

CULLOWHEE CONFECTIONARY COMPANY: A TEACHING CASE ON VALUING A FAMILY-OWNED BUSINESS

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CASE DESCRIPTION

This case is primarily concerned with developing criteria to evaluate a family business, the role of financial leverage and debt in developing a strategy, the role of family dynamics on business strategy, the use of financial and non-financial information to value family-owned businesses and evaluating a family-owned business in financial distress. Secondary issues include factors underlying growth, analyzing the business environment, and financing a buyout. The case has a difficulty level of three and is appropriate for junior level courses such as advanced managerial accounting, financial statement analysis or entrepreneurial strategy. Each timeframe (act) is designed to be taught in approximately half an hour and should require approximately three hours of outside preparation by students.

CASE SYNOPSIS

This teaching case covers two decades out of the history of Cullowhee Confectionary Company. As such, this case examines three distinct time periods of the company. Users may elect to cover the entire case or choose specific time periods that best meets the goals of the course; however, it is recommend that the entire case be presented so the background information can be used in all parts. Few accounting and finance cases deal with family owned (privately held) businesses. This case addresses unique issues frequently encountered in family businesses.

The case first addresses the topic of valuing a privately-owned family business and the difficulties of running a business when the owners have very different goals. Then, as the company faces changes in demand, the case flows into creating a new strategy and the creation of balanced scorecard and identifying performance measures. Finally, the company finds itself in facing financial issues and looks at how to value a family-owned firm in distress.

This case is based on real events and publicly available data. However, because we have taken some artistic liberties with the way the story is told, modified available data and added data where gaps in data availability existed, the names of the protagonists and company have been altered. We have taken great care to ensure that the changes made did not alter the actual dynamics and financial relationships for student analyses.

Key Words: *Business valuation, family-owned business, financial distress, strategy*

INTRODUCTION

Founded in the early 1900s, Cullowhee is among the oldest family owned and managed confectionery manufacturers in the United States. Cullowhee's product mix runs a full selection from peanut brittle to hollow chocolates. The company offers the most extensive array of fine high-quality chocolate and non-chocolate confections available in the marketplace. Historically, the company operated primarily in the fundraising sales channel selling seasonal items to schools, churches, clubs, associations, and other groups.

The confectionary production industry is profitable because companies use branding techniques to help consumers differentiate their brand from the competition. Since candy products are typically homogeneous, branding allows larger companies with well-known brands to pass on increasing commodity costs to consumers in the form of higher prices. Smaller companies that produce generic brands struggle to compete with the larger companies, as they have not established brand loyalty. However, price-sensitive consumers are likely to buy generic brands during tough economic times, which also benefits industry profitability.

In the past five years, consumers became more health-conscious due to increased media attention on the link between sugar consumption and diseases. For instance, according to *The New York Times*, high sugar consumption has been linked to diabetes in children throughout the past decade. This increased media attention has caused a growing number of consumers to lower candy consumption. However, industry revenue did not decline since major players, such as Mars, produced products that appealed to health-conscious consumers.

Finally, producers are increasingly using technology during production to improve operating efficiencies. At the same time the number of enterprises has declined at an annualized rate of about 1.6% to 372 in the five years to 2013 due to larger companies acquiring smaller companies to increase their market share and cut production costs.

ACT ONE: TOO MANY BRANCHES

Grace Alexander, the CEO and the great grandchild of the company's founders, her sister Callie Alexander and cousins Chloe and Anneke Nicholas along with the company's non-family management team emerged from yet another family stockholders' meeting in 2013 feeling the same frustration that plagued so many of the previous meetings. As the family has family tree has grown, so has the number of owners in the company. The once thriving ninety-year-old family business was feeling the weight of too many noninvolved family member heirs. While the managing family members wanted to reinvest the profits into the firm, the noninvolved family members wanted their inherited share of the profits without the burdens of ownership or management of the company. It was rapidly becoming apparent the continued survival of Cullowhee Confectionary would require a change.

