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FINANCING EXPONENTIAL GROWTH AT H3

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Abstract

H3 is a fast-food chain that introduced the concept of gourmet hamburgers in the Portuguese market. This case-study illustrates its financing strategy that supported an exponential growth represented by opening 33 restaurants within approximately 3 years of its inception. H3 is now faced with the challenge of structuring its foreign ventures and change its financial approach.

The main covered topics are the options an entrepreneur has for financing a new venture and how it evolves along the life cycle and different business approaches, namely franchising. It aims to be used as a learning tool in courses such as entrepreneurial finance.

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Case Study - Financing exponential growth at H3

Henrique Freire was looking at a crowded Avenida da Liberdade wondering about the future for H3. He knew that they travelled a long way since the small Café 3 grew into the national giant in the food industry that H3 had become. Yet, he was not at ease as he knew that a great opportunity was emerging: the internationalization of the concept. After dodging the temptation for four whole years it would be difficult for H3's shareholders to face this new challenge without an equity partner to support them. With this he wondered if the company was ready and how to structure such an overwhelming adventure. Should they seek someone to invest in this new venture? Should they just stay local? Does this fit their financing strategy so far?

1. The Company & Founders

In 2004 three friends (Miguel van Uden, António Araújo and Albano Homem de Melo[1]) decided to pursue their lifelong dream and open a restaurant. They wanted to create a concept where busy people could have lunch in a relaxed environment, with quality food but also a short experience to fit a business person lunch period. When constructing this business plan they decided that it was not necessary to have all of them working in the restaurant, thus only Miguel van Uden was full-time dedicated to the restaurant while the others maintained parallel activities.

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[1] See Exhibit 1 for a summary of the founders' past experience

Later that year Café 3 was founded with its equity spread equally through the founders in one of the most prestigious places in Lisbon, Avenida da Liberdade, in the heart of a cluster of companies and luxury shops, but also a step away from the historic city center. The restaurant offered a modern lounge where businesspeople could enjoy their lunch break with quality without wasting time. It had a large selection of dishes with fresh products to cope with the premium quality that the partners strived for since the beginning.

What started off as a trendy and successful restaurant soon revealed itself to be a financial disaster. Although the founders were passionate about the restaurant, the accumulated losses cried for the need of some change. Wondering about what had gone wrong they realized that the customers did not perceive the product with the quality the founders knew it had. Furthermore sustaining a large menu was damaging the possibility of creating a sturdy and lasting impression on clients by not being able to concentrate in any particular set of dishes. The only exception was the line of gourmet hamburgers that showed positive indicators in terms of consumer acceptance, but still was not enough to sustain the heavy structure arising from the high inventory due to the large menu.

In their quest for a solution two alternatives were considered: reshaping the existing restaurant or pursuing a completely new business model within the food industry. Left out was the possibility of moving to a new industry and throwing away a long-lasting dream of the three founders.

Once the team decided to start fresh, they established that they would not impose a concept on the market again but they would rather let the market impose a concept on them. This time there was no margin for any error and they assumed the risk by quitting

their jobs (except Miguel van Uden that already worked at Café 3) betting everything on the success of this new venture.

2. A New company

For a whole year the founders and their families searched for a market niche where they could make a difference. During that year they realized that the concept of "food court"[2] was developing fast in Portugal but some opportunities were still left unexplored. There were thousands of brands offering what the segment was known for – quick and low cost service. Nonetheless the team did not give up on one condition, the quality of the food. That was when they grasped what was missing in the segment and that was, as they proudly call it: *The not so fast food.* This concept was about fast service and quality food.

"We watched people coming in and out of restaurants for a whole year and we even benchmarked the colors of the brands so that when we go to the market we do it properly" – Nuno Van Uden, Public and Press Relations

Remembering Café 3, there was one concept that has the characteristics they require for this new venture, the gourmet hamburgers. They knew that their hamburgers had the quality they required and the acceptance by the clients that they desperately needed.

