

The Pudong Coffee Shop

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“Better to be deprived of food for three days, than tea for one.”
— Ancient Chinese Proverb

INTRODUCTION

The magnificent country that is China conveys a great many different images, but perhaps none more so than that of a Chinese tea house! However, that image is rapidly changing due to the recent growth of coffee shops. Just a decade after Starbucks opened their first store in China (in January 1999) a coffee culture has emerged in the land of tea drinkers. For example, Beijing now has more than 8,000 coffee shops – eight times more than just a decade ago – as the younger, affluent, urban Chinese professionals consider drinking coffee to be elegant and exotic (www.chinadaily.com). Based on reports issued by the London based International Coffee Association, it is estimated that coffee consumption in China is growing at a double-digit rate per annum, compared with a global average of slightly over two per cent. However, this impressive growth is partly due to the fact that China is starting from such a low base. On average, it is estimated that each Chinese person drinks about three cups of coffee a year, compared with somewhere between 500 to 700 cups for a typical American person (www.chinapost.com). Not surprisingly, it can be argued that China has the potential to become the largest coffee consuming country in the world because of its rapid economic growth and huge population. However, coffee consumption, for the time being, is highly concentrated in the large cities such as Beijing, Guangzhou, Shanghai and Shenzhen. Thus, if one assumes that the potential Chinese market for coffee is limited to, say, 20 per cent of its 1.3 billion population, that would provide

a market as big as that of the United States! Therefore, it is understandable that many international coffee chains have commenced operations in China in recent years; and these include, for example, Coffee Bean & Tea Leaf, Costa Coffee, Starbucks Coffee and U.B.C. Coffee. More recently, in June 2010, China Resources Enterprise (CRE), China’s biggest supermarket chain operator, indicated that it would buy 80 per cent of the Hong Kong-based Pacific Coffee for HK\$326m (about \$42m) and expand on the mainland in an attempt to tap into China’s growing coffee-drinking culture. CRE announced that it would develop Pacific Coffee by having its own coffee outlet in every one of its major shopping malls, with an ultimate goal of becoming the largest coffee chain in China in terms of size (www.FT.com). The average cost of a cup of coffee in these international chains amounts to between Yuan 30 and 40. Thus, many people believe that it is not the coffee itself that matters but rather the ambience and status experienced by its young, affluent clients. This ambience, together with location and visibility, create an interesting marketing challenge for coffee shop managers and their consultants.

Li Wang is one such coffee shop manager. He readily admits that he is an unlikely manager since he has very little experience in the hospitality sector. A few years ago he graduated from a university in Wuhan with a top class degree in English and International Relations. He received and accepted a scholarship to further his studies in Europe, where he undertook a Master’s degree. This European study allowed Li the opportunity to see some of the major European capital cities. They were all different, yet he remembered that they had one thing in common – coffee shops. Virtually each street had its own coffee shop; sometimes several of them existed side

by side. Each outlet allowed its patrons to relax and socialise with friends or simply ‘watch the world go by’. It seemed that time was not important to patrons of these establishments, since nobody was in a hurry. Li was fortunate that his student visa allowed him to work at weekends in his local coffee shop. While this provided him with some casual spending money, it also allowed him to perfect his English and to better appreciate and absorb aspects of Western culture, since he became friendly with many of the coffee shop’s clients.

On returning to China, Wang undertook a number of different jobs which included, at various times and various locations, an English language tutor, a bar-tender and a property salesperson. Thereafter, Li’s father, who was a prominent businessman, retired and sold out his own business. After family discussions, it was agreed that his father would purchase and Li would manage an established coffee shop in Pudong, Shanghai. Two years ago, his father provided ¥400,000 in capital to the new business and this sum was fully used to acquire the goodwill/customer loyalty of the existing coffee shop business. (Ownership of the building remained with the landlord but Li received generous rent terms and agreed to make a fixed annual rent payment of ¥200,000 until 2015.) Furthermore, he borrowed ¥410,000 from a bank, which was entirely used to immediately purchase new furniture and equipment by way of a 5-year loan at a 7% fixed rate of interest, with constant annual repayments at the end of each year. The following day, Li opened for business under the name The Pudong Coffee Shop, but he did not take any salary or bonus from the business.

