	\$1.61	\$1.34	\$2.68	\$1.49
2	\$1.07	\$4.28	\$18.46	\$5.89	\$2.14	\$1.59
3	\$5.35	\$3.48	\$7.76	\$4.28	\$4.28	\$5.22
4	\$2.14	\$5.89	\$4.01	\$1.87	\$3.75	\$3.72
5	\$4.28	\$5.89	\$1.87	\$2.41	\$3.48	\$2.41
6	\$6.15	\$1.61	\$4.01	\$3.75	\$1.34	\$7.98
7	\$2.94	\$12.84	\$3.21	\$3.48	\$2.68	\$2.66
8	\$6.42	\$9.63	\$5.62	\$6.96	\$4.55	\$2.00
9		\$5.62	\$5.08	\$5.62	\$1.34	\$1.81
10		\$10.70	\$3.48	\$5.08	\$4.55	\$2.00
11		\$1.61	\$6.69	\$1.34	\$1.34	\$2.00
12		\$1.61	\$1.34	\$1.61	\$1.61	\$7.45
13		\$9.10	\$4.82	\$5.34	\$1.34	\$4.22
14		\$9.90	\$12.84	\$3.48	\$3.75	\$1.49
15		\$2.41	\$8.56	\$2.14	\$6.96	
16		\$4.01		\$5.89	\$3.48	
17		\$1.87		\$5.89	\$2.14	
18		\$7.22		\$2.68	\$4.01	
19		\$7.22		\$1.07	\$2.68	
20		\$10.43		\$1.34	\$1.61	
21		\$11.24		\$1.61	\$1.61	
22		\$2.14		\$1.34	\$1.34	
23		\$2.94		\$2.41	\$3.48	
24		\$2.94		\$5.62	\$1.07	
25		\$14.18		\$1.34	\$3.21	

Table 3 shows the expected daily customers by hour of operation discussed with Joan. Thomas used the information from Table 2 to estimate the hourly and daily demand. Joan deduced that Thomas anticipated being busier in the morning, and that in the afternoon he predicted business would decline. In addition to serving customers, David planned to use the last few hours to get ready for the next business day. In all they expected to average 130 customers per day. They believed this was a conservative estimate, but recognized demand could vary by as much as  $\pm 10\%$ .

Table 3		
This Table shows the expected number of daily customers by hour of operation.		
Start of Hour	End of Hour	# of Customers/hour
7:00 a.m.	8:00 a.m.	20
8:00 a.m.	9:00 a.m.	20
9:00 a.m.	10:00 a.m.	20
10:00 a.m.	11:00 a.m.	20
11:00 a.m.	12:00 p.m.	15
12:00 p.m.	1:00 p.m.	15
1:00 p.m.	2:00 p.m.	10
2:00 p.m.	3:00 p.m.	5
3:00 p.m.	4:00 p.m.	5
Total expected daily customers		130

Table 4 shows the 2017 quarterly sales figures for Starbucks. David and Thomas planned to use this information to determine the seasonality of coffee sales. Joan was excited that David and Thomas provided her with these figures. Joan believed that including seasonality would help her create a more realistic financial model.

Table 4				
Starbucks 2017 Quarterly Revenue Figures (Thousands of Dollars)				
	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Revenue	\$5,294,100	\$5,661,500	\$5,698,300	\$6,073,700
Total Sales Revenue for 2017				\$22,386,800

Table 5 shows the expected labor expense for the project. David and Thomas planned on being the owner-operators of Laurens Street Café whereas Joan planned on being a silent partner in the business. She would not have any responsibilities for daily operations. Joan was thrilled to be a silent partner. She spent long hours working on projects and drank a lot of coffee while doing so. Occasionally Joan would go to the Starbucks near her house. She enjoyed coffee but disliked the high prices that Starbucks charged. She thought the café would be a lucrative business and a popular local alternative to the chain coffee shops in the area.

