CULLOWHEE CONFECTIONARY COMPANY: A SERIES OF TEACHING CASES ON VALUING A FAMILY-OWNED BUSINESS

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INSTRUCTORS' NOTE

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 case is designed to be taught in approximately 0.5 hours and should require approximately three hours of outside preparation by students.

CASE SYNOPSIS

This series of three short teaching cases cover two decades out of the history of Cullowhee Confectionary Company. Few accounting and finance cases deal with family owned (privately held) businesses. These cases address unique issues frequently encountered in family businesses.

The first case addresses the topic of valuing a privately owned family business and the difficulties of running a business when the owners have very different goals. The second case deals with creating a new strategy and the creation of balanced scorecard and identifying performance measures. Finally, the third case deals with valuing a family-owned firm in distress.

These cases are 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.

RESEARCH METHODS

These cases are based on real events and publicly available data. We also had the opportunity to interview several individuals with close ties to the real company. These individuals' stories and recollections have been combined with the public available information to tell the story from a narrator (i.e., authors) viewpoint. However, because we have taken some artistic liberties with the way the story is told, modified available data, and added data were 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 analysis.

TEACHING NOTES

Learning Outcomes

After successfully completing all parts of this case, students should be able to:
1. Develop criteria for evaluating a family-owned business.
2. Discuss alternative ways a small family-owned business can finance a buyout.
2. Discuss the role of financial leverage and debt in developing and deploying strategy.
3. Understand the role of family dynamics on business strategy for family-owned businesses.
4. Use (limited) financial and non-financial information to value family-owned businesses.
5. Evaluate family-owned businesses in financial distress.
6. Discuss factors underlying the growth with an industry
7. Analyze the business environment.

This case reviews three distinct time periods for the Cullowhee Confectionary Company. The instructor may opt to assign the entire case or choose to break the case into the individual acts. If you do break the case, it would be beneficial to supply all the financial information to students to assist in their decision-making process. The acts are named to reflect events that may be an indictor or issues with the sensitive cocoa tree and directly relates to each time-period in the confectionary company's life.

Suggested pre-work questions for Act One: Too Many Branches

1. Describe Cullowhee Confectionary's strategy.
2. Cullowhee's owners believe the company will be highly effective and can continue to grow in the next two years. Based on the data in Table 1, do you agree with their position?
3. What are the key factors underlying growth?
4. If the company decides to buyout the noninvolved family member heirs, what are the alternative ways the company can finance this buyout?

Answers and Additional In-Class questions (Act One: Too Many Branches)

1. What is Cullowhee's Strategy?

Cullowhee's strategy was to manufacture and sell chocolate and other confectionary products through the fundraising sales channel. After 2012, the company used a more diversified approach by trying to grow the company through product and sales channel development.

2. Based on the income statements provided in table 1, how likely is it in your opinion that the company can continue to grow over the next two years?

The income statements suggests that net income will be between $800K and $1M. Growth in administrative expenses (+15%) could be a concern.

3. What are the key factors underlying growth?

- high quality product
- competitors
- expansion
- new markets (international growth)

4. What are the alternative ways the company can finance a buyout of noninvolved family member heirs?

There are several ways the company may finance a buyout. These alternatives may include:

a. Personal funds of the involved members
b. Small business loans (SBA)
c. Seller financing – work out a payout structure with the noninvolved family members
d. Leveraged buyout – leverage some of the assets of the business to assist in the finance of the buyout. Normally this is done in combination with other methods, such as seller financing and/or SBA loans.

Provide an analysis of Cullowhee Confectionary's environment.

Porter's five forces

Buyers have significant power especially in the retail channel.

Suppliers. Cullowhee mainly uses commodity products. Individual suppliers have limited power.

Potential Entrants. For the chocolate and convention fundraising market, potential entrants include other producers of private label candies as well as national brands like Hershey and Mars.

Substitutes. In the fundraising market, Cullowhee faces competition from a variety of product offerings. See http://www.fundraising-ideas.org/location/ for an overview of fundraising alternatives.

Competitors. The fundraising market is very competitive. Cullowhee does face competition from other candy producers as well as other products.

The participating owners are interested in buying out the non-participating owners. What information would you like to have available to value the company?

Common answers include earnings, EBITDA, revenues. Common finance models are developed for publicly traded companies. An open question is how these models translate to privately held firms. These models typically use Earnings per Share (EPS), Dividends per Share (DPS), Free Cash Flows, etc.

How much is the company worth? How much should the participating owners offer the non-participating owners for their shares?

Because of the limited financial data that had been made available, students will have to make some assumptions.

There are several models one can use to value the company.