Table 1
INCOME STATEMENT FOR CULLOWHEE CONFECTIONARY COMPANY
FOR THE PERIOD 2008– 2012
(\$ IN THOUSANDS)

	2012	2011	2010	2009	2008
Net Sales	\$ 8,730	\$ 9,018	\$ 8,998	\$ 8,781	\$ 8,783
Cost of Goods Sold	\$ 4,854	\$ 5,059	\$ 5,220	\$ 5,964	\$ 5,704
Gross Profit	\$ 3,875	\$ 3,960	\$ 3,777	\$ 2,817	\$ 3,079
Operating expenses					
Total distribution expenses	\$ 414	\$ 469	\$ 571	\$ -	\$ -
Total selling expenses	\$ 1,947	\$ 1,949	\$ 1,773	\$ 1,565	\$ 1,270
Administrative expenses	\$ 596	\$ 492	\$ 491	\$ 432	\$ 417
<u>Total operating expenses</u>	\$ 2,957	\$ 2,911	\$ 2,836	\$ 1,997	\$ 1,687
Operating profit	\$ 918	\$ 1,049	\$ 942	\$ 820	\$ 1,392
Other Expenses					
Total Other expenses	\$ 120	\$ 102	\$ 117	\$ 130	\$ 182
Net Earnings	\$ 798	\$ 947	\$ 825	\$ 691	\$ 1,210

The initial thoughts were to trim the branches by buying out the noninvolved heirs. Everyone wondered if this was even possible. Would the majority sell for a cash buyout? How much would it take and even more important, what was a fair price? They agreed on one thing; the art and challenges of saving both the company and the family became the new mission of the managing family members. Their challenge now is to create a buyout offer and refinancing structure.

ACT TWO: FALLING LEAVES

After the buying out the noninvolved family members, the company finds itself in a every changing market. The market changes and conditions have forced Cullowhee Confectionary to consider a broader market approach. With varying degrees of success, Cullowhee's Vice President for Marketing Anneke Nicholas opened new channels within the retail drug, grocery, mass merchandise and convenience store market segments. The company also successfully introduced several new products and found additional revenues through the contract manufacturing and private label market segments. By 2019, fund raising product sales have fallen from a majority of revenue to just 35% with the remainder coming from the new product/service operations mix. With the new strategy and focus in place, Anneke Nicholas wants to develop a Balanced Scorecard and Strategy Map to support her efforts. She would also like to investigate which marketing channels the company should pursue to further reduce the dependency on fund raising sales.

	Actual	Actual	Actual	Actual	Forecast
	2017	2018	2019	2020	2021
Net Sales	\$9,690	\$8,457	\$11,104	\$10,587	\$12,140
Cost of Goods Sold	\$5,406	\$5,234	\$7,600	\$7,423	\$7,807
Gross Profit	\$4,284	\$3,223	\$3,504	\$3,164	\$4,333
Operating expenses					
Total distribution expenses	\$708	\$636	\$561	\$476	\$525
Total selling expenses	\$2,143	\$2,211	\$2,619	\$2,388	\$2,452
Administrative expenses	\$731	\$961	\$900	\$822	\$727
<u>Total operating expenses</u>	\$3,582	\$3,808	\$4,080	\$3,687	\$3,703
Operating profit	\$702	(\$585)	(\$576)	(\$522)	\$601
EBITDA	\$1,151	(\$125)	(\$106)	(\$31)	\$1,187

	2020 (Actual)	2021 (Projected)
Fundraising	\$ 3.61 MM	\$ 4.33 MM
Wholesale-to-Retail National	\$ 4.58 MM	\$ 6.75 MM
DSD	\$ 0.41 MM	\$ 0.34 MM
Direct Retail & Misc.	\$ 0.41 MM	\$ 0.62 MM
Contract Manufacturing	\$ 1.49 MM	\$ 1.13 MM

ACT THREE: THE DROUGHT

By the end of 2020, Cullowhee is in financial trouble and has filed for Chapter 11 bankruptcy protection. The firm is highly leveraged due to the buyout of family members and the shift from the fundraising market to other channels. This change placed the emphasis on retail branding of Cullowhee's brands and private labeling efforts with major retail chains. Although making inroads, to date the projected performance expectations have not been met.

Cullowhee had established supplier relationships for its private label and branded product portfolio with both national and regional retail markets. It was hoped that this type of expansion would show continued growth. However, the final results were mixed. At the same time, Cullowhee's own brand showed some positive growth within regional retailers at approximately 10 percent per year since 2018.

In the new product area, the Company has developed a well-honed process for moving concepts to market in relatively short periods of time allowing Cullowhee to quickly respond to

market opportunities identified by customers. For example, the Company developed a premium confectionery product with a national retailer whereby the total timeframe for product conception from ingredient identification, flavor profile creation, to package/merchandising positioning to full production and first order fulfillment was five months.

While an impressive accomplishment from a management and operations perspective, sale volumes failed to meet overall expectations and profitability. When Cullowhee emerges from Chapter 11, it is looking for an investor. Based on the financial data in Table 2 Case (B), what would be an appropriate valuation of the firm?

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