Table 5			
This Table shows the expected labor costs for Laurens Street Café.			
Labor Expense	Yearly Compensation		Monthly Compensation
Management:			
Co-manager	\$25,000.00		\$2,083.33
Co-manager	\$25,000.00		\$2,083.33
Hourly Worker(s):	Hours/month	Total Wage Expense/hour	Monthly Compensation
Worker #1	80	\$9.00	\$720.00
Worker #2	80	\$9.00	\$720.00
Worker #3	80	\$9.00	\$720.00
Total expected monthly compensation expense			\$6,326.67

Next, David and Thomas shared the hourly worker hours with Joan, which are based on observed staffing at The New Moon Café and Starbucks. Both operations seemed to have two to four employees working at a time. David and Thomas thought their café would be similar to The New Moon and Starbucks, and therefore estimated compensation based on three to four workers at all times. Importantly, David and Thomas were aware that for the first few years they would be helping at the coffee shop. If the project was successful, they would consider compensation increases, cash bonuses based on operating performance, or some combination of the two in the future. Until then, however, both David and Thomas believed their estimates were realistic. The compensation figures in Table 5 included the current 2018 employer social security and medicare rates of 6.2 percent and 1.45 percent, respectively.

The last piece of information provided by David and Thomas contained a proposed menu. They developed this menu based on menus from The New Moon and Starbucks. They believed that this menu was competitively priced and would attract customers. Joan closely observed the proposed drink menu in Table 6 and the proposed food menu in Table 7.

Table 6			
This table shows the proposed drink menu and prices for the Laurens Street Café.			
Drinks	Size		
	Small (12 ounce)	Medium (16 ounce)	Large (20 ounce)
<b>Hot Drinks</b>			
<b>Coffees and More</b>			
coffee	\$1.86	\$2.17	\$2.41
cappuccino	\$3.09	\$3.62	\$4.26
café latte	\$3.09	\$3.62	\$4.26
café latte (caramel or pumpkin spice)	\$3.09	\$3.62	\$4.26
café mocha (chocolate or white chocolate)	\$3.49	\$4.01	\$4.65
hot chocolate (chocolate or white chocolate)	\$2.73	\$3.27	\$3.80
oregon chai	\$3.66	\$4.28	\$4.57
<b>Espressos</b>			
single	\$1.47		
double	\$1.70		
extra shot	\$0.50		
americano	\$3.80		
<b>Teas</b>			
green tea			\$1.75
black tea			\$1.75
organic tea			\$1.75
<b>Torani flavor shots (add to anything you want)</b>	\$0.50		
<b>Cold Drinks</b>			
<b>Fruit Smoothies</b>			
various fruit flavors	5.00 and up		
<b>Iced Coffees</b>			
iced cappuccino			\$3.75
iced latte		\$3.62	\$4.26
iced mocha		\$4.01	\$4.44
iced frappuccino		\$4.48	\$5.20
iced chai			\$3.50
vitamin water			\$2.00
<b>Italian Soda</b>			
soda water plus Torani flavor shot			\$3.00
<b>Iced Teas</b>			
sweet tea			\$1.69
un-sweet tea			\$1.69
flavored tea (peach, raspberry, or other flavor of the day)			\$2.25
<b>lemonade</b>			\$2.25
<b>soft drinks (12 ounce can)</b>	\$1.75		
<b>Juice</b>			
apple juice	\$1.75		
orange juice	\$1.75		
<b>Milk Shakes</b>			
vanilla			\$5.00
chocolate			\$5.00
other flavors			\$5.00

Joan commented that the food menu was limited. She told David and Thomas that it offered slightly less items than Starbucks, and significantly less items than The New Moon. David and Thomas have gone back and forth with the idea of offering soups, salads, sandwiches, quiche,

and more breakfast items. They told Joan that they were aware of the benefit of increasing their food offerings, but wanted to keep it simple. They told Joan that if the business was successful, they would consider expanding their food menu.