1. A multiple of revenues.

In practice it might be difficult to find similar firms. Noting that competitors like Hershey are publicly traded and therefore not necessarily a good comparison. EPS Diluted) for Hershey during the time of this case is 2.96 (2.93). Stock Price at December 31 was $67.44 and a P/E ratio of 22.8.

2. An alternative would be the use of free cash flows.

$$FCFE = Cash\ flow\ from\ operations - capital\ expenditures + net\ borrowing$$

Using operating profit as a proxy for cash from operations, assuming there are no new investments (the reason the participating owners are considering buying out the non-participating owners) and a required rate of return 10% with a growth rate of 0%, the equity would be valued at almost $6.3 million. When the growth rate is 5%, the value increases to $15.8 million.

Cullowhee Confectionary Company
($ in 000s except for shares outstanding and value per share)

Required rate of return	10%					
Growth rate	0%					
		2008	**2009**	**2010**	**2001**	**2012**
Cash from Operations		918	1,049	942	820	1,392
Cash Investments		-	-	-	-	-
Free Cash Flow		918	1,049	942	820	1,392
Discount rate		1.1000	1.2100	1.3310	1.4641	1.6105
PV of free cash flows		834	867	708	560	864
Total PV of free cash flows	3,833					
Continuing value	13,920					

(CV)	
PV of CV	8,643
Enterprise Value	12,476
Book Value of Net Debt	6,200
Value of Equity	6,276
Shares outstanding	1,000
Value per Share	$ 6,276

3. Using the earnings and dividends policy (pay-out 80% of earnings) in a residual earnings model, the firm would be valued at $7.7 million.

Cullowhee Confectionary Company						
		Future RE = constant				
Required rate	10.0%					
		2008	**2009**	**2010**	**2011**	**2012**
Dividends		967.20	552.80	577.50	662.90	558.60
Earnings		1,210.00	691.00	825.00	947.00	798.00
Dividends reinvested			96.72	55.28	57.75	66.29
Cum dividend earnings			787.72	880.28	1,004.75	864.29
Normal earnings			1,329.90	760.10	907.50	1,041.70
Abnormal earnings growth			(542.18)	120.18	97.25	(177.41)
Discount rate			1.10	1.21	1.33	1.46
Present value of RE			(492.89)	99.32	73.07	(121.17)
Total PV of RE		(441.68)				
Total earnings to be capitalized		767.32				
Value per share		7,673.23				

Note that because all the owners are family, it is very important to arrive at a price that is "fair".

The next challenge is to find the resources to finance the buyout. How should the participating owners finance the buyout?

Ideally the owners would finance the buyout with a mixture of equity and debt. Because of the relatively large amounts involved, the participating owners had to use significant amounts of debt financing. How does this affect the company's strategy?

Because the firm is now highly leveraged, it limits the investment opportunities. The presence of debt covenants will restrict the owners' ability to purchase inventory, machinery, and spending on marketing and R&D.

Act Two: Falling Leaves Suggested pre-work assignments and questions.

1. Create a Balanced Scorecard and Strategy Map for Cullowhee Confectionary Company
2. Create pro-forma income statements for the next two years. Include your assumptions for growth/decline in revenues, gross margin percentage, and growth of SG&A expenses.
3. Is Cullowhee's growth sustainable?
4. Which marketing channel should Cullowhee pursue to reduce its dependency on fundraising sales? Why?

Answers and In-Class Assignments (Act Two: Falling Leaves)

1. Create a Balanced Scorecard and Strategy Map for Cullowhee Confectionary

Cullowhee's new strategy focusses on reducing its dependency on the fundraising channel.

Balanced Scorecard

- *Financial Perspective*: revenue growth in wholesale to retail market, revenue growth in direct retail market segment.
- *Customer perspective*: repeat orders, customer satisfaction,
- *Internal processes*: Change-over times, lead-times, employee turnover
- *Innovation & Growth*: # of new product launches, # of number of new retail outlets carrying the product.

2. Create pro-forma income statements for the next two years. Include your assumptions for growth/decline in revenues, gross margin percentage, and growth of SG&A expenses.

Answers will vary. Reasonable assumptions include small to no growth. Sensitivity analysis will aid a discussion on the challenges of valuation in general and especially evaluating family-owned businesses.

3. Is Cullowhee's growth sustainable?

Industry analysis shows that the market for candy has been increasing by an annual rate of about 5% but is expected to be stable for the next few years.

4. Which marketing channel should Cullowhee Confectionary Company pursue to reduce its dependency on fundraising sales? Why?

Students could perform Porter's 5 forces analyses for the various channels, margin analyses using industry averages, or use blue ocean strategy. Answers here will vary.

Provide an analysis of Cullowhee Confectionary Company's environment.

Suggested framework is PEST analysis:

- Political factors include taxation, tariffs, health education, and infrastructure.
- Economical factors include economic growth, interest rates, inflation
- Social factors include culture, health consciousness, population growth, age distribution,
- Technological factors include R&D, automation, and innovation.

