Savage's Bakery:

Knowing When to Invest More and When to Sell

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I. *Introduction*

In the fall of 2004, Van Scott, owner and general manager of Savage's Bakery, faced a dilemma: should he attempt to greatly improve the company or consider selling? He believed that the company had great potential; however, after twenty-six years, he did not know if he could continue with a lifestyle that put tremendous physical and mental demands upon himself and his family. Since purchasing the company in 1978, Van had seen a 150% turnaround on the bottom line adjusted for inflation. However, in 2004, for the first time in the company's history, the bakery experienced negative growth in net income.

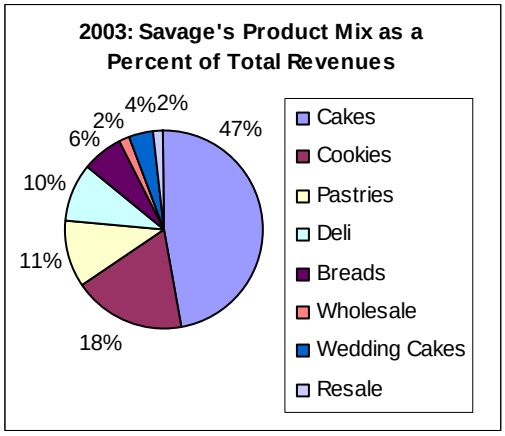
II. *Company Profile*

Equipped with an undergraduate degree from the University of Virginia and a Masters of Business Administration from the University of Alabama, Van decided to become self-employed. He had his eye on Savage's Bakery, a family-owned and operated bakery located in Birmingham, AL. It was established in 1939 by Mr. and Mrs. Savage, who dedicated their lives to creating the best baked goods known to those living in Birmingham. After the death of Mr. Savage in 1978, Van saved the bakery by purchasing the operation for $50,000.

In his first year as owner, Van utilized his business skills to increase sales dramatically, raising revenues by 80% from the prior year. Van's vision of providing high quality products that looked and tasted better than his competitors paid off as customers became loyal to his bakery. The early years, however, were not without difficulties. His decision to expand to another location was soon deemed a mistake. After purchasing the property, Van realized that in order for his business to grow and be profitable, his focus and energies had to remain centered on the original store and its prime location—the heart of Homewood, AL, an outlying community of Birmingham, where children walked to school and moms brought their kids to the park. As a result, he closed the second location within a matter months before expanding his operations at the original location. Due to the renewed focus, sales increased and the business grew quickly.

Van's continued mission to provide a stable and friendly work environment coupled with his high quality products and attention to service has drawn a tremendous amount of public and industry recognition over the years. In 2004, Savage's Bakery was selected as one of the top three bakeries in the South to receive Turner South's Blue Ribbon Special Award. Additionally, the bakery was consistently chosen as "Birmingham's Best Bakery" by readers of the Birmingham News. It is no wonder then that Savage's is known as the finest bakery in Birmingham. These accolades occur in large part because all of Savage's recipes are original and secret. All batters and icings are made from scratch on site with the highest quality ingredients. Each cookie, pastry, and desert is cut and prepared by hand, making every item individual and unique. Furthermore, the decorators are highly trained and skilled in making every special ordered cake truly unique.

Exhibit 1: Snapshot of Savage's Yearly Performance



Products	Percent Change in Product Mix as Percent of Total Revenues from 2003-2004
Cakes	-2.81%
Cookies	-3.30%
Pastries	-16.23%
Deli	-6.76%
Breads	-19.50%
Wholesale	31.22%
Wedding Cakes	-63.47%
Resale	119.96%

*Percentages and numbers have been disguised.

III. *The Retail Bakery Industry & Local Competition*

Within the retail bakery industry, numerous niches and differentiators make one bakery unique from another. In Birmingham, Alabama, competitors in the form of discount wholesalers, cafes, pastry shops, cooking schools, and national chain supermarkets with bakery departments, all vie for the largest piece of the pie. For instance, some bakeries are leaving standalone stores and locating their operations within bigger retailers' locations, while others are moving away from specialization and offering a wide array of products not traditionally associated with bakeries. Further diversity in this industry stems from bakeries that are following trends typically associated with other types of retail businesses, such as the consumer giants, who offer customers many of their shopping needs under one roof. The versatility associated with an independent bakery is a major advantage that allows it to adapt to changes in the marketplace and fulfill customer demands.