"When you open a restaurant in a mall you don't want to have everything in your restaurant, you want to have what you are best at, what you are better than the others. So, if someone wants a pizza he goes to our neighbor, but if he wants a

[2] *Food court - an area in a shopping mall where fast-food outlets are located.* – Oxford dicionary

hamburger he knows that ours are the best." – Nuno Van Uden, Public and Press Relations

The "food court" was characterized by mono-product restaurants, where the clients can buy the food and eat in a space that is common to all the restaurants. Thus it is crucial for a restaurant to be either the best or the only one offering its product. In this case this new company would never be the first to offer hamburgers, yet the founders felt it could be the one to offer the best hamburgers at such a small premium that would clearly compensate when compared with traditional fast-food chains.

Developing on the idea they gave considerable thought to every detail. They wanted to have a short menu[3] focusing on hamburgers as a main dish, three or four garnishes and some different sauces. As an instrument to ensure quality they wanted to have fresh products being delivered every day to each restaurant and avoid using anything frozen or pre-made, unlike typical fast food concepts.

"70% of the drinks we sell are home-made. We still sell Coca-cola, which is bought already done as we haven't figured out the formula, yet." – H3 Press Release

Service quality was the second pillar of their business model, so they defined a goal of a 20 second interval between a costumer ordering and the food being served. This would be possible by dividing the service into stations were each employee could perform its task as efficiently as possible resembling an assembly line approach, where the dish is composed in the different stations through which the client passes. This opposes the methodology where the workers are assigned with multiple tasks each (e.g. receiving the order, gather the ordered items and receive payment) and the client faces one single server.

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[3] See Exhibit 2 for an H3 sample menu

The pricing was higher when compared with the other fast-food chains due to the premium quality ensured by the freshness of its products. However they felt that this premium should be so small that a client values more the increase in quality than the increase in price when compared with the competitors. In order for this approach to the segment to be sustainable, they felt that inventory management would be decisive, as piling inventory would mean assuming big losses on a daily basis, thus they planned a careful approach where everything was thoroughly studied. *"We counted how many slices were in an average lemon, and then restricted our suppliers on the measures of the lemons we got, therefore there was no waste and we knew exactly when we needed to order again."*

3. The new management structure

At first only Miguel van Uden was working at Café 3, but with this new venture Albano de Melo and António Araújo felt they needed to step in and integrate the management structure. In this new outline the company was divided in four main areas: Finance & Expansion, Marketing & Quality, Operations and Kitchen.

António Araújo, who used to work as a lawyer and also managed an event's promotion company, now dealt with all the processes related with financing and accounting in H3. The multiple-award winner in marketing and advertising Albano de Melo became responsible for the communication and quality management. As a consequence, Miguel van Uden was now able to focus only on the operations leaving the other areas to the other partners. The fourth element that was in charge of the Kitchen department was Chef Vítor Lourenço, the former chef of Café 3 that continued with them after the restructuring. He was also in charge of the internal training of new employees, a pillar in the quality they aimed to achieve. Besides his position in the

hierarchy he also entered the shareholding structure with a minority position of 4%, while the other three founders divided equally the remaining share of the company.

4. Financing the *not so fast-food*

"When you combine ignorance and leverage, you get some pretty interesting results." – Warren Buffet

Although in practical terms the company remained the same after the change in business model, for all purposes this was regarded by the founders as a new start, and pursuing a new venture required a significant amount of capital investment. They knew that the puzzle of building a capital structure is often the defining challenge that distinguishes a sustainable and long-lasting venture from a good idea transformed in a big company on top of weak foundations ready to break at a minor contradiction. With that in mind the founders decided to invest a substantial amount of personal capital on the business but also worked to find an adequate debt instrument that allowed them to finance this new business opportunity while keeping control of the company.[4] The introduction of an external investor, both institutional and individual, was excluded given that the founders did not want to dilute their ownership.

The first problem they had to tackle was the accumulated losses that came from Café 3 resulting in a negative value of equity. The capital increase came through supplementary capital (81.211€) which was also used for financing the new venture. Regarding the debt instrument to complement the strategy was found within the dichotomy financial debt - capital leasing.

Financing the new venture through financial debt was extremely expensive due to the probability of default inherent to any new business and the subsequent loss given

[4] See Exhibits 3 & 4 for the company financial statements

default that the lending institution would incur in. Capital leasing on the other hand edges the risk of a big loss given default since the legal rights of the assets remain property of the lessor. The flexibility that this financing strategy would give to the business is crucial for freeing capital to make new investments in the short-run. Consequently they decided to pay the outstanding loans that came from Café 3 and use capital leasing to give the necessary leverage and flexibility to the business.

