

# **RITE FOODIES**

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## Rite Foodies

Gazing at the Empire State Building from his office one afternoon late in November 2007, Tom Watson, founder and CEO of New York Kitchens (NYK), was pondering over two financing plans. Watson was trying to decide whether or not he should raise his initial bid of \$85 million to purchase Rite Foodies – the legendary catering firm – from its current owner, American Chefs.

Morgan Lynch, American Chefs investment banker, had called Watson late last night informing him that his bid of \$85 million had been rejected and nothing short of \$100 million would be accepted. While Watson was pleased to still be in the running for Rite Foodies, he still had a major obstacle to overcome. NYK's board of directors had unwillingly approved the \$85 million offer and was sure to shy away at a \$100 million bid. Watson had been eyeing Rite Foodies for a while and he was now desperate to seal the purchase, but was not sure how much it was worth or how to finance it. Watson also knew that he had to act swiftly or pass on this unique growth opportunity and probably his last chance to be one of the industry's biggest players.

### The Catering Industry

The catering industry had two segments: (1) proprietary caterers and (2) contract caterers. While both types of caterers performed similar services, a proprietary caterer was an employee on the payroll of a non-catering company. Contract caterers were 'hired' from specialist suppliers like Rite Foodies, NYK, Wapetite, and Cakers Industries. The historical growth of the contract caterer segment of the industry was due in part to companies realizing that they gained operating flexibility by contracting out their catering needs as opposed to managing their own catering operations and kitchens. By late 2007, catering services were a \$10 billion industry growing at 6% per annum. Nonetheless, the industry was mature, fragmented and price-competitive. As a consequence, there was ongoing trend toward consolidation at the expense of smaller, local catering companies whose workers were often poorly screened and inadequately trained.

### Rite Foodies

The catering industry began in the early 1900's when Alison Rite established the Rite Party Agency. The firm gained fame over the twentieth century as the catering firm of choice for major events, such as the OSCAR's and the Olympic Games. Well-known celebrities, Carl Lewis, Michael Johnson, Charlie Chaplin and Angelina Jolie were quoted asking for the name of the caterers. The caterers were Rite's men and women.

Rite ran her firm until she died in 1954. The company was then headed by two generations of Rites until the family's reign ended in 1990 with the death of Al Rite. American Chefs, the \$5 billion food company – with brand names such as Lucky Stroke cigarettes, De Tox bourbon, Pikka-Pockets and MyteeHi energy drink – purchased Rite Foodies for \$162 million in 1992. American Chefs made the acquisition in order to expand the service side of its business and because it saw the Rite Foodies brand name as a great complement to 'a company with a portfolio of prolific brand names'. The Rite family sold the company to American Chefs because they felt the pressure of price competition and therefore the company needed a strong parent to compete and grow. By 2007 Rite Foodies was among the largest caterers in the United States, with sales over \$400 million, 150 offices in the United States, Canada and the United Kingdom, and a particularly heavy presence on the west coast of the United States. Table 1 provides selected financial data for Rite Foodies.

## **New York Kitchens**

When Tom Watson purchased NYK in 1973, the company had 18 employees and sales of \$163,000. Over the next 34 years, Watson had built NYK into a \$250 million catering company with 20,000 employees and 125 offices in 38 states and Canada. Table 2 gives selected financial information for NYK. Watson possessed a palate for fine food and built NYK with skillful marketing and highly selective employee screening and routine training. NYK's expansion had been fuelled by explosive growth in New York's economy and because the larger, and more established West Coast catering firms had ignored the East Coast market.

Although Watson was the founder and sole owner of the business, he sought the advice of his board of directors on all major decisions. The board of directors consisted of three members: Nick Faldo, Sandy Lyle and Ian Woosnam. Faldo was a well-known entrepreneur, CEO of an oil company and a NYK director since 1997. Lyle was an attorney, a former vice president of a communications firm, the former New York State Secretary of Health, Education and Welfare, and a NYK director since 1998. Woosnam was President of Wholesome Foods, a director of seven companies, and an NYK director since 1997.