Table 7	
This table shows the proposed food menu for the Laurens Street Café.	
<b>Food</b>	
Bagel (plain, cinnamon raisin, garlic, everything, etcetera)	
with butter or jam	\$1.62
with cream cheese, light cream or peanut butter	\$2.43
with gourmet cream cheese (honey pecan, sundried tomato, veggie)	\$2.94
Toast (white, wheat, rye)	\$1.50
Muffins (regular or low fat)	\$2.50
Croissants (plain, chocolate or strawberry cream cheese)	\$2.50
Danish (cream cheese or fruit)	\$3.00
Pastry	\$3.00
Scones	\$2.50
Cookies (chocolate chip, sugar, peanut butter, oatmeal raisin, and	\$1.25
Yogurt	\$2.00
Fresh Fruit (apple or banana)	\$1.00

## NEXT MEETING

Approximately two weeks later, David and Thomas arrived at Joan's office. They were excited about the meeting and wanted to get started right away. Joan immediately let them know that work still needed to be done. First, she described how she would analyze the initial investment by breaking it down into the following categories: (1) fixed capital: such as equipment (e.g., coffee equipment and other), furniture (e.g. tables and chairs), and fixtures (e.g., lighting and signage), (2) working capital: such as cash and inventory (perishable and non-perishable), (3) supplies (e.g., cleaning solutions, trash bags, and cash register tape), and (4) other start-up expenses (e.g., security deposit, prepaid insurance premium, and prepaid rent expense). In the end, Joan assigned David and Thomas the responsibility of selecting name brands, quality, and prices for all of the items on the list.

Next, Joan showed David and Thomas some statistics based on their market research. First, she noted that they tended to collect their data in the morning between the hours of 7:00 a.m. and 8:00 a.m. Second, during this period New Moon customers spent about \$4.15 net of tax, on average. Third, The New Moon processed about 32 customers per hour during this period. Joan suggested to David and Thomas that the current project should use the \$4.15 sales figure as an input estimate, and that the demand information in Table 3 seemed reasonable. She also suggested they include an annual sales growth figure of at least 20%. She arrived at this figure based on her experiences with similar small businesses.

While reviewing the labor information provided by David and Thomas, Joan noted that there were no plans to add additional labor or increase labor hours as revenue increased. Joan believed it would be beneficial to tie labor costs to changes in sales figures. She discussed this with David and Thomas. They decided that an annual pay increase of \$1.00 per hour per employee was appropriate.

Day	1	2	3	4	5	6	Average
Day of week	Tuesday	Saturday	Friday	Tuesday	Monday	Monday	Totals
SC ad valorem tax	7.00%	7.00%	7.00%	7.00%	7.00%	7.00%	
total sales (including tax)	\$33.97	\$276.91	\$89.36	\$124.22	\$81.39	\$46.04	\$108.65
total number of transactions	8	40	15	40	28	14	24
average with tax	\$4.25	\$6.92	\$5.96	\$3.11	\$2.91	\$3.29	\$4.44
average no tax	\$3.97	\$6.47	\$5.57	\$2.90	\$2.72	\$3.07	\$4.15
start time	7:15 a.m.	9:10 a.m.	7:01 a.m.	7:06 a.m.	7:07 a.m.	7:30 a.m.	
end time	7:25 a.m.	10:24 a.m.	7:42 a.m.	8:12 a.m.	8:12 a.m.	8:00 a.m.	
total minutes	10	74	41	66	65	30	55.2
transaction per minute	0.80	0.54	0.37	0.61	0.43	0.47	0.53
est. number of transaction per hour	48.00	32.43	21.95	36.36	25.85	28.00	32.10

The meeting ended with David and Thomas feeling overwhelmed by the amount of work they needed to get done. Joan suggested they meet again in two months. They agreed and a meeting date was set.

### THIRD MEETING

David and Thomas completed their work in a couple of months and called Joan to re-confirm their appointment. During the meeting the information they showed Joan is contained in Table 9 through Table 16. Table 9 shows expected preliminary costs associated with starting a business. As Joan reviewed the information, David and Thomas mentioned that they have been unsure which depreciation method to use. They are unfamiliar with the various methods of depreciation and have talked to several accounting professionals who have given them conflicting answers (e.g., straight line, double declining, or Modified Accelerated Cost Recovery System (MACRS), which is the accelerated depreciation method prescribed by the United States Internal Revenue Service where fixed assets are assigned to specific asset classes and depreciated over a certain number of years).



