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Paul M. Klekner (B)

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[1] This case was prepared by ROGER R. SCHNORBUS, Executive-in-Residence, Robins School of Business, at the University of Richmond, from various sources and will be used in his Mergers/Acquisition classes, dealing with Strategy and Valuation. The case is not intended to serve as an illustration of either effective or an ineffective handling of a business situation. This is a fictitious case study, including the name of the restaurant and the people involved.

BEGINNINGS

Paul Klekner graduated first in his class from the Culinary Institute of America (CIA) in 1998; his fellow students named him the chef most likely to succeed in the future. After graduation, he and his wife, Sarah, moved back to his home in Richmond, Virginia where he was employed as a chef at several restaurants including Bottega and Old Original Bookbinders.

In 2003, he decided to open his own restaurant, Rogerios, in the Tobacco Row section of Richmond. With an inheritance of $300,000 he received from his grandfather and borrowing $100,000 from SunTrust, a local bank, Paul felt that he had the financial resources necessary to begin this venture.

BUSINESS PLAN

With the help of an outside management consultant, Paul constructed a business plan which contained the following excerpts.

A) Business Opportunity – open a 4,500 square foot, 120 seat restaurant; menu would feature upscale pizza, upscale salads, pasta entrees, appetizers and diverse beverages including draft and imported beers, Virginia wines and special drinks, such as martinis and pina coladas. .

B) Target Customers – Active young professionals who typically eat out 2-3 times a week, including urban professionals, high rise renters in Tobacco Row, young singles and baby boomers with children.

C) Restaurant Industry – Sales growth in real terms in the total restaurant industry was projected to be approximately 2% per annum from 2005 to 2010; however, certain segments of the industry, including upscale pizza and pasta, were projected to grow at 5% for the same time period.

D) Marketing Plan

1. Brand – Rogerios is a very popular neighborhood restaurant located in the Tuscany region of Italy. Klekner visited this restaurant in 2001 and was fascinated by the fact that Rogerios attracted local residents on a frequent basis. The draw was a combination of good food, great beverages, and excellent service. Klekner felt the brand and concept would be ideal for Richmond.
2. Pricing Strategy – None of the 12 pizza varieties offered on the menu would be priced above $12; the same for the 6 pasta entrees and 4 specialty salads. Gross margins on the beer, wine and specialty drinks (martinis) would average over 60%.
3. Promotion – Klekner, with the help of a marketing consultant, put together a promotion plan targeted toward residents of the Tobacco Row, Church Hill, Shockoe Bottom and Shockoe Slip areas of Richmond. Such residents would receive direct mailings and door-to-door fliers announcing the opening of the restaurant followed by monthly mailings giving menu specials, etc. He would also receive “free” radio time in exchange for gift certificates to the restaurant. Lastly, a website would be established.

E) Operating Plan

1. Location – Rogerios would be located in a vacated building on Main Street in the heart of Tobacco Row. Although vacant for 2 years, the building was in relatively good condition and contained 4,500 square feet on the first floor and a 1,500 square foot apartment on the second floor. The first floor space had previously been used as a restaurant which would help in modernizing the facility at an affordable cost. Klekner envisioned using the apartment as a residence for he and Sarah.

2. Lease / Purchase – Since the commercial real estate market was weak in Tobacco Row, Klekner knew he had the "upper hand" in negotiating the lease / purchase of the building. Therefore, he was able to secure the following concessions:

   a) The landlord provided him with a build out allowance of $15 / sq. foot or $68,000 to outfit the restaurant and $15,000 to modernize the apartment.

   b) Klekner would receive free rent for the first 6 months for the restaurant space and apartment.

   c) If he purchased the building, all rents paid would be applied to the purchase price. This would amount to approximately $400,000 – see Exhibit 1.

   The specifics of the lease purchase were as follows.

   For the first floor space the lease would be 5 years beginning January 1, 2005 and ending on December 31, 2009. At the end of the lease term, Klekner had the option to buy the entire building at a price of $750,000 or continuing the lease for 3 additional 5 year periods. The terms of the lease called for a payment of $10 / sq. foot for the first year, followed by an increase to $12 from year 2 through year 5. If the purchase option was not exercised at the end of year 5, the rent would increase to $14 / sq. foot for the next five years followed by increases to $16 and $18 / sq. foot for the remaining two 5 year terms.

   For the apartment, the lease was $1,000 per month for the initial 5 year term. No provision was made beyond five years, as Klekner envisioned a move to a home by then.

