

CASH: AUSTIN'S CYCLE SHOP



A few years ago, Austin opened his own bicycle sales and service shop— called Austin's Cycle Shop. He determined that he needed \$50,000 to get up and running, so he used money from his own savings and borrowed money from a bank and a private investor, his brother-in-law. Start-up costs – his store lease, professional fees, licenses, furnishings for the store, inventory (bikes and parts), and equipment – were \$40,000. He put the remaining \$10,000 in the bank as a safety net for the early months when sales and revenue might be shaky. So his initial cash position was \$10,000.

But during the first year, Austin collected \$70,000 from selling and servicing bicycles. He also had expenses of \$55,000 (he took a very small salary that first year). So how much cash did he generate from his operations? What was his cash flow? Right, \$15,000. He never touched his initial cash reserves, so at the end of year 1, he had a total cash position of \$25,000 (\$10,000 cash position + \$15,000 cash flow).

Austin had choices in what to do with the \$25,000 cash he had at the end of his first year. He could put the entire \$25,000 in the bank for maximum liquidity. Or he could use part or all of it in investing activities; such as remodeling the building, making a down payment on a truck, or buying stocks or mutual funds for a greater return than his savings account offered. Or he could use it in financing activities; such as paying back part of his bank loan or repaying his investor. But Austin decided that for maximum safety and liquidity, he would keep all of his \$25,000 cash balance at the end of his first year in the bank. He had done well in the first year, but you never know when a competitor might open up across the street or a piece of equipment might break.

In his second year, he received \$100,000 in cash from sales and spent \$80,000 in operating his business, so he generated \$20,000 in cash flow. With higher cash flow in his second year of business, Austin decided to start using his cash. He paid back a portion of his bank loan, he bought a used truck so that he could offer to pick up and deliver customers' bikes, and he bought out his brother-in-law's investment. His brother-in-law was supposed to be a silent investor, but it didn't quite turn out that way and Austin was getting tired of the stream of advice he was getting during holiday meals.

Austin's Cycle Shop: Year 2 Cash from Operations

Cash position end of year 1:		\$25,000
Year 2: Total sales	\$100,000	
Less: Operating expenses	(80,000)	
Cash flow from operations		\$20,000
Less: Pay back bank loan	(5,000)	
Pay used truck	(7,000)	
Pay back investor	(3,000)	
Total cash used in nonoperational activities		(15,000)
Change in cash during year		+5,000
Cash position end of year 2:		\$30,000

Austin could have used even more than \$15,000 cash in nonoperational activities. He still had a cash position of \$30,000. He could have used, say, \$10,000 more (\$25,000 total) to buy more equipment or pay off more of his loan. He would have ended the year with only \$20,000 (\$45,000 total cash available minus \$25,000 used for investing and financing activities)—which is less cash than the \$25,000 he had at the end of year 1.

Would ending the year with less cash than he started have made Austin a bad manager? Not at all. He would have simply made a business decision that it was more important to his future operations to acquire assets, pay back the loan, and repay his investor. And because he generated more cash from operations – greater cash flow – in his second year (\$20,000) than in his first (\$15,000), Austin should be considered a good business manager, especially in a start-up enterprise.

PROFIT: AUSTIN'S CYCLE SHOP



Austin has made it through year three of his business. He's a bit more established and feels confident that he can keep cash flowing to keep the doors open, but he's becoming more focused on profit. He needs to be if he wants to survive and grow. Austin's gross profit is his sales price per bicycle or part sold, less his direct costs of buying the bicycle or part from his supplier and any related costs. Austin's net profit will be what's left over from the gross profit of all his sales after he deducts his remaining operating costs: the salaries of the people working in the shop, rent for his shop space, advertising online and in local publications, utilities, interest on debt, and taxes.

For his third year of operations, this is what his profit looked like:

Revenue (Sales)	140,000
- Cost of Goods Sold (COGS)	(91,000)
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Gross Profit	49,000
- Operating Costs	(38,000)
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Net Profit Before Tax	11,000
- Interest & Taxes	(4,000)
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Net Income (Net Profit, Net Earnings)	\$7,000

Austin's gross margin is 35 percent ($\$49,000/\$140,000$). His net margin is 5 percent ($\$7,000/\$140,000$). For retailers, those margins are average, but you'd expect higher than average margins for a specialty retailer like Austin.

Austin was disappointed with his operations. His monthly sales revenue was increasing. However, his expenses had also been creeping upward. His cost of goods sold had suddenly jumped because of supplier consolidations and price increases. His overhead had also grown faster than sales because he had hired two part-time employees – a service and repair technician and a sales clerk.