Item	Quantity	Price	Total
<u>Preliminary Investment:</u>			
Attorney Fees:	1	\$1,000	\$1,000
Site Preparation (capital improvements to building):			
general contractor fee, labor, & materials	1	\$5,000	\$5,000
wireless internet installation & hookup	1	\$500	\$500
Business Registration & Start-up tax:			
County of Aiken, SC business registration	1	\$0	\$0
City of Aiken, SC business license	1	\$60	\$60
State of SC Retail Food Establishment Permit	1	\$60	\$60
Subtotal			\$6,620

Despite being unable to decide which depreciation method to use, David and Thomas did decide which items to depreciate. They told Joan to depreciate capital investments over \$100. This policy avoided depreciating many inexpensive pieces of equipment. For example, Table 10 shows a *knock box* that costs \$35. Because this item costs less than \$100, the entire purchase price was going to be expensed to the income statement immediately. Table 10 shows the expected initial fixed capital investment in coffee equipment. Thomas told Joan the total investment in coffee equipment was expected to be \$19,174. Joan thought this was a reasonable amount.

Item	Quantity	Price	Total
<u>Coffee equipment:</u>			
Espresso machine (fully automatic)	1	\$11,999	\$11,999
Coffee airpot brewers (double)	1	\$1,616	\$1,616
Espresso coffee grinder	1	\$700	\$700
Coffee grinder	1	\$800	\$800
Knock box	1	\$35	\$35
Aluminum espresso tamper	2	\$26	\$52
Coffee bins (for beans)	6	\$500	\$3,000
Thermal carafes 1.9 liter (6 per box)	1	\$217	\$217
Thermometers	2	\$12	\$24
Steaming (frothing) pitchers 32 ounce	4	\$18	\$71
Pastry spatula	4	\$5	\$20
Decanter warmers (double)	0	\$134	\$0
Airpots 3.0 liter (6 airpots per case)	2	\$294	\$588
Aluminum coffee scoops (12 oz.)	2	\$12	\$24
Stainless steel espresso shot glasses (5 oz.)	4	\$7	\$28
Subtotal			\$19,174

Table 11 shows the expected initial investment in other equipment necessary to operate the café. Joan observed the total investment in other equipment was \$11,530. Most of this investment was attributable to the following six pieces of equipment: (1) cash register, (2) refrigerator, (3) freezer, (4) ice maker, (5) panini grill, and (6) tea brewer.

Item	Quantity	Price	Total
<u>Other Equipment:</u>			
Cash register	1	\$500	\$500
Wi-Fi equipment (modem and router)	1	\$200	\$200
Telephone	1	\$75	\$75
Whipped cream dispenser	2	\$100	\$200
Long bar spoons (11 inch)	4	\$4	\$16
Refrigerator (reach in)	1	\$1,845	\$1,845
Freezer (reach in)	1	\$2,305	\$2,305
Ice maker	1	\$1,999	\$1,999
Blender	1	\$430	\$430
Commercial Conveyor Toaster	1	\$550	\$550
Panini grill	1	\$966	\$966
White ceramic espresso cups with saucers (4 per case, 3 oz.)	4	\$25	\$100
Plastic Tabletop paper napkin dispensers	20	\$4	\$88
Sweetener dispensers (customer area)	1	\$129	\$129
Cream dispenser (half and half)	2	\$15	\$30
Milk dispenser (whole milk)	1	\$15	\$15
Milk dispenser (skim milk)	1	\$15	\$15
Spice Dispensers (cocoa, nutmeg, and cinnamon)	3	\$5	\$15
Pour spouts (set of 12 for syrups)	2	\$6	\$12
Black plastic baskets for food (36 per case)	2	\$55	\$110
Tea brewer	1	\$698	\$698
Tea dispensers	3	\$110	\$330
Quick Books Premier by Quicken	1	\$400	\$400
Trash cans (25 gallon)	3	\$168	\$504
Subtotal			\$11,530

Table 12 shows the expected initial investment in furniture and fixtures. David and Thomas reasoned that a table was constructed of a table top and a chrome base, which brings the price of a table above \$100. However, they estimated signage will be worthless in the future. They reasoned that if they stopped operating the café, the signage on the building and window would have little to no value.

While looking at Table 12 Joan became alarmed that David and Thomas did not include any light fixtures. She questioned them about this possible mistake. They said the prospective location was formerly occupied by an upscale Italian restaurant that left trendy light fixtures in place.