F) Management Team

Paul Klekner (Owner/Chef)
Mr. Klekner, age 32, would serve as the owner/chef of Rogerios. In such role, he would function as both the overall general manager and head chef of the restaurant. He would be responsible for all back end (kitchen) operations, including procurement. In addition to his chef training at the Culinary Institute of America, Klekner attended classes in business at the School of Continuing Studies at the University of Richmond.

Jack Clynick (Manager of Operations)
Mr. Clynick, age 37, would serve as Manager of Operations. In such capacity, he would supervise the front end operations of the restaurant as well as the bar. Clynick

holds an Associate Degree in Business; he also managed front end operations at both Ruth Chris' Steakhouse and Bottoms Up Pizza.

Jim Picanza (Accountant)
Mr. Picanza, age 31, would serve as a part-time accountant for Rogerios. Picanza holds a degree in accounting from Radford University and is a licensed CPA.

John Gramas (Attorney)
Mr. Gramas, age 29, would serve as part-time attorney for Rogerios. In such capacity, he would incorporate the restaurant as a Limited Liability Corporation (LLC) in Virginia and handle all legal matters. Gramas owns his own legal practice specializing in real estate.

Sarah Klekner (Bookkeeper)
Ms. Klekner, age 31, is Paul's wife; she would be the bookkeeper for the restaurant and assist Paul in both the procurement and marketing functions.

G) Financials **-** With the assistance of Mr. Picanza, Klekner developed the Proforma Income Statement for Fiscal 2005 which is contained in Exhibit 2. A profit of $87,520 was projected aided by six months of free rent. The statement included a $100,000 owner's expense per annum (5 years) which Klekner imposed in the business for the startup funds he invested. Also included in the payroll expense were salaries of $75,000 and $40,000 for Paul and Sarah.

From 2006 to 2009, Picanza and Klekner projected annual revenue and profit increases of 5% per annum. They considered the proforma to be very conservative and a worst case scenario. Also allowances for pricing and inflation were not projected beyond 2005.

EVENTS

Restaurant Opening

Rogerios opened for business in January 2005. As a result of several mailings to residents in the Tobacco Row area, newspaper ads, and press releases, the opening was a great success, with sales exceeding projections by 15% for the first 3 months. During this time period, Klekner worked every day at the restaurant and spent late evening hours reviewing financial results, menu changes, staff additions, etc.

Results (2005) – See Exhibit 3

Revenue

Revenue in 2005 was $2,176,000, exceeding the proforma budget of $2,048,000 by 6.25%. This was somewhat disappointing to Klekner because of the strong start; however revenue during the summer weakened as a result of very hot weather but finished with a strong December.

Profitability

Profits in 2005 were $55,180 falling short of the proforma budget of $87,520 by 37%. The main areas of concern were food and payroll costs which exceeded the budget by 5 and 10% respectively. Also controllable expenses exceeded budget because of higher legal and accounting fees.

Issues (2005)

Operations – From an operational standpoint, a prime issue was increasing the speed in which pizza was made since over 75% of food sales were pizza.

Management – The management team was spread very thin and Clynick was pressing for a sizeable pay increase.

Fiscal 2006 Action Plans

Financial – To address the profitability issue, the management team decided to raise menu prices by 10% for 2006. This would necessitate raising the price point of all pizza varieties above $12. For food costs, it was decided that better control was needed in the kitchen area in terms of portion sizes. However, no specific plan was discussed to accomplish this. It was also decided that no pay raises would be given to wait staff and kitchen staff, since their wages were already higher than local competitive rates.

Operations – Regarding the speed that pizza was made, Klekner felt that the best solution would be to have the pizza dough made by an outside vendor and delivered to the restaurant on a daily basis. This would free valuable space in the kitchen and lower cost on a long-term basis.

Management – Klekner also knew that he could not lose Clynick at this point. In addition to working long hours, Clynick possessed the skill set necessary to manage the diverse group of people who worked in restaurants. Klekner would offer Clynick a 10% pay increase..

Fiscal 2006 Results / Issues (see Exhibit 3)

Results

Revenue - Revenue in 2006 grew 11% to $2,416,040, aided by the 10% increase in menu prices. Klekner was pleased with this performance because several new chain restaurants opened in the Richmond area; he also sensed that Rogerios was establishing a very loyal consumer base.

Profitability – Profits in 2006 were $147,670; again Klekner was pleased with this performance because of paying higher rent, giving Clynick a 10% pay increase, investing in I.T. equipment and getting better control of food costs.

Issues

Operations – The outside sourcing of pizza dough was only moderately successful because of quality concerns; therefore the speed issue was not resolved.