Since Austin’s margins were declining, he had a big problem: He wasn’t earning much personally. If something didn’t change, his family wasn’t going to be able to afford his business much longer.

Austin was earning \$300 for every higher-end bicycle he sold:

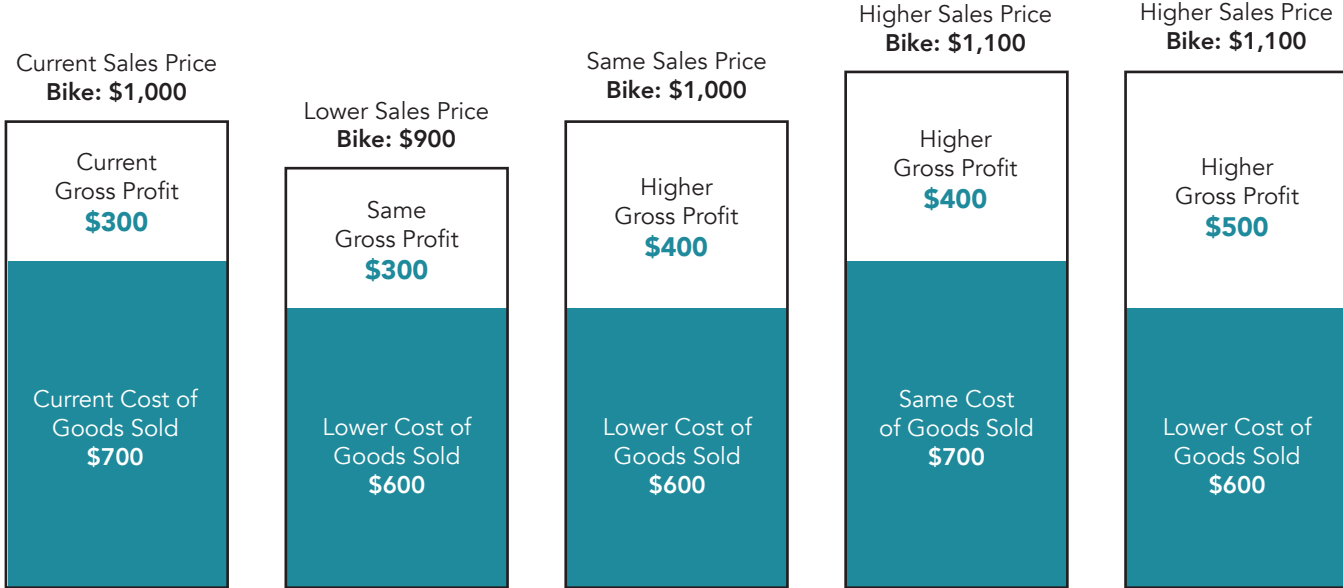
Product (bicycle) Sales Price:	1,000
- Cost of Goods Sold (COGS)	(700)
Gross Profit	\$300

He had two options to increase profit: (1) raise revenues by increasing prices or selling more of his products and repair services, and/or (2) lower his costs. If he raised his prices, his gross profit would be greater on each bicycle sold, but he might sell fewer units and reduce his total gross profit. If he lowered his sales prices, he could sell more bikes, but at a lower gross profit. Would the increase in sales make up for that? If he could reduce his cost of goods sold (the cost of the bicycle), he could lower his price, maintain his gross profit on each unit, and increase sales – creating greater cash flow and profits. But the cost was set by his supplier.

The way Austin saw it, his two options were actually four:

1. Try to negotiate with his supplier to lower his cost of goods sold to \$600 to enable a lower sales price of \$900 while keeping a gross profit of \$300. The lower prices could increase sales, thus increasing total gross and net profits and cash flow.
2. Try to lower cost of goods sold to \$600, keep the same sales price of \$1,000, and increase gross profit to \$400.
3. Increase the sales price to \$1,100 if cost of goods sold stayed at \$700, to generate higher gross profit of \$400.
4. Increase sales price to \$1,100 and lower cost of goods sold to \$600, to create gross profit of \$500.

Relationship of Sales Price, COGS, and Gross Profit



Austin decided customers would pay more for his products, so the first tactic he tried was to raise the price of his best-selling bike by \$100. His gross profit per bike increased to \$400. But instead of increasing his total gross profit, the strategy reduced his gross profit by \$200! What happened? He had averaged ten sales per month for a total gross profit of \$3,000 – to be increased, he had hoped, to \$4,000 (10x \$400). However, the next month he sold only seven bikes at the higher price for a total gross profit of only \$2,800 (7x \$400). His strategy had backfired, so he dropped his price back to the original.