This strategy led to the opening of the first two restaurants[5], in Saldanha and Amoreiras, whose success was translated into dozens of press articles praising its quality, while the financial results were already showing indicators of sustainability in the first year of investment.

5. Capitalizing on the success

"One day we will be the world's biggest hamburger chain"- H3's media release

The company ended the year of 2007 with a trendy restaurant constantly being highlighted in specific and general media but with the new challenge of growth on their hands. They believed that H3's unique approach to the fast-food segment could be easily replicable and the conditions for tackling growth where already met.

Without an institutional investor, the question on where to draw funds from arose again, but this time in a much bigger scale. Investing from their own funds was not an option given the scale and the inherent risk. The solution to this enigma was to expand their asset base through a mix of capital leasing and financial debt but the most important slice came from the cash-flow generation by the existing units. The tight inventory management taking place at H3 allowed freeing an important amount of money in the short run to refinance the growth.

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[5] See Exhibit 5 for a complete list of H3 restaurants

“The beautiful thing about this business is its ability to self-finance its own scalability”- Henrique Freire, Head of the International Department at H3

6. Time to let the bird out of the nest – A new business approach

The exponential growth the company was facing created some constraints both at business and corporate levels. The weight of the management structure was creating additional layers to cope with the standardization required by the business model and ensuring it was followed throughout all units. Furthermore the amount of investment needed to take advantage of all the growth opportunities was also escalating.

Instead of slowing down the growth pace H3 decided to embrace a new business perspective, franchising. With this the company could sustain its growth rate without making major investments. The franchisees would pay H3 for the brand and know-how utilization while making all the investment and ensuring the fulfillment of the quality standards H3 endeavored for.

In September 2008 the company opened doors for its first two franchises[6] in “DV Antas” and in the next month in “IKEA Porto”. Although own stores accounted for most of the company growth throughout 2008-2010 the company conceded two other franchises in 2009 and seven in 2010. At this stage the main concern of the management was not to find franchisees but to choose from the big pool of requests the ones that they felt to incorporate the spirit of H3. In fact, in 2010 the company was receiving an average of four franchising requests per week, and only ended up accepting two franchising deals, one for the North Region of Portugal and another one for the autonomous regions of Madeira and Azores. The franchisees were granted with the

[6] See Exhibit 5 for the list of H3’s own and franchise restaurants

exclusive use of the brand for that specific region, that is, H3 could not allow any other player to open a franchising unit in that region without the consent of this franchisee.

After the sonic boom of 6 restaurants opening in 2008 and 13 in 2009, it was not long before the first problems start appearing. Managing two restaurants and making sure they were able to cope with the quality standards that the company had been striving for was easy, but with growth, heterogeneity started to appear among the different units, which can be a killer factor in a franchising business model. The complaints stated that the problem was not with the overall quality, but that particular experience.

"When we are told that it (the hamburger) wasn't good it feels like a stab"[7] *– Miguel van Uden, H3 Founder*

To deal with this problem H3 created the "Grill School" headed by Chef Lourenço, the former chef of Café 3 and a detailed guide book[8], aimed at standardizing the product and guarantee that one "*H3 Tuga*" in *Amoreiras Shopping Mall* tasted exactly the same as the similar hamburger in *Fórum Almada Mall*. With this they were able to reverse the critics of non-uniform service into praises of quality management.

7. The typical H3 restaurant

At this stage H3 had two different business approaches in its restaurants: own and franchise restaurants.

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[7] In Revista Focus, May 2009

[8] The H3 Guide Book details graphically all the phases of the operations of a restaurant. It is written in a way that is of fast access and encouraging for the most uneducated employee to read. It explains the function on each station of the kitchen, how to prepare all the dishes, the cleaning routine, inventory procedures and other useful tips for the daily challenges of an H3 employee.