## **NYK's Acquisition of Rite Foodies**

Watson was interested in acquiring Rite Foodies for several reasons. First, he had always wanted to run the largest firm in the catering industry, and the purchase of Rite Foodies would make NYK the joint largest firm with Caker Industries – a subsidiary of Jonson & Jonson and the largest supplier of catering services. Second, Watson was convinced that American Chefs was mismanaging Rite Foodies and destroying a well-known brand name with its pricing strategy.

In September 2007, following a heated board room discussion, American Chefs decided on the sale of Rite Foodies as the catering firm did not fit in to the firm's long-run strategy. A public announcement to sell Rite Foodies was made in October. Following the announcement, NYK's chief counsel and secretary received a call from Tom Watson that gave the counsel an impression that Watson was prepared to do anything to purchase Rite Foodies. NYK's counsel knew that Watson was preoccupied with being the largest, and he was desperate to secure the Rite Foodies brand name.

Morgan Lynch, a leading investment bank, represented American Chefs in the divestiture of Rite Foodies and the bidding for the company promised to be hotly contested. A merger team of NYK senior management was assembled quickly to prepare NYK's offer which they knew, given the time constraint of the sale, would not have the benefit of full preparation.

Very quickly, the NYK merger team identified three key ways in which NYK could create value by acquiring Rite Foodies. The key source of value would stem from consolidating the operations of NYK and Rite Foodies by eliminating overheads, such as corporate headquarters, support staff, and redundant preparation sites and kitchens. The merger team believed that significant improvements could be achieved in the management of Rite Foodies net working capital. Another source of value identified by Watson and the merger team was the Rite Foodies brand name. The merger team believed that even in a highly competitive market, the catering services of NYK and Rite Foodies could be successfully marketed under the Rite Foodies name at a premium price. Specifically, the merger team felt that although premium prices might lead to lower revenues, the marketability of Rite Foodies brand name would result in gross profit margin improvements, and this would be sufficient to produce greater gross profits. For example, the merger team believed that a premium pricing strategy would definitely reduce NYK's revenues since the firm had acquired a significant amount of business over the past three years using a low price and high market share strategy.

The new pricing strategy would see NYK's revenues experiencing a smooth and steady decline to 70% of their 2007 level by the end of 2010 and then growing at 5% per year thereafter. Nonetheless, the merger team was uncertain on its estimate on the impact of the new pricing strategy on profitability. They expected the new pricing strategy would improve Rite Foodies gross profit margins from 8.5% in 2008 to 9% in 2009, 9.5% in 2010, and 10.25% thereafter. The merger team further expected the new pricing strategy to produce higher margins for NYK, increasing the projected operating profit from NYK's own business by \$1.2 million in 2009, \$1.5 million in 2010, \$2.0 million in 2011, and \$3 million in 2012. This increase in operating profits for NYK would be above and beyond that level that would otherwise have been realized, and was expected to grow at 5% per year, in line with sales, after 2012. Table 3 provides a 5-year forecast of NYK's net income and cash flow assuming that Rite Foodies is not acquired. The merger team also realized that there was a strong possibility that the new pricing strategy would have no impact on NYK's projected operating profits, and Rite Foodies gross margins would improve to only 8.5% in 2008 to 8.75% in 2009, 9% in 2010, and 9.5% thereafter.

On a more confident note, the merger team estimated that eliminating common overheads would reduce Rite Foodies operating expenses as a percentage of sales to 6% in 2008, 5.9% in 2009, and 5.8% in 2010 and beyond. The merger team also forecast that Rite Foodies net plant and equipment could be reduced to 4% of sales and maintained at that percentage relationship for the foreseeable future.

