



MIHIR A. DESAI

ELIZABETH A. MEYER

The Valuation and Financing of Lady M Confections

The phone rang at the office of Lady M, a specialty cake bakery run by Ken Romaniszyn (GMP 2012). May 2014 had been quite a month for them; their phone had been ringing off the hook with potential investors. Ever since opening their second bakery in 2012 in The Plaza Food Hall in New York City, things seemed to be happening so quickly: Lady M opened a third shop in New York City, one in Los Angeles, and had licensed in both Singapore and South Korea. People couldn't stop talking about this cake 'boutique'—from its delicate, aesthetically-pleasing goods to its sleek, understated décor. Lady M had been featured in *Oprah Magazine* twice in one year and attracted the attention of many celebrities.

Investors had been calling daily, hoping to expand the Lady M brand to Asia and the Middle East. This particular investor, from China, had offered ten million dollars and a line of credit in exchange for an equity stake in the company along with exclusive franchising rights in China. This line of credit was especially alluring to Romaniszyn, as he had been considering opening a new boutique in the new World Trade Center in New York City. This was quite a risk, however, since the annual rent alone for that location was \$310,600.

Romaniszyn and Daisy Tom, the company's newly appointed CFO, had two things on their mind: the World Trade Center location and the Chinese investor's offer. Was the World Trade Center location worth the high cost? How many cakes would they have to sell to make the location viable and get their initial investment back in a reasonable amount of time? If they chose to open the World Trade Center location, how should they fund the construction costs? Should they take the ten-million dollar offer from the Chinese investor? How much of an equity stake would the investor get for that amount? Was this money and line of credit worth forfeiting an entire market? With all of the investors calling, Romaniszyn and Tom began to wonder exactly how much their quickly-growing company was worth.

A History of Lady M

Lady M Confections was founded in May 2001 as a cake wholesale business. In the beginning, it sold cakes to upscale restaurants and luxury hotels in New York City. In December 2004, Lady M opened its first boutique in the Upper East Side of New York. This boutique, with its sleek white and silver appearance, won a design award in the May 2006 issue of *Interior Design Magazine*. Lady M was

Professor Mihir A. Desai and Research Associate Elizabeth A. Meyer prepared this case. It was reviewed and approved before publication by a company designate. Funding for the development of this case was provided by Harvard Business School and not by the company. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

Copyright © 2015 President and Fellows of Harvard College. To order copies or request permission to reproduce materials, call 1-800-545-7685, write Harvard Business School Publishing, Boston, MA 02163, or go to www.hbsp.harvard.edu. This publication may not be digitized, photocopied, or otherwise reproduced, posted, or transmitted, without the permission of Harvard Business School.

different than its competitor bakeries; rather than serving the traditional, sugar-laden cakes that Americans are used to, Romaniszyn instead looked to emulate the bakeries of Japan. While influenced by the French, the Japanese bakeries focused on a delicate, less sweet taste and a careful attention to aesthetics. Lady M's signature dessert was their Mille Crêpe, a minimum of 20 layers of French crêpes layered with pastry cream (see **Exhibit 1** for photographs of Lady M's Mille Crêpe). On the opening day of their first boutique, Lady M's entire collection of Mille Crêpe cakes sold out within hours. Critics raved about the new bakery. Amanda Hesser from *New York Times Magazine* proclaimed:

Since it's impossible and foolish to claim that something is the best of anything in New York, I'll hedge my bets and say that the Mille Crêpes at Lady M Cake Boutique, just off Madison Avenue on the Upper East Side, is at least the second-best cake in the city. It succeeds so splendidly not just because it's wildly delicious but also because it's a clever design. Any number of decent pastry chefs could have come up with it. But they didn't.¹

After the success of the first Lady M boutique, Romaniszyn opened two more in New York City: one in The Plaza Food Hall in June 2012, and one in Bryant Park in July 2013. One was also opened in Los Angeles in August 2013. In April 2014, Lady M employed approximately 120 total workers in their domestic operations: around one-third in the kitchen, 10 in corporate, and the rest working in retail. The kitchen workers churn out approximately 7,000 crêpes per day and go through one imported crêpe pan approximately every four weeks. Romaniszyn understood the importance of keeping the kitchen staff happy, since it could take three to six months to find and train a new pastry chef.