To lower his cost of goods sold, Austin began shopping for a new supplier who might compete for his business. It worked. He found a second supplier and used its pricing to negotiate a better deal with his current supplier. He was able to reduce his COGS by \$100, putting his gross profit at \$400. Sales held at about ten bikes per month, increasing his total gross profit to \$4,000 per month. Things were looking up.

A few months went by with increasing sales, and Austin decided to take a risk and decrease his sales price to \$950 to see if he could increase the number of bikes sold. Sales jumped up to twenty units each month and he was raking in \$7,000 a month in gross profit. Things were going so well with the current price and gross profit that he decided to stick to the formula.

Austin was happy that his profits were on the rise, but he also realized that he could be doing a better job controlling his operating expenses – his overhead. For the year, his overhead would be higher than the previous year because he had two employees for the entire period. He was watching his bottom line carefully. New bike sales revenue was outstripping bike-servicing revenue, so he decided to reduce the hours of his service and repair technician. He also reduced the hourly pay of his sales clerk and created a sales commission incentive plan. His sales remained on an upward trend, and he felt sure his net profit margin would look better this year.

ASSETS: AUSTIN'S CYCLE SHOP



Austin, as always, was searching for ways to grow his business and become more profitable. He saw his larger competitors in the market thriving as the popularity of cycling as a form of exercise and as a competitive sport grew. He wanted to take advantage of the boom, but was struggling. Austin had been digging into his cash over time, and now he had an opportunity that could change his future profits, but he wasn't sure he could take advantage of it.

Austin's supplier said that if he placed larger orders for bicycles, parts, and accessories (his inventory, an asset), he could get a substantial discount. If he could reduce his cost of goods sold, Austin could lower his sales prices—which could mean more units sold and more profit. But Austin would need more up-front cash and storage space, which he didn't have. He couldn't sell his inventory of bicycles and parts faster to generate more cash flow because he didn't want to lower his prices anymore. He couldn't borrow any more money because the bank didn't think he had enough asset strength to support a loan: His liquid assets were not sufficiently large in relationship to his liabilities.

Austin wondered if he had been neglecting his asset strength and if it would cost him a major opportunity to take his business to the next level.

He started thinking about bringing in an equity partner to invest in the shop. With more cash, his balance sheet would be stronger, his liquidity would improve, and he would be able to place larger inventory orders, lower his price, sell more bikes faster, and generate more cash and profit. It was the best choice, he decided, and he started the process of seeking out an investor.

Austin only wanted to work with an investor who was knowledgeable about his industry and who could bring experience to the table. He'd tried the silent investor path with his brother-in-law, and that hadn't worked well. As he talked to investors and as they looked at his financial statements, they asked questions about his operations, specifically how he was utilizing his assets. When Austin began considering their questions, he came to some important realizations about his company.

First, he was not using his human capital in the smartest way possible. He had his one sales associate, who worked for part salary and part commission, working hours when Austin couldn't or didn't want to be in the store, which really meant when business was slow. But now

he realized that he also needed her there when business was booming, to help close more sales. So he decided to shift her hours so that she could generate more sales per hour of work.

He was also wasting leased space. He was storing a fair amount of inventory in the back room, when he could be using the space to expand his bike service and repair operation. His was one of the few shops that offered that service, so he needed to maximize it. He could lease warehouse space for much less than his retail space, and then use his retail space to generate more service revenue. He would have to hire another technician, but his margin on service was better than his margin on bike sales, so he thought it would be worth it.

Making these two simple changes in how he utilized his assets resulted in immediate growth in sales and profit. And the interest of two investors.

GROWTH: AUSTIN'S CYCLE SHOP



Austin was in his seventh year now. His margins were strong, he was profitable, and he was making a nice living from the business. But Austin was ambitious, and he knew there were market opportunities to be pursued.

The city he was in had grown geographically over the previous six years. One newer residential neighborhood didn't have a bike shop yet, and he wanted to beat his competitors into it. He had already scouted out some space that would work well for his needs and that had good foot traffic. Opening another shop would also make him the first local bike shop to have more than one location.

At the same time, he found an opportunity to buy another store near campus from an owner who was ready to retire. With more stores, Austin could buy inventory for all the shops at greater discounts, tap into the college market, and drive more cash and profit. Motorized scooters had become popular among students, and adding this product line in the acquired store could increase sales. Austin also knew that if he didn't buy the shop, another competitor might, buying market share and potentially cutting into his business.