Table 12			
Item	Quantity	Price	Total
<b>Furniture:</b>			
Indoor Table tops (4 top-36"round)	6	\$275	\$1,650
Indoor Table bases (4 top-chrome)	6	\$71	\$423
Indoor Table tops (2 top-30"x30")	10	\$33	\$325
Indoor Table bases (2 top-chrome)	10	\$71	\$705
Indoor chairs (with padded seat)	50	\$49	\$2,450
Indoor lounge chairs	4	\$500	\$2,000
Indoor couches	2	\$1,000	\$2,000
Outdoor Tables (4 top-36" round)	4	\$90	\$360
Outdoor chairs	16	\$57	\$912
Outdoor umbrellas (9-foot)	4	\$200	\$800
Padlocks (to lock outdoor chairs and Tables)	4	\$20	\$80
Security chains/cables (to lock outdoor chairs and Tables)	4	\$25	\$100
Subtotal			\$11,805
<b>Fixtures:</b>			
Lighting fixtures	0	\$100	\$0
Menu board	1	\$250	\$250
Signage on building	1	\$1,000	\$1,000
Signage on front window	1	\$500	\$500
Subtotal			\$1,750

Table 13 shows the expected initial investment in cash and perishable inventory. Joan noted that the investment in inventory was relatively small compared to the investment in fixed capital. The total investment in perishable inventory was only \$1,369, with the largest amount in coffee beans. David and Thomas told her they plan to keep inventory levels low because suppliers deliver daily. They also explained to Joan that a vendor will roast their coffee beans and they will grind beans on location. They did explore the possibility of roasting coffee beans on location, but decided to forgo this investment. David told Joan that if the café is successful, they might invest in roasting equipment in the future.

Table 13			
Item	Quantity	Price	Total
<u>Initial Working Capital Investment:</u>			
Cash:	1	\$10,000	\$10,000
Subtotal			\$10,000
<u>Perishable Inventory:</u>			
Coffee beans (qty in pounds, price per pound)	50	\$8	\$400
Tea (green, black, organic, other)	1	\$20	\$20
Lemonade (per case)	1	\$25	\$25
Juice (apple, orange)	2	\$25	\$50
Half and Half (quarts)	4	\$2	\$8
Whole milk (gallons)	6	\$4	\$24
2% Milk (gallons)	6	\$4	\$24
Skim milk (gallons)	6	\$4	\$24
Soy milk (gallons)	2	\$6	\$12
Bananas (lbs)	3	\$1	\$3
Apples (lbs)	1	\$5	\$5
Whip cream	6	\$5	\$30
Bagels (per dozen)	6	\$12	\$72
Chocolate chip cookies	2	\$6	\$12
Sugar cookies	2	\$6	\$12
White chocolate chip macadamia nut cookies	2	\$6	\$12
Butter pads (per case)	1	\$20	\$20
Margarine pads (per case)	1	\$20	\$20
Cream cheese	1	\$20	\$20
Light cream cheese	1	\$20	\$20
Flavored cream cheese (honey pecan)	1	\$20	\$20
Flavored cream cheese (sundried tomato)	1	\$20	\$20
Flavored cream cheese (veggie)	1	\$20	\$20
Peanut butter	1	\$20	\$20
Grape jelly pads (case)	1	\$20	\$20
Strawberry jelly pads (case)	1	\$20	\$20
Apple jelly pads (case)	1	\$20	\$20
Honey	1	\$20	\$20
Muffins (per dozen)	1	\$12	\$12
Pastries (per dozen)	1	\$12	\$12
Sugar packets (per case)	1	\$50	\$50
Sweet 'n Low packets (per case)	1	\$25	\$25
Splenda packets (per case)	1	\$25	\$25
Equal packets (per case)	1	\$25	\$25
Cocoa spice	1	\$5	\$5
Nutmeg spice	1	\$5	\$5
Cinnamon spice	1	\$5	\$5
Torani syrups (750 ml bottle)	12	\$5	\$60
Torani sauces (64 ounce container)	8	\$10	\$80
Torani smoothie mix (64 ounce container, asst. flavors)	6	\$10	\$60
Ice cream (gallons)	4	\$5	\$20
Whole wheat bread for toast (loaves)	2	\$2	\$4
Rye bread for toast (loaves)	2	\$2	\$4
White sourdough bread for toast (loaves)	2	\$2	\$4
Subtotal			\$1,369

Table 14 shows the expected initial investment in nonperishable inventory. Joan observed that the \$1,060 total investment in nonperishable inventory was relatively small. David and

Thomas explained that they planned on keeping low inventory levels because suppliers deliver daily.