Own Restaurants[9]

The majority of H3's units are owned by the head company, which means that the investment is made by the company in both fixed assets and all of the phases of the supply chain. The average investment required to open a new H3 unit is €250.000 excluding working capital requirements. Per year each restaurant is able to generate around €750.000 of sales, with a "COGS to Sales ratio" of 30% and an operating margin of 11%. The clients pay immediately so the account receivables are inexistent. H3 takes on average 96 days to pay to suppliers and 13 days to empty its stocks. The marginal investment required at a corporate level is assumed irrelevant for the opening of a new restaurant. The cash-flow from the operations as well as the short-term financing that arose from the negative net working capital was used to fund the next restaurant. The remaining part of the financing requirement evolved throughout the years as patent in H3's financial statements.

Franchising Restaurants

The franchising agreements secured by the company had three different ways in which the franchisees created value for H3: a signing fee, percentage of sales and participation in the logistics. The signing fee is paid for each new restaurant and that is highly variable depending on the location and if there is any especial payments to the shopping mall in which the restaurant is going to be in. Secondly the franchisee pays between 5-9% of its sales (depending on the level of sales) to compensate for the continuing effort that H3 needs to do to support its franchisees.

The last one is logistics where there are two different phases: the initial investment and the ingredients for the daily operations. The initial machinery H3 does

[9] The actual values were disguised to protect confidentiality. Accounts receivable and inventories values refer to the official financial statements of H3.

not require that the franchisee buys it from the company, but in any situation it requires the approval of the company. For the logistics during the activity H3 defined three types of products: *exclusive, important* and *undifferentiated. Exclusive* products are the ones that H3 feel that are crucial to the quality and thus requires the franchisees to buy from the company (e.g. meat for the hamburger). *Important* products are the ones that H3 gives the freedom for the franchisee to choose the supplier but require approval from the company. Finally *undifferentiated* products are the ones that influence so little in the final quality that the franchisee can choose on its own without requiring approval (e.g. salt).

At this stage only the restaurant at *Madeira Shopping* had a different approach, where H3 participated also in the initial investment, owning then a higher stake in the sales of this unit, which meant it worked as a hybrid between own and franchising unit.

For H3 the franchising unit represents a client, so in this case the value of account receivables is no longer negligible.

8. A new era for H3

"The size of the Portuguese market is limited. We estimate it to have enough room to open around 50 H3 restaurants in the country." – Henrique Freire, Head of the International Department at H3

The business model pursued by the company was targeted at urban centers that have a shopping mall with a restaurant area and it was reaching the saturation point given that the company did not want H3 restaurants competing against each other. As a consequence of its exponential growth, H3 had to face a difficult decision that companies usually make in a much more mature phase. They had three options at this

point: decreasing the growth rate and only explore the few options left, changing the business model to allow new alternatives to emerge or going abroad.

Decreasing the growth rate would mean wasting the momentum gained by the company during these three intense years where they were able to grow an admired brand and a set of remarkable partners interested in pursuing a joint-venture of any kind. This option was not seriously considered by the team that still maintained the passion and belief on the potential of this project.

Both internationalization and a change in the business model were being equated by the company at this stage.

9. H3 learns foreign languages

"We want to get where we are able to be and where it makes sense for us to be."[10] *– António Araújo, H3 Founder*

In the middle of 2010 H3's management was convinced that the company was consolidated and ready to expand internationally. From this belief a new department within the company was born: H3 International. Thus, in June 2010, Henrique Freire, a former partner of M&A at KPMG, entered the firm to head this new department.

His first task was to identify the potential markets and the availability of local partners to help them. The prospects were enormous, but the company maintained the strict criteria that characterized the search for a franchising partner within Portugal. From the analysis there were three opportunities that arose from the pool of candidates: Spain, Poland and Brazil.

[10] in Revista Focus, May 2009

Spanish Market

Spain was the most advantageous foreign market from the point of view of logistics and control as H3 had already some relations with Spanish suppliers which made easier to develop the supply chain in that country. The main drawbacks on this market were that it is a very mature market, with fierce competition and practically no food courts, which forced H3 out of the shopping malls. To circumvent the inexperience of H3 with this new business approach, the company was able to secure an agreement with the largest foodservice group in Iberia. This settlement granted the exclusive use of the H3 brand in Spain to this franchisee, which would incur in all the needed investment and pay an entering fee and royalties as percentage of sales. The logistics would be handled by the Spanish group, given that H3 relied on the experience of this player.