Management – Clynick was pressing for an equity position in the business.

Fiscal 2007 Action Plans

Financial – Because of the strong competitive activity, no price increase would be taken in 2007; also 5% pay raises would be given to key employees in the kitchen, bar and wait staff areas.

Operations – Other vendors would be approached regarding the outsourcing of pizza dough. This had to be achieved even if food costs increased; also continued investments in I.T. would be made to improve the procurement and billing functions.

Marketing – Although a workable website was in place, improvements were necessary involving menu content and online reservations; also no formal marketing program was in place and this had to be addressed.

Management – Klekner felt that Clynick was a needed taskmaster but at times was too abrasive with the front end staff and challenged too many of his decisions. He would offer Clynick a 5% pay increase and "explore" a replacement for him.

Fiscal 2007-2008 Results / Issues (see Exhibit 3)

Results

Revenue - Revenue in 2007 grew to $2,794,130, an increase of 15.6% from 2006; Klekner termed this the "over the hump" year in that everything seemed to click from an operations standpoint and no price increases were taken. In 2008, revenue grew to $3,275,046, an increase of 17.2% from 2007. This was aided by a 5% price increase on all menu items and a 10% increase in all beverages. Klekner termed this a "breakout" year for Rogerios. Clearly, the momentum was growing.

Profitability – Profits in 2007 and 2008 were $210,580 and $345,670, respectively. The strong profitability performance in 2008 was attributable to the implementation of a new marketing program that began in mid-2007, the price increases and resolution of the pizza dough issue.

Issues

Operations – In 2007/2008, significant progress was made in finding a vendor who could supply pizza dough to the restaurant. By early 2008, all pizza dough was supplied by this vendor with a significant decrease in cost. Also during this period, continued investment was made in I.T. to improve inventory management, credit card transactions and financial control.

Management – During 2008, significant improvements were made to the Rogerios' website in the content area; also a marketing consultant worked with Sarah Klekner to develop and implement a formal marketing program. The main emphasis of the program was communicating with the existing consumer base. This was accomplished through an email campaign and rewards program. Other forms of media used were cable T.V. and selected print ads.

Management – The situation with Clynick had deteriorated to a point where he had to be fired; finding a replacement would be difficult.

Other Issues

Because of the continued success of Rogerios, Klekner had been approached by several people regarding the expansion/sale of the business, specifically:

1) Tom Tameo, CEO of the Perfect Pizza restaurant chain met with Klekner to discuss “expansion” options between the two companies. Tameo was fascinated by the quality and popularity of Rogerios and envisioned a merger to get Perfect Pizza into the upscale end of the pizza market. Specifically, he wanted to open 5 additional Rogerios locations in Central Virginia. His plan was to purchase Klekner’s business and offer him an “Earn Out” option and the opportunity to start and grow the 5 new locations. Tameo told Klekner that “he would pay top dollar for the business” since he was a “strategic buyer”.
2) J. Buford Thompson, a wealthy Richmond entrepreneur was a frequent customer at Rogerios. He told Klekner that he wanted his grandson, Bradford, to own a well-run business and that he was willing to pay “whatever it takes” to buy such a business. Although, neither he nor Bradford knew anything about restaurants, he had owned or invested in a number of other businesses. Thompson told Klekner that he wanted to buy Rogerios ASAP and retain him for a 6-month period as a consultant to get Bradford up and running.
3) Joe Thurston was the owner of Joe’s Bakery, the company that ultimately supplied pizza dough to Klekner. Thurston had grown his business in 2008 to revenues of close to $2 million and had recently secured a contract to supply the Mama Jane’s pizza chain (25 locations in Central Virginia) with their dough requirements. Thurston, in his late 50’s, was looking for a partner to grow his business. He approached Klekner and said, “Paul, there is real dough to be made in the dough business; why don’t you sell Rogerios to me and we can then enter into some type of partnership.”

Fiscal 2009 Results / Issues

Results

<u>Revenue</u> - Revenue in 2009 fell to $3,092,176, a decrease of 5.6% from 2008. This was caused by several reasons including the economic downturn and the opening of a new Italian restaurant in Shockoe Slip. However, the biggest reason was the firing of Horan in late 2008; it took over 6 months to find his replacement and during that time a number of service issues arose causing a revenue decline of over 15% during the first 6 months of 2009. In order to increase revenue for the remainder of the year, various marketing programs were put in place including coupons and increased cable T.V. advertising.

