CHAPTER 9 THE ECONOMICS OF THE BUSINESS

9.1 Unit Gross Profit

Gross Profit is the difference between sales revenue and the cost of goods sold. From our interview conducted with a local café manager the margin of return on top of the cost of a cup of coffee is in the range of 250 % and above. For simplicity, we assume that the fix cost is sunk cost will not contribute to the Gross Profit of the unit product. For a single cup of coffee, we expect the variable cost to be approximately 30 % of the sale price. As such, for a single cup of coffee sold at RM9.50:

	RM
Sale of Coffee	9.50
Less COGS	
Variable Cost	2.85
Unit Gross Profit	6.65

The above simple representation will be the basis of our evaluation of the cash flow for the business plan. From our interview with the local café manager, the above data is critical as the initial capital outlay of the café is will affect the viability of the project. This projected margin is acceptable for a premium specialty café outlet. Anything lower than that will affect the feasible of the business negatively

As for the sales of food items such as sandwiches, the cost of goods may vary considerable depending on what items are involve. However for a average comparison we have decided to use the cost of a tuna sandwich for our evaluation. The items used to make the sandwich are identified below.

	RM
Sale Price of Tuna Sandwich	11.50

Less COGS		
Variable Cost		
Whole Meal Bread	1.00	
Tuna with mayonnaise	1.00	
Greens (Lettuce and tomato)	.80	(2.80)
Unit Gross Profit		8.70

In this case the assumption of 25% came close the original estimate based on the information gathered from our interview with the café manager of 30%. For simplicity, this report will focus on the assumption of 30% unit variable cost.

9.2 Potential Earnings

Historically, coffee has been viewed as an old fashioned beverage for the old people with just two flavours i.e. regular local roasted coffee or instant coffee. Local consumers have not been really exposed to the specialty coffees until the last five years. In order to effectively forecast the projected cash flow of the business to fully appreciate the economic of the business it is critical that we establish the size of the specialty coffee consumer market in the Klang Valley. Such data is not available and we need to make slight adjustment to the figure available in the United States.

Variable cost in the business will involve the use of perishable product namely coffee bean, milk, sugar and the cost of purchasing finger food from suppliers. Fixed cost on the other hand consist mainly of salary of both operating staff, management staff, rental and utilities (water and electricity). Projections are necessary in this area as actual data of the actual operating cost of specialty café is not available.

As for the projection of the profitability of the business attempt was conducted using the US coffee consumption data as a benchmark. In North America alone, a survey conducted by National Coffee Drinking Trends survey reported that 25% of the American public above 18 years of age drink coffee daily with another 28% of the population drink occasionally. This report also concluded that coffee drinkers consume 3.3 cups (male) and 1.7cups (female) of coffee daily.

Using the same data and reducing the consumption to half, the following can be derived on the consumption of gourmet coffee in Malaysia, based on some conservative assumptions:

Assumptions :

- Local Klang Valley white coffee and local coffee consumers are ignored.
- Based on the survey conducted by *National Coffee Association* of USA in the year 2001, an average American male and female consumer consume 3.3 and 1.7 cup of gourmet coffee per-day. Taking approximately 1/3 the figure, assume Malaysian take ((3.3+1.7)/2)/3 = 0.83 cups per-day. (Information derived from web-page for coffee statistic coffeescience.org/factrend.html)
- 25%/3 = 8.3% of the population in the Klang Valley consumes gourmet coffee daily.
- Average price per 9 ounce cup of coffee with a single order of finger food average to a total price of RM 9.50.
- A total of 100 specialty coffee shop operating in the Klang Valley and for simplicity all have equal no. of patrons per-day.
- Sales of finger food and pastry are ignored.

Based on the above bearable assumptions, the following illustrates the anticipated income of the café.

- The total cups of gourmet coffee sold in the Klang Valley alone can be estimated to be 0.083 * 0.75*1,400,000 population * 0.83 cups per-day = 72,335 cups per day.
- Total average daily revenue that can be generated per store is 72335/100 * RM9.50 = **RM 6,871**

As the above assumptions are based on US data, we have conducted an observation survey of one of the popular specialty outlets in the Klang Valley to better estimate the actual potential of the business venture. Detail information on the survey is attached in the Appendix. Based on our observation, an average of 35 patrons purchased a drink from a local Coffee Bean outlet in an hour.

It is critical to establish the operating cost of the business to effectively forecast the projected cash flow and eventually the profit of the business.

We have encountered much difficulty in obtaining the profit margin from the foreign franchise coffee outlets. To overcome this difficulty, we opted to establish the cost of each cup of coffee scientifically using an average 9 ounce serving cup.

Assuming the above assumptions holds and the monthly rental expense of the café is RM 25,000.00(utilities not included) in the local malls. The conservative earning potential for the café are as described below:

Estimated Potential Earning from Monthly Cash Flow for One Outletwith varying volume of sales of 15, 25 and 35. (Capital investment, marketing and promotional cost are not included)

			V.Low Sales **Normal**	**Low Sales**
		Vol. =15	Vol.=25	Vol.=35
Revenue: RM 9.50 x Vol./hr x 12hr/day x 30 day		51,300	85,500	119,700
Cost of Goods Sold				
Variable Cost (at 30% of Revenue)		(15,390)	(25,650)	(35,910)
Gross Profit		35,910	59,850	83,790
Fixed Cost				
Labour				
Staff 1,000 x 5	(5,000.00)			
Opportunity Cost/Manager	(7,500.00)			
Rental/Utilities	(25,000.00)	(37,500)	(37,500)	(37,500)
Net Profit/Operating Profit		-1590	22,350	44,290

The above table did not take into account the marketing and promotional cost to simplify the calculation. The above data were adopted in lieu of the US data as the figures are actually more conservative. Based on the above simple projection the speciality café business is a viable investment and can be profitable. However, the above analysis may take time to materialise as consumer may take time to accept the new concept. With intense promotional exercise, we anticipated a gradual increase in the volume of customers patronising Borneo café surpassing the above forecast. The monthly cash flow for the café is presented in Table A on of the Appendix.