Polish Market

Poland was a completely different case, the market was in a growth phase and the food court spaces were flourishing throughout Polish cities. The main advantage of this market was the possibility of replicating the Portuguese concept in a fast growing environment, while the key challenge was taking care of a whole new supply chain in a country where H3 did not have any kind of networks. A major driver for H3 to be interested on this opportunity was the prospect of working with two valuable partners that would secure 60% of the investment, while H3 was responsible for the other 40%. The suppliers would be the same as in the Portuguese company, leading to a very dramatic change in terms of the net working capital approach.

Brazilian Market

This was a market that was still tangled in a fog of uncertainty given that there was still no partner to neither pursue a joint-venture nor a franchising approach. Nevertheless this was the market that the founders and Henrique Freire felt was the

most natural for the business model that H3 pursued. The food court was extremely well developed in this market and the rate of growth was immensely appealing.

The company was well aware of the challenges that might arise from going alone to this market and thus the preferred outcome at this moment was postponing this opportunity while no partner was found.

10.Deciding H3's fate

(In terms of consolidation of processes) "We don't envy the major fast food chains in the world" – Henrique Freire

The last thing on their minds was that although they found the potential for successful international ventures, they should regarded again as a start-ups and they did not want to conduct the cash stream of the Portuguese operations to such a risky project.

Henrique Freire's belief that this company had the potential to compete side by side with the most renowned franchises in the world was partially what led him to accept joining the company. He firmly believed that this company had the structure and the know-how to be able to create value in any market. Nonetheless, the specificities of each market where an unknown in the equation of internationalization, moreover the investment needed was overwhelming when compared to the incremental effort required within national borders for opening a new set of stores. He was continuously reassured that the company had the tools to tackle any obstacle that is set on its way. However he knew that most of H3's success is given by the company not leapfrogging important stages on its development. Is this the best timing to take advantage of these three opportunities? What implications shall they have in the strategy of H3? Is the same financing strategy valid for these foreign ventures?

Teaching Note - Financing exponential growth at H3

1. Teaching Purpose

This case discusses the financing strategy of the growth in H3 since its inception until the internationalization of a mature company. It covers different types of financing strategies for diverse business phases and the change in business approach as a way to sustain growth. It is aimed to be used in courses such as Entrepreneurship, Entrepreneurial Finance or Finance as a comprehensive tool for analyzing different alternatives an entrepreneur faces, with special emphasis on financial approaches – leasing, own capital and financial debt – and business approaches – franchising, owned units and joint-ventures.

2. Possible Study Guide

1. Was the three partners' background adequate for opening a restaurant such as Café 3? And H3?
2. Many companies seek an external investor such as a Venture Capital firm or a Business Angel when entering in a new venture. Should the shareholders of H3 have tried to secure any of these sources in an early stage? What would be the implications of it?
3. H3's founders decided to be the only equity investors in this venture. Discuss its implications and other alternatives.
4. How did H3 approach its financing at each stage? (Hint: Build a Cash Flow Statement)

5. Why do firms decide to franchise? What are the implications of it? Was the decision in due time at H3?
6. Discuss how the financing of a business such as H3 becomes increasingly self-sustainable with scale.
7. What are the implications on the financial strategy of H3 if the company decides to pursue each of the international opportunities? Would it make sense for H3 to pursue them right now?

3. Class Plan

This should accompany a class aimed at introducing the thematic of financing and structuring new ventures. It can also be used as an introduction to a more extensive work where students are asked to propose a structure to the foreign ventures of H3. The proposed flow of the lecture would be as follows. The initial motivation can be presented to students under the Entrepreneurial Process model[11] and the instructor could encourage the students to evaluate the process of choosing a line of business, comparing the alternative of suppressing a market need (as the process for H3) to creating a new market one (as the process for Café 3).

In what is H3's strategy different from other fast-food companies? What are its strong and weak points?

The fast-food segment is known for two main characteristic: quick service and low-cost meals, but one less emphasized characteristic, for obvious reasons, is the typical low quality of food which is frozen and stored for long periods of time resulting in deteriorated products being sold to the costumer. H3 main innovation was to add a

[11] See Exhibit TN1

small premium to the price of each meal that allowed the company to always use fresh and quality products. Its strict mono-product approach also created an edge over typical fast-food companies in terms of inventory management, which will be crucial for H3's business plan. To better summarize the evaluation of H3's strategy students should be encouraged to build a SWOT analysis[12].