<u>Profitability</u> – Profits in 2009 plunged to $214,162 or a decrease of 38% from 2008. Higher food, beverage and marketing costs contributed to the decline resulting again from Horan’s firing and the necessity of higher marketing expenditures. Klekner termed 2009 a “breakdown” year and blamed himself for the poor handling of the “Clynick situation”.

WHAT’S NEXT

In late 2009, Klekner and Sarah sat in their apartment and pondered their future. Klekner was proud of their achievements, namely:

- Growing revenue by over one million from 2005 to 2008.
- Growing profitability to approximately $350,000 in 2008 and achieving a Return on Sales (ROS) of 10.5% in that year; this was significant in that well run restaurants were measured by an ROS of over 10%.
- Being named Richmond’s best upscale pizza restaurant in 2008 by Richmond Magazine.
- Establishing I.T. systems that favorably impacted the procurement, inventory, financial and sales functions.
- Establishing a marketing program that was producing results at a very modest investment.
- Outsourcing of pizza dough was a tremendous success in increasing speed and reducing cost.
- Clynick had been fired and a solid replacement was in place

Despite these achievements, Klekner had many concerns:

- During the past 5 years, he and Sarah had averaged work weeks of 80 hours and had taken no vacations; they were “prisoners’ of the business and were worn out.
- Fiscal 2009 had been a very challenging year with declines in revenue and profitability. Although, he felt that the 2008 numbers could be achieved, he knew that those numbers represented near optimal performance levels given present seating capacity and pricing limitations.
- A decision had to be made regarding the lease purchase agreement; should he buy the building or continue leasing.

Klekner looked at Sarah and said “maybe we should sell the restaurant. I have no idea of what it’s worth but at the right price, it may be the right thing to do”. I will meet with Jim Picanza and John Gramas to get their thoughts on a sale and how the deal should be structured.. Also Tom Tameo, J. Bradford Thompson and Joe Thurston are still bugging me about their aspirations. Sarah looked back at Klekner and said, “Paul – I’ve been looking for the right opportunity to tell you about something very important to our future – I’m pregnant.”

Exhibit 1

Lease / Purchase Agreement

- Option to Purchase Building at End of Year (2010)
  - Purchase Price - $750,000
    - Rental Offsets

	Restaurant	Apartment
Year (1) 2005 -	$32,500	$12,000
Year (2) 2006 -	$78,000	$12,000
Year (3) 2007 -	$78,000	$12,000
Year (4) 2008 -	$78,000	$12,000
Year (5) 2009 -	$78,000	$12,000
Totals	$344,500	$60,000

Total for Restaurant and Apartment = $404,500

Exhibit 2

ROGERIOS
2005 (1) Proforma Income Statement

		2005 $	2005 %
REVENUES			
	Food Sales	1,374,208.00	67.1
	Beverage Sales	673,792.00	32.9
	Total Revenue	2,048,000.00	100.0
COST OF GOODS SOLD			
	Food Cost	557,056.00	27.2
	Beverage Cost	190,464.00	9.3
	Total COGS	747,520.00	36.5
GROSS PROFIT		**1,300,480.00**	**63.5**
EXPENSES			
	Controllable (2)	405,000.00	19.8
	Total Controllable	405,000.00	19.8
Payroll			
	Staff	305,000.00	
	Management	297,960.00	
	Total Payroll	602,960.00	29.5
Occupancy Cost			
	Lease (3)	32,000.00	1.6
	Interest (4)	10,000.00	0.5
	Insurance, Utilities	62,500.00	3.1
	Total Occupancy Cost	105,000.00	5.2
Other Expenses			
	Owner Expense (5)	100,000.00	4.8
	Total Other Expenses	100,000.00	4.8
	Total Expenses	1,212,960.00	59.2
Net Income		87,520.00	4.3

Notes Accompanying Income Statement

1. Fiscal year begins January 1.
2. Controllable: Controllable includes general and administrative, advertising / promotion and direct expenses.
3. Lease: Year 1 lease is $10 / sq. ft. x 6,500 sq. ft. = $65,000; however, first 6 months are free; therefore expense for Year 1 (2005) is $32,500. Year 2 through Year 5 lease is $12 / sq. ft. x 6,5000 sq. ft. = $78,000.
4. Interest Expense: $100,000 loan at 8% for 15 years.
5. Owner's Expense: Loan of $250,000 from owner (Klekner) to restaurant; repayment of $100,000 / yr for 5 years.