Political

New legislation pushing for healthier snacks in school has reduced the ability to generate sales through fund raising in schools.

Economical

The Candy Production industry produces and sells a range of non-chocolate confectionery products including soft candies, hard candies and chewing gums. The common input to all of these products is sugar which increased 1.7% between 2015 and 2020. Sugar cost and the development of new health-conscience products drove industry revenue over the past five years. Industry revenue increased 2.3% in the five years up to 2020 to total revenues of $9.9 billion; but any decline in future sugar pricing could have a negative impact on revenues.

While the demand for chocolate production declined 2.3% between 2015 and 2020, demand from confectionery wholesalers grew during this period as American households are demanding more non-chocolate confectionery products and there are many established brands that consumers purchase. As consumer demand for candy remains relatively stable, retailers such as grocery and convenience stores will demand industry products from confectionery wholesalers.

Social

In the past five years, however, there was a decline in per capita sugar and sweetener consumption as the media linked sugar consumption with diseases such as diabetes. More Americans became health-conscious during this time and reduced their consumption of confectionery products, hampering potential revenue growth. This presented a challenge to producers as they decided how to appeal to the growing number of health-conscious consumers.

Technological

In order to appeal to health-conscious consumers, producers started developing and marketing sugar-free and organic candies. Product innovation is expected to continue as consumers demand more sugar-free and low-calorie options. For example, sugar-free gums have become a mainstay on the shelves over the last 10 years. As of 2020, sugar-free gum accounted for 85% of the chewing gum market sales and almost 20% of revenue. For example, Wrigley a subsidiary of Mars, introduced *Orbit White* sugar-free chewing gum in 2016. Many sugar-free chewing gums have been awarded the American Dental Association's Seal of Acceptance because a study showed that chewing sugar-free gum for 20 minutes after eating stimulated saliva flow, reduced plaque acids and strengthening teeth. *Extra* is at the top of the market with approximately 528 million in sales in 2020.

Organics and natural products have also grown dramatically as ingredients such as high fructose corn syrup, preservatives, artificial colors have become a major concern with consumers. Sales of USDA certified organic products has increased in recent years. Gary Ricco, CEO of Mount Franklin Foods stated “there is a greater awareness and understanding of these certifications among consumers …. They are looking for products with these certifications, even in their snacks and treats."

In addition to sugar-free gum, companies introduced new candies and flavors. For example, the Jelly Belly Candy Company created a beer flavored jellybean in 2019. The company also experienced a boost in revenue during these years. Companies have also moved towards more adult chewy candy, which includes granola. The chewy candy segment generates approximately 32% of the revenue for the candy industry in 2020. Many companies consistently introduce new candies and flavors to keep brand-loyalty consumers happy as well as attempt to attract new consumers. By introducing new candies and flavors, major players are able to grow their market share and make the industry more concentrated.

Act Three: Suggested pre-work questions (Act Three: The Drought)

By the end of 2020, Cullowhee is in financial trouble. The firm is highly leveraged due to the buyout of family members and the shift from fundraising market to other channels has not been successful. When Cullowhee emerges from Chapter 11, it is looking for an investor.

1. Based on the financial data in Table 2, what would be an appropriate valuation of the firm? How do you value a firm in financial distress, highly leveraged, with negative earnings?
2. Based on this information, would you invest in Cullowhee Confectionary Company? Support your answer.

Answers

1. Based on the financial data in Table 2, what would be an appropriate valuation of the firm? How do you value a firm in financial distress, highly leveraged, with negative earnings?

Traditional valuation models are based on the going concern assumption. In this case, the going concern assumption might be an issue. Hence, discounted cash-flows (DCF) valuation with the terminal value calculations will not be appropriate. Also, the use of relative valuation (i.e., comparing valuation to valuation of other i.e., healthy firms) would not be appropriate. Possible options for using the DCF include simulation, modified DCF valuation (using probability distributions), or use the DCF model but make an adjustment for the probability of distress and its impact. For a thorough review of valuing firms in financial distress see Damodaran (2012). The lower bound of the valuation would be the market value of the firm's net assets.

Other considerations may include attempts at the valuation of an established brand or brand equity. In addition, several new relationships and private branding opportunities have been developed but not financially realized. Considerations of Customer Lifetime Value may also be appropriate issues to consider in a valuation.

2. Based on this information, would you invest in Cullowhee Confectionary Company? Support your answer.

Answers will vary for this portion. Students should show clear support for their position if they would or would not invest in Cullowhee Confectionary Company. Inform students that in the end, the company was sold to outside investors. Today, the company is still operational;

however, the original family only holds a 15% ownership in the company is no longer active in the operations.

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