As many people know, the Huangpu river divides the giant cosmopolitan city of Shanghai into two regions, namely Puxi (West side) and Pudong (East side). Over the past two decades Pudong, which is officially known as Pudong New Area, has emerged as China’s financial and commercial hub. Pudong is now home to, for example, the Shanghai Stock Exchange, the Lujiazui Finance and Trade Zone, the Waigaoqiao Free Trade Zone, the Jinqiao Export Processing Zone, the Zhangjiang Hi-Tech Park and a skyline that includes the symbolic Oriental Pearl Tower, the Shanghai World Financial Centre and the under-construction Shanghai Tower, which is set to become the tallest tower in China when it is completed in 2014.

THE CURRENT SITUATION

The Pudong Coffee Shop is located on the ground floor of a large residential apartment complex near the ample open spaces of Century Park and close to several important large office buildings. Also in the locality are the campus of a private business school, which accepts its quota of

international students, and some international secondary schools. The ground floor of the apartment block includes Li’s well-designed coffee shop - occupying about 60 square metres - which consists of the customer area, service area together with glass display counters, wash rooms, kitchen and storage space area. There is also considerable frontage where patrons can sit outside when the weather permits. In total, the coffee shop has (internal and external) space for about 50 customers. Its operating hours are from 8am to 9pm, seven days a week, 365 days a year. The menu, printed on recycled paper, includes a variety of competitively priced coffees – espresso, cappuccino, latte and mocha - teas and soft drinks. It provides breakfast (muffins, toast etc.), lunch (freshly made sandwiches to order, wraps, salads, pies etc.) and evening food (tiramisu, chocolate and other cakes).

In many ways, The Pudong Coffee Shop is very similar to many other Chinese enterprises that are family-owned and operated. As a family business, it is expected to provide a comfortable living for its owner and family dependants. However, as with all businesses in China, there is significant competition. For example, the ground floor of the apartment block also contains two similar enterprises, one of which is an Italian-style restaurant and the other an ice cream café. The local presence of competition has resulted in a lower than expected sales growth in the two years of Li’s management. It also restricts any price increase; and Li’s prices are similar to most other outlets in the area.

Wang’s limited business experience, which is from an employee rather than a managerial perspective, has taught him that customer loyalty is a most important ingredient for business success. Thus, while on the premises, Li is always available to say “Huan ying guang lin” to his customers and encourages his staff to do likewise. The Pudong Coffee Shop is an intimate establishment but it is also a non-smoking area. Daily papers, ample magazines and books are provided, since Li wants his coffee shop to be a place where customers can be casual and relax on the sofas and soft chairs provided. There is no piped music playing in the background, nor are there live performances, as this facilitates what he terms “quiet whispers” to take place. The amount of “take-away” business is negligible. He provides a good quality of product and customer service and this includes providing free fruit and biscuits in the afternoon. In addition, two other full-time employees work in the business and several part-time unskilled staff are engaged as necessary and work flexible rosters each week.

In January 2010, as the new financial year started, a number of items caught Wang’s attention. While scanning the Internet he noticed several sites that ranked coffee shops on the basis

of several criteria which were important to potential customers. He realised that if his coffee shop was to thrive in the future, he would have to closely monitor performance in those areas, even if some of the criteria were very subjective or difficult to measure. In addition, Wang also received a summary of a private analysis of coffee shops in the district, which had recently been completed as part of an MBA project. Wang personally knew the supervising professor and considered it reasonable to assume that the study was both reliable and valid. It provided a wide range of information on coffee shop activities, the scale of costs and other matters (see Table 2). He believed that some of this information could be useful to him. Furthermore, Wang had just received the draft (unaudited) financial statements for the year ended 31st December 2009 – the second year of operations (Table 3). The annual turnover of the shop amounted to ¥930,000 and, based on the number of cash transactions, he crudely estimated that the average spend per customer was ¥50. These financial summaries, together with some basic data that he obtained and some assumptions, would allow him to prepare budgets for the next year. Li Wang realised that he would have to take a greater interest in financial matters in order to get a comprehensive overview of the business, especially since he could not understand why the business generated a loss during the previous financial year but also improved its cash flow!