What is the importance of a good team in a new venture? In what were different the skills required for a normal restaurant and a franchising business model?

In entrepreneurship the team is as important as the idea itself, as the survival of the business is all about the implementation. In this case we see the difference when there is a fit from the idea and the founders' background compared to the initial stage where none of them had relevant experience.

When they opened Café 3 the three partners had no experience from owning a restaurant and only one of them left his previous job to work full time at the restaurant, which indicates a lack of commitment. In 2007 when they prepare for H3 they bet everything on this idea and they had some key skills for a franchising approach. Albano de Melo was specialist in Marketing & Advertising which is decisive in the success of a "food court" concept where competition for getting the client to one's restaurant is fierce. Miguel van Uden and António Araújo had managerial experience, which relevant here where they have to design the guidelines for the whole company but the actual operations are left to the individual restaurants to develop, contrarily to what happens in a *standard* restaurant such as Café 3.

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[12] See Exhibit TN2

Moreover we can use the VOS Indicator ™ [13] to compare the two alternatives:

	Potential Attractiveness	
Management Team[14]	**Café 3**	**H3**
Experience/expertise	Little	General
Functional areas	Few covered	All covered
Flexibility/adaptability	Slow to adapt	Able to adapt
Entrepreneurial Focus	One Founder	Full Team

What are the possibilities to finance a new venture? What are the pros and cons of each one in the case of H3?

Here the students are encouraged to elaborate a list of pros and cons of each of the financing source for start-ups and apply it to H3's case. The most important resources are discussed below with a set of possible debate points, from the point of view of the entrepreneur.

Entering a business with an investment made entirely with own equity is extremely risky and equity from another partner is very expensive given that in the event of default the equity holders will sustain a very big loss. Thus, entrepreneurs try to make a balance between equity and debt instruments that fit their requirements in terms of flexibility and ownership. Different ventures will require difference financing strategies depending on the business characteristics and the owner's preferences.

The equity instruments an entrepreneur can use are: own equity or an external equity investor. Making the equity investment relying solely on own capital has as main

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[13] LEACH and MELICHER – 2009, Entrepreneurial Finance, 4th Edition, Ohio: South-western, 52-55

[14] The VOS Indicator ™ is a much more extensive tool but for the purpose of this case this should be the highlighted part to provide a systematic comparison between the fit of the management team to both business models.

advantages the control over the venture and the entitlement to all the venture proceedings after repaying debt holders while the main problem related with this strategy is the risk to which the entrepreneurs get exposed to. In the case of H3 the founders favored the control over the risk and decided not to bring any external investor to the venture. Moreover, in a venture such as H3 the self-financing that is created through the Net Working Capital gap (studied further ahead) decreases the financing requirements by sharing the financing risk with the suppliers. Nonetheless there are some advantages[15] on having external investors that H3 forfeited by choosing this strategy. In a financial approach such as H3's, where the Working Capital is crucial, having an equity partner that increases the reliability to suppliers increases its bargaining power and would enhance this effect. Furthermore a right partner, with experience in the field is expected to add value in building the whole value chain of the new company.

As in a typical venture H3 founders also decided to resort to debt instruments to dilute the risk of the venture. As in more mature companies, the cost of debt is considerably lower than the cost of equity, but in the case of a new venture the value of the tax shield is on average zero, given that a new venture is not expected to generate profit in the first year. Thus, the emphasis on the advantages[16] of having a debt instrument relies mostly on the cost of capital and risk sharing. The relevant instruments to study here are the financial debt and the capital leasing. Financial debt is when an institution (e.g. a bank) lends the capital to the company and the company owns both the legal and economic rights of the asset, while in the capital leasing the lessee pays a

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[15] ROGERS, Steven – 2009, Entrepreneurial Finance, 2nd edition, Kellogg School of Management, New York: McGraw Hill, 237-281

[16] KOLLER, Tim et al. – 2010, Valuation, 5th edition, New Jersey: McKinsey & Company, Wiley

periodic installment to the lessor for the economic rights of the asset. Leasing has a bigger advantage over debt when the probability of default is higher, given that the lessor owns the legal rights and in the event of default is not subject to the long and complicated process of bankruptcy to recover the collateral of a loan, as it is with financial debt. The lower loss given default will be reflected on the pricing of the leasing and for this reason the strategy designed by the founders of H3 relying on leasing rather than financial debt implied a lower cost of capital, freeing additional funds in the short-term.

