Corner Table Incorporated: establishing a frozen food division

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Abstract

In this fictitious case, Corner Table Incorporated owns and operates a chain of 47 Lisa C's restaurants in six states. Maxwell Alexander, the firm's founder and CEO, is in the process of determining how to continue the company's tradition of successful growth. One obvious strategy would be to continue the approach taken in the past and add more restaurants. However, Maxwell is very concerned that effectively managing more restaurants and maintaining the quality of the customer experience would stretch the company thin and be extremely difficult to achieve. As a result, he has rejected opening more Lisa C's restaurants at this time. Maxwell and other senior managers have been considering alternative opportunities for growth. The most promising alternative is the sale at grocery stores of prepackaged versions of Lisa C's most popular desserts. Two alternative approaches for Corner Table to sell frozen desserts have been developed. The first approach is a widespread distribution strategy, whereby frozen desserts would be offered to any grocery store or supermarket chain that wants to sell them. The second approach is an exclusive distribution strategy. Under this approach, one supermarket chain would be selected as the exclusive retailer of Lisa C's frozen desserts. Maxwell Alexander has assigned students the task of analyzing whether Corner Table should sell Lisa C's desserts through grocery stores, and if so, which potential growth strategy should be pursued.

Keywords: capital budgeting, finance, expansion, teaching case, project analysis

TEACHING NOTE – CORNER TABLE INCORPORATED: ESTABLISHING A FROZEN FOOD DIVISION

Case Overview

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One obvious strategy would be to continue the approach taken in the past and add more restaurants. However, Maxwell is very concerned that effectively managing more restaurants and maintaining the quality of the customer experience would stretch the company thin and be extremely difficult to achieve. As a result, he has rejected opening more Lisa C's restaurants at this time.

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Maxwell Alexander has assigned students the task of analyzing whether Corner Table should sell Lisa C's desserts through grocery stores, and if so, which potential growth strategy should be pursued.

Learning Objectives

The purpose of this case is to give students the opportunity to conduct an in-depth analysis of two mutually exclusive projects and then determine which, if either, should be pursued. The case incorporates many of the elements often taught in an introductory finance course at the MBA or undergraduate level.

To decide among the two expansion opportunities, students must compute the net present value of each alternative. This process involves two primary tasks. First, students must analyze a variety of information to determine the relevant expected annual cash flows for each expansion strategy. Second, students must ascertain the appropriate discount rate for each project. The cost of capital for each project can be found by computing the firm's weighted-average cost of capital and adjusting it for the relative risk of each expansion alternative.

The firm's capital structure includes common stock, preferred stock, a bond, and a loan. For the common stock, monthly data are given that allow students to estimate beta and the expected return of Corner Table common stock. The expected return for the preferred stock and bond and the current market value of the loan must also be computed using information given in the case and standard models.

This case involves a great deal of number crunching. It gives students extensive opportunities to apply many financial models and incorporate many skills that are commonly taught in finance classes, especially ones covering basic fundamentals. The case also requires a written report, which provides students with the opportunity to develop writing and data presentation skills.

The case is easy for instructors to modify to be more consistent with their approach to the material. For example, in the provided solutions, beta is estimated from excess returns using the rate on three-month Treasury Bills as a proxy for the risk-free rate. However, beta could be estimated other ways such as with a traditional market-model approach with unadjusted returns. If the estimation were done differently in Excel, all the relevant numbers would change automatically and the instructor would be able to easily see the effect of any changes.

An Excel workbook with all relevant quantitative analysis is available to instructors.

CASE – CORNER TABLE INCORPORATED: ESTABLISHING A FROZEN FOOD DIVISION

Company Overview

Corner Table Incorporated began operating on February 3, 1993, when it opened its first Lisa C's restaurant in Frederick, Maryland. It was an instant hit. The restaurant's assortment of delicious desserts attracted a tremendous amount of attention and resulted in strong customer loyalty. The desserts were so beloved that customers would wait up to several hours for the opportunity to enjoy one of several daily specials referred to as "Treats from Grandma's Kitchen."