Could he do both moves at once? Acquire a competitor and open a shop in a new neighborhood? Although he'd heard horror stories about acquisitions, he thought that in this case, opening a new store in an untested market was possibly the riskier growth strategy.

Austin has asset strength, and he thought he could get enough capital from his investor and the bank. But to analyze the return on these investments (ROI), he decided to develop a business plan for his company's future expansion. He had to figure out how much cash he would need, carefully assess projected revenue and profit from the new stores, analyze personnel needs, explore lease costs in the new neighborhood, and gather a host of other information about costs and opportunities to present to investors. He just hoped they saw the potential he saw.

PEOPLE: AUSTIN'S CYCLE SHOP



Austin had received the funding he needed to expand his operations, but now he needed to make some important decisions about how to combine operations in three locations: his current store, a new store, and an acquired store.

Austin talked regularly with his own employees about how they felt about working for him and what could be improved for greater customer and employee satisfaction. He surveyed his current customers and customers of the acquired shop and found that they would like to hear more about cycling tips, deals, great rides, and more from Austin and his employees. Austin decided to get the employees involved in creating a regular e-mail newsletter to build a more loyal customer base and give employees an opportunity to be creative and share their knowledge.

He needed to spend more time training and coaching his employees in how to create a more complete customer experience, one that was consistent across all locations. He had never created a real training program before, but as he began searching for new employees for the new stores, he knew it was time. An important point of that training would be helping his employee teams work effectively together, in addition to thinking of the employees in other stores as internal customers.

He wanted to keep key people for the long term, so he began to look at competitive wages and benefits. And he began a career path discussion with each of his employees to better plan for their future growth, so that his business could grow profitably. Austin needed to make sure the new store and the acquired shop were setup to maximize revenue and profit. The key, he knew, was identifying what customers in these neighborhoods were looking for.

He regularly surveyed his own customers, but the needs of his new customers would be different because the demographics of the neighborhoods were very different. In his current shop, he mostly catered to sport cyclists, so he carried high-performance bikes. Near the college campus, he'd be dealing with a younger demographic made up of people who didn't have as much cash to spend. He reviewed the sales history for the acquired shop and his assessment was confirmed. The inventory of high-performance bikes had a poor turnover rate, but the lower-cost models had strong sales numbers. He decided to keep a few high-performance models on hand but to focus his inventory on a range of affordable bicycles. He would also begin selling scooters, because they were very popular with college students.

In the new shop, he would be in the middle of a highly residential neighborhood. He spent some time in the new neighborhood, watching families who were out and about. Cycling among families seemed common, and so he knew he would need to sell kids' bikes. It was a fairly affluent neighborhood, and there was a broad range of higher-end kids' bikes that were highly adjustable and designed to last for a long time. He had also seen some innovative baby carriers from his suppliers that he thought would be good sellers. And it seemed like touring bikes would be a good idea for the adult inventory, with some high-performance bikes and parts on hand for the local fanatics.

One thing that surprised him was the number of scooters he saw in the neighborhood. He hadn't anticipated that. He decided that he would also offer scooters at the new store, which would give him greater leverage in negotiating with suppliers.

GOING PUBLIC: AUSTIN'S CYCLE SHOP



It had been two years since Austin acquired a competitor and opened a new store. He had developed growing brand recognition for his excellent products and services. He focused more and more on expanding his customer base and on the continued growth of his business.

The various stores excelled in different ways, but he wanted all of his employees to be focused on his vision for the company: a new type of bicycle shop, focused on the highest levels of service, that could grow locally, regionally, and even nationally. He began having regular all-staff meetings with his employees to share how the company was doing overall and what types of challenges each store was facing. The meetings were also intended to get employees involved in discovering solutions to those challenges and in finding opportunities to grow the business.

After the first few meetings, the employees seemed to catch on to Austin's vision and offered up interesting ideas for increasing growth and profitability, including a dynamic cross-store inventory-management system that would help any store meet any customer's needs quickly.

This process helped Austin discover his new overall vision for the company: to create a national brand and one day take the company public. How? Take the company online, selling bikes and parts to a broad range of customers – customers whose needs he better understood through the development of his various shops. But he knew he would need to go even further to offer unique products and services to bicycle enthusiasts.

Austin sought out another investor who could offer the capital he needed to hire an online retail-consulting firm. The consultants helped him hire the right Web developers, assess marketing approaches and possible partnerships, and anticipate capital and asset needs. He developed relationships with custom bicycle manufacturers as well as local retailers in key geographic areas, which helped him offer a level of service unlike anything the other online retailers could match. He was even able to develop his own line of branded bicycles by working with the major manufacturers.