THE CHALLENGE

Wang considered that his business should be performing better, but he knew there were some positive aspects. For example, the coffee consumption market in China was expanding at a rate estimated to be in excess of 10 per cent per annum. In addition, his customer base, although constant, was loyal and consisted of local professionals and expats. Customer complaints were the exception rather than the rule, although Wang realised that dissatisfied customers rarely complain directly to the manager or to employees.

Li Wang believed that properly managed coffee shops would always survive and prosper, and he accepted the responsibility that he was now the leader who was needed to provide direction for the business. He was confident that the employees would support his initiatives - especially if rewards for successful performance were offered. There were so many things for him to consider that it was difficult to decide where to start. Therefore, in early January he attended a short Executive Education course delivered by the local business school. His lecturers persuaded him that a logical decision-making sequence would be to identify the coffee shop's current situation and then decide on an appropriate

future direction and a means for its attainment. In addition, he would need to develop some appropriate measures to help drive business performance, since one lecturer reminded seminar participants that the 'bottom line' belongs down at the bottom for a reason. Far above it, and of much greater importance, are a number of significant activities whose successful performance is required to generate adequate financial returns. Wang remembered a simple diagram linking activities to results based on the proposition that "if we have the right facilities and employees doing the right things, then our customers will be loyal, and we will generate the financial returns" (see Figure 1). In simple terms, Wang realised the best espresso, served by a rude or incompetent barista, is not an enjoyable experience! Wang knows that you are enrolled in a managerial accounting course and has asked you to advise him. Specifically, you are required to prepare a report that addresses the following issues:

1. An analysis of the current situation of the business using the available information.
2. Advice on what Wang should do in the future in order to achieve greater profitability. Your suggestions should be embedded in your analysis of Issue #1.
3. Within your suggestions regarding Issue #2, prepare a logical, integrated set of critical success factors and related key performance indicators to assist management and employees to achieve your recommendations. What additional comments would you make in this regard?
4. For budgeting purposes, Li has quickly made the following assumptions for 2010, based on data that he has obtained:
Sales prices will increase by 3 per cent (in line with competitors) and sales volume will increase by 5 per cent, which was the growth achieved in the previous year; general inflation is expected to increase discretionary cash expenses by 4 per cent; suppliers will extend trade credit at the same rate and the inventory turnover rate will be unchanged. No investing or additional financing activities will be undertaken.
Prepare an income and cash flow forecast for the financial year ending 31st December 2010, together with a balance sheet at that date, based on these assumptions, compared to 2009.
5. What other issues could you bring to Wang's attention? Make suggestions or recommendations. You should include a calculation of the break-even point for the financial years ending 2009 and a forecast for 2010. You should also provide an overall valuation of the coffee shop, assuming it is to be soon sold as a going concern.

Table 1**Judging Criteria for Coffee Shops***(not listed in order of importance)*

1. Beverages/food provided must be of good quality
2. Décor, temperature and noise levels
3. Free WiFi
4. Friendly staff
5. Excellent customer service
6. Presentation of food and food offering
7. Cleanliness and overall hygiene
8. Availability of space
9. Overall value for money

Source: Various Websites

Table 2**Survey of Coffee Shops in Local Region****Table 2A:****Analysis of Total Revenue Earned**

	%
Beverages/drinks	40%
Food sales	60%
	100%

Table 2B:**Types of Food and Beverages Served in Coffee Shops %**

Beverages	%
Tea and Coffee	100%
Cold Drinks	98%
Smoothies	24%
Food Sales	%
Sandwiches and Wraps	100%
Cakes and Desserts	90%
Biscuits, Muffins etc.	70%
Toasts e.g. Bread	50%
Salads	30%