By mid-1993, it became clear to Maxwell Alexander, president of Corner Table, that he should expand the company by opening a restaurant at another location. The second Lisa C's was opened in Baltimore in 1994. Like the first restaurant, it was an immediate success. Waits of up to three hours were not uncommon. Over the next several years, Corner Table continued to expand by opening new restaurants throughout Maryland. In each case, customers were passionate about the restaurant's desserts.

On January 1, 1999, Corner Table issued common stock in an initial public offering to raise funds for an even more aggressive expansion into several neighboring states. Four years later, preferred stock was issued to raise additional funds. Two years ago, on January 1, 2009, a 15-year bond was issued to help finance additional expansion.

Today (January 1, 2011), Corner Table owns and operates a chain of 47 Lisa C's restaurants in six states. To raise funds, the firm has issued common stock, preferred stock, and a fixed-rate bond, as well as taken out a bank loan.

Capital Structure

Corner Table has 15 million shares of common stock outstanding. The stock is currently priced at $21.87 per share.

Corner Table also has two million shares of preferred stock outstanding priced at $31.69 per share. The stock has paid an annual dividend of $2.25 on every December 31 since 2003. The dividend is expected to remain unchanged.

Monthly rates of return for three-month Treasury bills, month-end share prices for Corner Table common stock, and month-end values for the Traders 1000, a widely used index to estimate returns for the entire stock market, are reported in table. Data from December 31, 2005, to December 31, 2010, are provided.

Corner Table's third source of public financing is a bond issue that was initially sold to the public on January 1, 2009, with a maturity of 15 years. The 150,000 bonds outstanding have a face value of $1,000 each and a fixed annual coupon rate of 7.76 percent. Coupons are paid annually on December 31, and all principal is scheduled to be repaid at maturity on December 31, 2023. The bonds are currently selling for $968.66.

Finally, Corner Table took out a loan for $150 million from Frederick Financial. The loan was taken out on January 1, 1998, for 20 years and matures on December 31, 2017. At the time of origination, the overall level of interest rates was high and Corner Table was viewed as being quite risky, so the annual interest rate on the loan is substantial at 12.4 percent. The loan involves annual interest payments on December 31 with all principal repaid at maturity. Today, if Corner Table were to take out a loan for $150 million that matured on December 31, 2017, the bank would charge it an annual interest rate of 5.7 percent.

Current situation

Corner Table has been a successful, profitable, and growing company for almost 2 decades. New restaurants have been opened, and they have not only been profitable, but they have continued to deliver consistently good service and delicious food, especially the desserts. Maxwell Alexander is in the process of determining how to continue the company's tradition of successful growth.

One obvious strategy would be to continue the approach taken in the past and add more restaurants. However, Maxwell is very concerned that effectively managing more restaurants and maintaining the quality of the customer experience would stretch the company thin and be extremely difficult to achieve. As a result, he has rejected opening more Lisa C's restaurants at this time.

Therefore, Maxwell and other senior managers have been considering alternative opportunities. To assist them with this process, they hired Pasha Consulting on December 31, 2009, to explore possible options for expansion. The contract between Corner Table and Pasha called for an immediate payment to Pasha of $200,000, as well as annual payments of $100,000 two and three years after the consulting firm was initially hired. Each of these $100,000 payments would increase to $150,000 if Corner Table were to adopt one of Pasha's proposed strategies.

The most promising alternative that Pasha has proposed is the sale of prepackaged versions of Lisa C's most popular desserts at grocery stores. Moreover, the consulting firm identified a manufacturer, Shingo Corporation, that has developed specialized equipment and processes that can make frozen versions of three of Lisa C's most popular desserts—Peanut Butter Cookie Bombs, Stockholm Apple Pie, and CrumbleBerry Cobbler.

One week ago, when Maxwell tasted Shingo's versions of his company's desserts, he was very impressed with the similarity between the restaurant and frozen versions of each dessert. Being a very impulsive person, Maxwell immediately created the frozen food division and decided that, as long as the numbers supported it, the next phase of Corner Table's growth would involve selling the three desserts through retail distribution.

Pasha has developed two alternative approaches for Corner Table to sell frozen desserts. The first approach is a widespread distribution strategy, whereby the three frozen desserts would be offered to any grocery store or supermarket chain that wants to sell them. The primary advantage of this strategy is that it would enable Corner Table to sell high volumes, which would result in expected economies of scale and relatively low production and distribution costs.