Since 2010, Lady M had experienced considerable growth, with sales growing at a high of 81% in 2013 (see **Exhibit 2** for annual financial statements.) In addition, Lady M had seen net margins atypical of the restaurant industry; typically they run in the single digits but in 2013, Lady M had a profit margin of 11.4%. Lady M had been featured in many magazines, including *Oprah Magazine*, *Harper's Bazaar*, and *Vogue*, and had many celebrity fans, including Oprah and Martha Stewart, who stated that she "has been in love ever since" she tried their Mille Crêpe and baguette sandwich.²

Romaniszyn viewed Lady M as occupying a unique position in the market; while some bakeries attempted to replicate their signature mille-crêpe, none were able to do so. "Sometimes we joke that we're not a cake company, we're a crêpe company," Romaniszyn remarked. "Because a lot of people do try to copy what we do. Maybe they can make a few cakes. But no one could ever do it to our scale, and no one could ever make it to our quality, because the way we make the crêpe is special." Although other specialty bakers, such as Magnolia Bakery or Two Little Red Hens, could be considered competitors, Lady M had its own niche market in less sweet, aesthetically-pleasing baked goods.

4 World Trade Center

"Although Lady M is Japanese and French, I want people to think: Lady M is New York." Romaniszyn said. The World Trade Center was certainly a prestigious and iconic location in New York City, but it was not cheap. While setting up a new boutique typically costs around \$600,000, Romaniszyn predicted that the construction costs for the new World Trade Center location could

¹ Amanda Hesser, "The Way We Eat: Building a Modern, Multistoried Dessert," *New York Times Magazine*, May 15, 2005. <http://www.nytimes.com/2005/05/15/magazine/15FOOD.html>, accessed April 2015.

² Martha Stewart, *The Martha Stewart Show*. "Lady M in New York," 2007, <http://www.marthastewart.com/991656/lady-m-cake-boutique-new-york-city#991656>.

easily reach a million dollars. Rent was also substantially higher at this location at \$310,600 with an annual escalation of 3%. On top of this, they were looking at annual utility costs of approximately \$38,644 (with an annual escalation of 3%) and annual labor costs of approximately \$594,750 (with an annual escalation of 5%). The space was set to be 560 square feet within a food hall of 1,000 seats. Was the prestige worth the extra cost?

Based on the commercial nature of the area, Romaniszyn predicted the new World Trade Center location would have similar sales patterns to the Bryant Park location (which made \$1,152,001 in revenue in 2013). In Bryant Park, not only did they get the whole-cake purchases from businessmen on their way home after work, but also the customers who purchased individual slices, who may be on their lunch break or perhaps want to have a meeting in a different location. Romaniszyn expected the World Trade Center to also have both types of sales. When asked about possible self-cannibalization, Romaniszyn replied “In New York, every 10 blocks is like a different city. People don’t want to go 10 blocks. Really, it’s a 10-minute walk but they don’t want to go. It’s got to be within a two-block radius. It will make it really convenient for a lot of people to pick up cakes.” In addition, Romaniszyn hoped that this new location would open the business up to corporate catering because it would be in such a large office complex.

In order to decide whether the new location would be worth the expense, Romaniszyn and Tom decided to do a break-even analysis. They were interested in seeing how many cakes they would have to sell each day (at an average price of \$80 and with cost of goods sold assumed to be 50%) in order to make a profit in the first year. In addition, they were interested in how quickly cake sales would have to grow in order to pay back their start-up costs within five years of opening the new location. Although they were hoping sales would grow by 20% per year, if the new location didn’t do very well they might only see sales growth of 5%. Based on this information, they would decide whether to open the new boutique.