In order to formulate a reasonably practical and sensible projection, assumptions are made necessary ~~to~~ compliment the analysis. The assumption include:

<u>Assumptions For the Normal Scenario Analysis</u>

1. Variable cost of a unit product is approximately 30% of the sales figure.

2. Revenue is expected to start at 60% of full capacity and grow at a rate of 10% monthly up to 7 months before stabilising at RM 109,725 monthly.
3. Salary for operation staff is expected to rise at 10 % annually.
4. Opportunity cost which is the actual salary of each partners who will be foregoing their current job is RM 7,500 each. To increase at a rate of 10% annually.
5. Capital invest of each café is RM 300,000.Please refer to section 8 on Cost
6. Tax is 30%.
7. Cost of Capital for the investment is 15%.
8. Rental is assumed to be constant for the first 2 years before increasing by 5 % in the third year.

In order to test the sensitivity of the entire project in different economic environment, our team has project a pessimistic cash flow to effectively test the project under a less favourable economic condition. The pessimistic outlook will enable a better perspective of the project in less conducive economic environment. Please refer to Table B of the Appendix

<u>Assumptions For the Pessimistic Scenario:</u>

9. As per items 1, 3, 4, 5, 6 and 8 above.
10. Revenue is expected to be lower by 10 % of the normal scenario analysis. Cost of capital is increase to 20%.

From Table A and B, the projected monthly cash flow for the Single Borneo Café for the first three years is assuring with the following financial results:

Table 9.1 Projected Financial Results (First Three Years)

Financial Parameter	Results of Projection	
	Normal Scenario Analysis	Pessimistic Scenario Analysis
Net Present Value (NPV)	RM948,753	RM274,473

Internal Rate of Return (IRR)	12%	5%
Payback Period	10 months	18 months

The pessimistic projection of payback of 18 months showing a positive NPV is encouraging especially when the forecasted sales is based on the current investigation when the country is only stepping out of the economic turmoil. We anticipate the IRR of 12% will improve given time to source for cheaper loans and investor such as the Angels. As such, the investment is feasible.

Clearly, if the assumptions are right and the economic condition turn for the better, Borneo Café stand a chance to profit based on the above projections. In short, prudent financial budgeting measures and aggressive promotional, marketing strategies must all be synergised to work towards the targets put forward in this business plan.

9.3 Months to Breakeven (Pay Back Period)

The payback or breakeven period for a single café are 10 months and 18 months for the normal and pessimistic scenario. These figures are deemed acceptable in the industry standard. Unfortunately, an actual comparison with the local specialty café is not available for comparison. In any way, the maximum pay back of 18 months for a single outlet is deemed feasible.

The task now remain how should we maintain the profit of the business in the long run. We believe that in order to avoid degradation of revenue and sales for Borneo Café, branding, promotion, marketing and advertisement are critical issues to be addressed. These issues are addressed in this report separately.

9.4 Coffee Material Source and Prices

This section provides some contact information of coffee bean suppliers and roasters.

Raw coffee bean Importer:

Kwong Seng Hung Co. Pte Ltd
No 174, Lebuh Pantai, 10300 Penang
Tel: 04-2616197 Fax: 04-2625910

Local Coffee Roaster :

Sin Heap Seng Kilang Kopi
1053, Jalan Haji Sulaiman, Kampung Berapit, 14000 Bukit Mertajam, Seberang Prai, Pulau Pinang
Tel: 04-5387853 Fax: 04-5304567
Contact : Mr Yeap Thay Oh

White Coffee Supplier:

White Coffee Sdn Bhd
No 8, Jalan Gasing, 4600 Petaling Jaya, Selangor, Malaysia
Tel: 03-77831816 Fax: 03-77832248

Price of Espresso Coffee machine:
About RM9, 000 for a second hand machine.
About RM18, 000 for a new machine

9.5 Coffee Bean Price

Since the main attraction to Borneo Café is white coffee, knowing the source and price of coffee bean will help the management to estimate the cost and also to source for the best price to roast white coffee. The following information is obtained from a local coffee roaster in Penang, Sin Kheng Lee Co.

Table 9.2 Prices of coffee beans

Type of bean	Price (RM / kg)
Robusta (Jawa)	2.30
Local Black Coffee: Wholesale	6.50
Local Black Coffee: End consumer price	10.00
White coffee: End consumer price	20.00
Arabica roast: End consumer price	36.00

9.6 Capital Expenditure

As a guideline, our interview with the local café manager cum entrepreneur revealed that in 1996, the estimated cost to set up a café inclusive of the cost of equipment, furniture and utensils is about RM200,000. Today we have estimated that the cost would have increased. The estimated cost for the setting up of one local outlet for Borneo Café is as follow:

	RM
Renovation of premise	200,000.00
Equipments	50,000.00
Furniture	25,000.00
Miscellaneous Expense	25,000.00
Estimated Total Cost	300,000.00