The second approach is an exclusive distribution strategy. Under this approach, one supermarket chain would be selected as the exclusive retailer of Lisa C's Treats from Grandma's Kitchen. The primary advantage of this strategy is that the supermarket chain, and therefore Corner Table, would be able to charge a premium for the desserts. Moreover, the supermarket chain would contribute heavily to marketing costs.

Widespread distribution approach

If Corner Table pursues the widespread distribution approach, the firm expects that sales would be sufficiently high that purchasing the necessary equipment from Shingo would be more cost-efficient than paying Shingo to produce the desserts for them. The equipment needed to manufacture all three types of desserts would cost $11,500,000. Payment would be due immediately. The equipment would be depreciated straight-line to $1,000,000 over 7 years. Corner Table believes that it would be able to sell the used equipment for $2,700,000 on December 31, 2016.

Production and sale of frozen desserts could begin immediately, and Corner Table anticipates selling 350,000 frozen desserts in 2011 for $10.00 each. The desserts are expected to be popular and unit volume is expected to increase annually by 50 percent from January 1, 2012, through December 31, 2013; by 25 percent from January 1, 2014, to December 31, 2016; and by 8 percent thereafter. The unit price of the desserts is expected to increase at the rate of inflation, which has been forecast to be 3.5 percent per year.

Under the widespread distribution approach, Corner Table would have a variety of variable annual costs. First, Corner Table would be obligated to pay Shingo a fee of 40 cents per unit sold. This fee is not expected to change over time. In addition, other variable costs such as ingredients, labor, electricity, distribution costs, etc. are expected to equal 45 percent of the total revenues from selling frozen desserts.

In 2011, Corner Table expects fixed costs, except for marketing costs, to be $81.5 million if the firm pursues the widespread distribution strategy. If the firm does not expand into frozen food distribution, fixed costs, except for marketing costs, are expected to be $76.2 million. Regardless of whether Corner Table expands into the widespread distribution of frozen desserts, fixed costs are expected to increase annually by 5 percent.

In addition to the fixed costs noted in the previous paragraph, the firm also has annual marketing costs. Without widespread distribution of frozen desserts, the firm's total marketing costs would be allocated evenly to each of Lisa C's 47 restaurants, with each restaurant being allocated a marketing expense of $60,000 in 2008.

If Corner Table pursues widespread distribution of frozen desserts, then total marketing costs for the firm are expected to be $3,200,000 in 2011. Of this total, 70 percent would be allocated to the existing restaurant division of Corner Table and 30 percent would be allocated to the newly created frozen food division. Like the other fixed costs, total marketing costs are expected to increase by 5 percent a year, regardless of whether or not Corner Table pursues widespread distribution of frozen desserts.

Incremental net working capital associated with frozen food activities at the end of any given year is expected to equal 27 percent of the revenues forecast for the following year. Net working capital associated with frozen foods was zero on December 31, 2010, but would equal

27 percent of the revenues forecast for 2011 on January 1, 2011, at the start of the project if the widespread distribution approach to growth was pursued.

Annual cash flows through December 31, 2016, associated with Corner Table's strategy of growing through widespread distribution of frozen desserts should be carefully estimated based on all relevant information. However, for cash flows after December 31, 2016, Corner Table believes that a more general approach can be taken, as the project will have matured and sales growth will have moderated by then. Corner Table expects total project-related cash flows in 2017 to be $1,400,000, and that cash flows will grow steadily by 4 percent a year after December 31, 2017.

Corner Table believes that selling frozen desserts through supermarkets is riskier than the company's traditional activities associated with operating restaurants. As a result, the firm believes that the appropriate discount rate for the project is equal to 2.00 percentage points more than the discount rate it would use on a project that is of average risk for the company.

Exclusive distribution approach

The exclusive distribution approach to frozen-food sales involves making a single, large supermarket chain the exclusive seller of Lisa C's frozen desserts. Maxwell Alexander believes that grocery retailers would be interested in becoming the exclusive seller of Lisa C's desserts, and interviews of leading grocers by Pasha Consulting confirms this belief.