Exhibit 3

ROGERIOS
Summary Income Statement 2005 - 2009

	2005	2006	2007	2008	2009
REVENUES					
Food Sales	1,438,356	1,597,002	1,846,920	2,164,806	2,087,219
Beverage Sales	737,644	819,038	947,210	1,110,240	1,004,957
Total Revenue	**2,176,000**	**2,416,040**	**2,794,130**	**3,275,046**	**3,092,176**
COST OF GOODS SOLD					
Food Cost	584,908	657,162	762,797	890,813	881,270
Beverage Cost	176,814	229,523	265,442	304,579	287,572
Total COGS	**761,722**	**886,685**	**1,028,239**	**1,195,392**	**1,168,842**
GROSS PROFIT	**1,414,278**	**1,529,355**	**1,765,891**	**2,079,654**	**1,923,334**
EXPENSES					
Controllable	490,842	453,565	526,320	665,127	683,176
Payroll	663,256	685,620	783,611	819,377	777,246
Occupancy	105,000	142,500	145,380	149,480	148,750
Owner Expense	100,000	100,000	100,000	100,000	100,000
Total Expenses	**1,359,098**	**1,381,685**	**1,555,311**	**1,733,984**	**1,709,172**
NET INCOME	**55,180**	**147,670**	**210,580**	**345,670**	**214,162**

Exhibit 4
Balance Sheet
For the Period 2005 - 2009

	2005	2006	2007	2008	2009
ASSETS					
Current Assets					
Cash Assets					
Cash Checking	$ 27,313	$ 96,673	$ 99,450	$ 206,427	$ 105,642
Cash Payroll	20,000	19,450	23,450	14,128	24,500
Cash Savings	25,000	50,000	75,000	100,000	125,000
Total Cash	72,313	166,123	197,900	320,555	255,142
Receivables					
AMEX	22,450	19,000	15,000	17,560	32,500
VISA	34,500	2,250	35,000	42,000	64,500
Master Card	12,000	13,450	14,500	15,000	39,780
House Accounts	3,450	4,500	5,000	6,500	42,000
Total Receivables	72,400	39,200	69,500	81,060	178,780
Prepaid Expenses	19,000	21,000	22,500	34,500	42,000
Inventory					
Food	75,000	67,500	55,600	23,000	52,000
Wine	58,000	34,000	65,000	47,000	69,000
Beer	23,000	34,000	23,450	12,500	28,000
Liquor	14,500	34,500	23,000	12,000	24,500
Other Beverage	9,000	8,750	6,700	3,450	18,126
Total Inventory	179,500	178,750	173,750	97,950	191,626
Fixed Assets					
Furniture & Equipment	95,000	95,000	95,000	95,000	95,000
Leasehold Improvements	97,000	97,000	97,000	97,000	97,000
(Accumulated Depreciation)	(34,324)	(69,505)	(105,257)	(143,152)	(181,690)
Total Fixed Assets	157,676	122,495	86,743	48,848	10,310
Other Assets					
Security Deposit	20,000	20,000	20,000	20,000	20,000
Liquor License	3,500	3,500	3,500	3,500	3,500
Artwork	25,000	25,000	25,000	25,000	25,000
Total Other Assets	48,500	48,500	48,500	48,500	48,500
TOTAL ASSETS	$ 549,389	$ 576,068	$ 598,893	$ 631,413	$ 726,358
LIABILITIES & STOCKHOLDERS EQUITY					
Liabilities					
Current Liabilities					
Current portion of Long Term Debt	22,322	24,174	26,181	28,354	30,707
Accounts Payable	98,000	102,000	110,000	109,000	153,000
Accrued Wages	54,500	63,000	72,000	84,500	93,000
Accrued Payroll Taxes	32,500	42,000	54,000	76,700	82,000
Gift Certificates Payable	10,000	12,000	5,000	4,500	45,000
Total Current Liabilities	217,322	243,174	267,181	303,054	403,707
Notes Payable					
Notes Payable to Shareholder	214,562	194,607	172,997	149,592	124,245
Long Term Note Payable	92,506	88,286	83,716	78,767	73,406
Total Notes Payable	307,067	282,893	256,712	228,359	197,651
TOTAL LIABILITIES	$ 524,389	$ 526,068	$ 523,893	$ 531,413	$ 601,358
STOCKHOLDERS EQUITY					
Capital Contribution	-	-	-	-	-
Owner's Cumulative Cash Distributions from R/E	(30,180)	(152,850)	(338,430)	(659,100)	(848,262)
Retained Earnings	55,180	202,850	413,430	759,100	973,262
TOTAL STOCKHOLDERS EQUITY	25,000	50,000	75,000	100,000	125,000
TOTAL LIABILITIES & STOCKHOLDERS EQUITY	$ 549,389	$ 576,068	$ 598,893	$ 631,413	$ 726,358