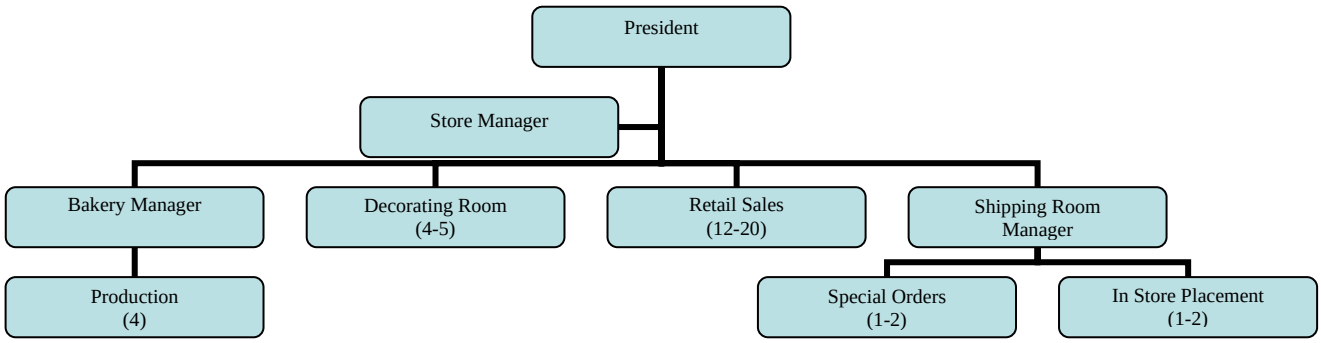
The changes in the marketplace, however, pose significant challenges for high-end specialty bakeries such as Savage's. Bakeries of this type typically make everything from scratch, and therefore have large equipment investments that are not easily transportable. High-end bakeries, such as Savage's, additionally tend to build their reputations and place in the market in part due to their unique and individual product offerings. These unique products make competing with the something-for-everyone model of retailing impossible. Furthermore, this combination of complicated machinery and artistic product output mandates hard-to-find, highly skilled employees who often require significant training.

To compound the above problems, the extensive competition for consumers' disposable income has resulted in a vast array of similar choices. High-quality specialty bakeries such as Savage's now face competition from myriad low-quality bakery startups that, by virtue of prefabricated dough and prepackaged goods, have very low barriers to entry and are proliferating in high-traffic areas. The challenges, unfortunately, are not limited to competition within the sector. The government's recent deregulation of the commodities market for dairy products has caused prices to increase considerably; for example, the price of butter has tripled in 2004. Moreover, the price of pecans has skyrocketed as a result of hurricane damage. For the high-quality bakery that uses premium ingredients, this has been devastating.

The government and the environment are not the only external factors that are causing problems for bakeries. The low carbohydrate craze, most readily identified with the Atkins Diet, has also had a tremendous impact on the industry as a whole. Michael Arndt stated in a Business Week article that the Atkins Diet caused same store sales for baked good-heavy retail chains, such as Panera, to be flat or down in the last six months beginning January 2004. He also predicted "2-3% year-on-year monthly sales gains through the second half of the year" for retail stores specializing in high-carbohydrate menus. As a result, the bakery industry will take significant time to recover from the low-carbohydrate craze.

IV. *Management & Employees*

Exhibit 2: Organizational Chart



The success of Savage's is due largely to the commitment and loyalty of employees to Van. He has created a family work environment, and key employees have made Savage's a second home—many have worked at the bakery for over 15 years. This loyalty stems from the respect and freedom to be innovative as well as the flexibility Van affords his employees. This same freedom for innovation that Van encourages has, however, led to problems with management, particularly in areas of communication, implementation, and procedure. At times, the various managers are not coordinated, and this has resulted in confusion, resistance, and insubordination among employees. Additionally, the retail store has lacked a full-time sales manager for the past eighteen months, which has led to poor customer service on some occasions.

Hiring quality employees is critical to the success of Savage's Bakery. Unfortunately, the bakery is approaching a time when its valuable employees are reaching retirement age. Savage's is having difficulties in replacing these employees since many skilled bakers today want to own their own businesses. In the front of the store, the non-skilled employees who are presenting the public face of Savage's are often hard to retain due to lack of fulfillment and satisfaction from the work that they do. Additionally, the caliber and work ethic of some current employees, usually those serving the public, is below par. The training programs are not translating into the superior customer service that the bakery needs.

V. *Operations & Sales*

Currently, Savage's Bakery is repairing old machinery rather than investing in new capital expenditures. The growing costs of these repairs, however, have forced the company to consider purchasing new machinery. This creates a unique problem for a high-end bakery such as Savage's. As technology advances, bakery machines are becoming more robotic, and Savage's is concerned that adding these automated machines may reduce the quality and homemade image of their products. This is not to say that Savage's is not embracing technology—improvements and upgrades of computer software and hardware have led to the creation of a very efficient ordering and delivery system. This investment is reflected in the significant increase of leased equipment expense in 2003.

A major strength of Savage's involves Van's long-term relationship with his suppliers and distributors. His savvy strategic partnership with food distribution giant Sysco, for example, has allowed Van to focus on production and strategic planning, while Sysco monitors inventory levels and handles all manufacturer rebates for products purchased. Sysco's main distribution center is located less than an hour from Birmingham. As a result of this relationship, costs are cut, and product ingredients are readily available; Savage's is never out of inventory.

In the area of marketing, Savage's Bakery has developed effective public relations through various promotions and charitable donations. Primarily, Savage's has relied on word-of-mouth as its source of marketing. The success of this word-of-mouth marketing is completely contingent upon Savage's offering a high-quality and unique product that cannot be easily duplicated. Involvement with non-profit organizations through charity events has proven successful in the past and is a definite way to increase community involvement and support. For instance, in order to attract new customers, Savage's needs to rely less on pure word-of-mouth marketing, and instead increase community outreach initiatives such as donating baked goods to kindergarten classes as well as arranging additional charitable events in conjunction with non-profit organizations.