If Corner Table undertakes the exclusive distribution approach, the company does not forecast sales being sufficiently high that purchasing equipment from Shingo Corporation would be cost efficient. Instead, Corner Table would contract production of all desserts to Shingo, which would be paid an estimated amount each year equal to 78 percent of the revenues from the sale of frozen desserts during that same year. Corner Table expects no other variable costs.

Under the likely terms of an arrangement with Shingo, production could begin immediately. Corner Table anticipates selling 80,000 frozen desserts in the first year for $14.50 each. Note that this volume is much smaller than under the widespread distribution approach, but that the anticipated price is higher.

The desserts are expected to be popular and unit volume is expected to increase annually by 40 percent from January 1, 2012, through December 31, 2014; by 20 percent from January 1, 2015, to December 31, 2018; and by 5 percent thereafter. The unit price of the desserts is expected to increase by 4.0 percent per year, slightly more than the forecast rate of inflation.

In 2011, Corner Table expects fixed costs, except for marketing costs, to be $77.9 million if the firm pursues the exclusive distribution strategy. If the firm does not expand into frozen food distribution, fixed costs, except for marketing costs, are expected to be $76.2 million. Regardless of whether Corner Table expands into the widespread distribution of frozen desserts, fixed costs are expected to increase annually by 5 percent.

In addition to the fixed costs noted in the previous paragraph, the firm also has annual marketing costs. Without exclusive distribution of frozen desserts, the firm's total marketing costs would be allocated evenly to each of Lisa C's 47 restaurants, with each restaurant being allocated a marketing expense of $60,000 in 2011.

One of the benefits of the exclusive distribution approach is that Corner Table expects its retail partner to make a substantial contribution to marketing the products. As a result, under exclusive distribution, total marketing costs for the firm are expected to be $2,000,000 in 2011. Of this total, 80 percent would be allocated to Corner Table's restaurant division and 20 percent would be allocated to the newly created frozen food division. Like the other fixed costs, total marketing costs are expected to increase by 5 percent a year, regardless of whether or not Corner Table sells frozen desserts.

Incremental net working capital associated with frozen food activities at the end of any year is expected to equal 18 percent of the revenues forecast for the following year.

Annual cash flows through December 31, 2018, associated with the exclusive distribution of frozen Lisa C's desserts should be carefully estimated based on information provided. However, for cash flows after December 31, 2018, a more general approach can be taken, as sales growth is expected to have reached its long-term level by that time. Corner Table believes that total project-related cash flows in 2019 will be $300,000 and that total cash flows will grow steadily by 3 percent a year after December 31, 2019.

Corner Table believes that selling frozen desserts through exclusive distribution is not only riskier than its traditional activities associated with operating restaurants, but riskier than widespread distribution of frozen desserts. As a result of the high level of risk associated with the exclusive approach, Maxwell believes that the appropriate discount rate for exclusive distribution is equal to 4.00 percentage points more than the discount rate it would use on a project that is of average risk for the company.

Assignment

Maxwell Alexander has assigned you the task of analyzing how Corner Table should proceed. Specifically, he wants a written report that answers the following question:

Should Corner Table choose the widespread distribution approach, the exclusive distribution approach, or neither?

Maxwell Alexander has a short attention span. He wants the main body of the report to be no more than three pages long (double spaced, 12 point Times New Roman font, and at least 1 inch margins). The main body should include an introduction and conclusion, as well as one or more main sections that summarizes and discusses all analysis.

Despite the strict page limit on the body of the report, Maxwell knows that assertions, comments, discussion, and suggestions must be well supported, so he has placed no limit on the number and length of appendixes that can be included. Although he has a short attention span, many of Corner Table's highly paid executives, including the chief financial officer, prefer details to be thoroughly and clearly presented.

Additional notes and information

This section provides notes and information that may assist in the analysis of the two growth alternatives:

•Whenever relevant, use information over as long a period of time as possible.

•Use the most appropriate approach to estimate the value and expected return for each type of equity and debt.

•Do not round any calculations. For example, any monetary figure such as a stock dividend, dessert price, or total costs should not be rounded to the nearest penny. Moreover, any figure expressed as units such as the number of frozen desserts sold in a year should not be rounded to the nearest whole number. Although rounding should not be conducted in calculations, students should present figures in tables and text in ways that are clear and informative. This likely involves rounding figures that are presented.