The merger team was less certain about improvements in Rite Foodies net working capital. This was due to an uncertainty associated with NYK's accounting department to handle a much larger and broader set of operations. The merger team forecast that Rite Foodies net working capital as a percentage of sales could be lowered to 8.6% in 2008, 7.4% in 2009, and 6.2% thereafter. However, if NYK's accounting department encountered difficulties in integrating the two firms operations, then Rite Foodies net working capital would remain at 9.5% of sales.

The NYK acquisition of Rite Foodies was not universally popular. Many of the investment banks and potential lenders that NYK had approached had cited inadequate cash flows and weak market conditions following the recent drop in the stock market in the previous month. However, a representative of Slumber & Co., a NY investment bank, indicated that he could get financing for the acquisition from two of the largest in the industry - either Chemistry Bank or GEM Credit Corporation.

In addition, Tom Watson had some problems with NYK's board of directors. For instance, Nick Faldo thought that there would be obvious synergies in merging the businesses, but there was insufficient management depth and knowledge to run both businesses combined. According to Faldo, there was no senior manager that could manage the day-to-day details of operating a \$650 million business. In short, Faldo felt that NYK did not need growth – the field people might be able to handle the merger but corporate management definitely could not.

The merger team, nonetheless, pressed forward with their analysis of Rite Foodies. In addition to the current market conditions, the analysis tool particular note of Wapetite, the only publicly traded catering firm (see Tables 4 and 5). Only 12 days after receiving details of the sale from Morgan Stanley, and with the reluctant approval of his board of directors, Watson bid \$85 million for Rite Foodies.

Watson did not receive any response on his bid for two weeks. Through another contact, Watson had learned that another firm had bid higher than NYK and the Morgan Stanley was negotiating with that firm. Watson was disappointed once he realized that this might be his last chance to be one of the biggest in the industry. When Morgan Stanley informed Watson that his bid was too low and that nothing less than \$100 million would be accepted, Watson became

quietly elated as he realized that he still had a chance to buy Rite Foodies. But he also suspected that Morgan Stanley had called him because the higher bid had been unsuccessful in securing the financing for the higher bid.

### **A \$100 Million bid – the Financing**

In a last attempt to better his original bid, Watson asked his investment banker to determine the options to finance a \$100 million offer. The banker responded with two alternatives. The first came from an investment firm that would provide both debt and equity. The debt would be for \$75 million with seven years to maturity and interest rate of 11.5%. The debt would not be amortized and would be payable in full at maturity. The debt would be a senior obligation and be backed by the all assets of the combined firm. The remaining \$25 million in equity would be provided in exchange for 45% of the equity in the combined firm. The second came in the form of 100% debt financing from a bank. The bank agreed to loan \$100 million at an interest rate of 13.5% per year. The loan would be amortized at \$5 million per year for 6 years, with a final payment of \$70 million at the end of year 7. This loan would also require the collateralization by all of the assets of the combined firm.

The required debt service under both alternatives concerned Watson. The new combined firm's high leverage and nonpublic status could make any cash flow problems over the next 5 years problematic. The merger team also reminded Watson that \$100 million purchase price would create goodwill on NYK's balance sheet which would need to be amortized at a rate of \$5 million per year over the next 10 years. Amortization of goodwill had to be expensed for financial reporting purposes and could not be expensed for tax purposes. The current corporate tax rate was 34%.

Watson sat in his office contemplating the biggest decision of his career. As an entrepreneur and an experienced catering executive, Watson had a feeling that Rite Foodies was a good buy. However, he had continually relied on the expertise of his board of directors in providing financial guidance. He had managed to sway his board of directors on the \$85 million bid but he was sure that they would shy away from a \$100 million offer for Rite Foodies. How could he justify a \$100 million bid for Rite Foodies, particularly in lieu of his \$85 million earlier bid? And, if he was successful in convincing the board of a \$100 bid, then how was he going to finance the acquisition?