The Valuation of Lady M

Aside from the new boutique decision, Romaniszyn and Tom also had to consider the offer from the Chinese investor. If they accepted the \$10 million equity-stake offer, how much of their company would they be giving up? Was this offer worth it, considering they’d also lose their franchising rights to China? If they chose not to accept this offer but decided to open the new boutique, they needed to raise the money from other sources. With interest rates so low, should they instead choose to take out a bank loan?

The two decided to work out some baseline assumptions to value Lady M. For the year 2014, which was only around halfway over, they assumed the following:

- Sales would be around \$11 million. This was actually quite conservative, considering that sales growth had been 81.3% the previous year.
- Cost of goods sold; sales, general, and administrative (SG&A); and research and development (R&D) expenditures (all as a percent of sales) would behave similarly to 2013.
- Capital expenditures would be approximately 0.3% of sales.
- Additions to intangibles would be zero (as they also were in 2012 and 2013.)
- Amortization would be zero.
- The tax rate would be 35%.

- Working capital increased by \$10,800 in 2012, \$271,200 in 2013, and was expected to increase by \$68,000 in 2014.

In forecasting the next five years, Romaniszyn and Tom assumed the following:

- Annual sales growth would be 20% for 2015, 40% in 2016 (since the World Trade Center location would potentially be opening in late 2015), and 25% for the three years afterward. They assumed an annual sales growth rate of 4% in perpetuity.
- Cost of goods sold had consistently been approximately 25% of sales but had been dipping in the past two years. They expected it to remain approximately constant over the next five years.
- With rent and labor costs making up a large portion of their expenses, Romaniszyn and Tom expected SG&A costs to remain approximately the same as prior years, but to decrease by one percentage point each year.
- Although R&D costs had been negligible in the past, they decided they should probably assume some cost in the future as well, albeit only 0.1% of sales.
- With the prospect of opening a new store in the following year, the two decided to allocate \$1,000,000 for capital expenditures in 2015. After that, however, they assumed that no new stores would be opened and capital expenditures would remain approximately 0.3% of sales.
- Depreciation was expected to rise by five percentage points each year starting in 2014, becoming 100% of capital expenditures in 2019.
- Additions to intangibles would be zero.
- Amortization would be zero.
- The tax rate would continue to be 35%.
- The two expected the change in working capital to remain a constant percent of the change in sales and behave similarly to 2014.

In order to do a discounted cash flow analysis, Romaniszyn and Tom assumed Lady M's weighted average cost of capital was 12%. They chose a 12x EBITDA multiple.

Conclusion

With the day coming to a close, Ken Romaniszyn and Daisy Tom remarked upon how quickly this mom-and-pop cake operation had turned into a quickly-growing multinational company. They needed to figure out exactly how much their company was worth to take advantage of the investor attention they had been receiving recently. They were also running out of time to make a decision as to whether to open a new location in the World Trade Center. If they chose to open this new location, they would need to decide how to fund it – should they take the Chinese investor's offer of \$10 million plus a line of credit? Exactly how much of their business would they be giving up? The two certainly had a lot to think about.

Exhibit 1 Mille Crêpe and Green Tea Mille Crêpe



Source: Company documents.

Exhibit 2a Unaudited Consolidated Statements of Financial Condition

	12/31/2012	12/31/2013
Assets		
Cash	524,785	712,011
Investments in subsidiaries	-	-
Intercompany receivable	-	-
Affiliated receivable	53,037	135,267
Accounts receivable	276,197	387,044
Inventory	39,360	107,937
Prepaid expenses and other receivables	23	5,689
Deposits	54,100	99,809
Fixed assets, net	449,900	1,512,610
Total Assets	1,397,402	2,960,367
Liabilities and Shareholders' Equity		
Liabilities:		
Compensation payable	-	281,383
Intercompany payable	-	-
Accounts payable and accrued expenses	267,826	328,561
Deferred rent payable	-	63,097
Advanced receipts	-	6,022
Corporate tax payable	434	2,842
Interest payable	3,500	3,500
Loans payable - short term	412,500	99,980
Loans payable - long term	295,001	917,635
Total Liabilities	979,261	1,703,021
Shareholders' Equity:		
Capital Stock	1,886,504	1,886,504
Retained earnings	(1,780,234)	(1,484,770)
Current earnings	311,871	855,613
Accumulated other comprehensive income (loss)	-	-
Total Shareholders' Equity	418,141	1,257,346
Total Liabilities and Members' Equity	1,397,402	2,960,367

Source: Company documents.