Table 2C:**Operating Costs as % of Total Revenue in Coffee Shops (average)**

Percentage of Sales	%
Food and beverages	40%
Wages and remuneration	20%
Rental	20%
Utilities (light and heat etc.)	5%
Depreciation of tangible assets	5%
Advertising and promotions	5%

Table 2**Survey of Coffee Shops in Local Region (continued)****Table 2D:****Steps Taken to Encourage/Improve Business in Coffee Shops %**

Activities	%
Refurbishment of outlets	70%
Staff training	60%
Additional opening hours	50%
WiFi facilities	40%
Loyalty programmes for customers	40%
Wider product range	35%
Increased advertising	30%

Table 2E:**Analysis of Customers by Age in Coffee Shops %**

Age of customers	%
Under 20 years	20%
21-30 years	45%
31-50 years	25%
Over 50 years	10%
	100%

Table 2F:**% of Total Customers (Footfall) Served by Time of Day**

Time of Day	Monday to Friday	Saturday & Sunday
Morning (8am to 11am)	23%	20%
Lunch-time (11am to 2pm)	33%	33%
Afternoon (2 pm to 5pm)	16%	23%
Tea-time and early evening (5pm to 9pm)	28%	24%
	100%	100%

Table 3
Draft (unaudited) Annual Financial Summaries

The Pudong Coffee Shop

Summarised Income Statement (unaudited) for year ended:

	31st December 2009	31st December 2008
	¥	¥
Revenue (beverages/drinks)	485,000	465,000
Revenue (food sales)	<u>445,000</u>	<u>450,000</u>
Total revenue (food and beverages)	930,000	915,000
Cost of sales	<u>(420,000)</u>	<u>(389,000)</u>
Gross profit	<u>510,000</u>	<u>526,000</u>
Less Operating expenses:		
Depreciation of tangible assets	(82,000)	(82,000)
Wages and remuneration	(130,000)	(110,000)
Rental	(200,000)	(200,000)
Utilities (lighting and heating etc.)	(48,000)	(39,000)
Garbage collection	(10,000)	(9,000)
Advertising and promotions	<u>(30,000)</u>	<u>(25,000)</u>
Total operating expenses	<u>(500,000)</u>	<u>(465,000)</u>
Operating profit for year	10,000	61,000
Interest payable on loans	<u>(23,710)</u>	<u>(28,700)</u>
Profit (loss) for year	<u>(13,710)</u>	<u>32,300</u>

The Pudong Coffee Shop

Summarised Balance Sheet (unaudited) at:

	31st December 2009	31st December 2008
	¥	¥
Goodwill	400,000	400,000
Furniture and fittings (net)	246,000	328,000
Inventories	44,000	38,000
Cash at bank	<u>198,000</u>	<u>196,000</u>
Total assets	<u>888,000</u>	<u>962,000</u>
Owner's equity	418,590	432,300
Bank loan payable	262,410	338,700
Trade payables	<u>207,000</u>	<u>191,000</u>
Total liabilities and owner's equity	<u>888,000</u>	<u>962,000</u>

Table 3
Draft (unaudited) Annual Financial Summaries (continued)