Table 14			
Item	Quantity	Price	Total
<u>Nonperishable Inventory:</u>			
Paper cups 12 ounce ( 1000 cups per case)	1	\$64	\$64
Paper cups 16 ounce (1000 cups per case)	1	\$125	\$125
Paper cups 20 ounce (500 cups per case)	1	\$76	\$76
Lids (one size fits all paper cups; 1000 per case)	1	\$44	\$44
Recycled paper coffee sleeves (1300 per case)	1	\$75	\$75
Splash sticks (500 per box)	1	\$20	\$20
Wooden stir sticks 7.5" (500 per box)	2	\$12	\$24
Cup carriers (4 cup 300 per case)	1	\$65	\$65
Plastic cups 16 ounce for cold drink (1000 per case)	1	\$88	\$88
Plastic lids 16 ounce for cold drinks (1000 per case)	1	\$51	\$51
Film wrapped drinking straws ( 6000 straws per case)	1	\$67	\$67
Knives biodegradable starch(1000 per case)	1	\$59	\$59
Forks biodegradable starch (1000 per case)	1	\$59	\$59
Spoons biodegradable starch (1000 per case)	1	\$59	\$59
12x12 Dry wax flat sheets (1000 per case)	1	\$93	\$93
Paper coffee filters (1,000 count)	1	\$14	\$14
Paper tea filters (500 count)	1	\$17	\$17
Paper napkins (6,000 per case)	1	\$62	\$62
Subtotal			\$1,060

Table 15 shows the expected initial investment in supplies and other items. Thomas said the landlord of the current location required a \$2,500 deposit plus the first three months of rent on the lease signing date. Thomas told Joan to plan on recouping the security deposit at the end of the project plus he told her that the last three months of rent would be zero. They were expecting to sign a three year lease.

Table 15			
Item	Quantity	Price	Total
<u>Supplies:</u>			
Lobby broom & dust pan combination	1	\$26	\$26
Wet floor sign (multilingual)	1	\$24	\$24
Mop head (16 ounce) and handle	1	\$20	\$20
Mop bucket with wringer	1	\$75	\$75
Disposable food preparation gloves (500 gloves per box)	1	\$10	\$10
Tabletop cleaning solution	1	\$50	\$50
Floor cleaning solution	1	\$50	\$50
Spray bottles for cleaning solution (6 bottles per case)	1	\$12	\$12
Espresso machine cleaner (200 Tablets)	1	\$35	\$35
12"x12" Cleaning rags (60 per pack)	1	\$33	\$33
Cash register tape (thermal-3-1/8"x230' 50 rolls/carton)	1	\$61	\$61
Credit card tape (thermal-3-1/8"x230' 50 rolls/carton)	1	\$50	\$50
Whip cream charges (box of 24)	1	\$22	\$22
Trash bags ( 25-35 gal, 1.5 mil, 100 per carton)	1	\$32	\$32
Subtotal			\$500
<u>Other (Prepaid Expenses):</u>			
Rent expense (first 3 months)	3	\$1,500	\$4,500
Security deposit	1	\$2,500	\$2,500
Monthly insurance premium (liability, worker comp.)	1	\$250	\$250
Subtotal			\$7,250

Finally, Table 16 shows a summary of the expected initial investment by subcategory. David and Thomas estimated an initial investment of \$70,998. Most of this investment was in fixed capital and cash.