•In future years, Corner Table plans to maintain the same proportions of common and preferred equity, short- and long-term bonds, and short- and long-term loans as it has now.

•The corporate tax rate is 40 percent.

•Currently, the annual rate of return on three-month Treasury bills is 5.40 percent and the expected annual return on the Traders 1000 is 12.50 percent.

•If taxable income associated with an approach to expansion is negative, then assume that incremental income taxes paid would be negative, as the negative income from the expansion project could be used by Corner Table to offset positive taxable income from restaurant activities.

•Unless clearly stated otherwise, assume information reflects incremental frozen-food activities.

• Cash flows that take place over a year, such as those associated with revenues and expenses, should be treated as taking place at the end of the relevant year. So for example, revenues and expenses for 2012 should be treated as taking place on December 31, 2012.

Table 1			
Monthly financial data, December 2005 to December 2010			
	Month-end index value or share price adjusted for dividends (in dollars)		Average monthly return for 3-month Treasury bills (in percent)
Month	Traders 1000	Corner Table common stock	
Dec-10	801.20	21.87	0.45
Nov-10	808.43	22.68	0.44
Oct-10	812.36	22.56	0.45
Sep-10	771.64	22.22	0.44
Aug-10	761.43	22.85	0.44
Jul-10	743.17	21.88	0.44
Jun-10	740.46	21.31	0.44
May-10	711.31	21.73	0.43
Apr-10	723.95	19.88	0.44
Mar-10	760.15	22.63	0.43
Feb-10	725.12	22.52	0.42
Jan-10	729.97	23.43	0.42
Dec-09	729.64	22.72	0.42
Nov-09	724.00	22.10	0.39
Oct-09	699.70	19.64	0.39
Sep-09	687.99	18.12	0.39
Aug-09	712.70	17.15	0.39
Jul-09	683.38	17.13	0.39
Jun-09	703.48	19.26	0.38
May-09	679.05	18.30	0.39
Apr-09	691.08	18.34	0.39
Mar-09	647.83	16.36	0.40
Feb-09	672.93	17.00	0.39
Jan-09	698.08	15.12	0.39
Dec-08	661.51	16.17	0.39
Nov-08	690.79	15.37	0.39
Oct-08	669.07	15.11	0.39
Sep-08	655.54	13.82	0.38
Aug-08	624.16	12.65	0.37
Jul-08	629.41	11.62	0.36
Jun-08	638.99	12.01	0.37
May-08	638.87	11.17	0.37
Apr-08	638.78	12.45	0.38
Mar-08	631.16	12.54	0.38
Feb-08	653.20	13.93	0.38
Jan-08	641.16	13.24	0.38
Dec-07	644.74	11.05	0.39
Nov-07	644.91	11.83	0.39

Table 1 (continued)			
Monthly financial data, December 2005 to December 2010			
	Month-end index value or share price adjusted for dividends (in dollars)		Average monthly return for 3-month Treasury bills (in percent)
Month	Traders 1000	Corner Table common stock	
Oct-07	592.59	11.24	0.39
Sep-07	598.90	11.57	0.40
Aug-07	567.70	10.47	0.41
Jul-07	584.64	11.23	0.42
Jun-07	556.57	10.13	0.43
May-07	554.47	10.46	0.42
Apr-07	548.68	10.16	0.42
Mar-07	513.47	9.99	0.42
Feb-07	483.46	9.82	0.42
Jan-07	479.45	9.79	0.41
Dec-06	496.30	11.11	0.42
Nov-06	492.69	11.05	0.42
Oct-06	533.69	11.90	0.42
Sep-06	513.74	12.62	0.41
Aug-06	456.55	12.09	0.41
Jul-06	507.15	13.07	0.40
Jun-06	527.05	12.75	0.41
May-06	574.19	13.81	0.41
Apr-06	597.59	13.56	0.42
Mar-06	613.84	14.64	0.42
Feb-06	665.48	15.10	0.43
Jan-06	619.76	15.19	0.44
Dec-05	646.21	15.08	0.39