The Pudong Coffee Shop

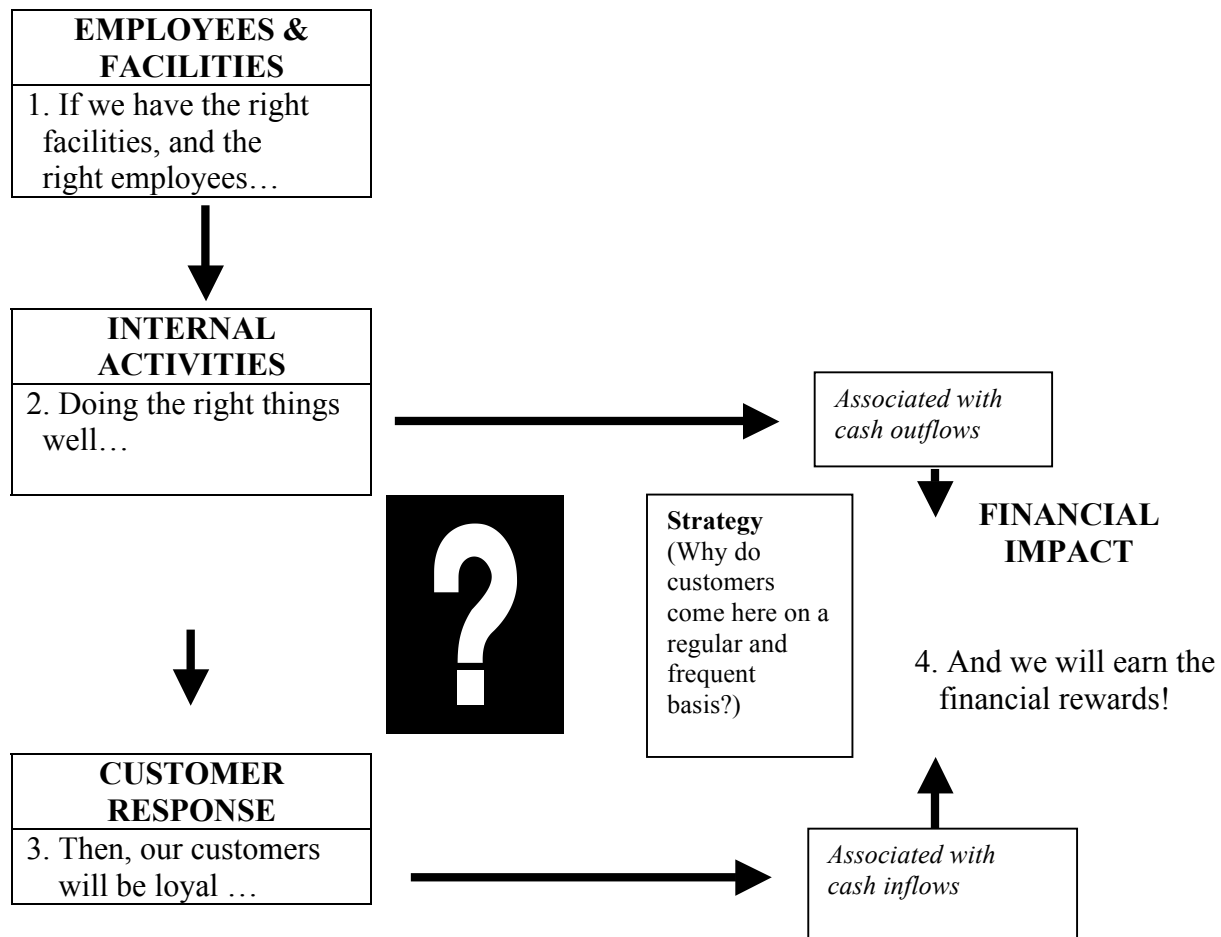
Summarised Cash Flow statement (unaudited) for year ended:

31st December 2009

31st December 2008

	¥	¥
Operating cash flow		
Operating profit (loss) for year	10,000	61,000
Add: depreciation	<u>82,000</u>	<u>82,000</u>
	92,000	143,000
Changes in working capital:		
Less: Increase in inventories	(6,000)	(38,000)
Add: Increase in trade payables	<u>16,000</u>	<u>191,000</u>
	102,000	296,000
Investing activities	Nil	Nil
Financing activities:		
Repayment of loan including interest	(100,000)	(100,000)
= Overall cash flow (deficit) for year	2,000	196,000
Add: Opening bank balance	<u>196,000</u>	<u>Nil</u>
Equals: Closing bank balance	<u>198,000</u>	<u>196,000</u>

Figure 1
The Link Between Activities and Results



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