Was this company (H3) a typical venture capital target? What could institutional investors add to H3?

Venture Capitalists usually invest on completely innovative ideas in high-tech, fast growing sectors with proprietary technology, which is clearly not the case of H3. Although H3 had a solid business model it does not fit in the type of firms that venture capital firms usually hold on their portfolios.

Looking closely at H3's business model its supply chain is one the most important aspects, especially the short-term financing generated by the negative net working capital. Thus, having an institutional investor could foster the confidence of suppliers which would be willing to concede a higher payment period. Moreover the standardization that H3 had eventually to do and spend a lot of resources could be easier if the institutional investor had already experience with such processes. The problems that arose after the initial growth phase might have been avoided by a more experience partner anticipating the standardization process.

Nonetheless as seen in the previous topic, venture capital did not fit H3's objectives in terms of ownership and the intrinsic characteristic of this business to self-finance decreases the attractiveness of external equity investors.

H3's financing strategy evolved drastically during these three years. Why was it able to change and why did it change? Does it follow a traditional venture financing strategy along the life cycle timeline?

In building a franchising restaurant model there are two main phases in the financial structure. At first there is the need for a big capital injection to invest in fixed assets and other operating needs for the first unit, which has to come mandatorily from one of the instruments discussed above either through equity (own or from a third party) or debt. The second stage is when the restaurants start generating cash-flow which can be used to finance other restaurants. This is then an example of how to build a fast growing company without continuous investment by using the operations as a critical source of funds[17]. Students should also be encouraged to discuss the impact of this strategy in terms of the payoff to shareholders that are, in the short-run, postponing the collection of dividends to favor growth.

If we take a closer look at the financing evolution and relating it with the life cycle[18] of the company we see that it follows a standard approach: first financing the venture mainly through equity, then harvesting the cash flow and financing from operations (here with a higher importance than most ventures) and finally financial debt.

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[17] See Exhibit TN3

[18] LEACH and MELICHER – *Entrepreneurial Finance* (4th Edition 2009) – South-western, 23-28

What is the defining characteristic of this business that allows this exponential growth without continuous capital injections?

The critical tool to analyze in this topic is how a restaurant is able to have negative working capital requirements and how a big franchising can increase this advantage. As the restaurants start to operate they will start receiving from clients immediately, thus leaving the balance only to inventories and account payable. The inventories are rather small in a restaurant, especially when the business model is based on daily products and a tight inventory management. The days in account payables escalate with the bargaining power of a company, which is a function of, among other things, its size. Therefore, as H3 was able to grow, it created conditions to short-finance even more growth through this gap. If we take a look to the values presented for a typical H3 restaurant one can see that in the first year a restaurant creates a short-term financing of €51.164 through negative working capital requirements and an operating result of €79.863. When comparing this to the investment in one restaurant we see that we generate around half of the needed investment for the next restaurant. This is what makes the financing strategy of H3 peculiar and not replicable in other areas of business. In a typical business clients are likely to have some bargaining power that allows them to pay later which, together with the inventories, nullifies the effect of the suppliers' financing. Given this, the scalability of typical businesses has to be financed through continuous capital injections, contrarily to the operational financing verified at H3.

How is franchising an option for growth in capital constrained companies? What other opportunities or challenges arise from this?

In a franchising model the franchisee pays a fixed and a variable fee to the franchisor for the use of the brand, know-how and access to the supply chain. For a company as H3 this is an option to expand the business without investment, given that the investment is, on its majority, made by the franchisee.

This business model should not be regarded as a mere way to promote growth, but also as a tool to decrease risk and align incentives[19]. By leaving the operational part to the franchisee, the franchisor is edging the risk of that particular restaurant failing and not recovering the investment made. In a different perspective a store manager that has a stake in the company (franchisee) has greater incentives to manage properly the brand than a store manager employed with the master franchising.