VI. *Performance & Value*

As seen in the financials below, costs are increasing due to increased ingredient prices, while revenues are down due to trends of the market, such as the low-carbohydrate craze. In order to combat these market difficulties, Van has been able to maintain a labor cost of 28% of sales, which is far below the industry average of 32%.

Note, the Net Income figure for this portion of 2004 is in advance of the large expenditures (such as the bulk of salaries) that Savage's pays at the end of the year. This is why this number appears high. According to Van Scott, the bakery's final Net Income will be below that of 2003.

Exhibit 3: Selected Financial Data 2002-2004 Table

	Jan-Aug 2004	2003	2002
Revenue	1,054,443.28	1,807,183.00	1,806,593.73
Other Revenue			
Total Revenue	**1,054,443.28**	**1,807,183.00**	**1,806,593.73**
Cost of Goods Sold			
Product Purchases	207,094.73	349,761.02	358,889.27
Wages	361,196.69	635,711.45	655,620.01
Less Discounts/Other Income	-1,811.06	-2,915.00	-2,995.76
Total COGS	566,480.36	982,557.47	1,011,513.52
Gross Profit	487,962.92	824,625.53	795,080.21
Expenses			
Advertising	7,564.84	16,988.43	16,453.48
Auto/Delivery	1,908.64	4,545.07	5,091.11
Cash (Over)/Short	-521.95	485.80	-2,424.29
Chartiable Contributions	1,664.25	344.30	1,997.14
Chariable Contributions (Other)	-1,664.25	0.00	0.00
Contract Labor	3,725.67	1,752.03	714.80
Depreciation	23,444.56	22,895.39	43,229.04
Employee Vacations	6,975.50	13,010.40	14,524.40
Equipment Leases	43,268.05	41,391.72	15,961.00
General Expenses & Fees	21,539.94	35,637.64	29,139.34
General Maintance	4,333.58	6,970.00	6,694.56
Insurance	56,888.09	67,223.98	80,383.76
Interest Expense	6,810.74	15,328.30	32,095.66
Legal & Accounting	19,105.48	30,608.22	28,889.13
Misc.	718.90	4,854.02	21,992.82
Rent	56,083.55	91,311.58	88,303.33
Repairs/Maintenance	24,943.57	22,824.77	20,538.72
Salaries & Bonuses	83,227.72	347,623.28	285,116.94
Security	1,615.88	965.00	891.25
Supplies	16,270.77	21,082.91	18,405.50
Taxes & Licenses	19,434.04	5,879.56	12,614.40
Telephone & Communications	11,658.87	10,648.66	12,576.04
Training	101.00	3,040.00	280.37
Utilities	24,609.13	35,142.23	35,731.84
Total Operating Expense	433,706.57	800,553.29	769,200.34
Net Income	**54,256.35**	**24,072.24**	**25,879.87**

(*Financial info has been disguised to preserve Van Scott and Savage's Bakery's desire for anonymity.)

VII. *The Future*

Faced with these challenges, Van considered his professional and personal options. He could sell the entire bakery, improve and innovate in order to return net income to its former positive growth rate, or sell a percentage of the bakery but remain on as majority owner in an advisory capacity. The prospect of watching his life's work slowly vaporize through continued financial losses was certainly not an option; therefore, it was time to make a final decision that would shape the future of Savage's Bakery.

Sell the Entire Bakery
Should Van begin planning an exit strategy? Ned Minor stated in a Business Week article that "knowing how and when to begin the exit planning strategy is key to smoothing the transition and ensuring a financial reward appropriate to the years of sacrifice most business owners have invested to establish and build their outfits." Before selling the bakery, Van must determine a fair selling price and convince buyers that this is a lucrative investment.

Sell a percentage of the Bakery
Selling part ownership in the bakery would allow Van to maintain a controlling interest in the bakery, while sharing much of the workload and stress. Importantly, the bakery would benefit from the goodwill associated with Van's legacy as he could continue to be the figurehead of the firm, while he could gradually phase out his day-to-day responsibilities.

Improve the Bakery
Even if Van makes the decision to sell the bakery, improvements could increase the value of the company. These improvements might include addressing the issues above regarding employee retention and training, developing new marketing and products, increasing revenue via wholesaling Savage's products to like-minded retailers, and offering banquet rooms and catering services on the bakery's existing property.

Improve the Operation
Another approach to increasing the value of the business would be working to regain presence in the market in the areas that have seen a decrease in sales, through expansion—primarily wedding cakes and pastries for example. Through marketing, advertising, and building customer relationships, lost sales due to increased competition could be recaptured.

Finally, given the additional space that the bakery owns, a catering operation could be easily implemented.

References Cited
Related BusinessWeek Articles
Based on a search of www.businessweek.com, keyword: "diet," "valuation," "exit strategy."

Minor, Ned, "Oiling the Hinges on your Exit Strategy," Business Week On-line, August 3, 2004.

Arndt, Michael, "Dude Where's my Carb?" Business Week, Issue 3895, August 9, 2004, Page 57.