**Table 1****Financial Information on Rite Foodies (\$ Million)**

	2003	2004	2005	2006	2007(E)
Income from services	296.4	307.7	312.4	367.7	408.3
Cost of services provided	<u>264.5</u>	<u>275.4</u>	<u>286.3</u>	<u>342.5</u>	<u>381.7</u>
Gross profit	31.9	32.3	26.1	25.2	26.6
Operating expenses	<u>15.5</u>	<u>17.1</u>	<u>24.9</u>	<u>24.5</u>	<u>27.0</u>
Operating profit	16.4	15.2	1.2	0.7	-0.4
Cash	3.8	2.7	2.3	0.0	1.0
Accounts receivable, net	48.7	51.0	55.0	62.8	67.3
Other current assets	<u>0.0</u>	<u>0.0</u>	<u>0.6</u>	<u>0.6</u>	<u>1.0</u>
Total current assets	52.5	53.7	57.9	63.4	69.4
Net property, plant and equipment	11.0	11.3	13.1	15.1	17.6
Total assets	63.5	65.0	71.0	78.5	87.0
Accounts payable	0.4	1.0	2.4	4.7	3.4
Accrued expenses and other current liabilities	<u>29.3</u>	<u>29.1</u>	<u>25.6</u>	<u>22.6</u>	<u>27.2</u>
Total current liabilities	29.7	30.1	28.0	27.3	30.6

**Table 2****Financial Information on NYK (\$ Million)**

	Year ending 12/31/06	Year ending 12/31/07(E)
Income from services	243.6	251.5
Cost of services provided	<u>221.9</u>	<u>229.4</u>
Gross profit	21.7	22.1
Operating expenses	<u>16.1</u>	<u>14.5</u>
Operating profit	5.6	7.6
Interest expense, net	0.7	0.4
Amortization of goodwill	0.3	0.3
Income before tax	4.6	6.9
Taxes	<u>2.4</u>	<u>2.9</u>
Net income	2.2	4.0
Cash	1.0	1.2
Accounts receivable, net	33.8	34.0
Other current assets	<u>8.3</u>	<u>13.4</u>
Total current assets	43.1	48.6
Notes receivable	2.4	2.4
Goodwill	1.8	1.5
Net property, plant and equipment	<u>1.8</u>	<u>2.6</u>
Total assets	49.1	55.1
Notes payable	1.0	1.6
Current portion of long-term debt	1.0	1.1
Accounts payable	2.7	2.1
Accrued expenses and other current liabilities	<u>26.5</u>	<u>30.4</u>
Total current liabilities	31.2	35.2
Long-term debt, less current portion	3.1	2.0
Shareholders' equity	<u>14.7</u>	<u>18.0</u>
Total liabilities and equity	49.0	55.2

**Table 3****Forecast of NYK Income and Cash Flow (\$ Million)**

	2008	2009	2010	2011	2012
Net Income	4.1	4.3	4.6	4.8	5.0
Plus amortization of goodwill	0.3	0.3	0.3	0.3	0.3
Less change in net property, plant and equipment	0.1	0.1	0.1	0.1	0.1
Less change in net working capital	1.2	0.7	0.7	0.7	0.8
Less amortization of long-term debt	1.1	1.0	1.0	0.0	0.0
Total cash flow	2.0	2.8	3.1	4.3	4.4

**Table 4****Financial Data on Wapetite****Wapetite Corporation** (provides contract catering services)

Sales (\$ millions)	382.0	Debt (\$ millions)	10.6
Earnings (\$ millions)	5.7	Assets (\$ millions)	130.4
EPS	\$1.47	Stock price	\$18.00
Book equity (\$ millions)	39.7	Beta	0.89
Shares outstanding (millions)	3.9	Credit rating (S&P)	A

**Table 5**

**Capital Markets Information as of Year End 2007**

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3-month Treasury bill rate	5.78%
30-year Treasury bond rate	8.58%

Historical market risk premium (1960-2007)	7.50%
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***Corporate bond yields:***

AAA	9.38%
AA	9.68%
A	9.99%
BBB	10.58%

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