Exhibit 2b Unaudited Consolidated Statements of Income and Comprehensive Income

	12/31/2012	12/31/2013
Sales Revenue	4,132,517	7,491,187
Cost of Sales	1,303,416	1,632,722
Gross Margin	2,829,101	5,858,465
Compensation		
Salaries and wages	1,309,589	2,691,881
Employee benefits	65,676	124,827
Total Compensation	1,375,265	2,816,708
PRIME COST	1,453,836	3,041,758
Other Controllable Expenses		
Sales, General, & Admin.	2,449,200	4,342,500
Direct operating expenses	273,864	499,837
Marketing	4,004	24,679
Utilities	91,272	125,102
General and Administrative	233,335	406,819
Repairs and Maintenance	98,506	104,450
Research and Development	-	-
Total other controllable expenses	700,982	1,160,887
CONTROLLABLE PROFIT	752,854	1,880,871
Occupancy and Depreciation Expenses		
Occupancy	351,075	753,379
Depreciation & Amortization	41,800	149,007
Depreciation	41,800	149,007
Amortization	0	0
Insurance	40,332	49,974
Other (Income) Expense		
Other (Income)	(21,627)	(38,479)
Interest Expense	21,804	37,186
Other expense	3,179	-
NET INCOME BEFORE INCOME TAXES	316,292	929,804
Corporate Taxes	4,421	74,191
NET INCOME	311,871	855,613

Source: Company documents.

Exhibit 2c Unaudited Consolidated Statements of Retained Earnings and Stockholders' Equity

	12/31/2012	12/31/2013
Capital Stock		
Beginning Balance	1,886,504	1,886,504
Stock Issued	-	-
Ending Balance	1,886,504	1,886,504
Reinvested Earnings		
Beginning Balance	(1,780,234)	(1,484,770)
Net Income	311,871	855,613
Dividends	-	-
Ending Balance	(1,468,363)	(629,158)
Accumulated Other Comprehensive Income (loss)		
Beginning Balance	-	-
Net foreign currency translation	-	-
Ending Balance	-	-
Total Shareholders' Equity	418,141	1,257,346

Source: Company documents.

Exhibit 2d Unaudited Consolidated Statements of Cash Flows

	12/31/2012	12/31/2013
Cash Flows from Operating Activities		
Net Income	311,871	855,613
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Depreciation and amortization expense	-	149,007
Other	(227)	-
Decrease (increase) in:		
Affiliated receivable	7,782	(135,267)
Prepaid expenses and other receivables	-	(5,666)
Accounts receivables	(17,677)	(110,847)
Intercompany receivables	-	-
Deposits	(16,875)	(45,709)
Inventory	(4,597)	(68,577)
Increase (decrease) in:		
Compensation payable	-	281,383
Intercompany payables	-	-
Accounts payable and accrued expenses	-	63,837
Deferred rent payables	-	-
Advanced receipts	558	-
Corporate tax payable	(22)	5,328
Loans payable - short term	270,000	(12,520)
Interest payable	1,750	-
Total Adjustments	240,692	184,065
Net cash provided (used) by operating activities	552,563	1,039,678
Cash Flows from Investing Activities		
Purchase of fixed assets	(15,197)	(394,150)
Leasehold improvements	(127,015)	(800,244)
Net cash provided by (used in) investing activities	(142,212)	(1,194,393)
Cash Flows from Financing Activities		
Proceeds (payments) on long-term loan	(24,540)	222,634
Net cash provided by (used in) financing activities	(24,540)	222,634
Net increase (decrease) in cash and cash equivalents	385,811	67,919
Cash, beginning of period	138,975	644,092
Cash, end of period	524,785	712,011

Source: Company documents.