The main challenge in a franchising is to assure that the quality standards are followed in every franchise and every task increasing the pressure on the quality control procedures. Thus, the choice of the franchisee can determine not only the success of a single unit, but can also influence the master franchising.

In the case of H3 one can identify a problem in the timing to start the first franchise given the problems that arose from heterogeneity. Although the firm was effective in reversing the critics, the homogenizing work with the Guide Book and the Grill School should come before the expansion and not as a corrective measure.

What is the implication of changing the business model for a company as H3 at the stage where it is in 2010?

Changing the business model at a stage of consolidation would mean getting out of the *food court* and enter in a market where H3 would have to build a whole new

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[19] Fulop Christina & FORWARD JIM (1997): Insights into Franchising: A Review of Empirical and Theoretical Perspectives, The Service Industries Journal, 17:4, 603-625

value chain. The *food court* segment is based on the premise that a restaurant does not need to offer everything but function actually as a complement to the rest of the supply, thus to expand to a different segment it would need to incorporate enough *reasons* to get the costumer there, that is, the decision to go to H3 would be most of the times taken before the client actually get to the place contrarily to what happens in the *food court.*

By increasing this offer there would be higher constrains on inventory management which would affect the capacity to generate negative working capital requirements which has been a terrific tool in this expansion phase.

What is the role of strategic partners in foreign ventures?

When entering foreign markets there are multiple challenges that are different from the ones the company faces in its home country, so the partners can help in one or more of these issues.

There are multiple partnerships that can be built, but in the case of H3 the relevant ones are:

<u>The partner makes the investment and explores the restaurant</u> – it works as a franchising, which will hedge the risk of entering a new market but also cap the possibility of higher gains. There is no value added for H3 besides the royalties paid by the franchisee.

<u>The partner and H3 enter in both stages of investment and operations</u> – H3 will be able to put in place their value chain approach and implement the concept correctly while the partner would provide knowledge of the market itself and, if a right partner is found, implement also some best practices. This approach can benefit not only the new venture itself, but it can also contribute to an improvement in the overall value chain.

The partner only enters as an investor – this approach will have a small value added besides spreading the risk.

All-in-all the main role of a strategic partner is to decrease the risk and support the implementation of the company.

As important as or even more important than structuring the type of partnership is to choose the right partner. This premise is vital to ensure the maintenance of the quality standards of H3 and guarantee the best approach to the specificities of a certain market in a set of items that can go from the right industry analysis to the construction of the adequate value chain.

How would you evaluate the alternatives for growth at H3?

This question should be open-ended where the main point to look for is the fit of the proposal with the characteristics of the opportunity and especially its implications on H3's strategy.

In the Spanish market the food court is said to be highly underdeveloped which means that the current H3 strategy would be unsustainable there. From this there are two possibilities: changing the business model when approaching that country or abandon the idea of going to Spain. The franchising agreement that H3 already was able to secure with the largest foodservice provider in that country is reassuring that the company can hedge the risk of changing the business model without risking the brand's reputation. As the investment would be done by the Spanish group there is no puzzle on where to draw funds for this new venture.

Poland is a different case for this matter. The company would still need to spend around 40% of the total investment made in the country, therefore it would be vulnerable to a big operational risk on a growing country but yet uncertain on its future.

However part of this risk would be mitigated by the two local partners that would add tremendous value for a successful implementation. The major problem is that, has seen until here, this is a business that requires scale which is much more difficult to gain here given the constraint of having the same suppliers as for the Portuguese restaurants. The restrictions would be much bigger when dealing with suppliers and the inventory would increase heavily, eliminating one crucial financing tool for this kind of business.

Brazil is still a question mark. The potential of the market is huge but there is no investor that met the strict criteria of H3. Thus the recommendation here should be to wait because the main drivers of value creation of a company such as H3 would be highly constrained: building an appropriate supply chain (it would be impossible to use the Portuguese channels effectively), adapting the company to the new consumers and other specificities of the value chain.

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[20] All the references are in the case are made in due place during the case-study and teaching note. The present page is merely to be used as a summary of the general references used during the elaboration of this work.