Table 16	
This Table shows the expected initial investment by subtotals.	
Investment Category	Subtotal
<u>Preliminary Investment:</u>	\$6,560
<u>Fixed Capital Investment:</u>	
Coffee equipment:	\$19,174
Other Equipment:	\$11,530
Furniture:	\$11,805
Fixtures:	\$1,750
<u>Working Capital Investment:</u>	
Cash:	\$10,000
Perishable Inventory:	\$1,369
Nonperishable Inventory:	\$1,060
Supplies:	\$500
<u>Other (Prepaid Expenses):</u>	\$7,250
Total expected initial investment	\$70,998

The meeting ended with Joan telling David and Thomas that she would need a few weeks to develop a financial model to analyze the project that includes sensitivity and scenario analysis, formulate a recommendation, and prepare a presentation.

After David and Thomas left, Joan began looking at the information she requested on operating expenses. David and Thomas told her they obtained this information by (1) conducting a survey of area restaurants of similar size, (2) consulting with vendors who service cafés in the

region, and (3) computing the unit cost for a 12 ounce cup of coffee. Joan looked at the information in Table 17.

Table 17	
This Table shows the estimated expenses associated with operations. The cost of goods sold is a variable expense; all other expenses are assumed to be fixed.	
Item	Estimate
<u>Monthly</u>	
Cost of Goods Sold (% of sales)	25.00%
<i>Selling, General, &amp; Administrative Expenses:</i>	
Payroll Expense	\$6,326.67
Rent Expense	\$1,500.00
Utility Expenses:	
Gas	\$300.00
Electric	\$300.00
Water	\$200.00
Sewer	\$50.00
Trash	\$100.00
Cable (Wi-Fi, phone & T.V.)	\$200.00
Credit Card Processing Fee*	\$50.00
Insurance	\$250.00
Advertising Expense	
Printed Materials	\$150.00
Signage	\$100.00
Web Design and Maintenance	\$200.00
Marginal Tax Rate (federal, state, and local)	40.00%
<u>Annual</u>	
City of Aiken Business License (annual)	\$60.00
State of South Carolina Retail Food Establishment Inspection Fee	\$60.00
*40% of sales will be on credit. There is an additional fee of 2% of the total sales amount, plus \$0.25 per credit card sale.	

### TERMINAL YEAR NON-OPERATING ITEMS

David and Thomas planned on signing a three year lease with an option to renew the lease for another three years at the current rental rate. For the current feasibility study, Joan planned on analyzing the project under two different assumptions. First, she would assume the project ended in three years, and at this time David and Thomas would recoup their investment in certain fixed capital and working capital items listed in Tables 9-15. Second, she assumed the project was a going concern in three years.

## **SPECIAL ITEMS**

David told Joan that the three months of pre-paid rent expense would be recovered in months 34 through 36, and the monthly pre-paid insurance premium would be recovered in month 36. Also, Joan was aware that the entire expected initial investment in supplies and certain fixed capital items will be expensed to the income statement during the first month of operations, time  $t=1$ , however, the cash outflow for these items will occur at time  $t=0$ .

## **THE FINAL MEETING**

The day of the final meeting is coming and it was Joan's responsibility to perform a feasibility study of the project based on traditional capital budgeting methods, draw a conclusion, make a recommendation, and present the results to David and Thomas. If the investment was value enhancing, the next step was to develop a business plan and secure financing. Joan was also responsible for exploring Small Business Administration (SBA) sources of capital and SBA eligibility requirements, and creating a justifiable weighted average cost of capital. If the project was value destroying, Joan would recommend that David and Thomas re-work their numbers or reject the project. For example, in this analysis David and Thomas decided to purchase a relatively expensive espresso machine that was fully automatic. The New Moon used a cheaper, semi-automatic espresso machine in their café.

Lastly, after discussing David and Thomas's financing options with Jim Matson, principal of Matson Consulting, Joan determined that a small business development loan could be the best financing option for this venture. The U.S. Small Business Administration offers guarantee loan programs to those who qualify; this was a great opportunity for David and Thomas. Jim Matson said that he believed the financing for Laurens Street Café would require 50% equity. He also said these types of loans have an average interest rate of 7.5%. Finally, David and Thomas told Joan they required a return on their equity investment that is similar to an equity investment in Starbucks.

## **THE CHALLENGE**

Now that the final meeting has taken place, assume that you are Joan and use the information in the case together with your knowledge of capital budgeting skills to create a model to investigate if David and Thomas should launch Laurens Street Café.