It took a couple of years to really achieve success through his online venture. Once he had, he decided to take his privately held company public. He needed increased access to both equity and debt capital from public markets to grow his earnings.

Austin would have a lot of expenses as his company went through an Initial Public Offering (IPO). There would be added overhead costs, plus the time he would have to devote to complying with SEC regulations and reporting requirements. He would have to focus on delivering consistently increasing quarterly earnings so that investors would see his company as a growth stock and push the price higher.

However, he felt that the benefits outweighed the costs. As he looked at the competitive landscape, he felt that by becoming a public company he would have a significant advantage over locally owned cycle shops and small online retailers – he could grow more rapidly and profitably. He wanted to become the Amazon of bikes – and steal bike business away from Amazon!

He began working on the IPO with a securities broker-dealer and attorneys.

From personal lessons learned, Austin knew that despite becoming a public company, he would have to continue his focus on the 5 Business Drivers – the foundation of his future success. The big picture of Austin's Cycle Shop was expanding, but the fundamentals would never change.

AUSTIN'S CYCLE SHOP CONSOLIDATED INCOME STATEMENT

(In thousands, except per-share amounts)

For the year ended December 31	2018	2017	2016
TOTAL REVENUE	\$8,300	\$7,200	\$6,400
Cost of Goods Sold	4,600	4,200	3,840
GROSS PROFIT	3,700	3,000	2,560
Operating Expenses:			
Research and Development	500	440	369
Sales and Marketing	850	730	641
General and Administrative	370	320	270
Depreciation and Amortization	486	328	256
TOTAL OPERATING EXPENSES	2,206	1,818	1,536
OPERATING INCOME	1,494	1,182	1,024
Interest Income	300	200	107
Interest Expense	96	53	58
Income before provision for income taxes	1,698	1,329	1,073
Provision for income taxes	611	478	386
NET INCOME	\$1,087	\$851	\$687
Basic earnings per share	\$0.27	\$0.26	\$0.23
Diluted earnings per share	\$0.25	\$0.25	\$0.22
Shares used in per-share calculation – basic	4,002	3,275	2,988
Shares used in per-share calculation – diluted	4,300	3,408	3,112

AUSTIN'S CYCLE SHOP

CONSOLIDATED BALANCE SHEET

(In thousands, except per-share amounts)

As of December 31	2018	2017
ASSETS		
Current Assets:		
Cash and cash equivalents	\$827	\$580
Short-term investments	1,189	1,157
Accounts receivable	1,242	1,303
Inventories	652	362
Prepaid expenses and other current assets	705	412
TOTAL CURRENT ASSETS	4,615	3,814
Long-term investments	3,202	2,017
Property and equipment, net	2,913	1,969
Goodwill and other intangibles	10	0
Other assets	1,787	1,162
TOTAL ASSETS	12,527	8,962
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$361	\$250
Income taxes payable	576	411
Accrued payroll and related expenses	571	392
Other accrued liabilities	750	728
TOTAL CURRENT LIABILITIES	2,258	1,781
Long-term debt	343	143
TOTAL LIABILITIES	2,601	1,924
Shareholders' Equity:		
Common stock and additional paid-in capital, \$0.001 par value 5,400 shares authorized: 4,002 shares issues and outstanding in 2018 and 3,210 shares in 2017, 198 options outstanding	5,011	3,210
Retained earnings	4,915	3,828
TOTAL SHAREHOLDERS' EQUITY	9,926	7,038
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$12,527	\$8,962

AUSTIN'S CYCLE SHOP

CONSOLIDATED STATEMENT OF CASH FLOWS

(In thousands, except per-share amounts)

For the year ended December 31	2018	2017	2016
Cash flows from Operating Activities:			
Net Income	\$1,087	\$851	\$687
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and Amortization	486	328	256
Change in operating assets and liabilities:			
Accounts receivable	61	(166)	56
Inventories	(290)	(266)	(205)
Prepaid expenses and other current assets	(293)	22	10
Accounts payable	111	28	15
Income taxes payable	165	154	75
Accrued payroll and related expenses	179	127	63
Other accrued liabilities	22	954	304
NET CASH PROVIDED BY OPERATING ACTIVITIES	1,528	2,032	1,261
Cash flows from Investing Activities:			
Capital Expenditures	(1,410)	(417)	(389)
Purchases of investments	(1,217)	(1,820)	(1,192)
Other asset purchases	(655)	0	0
NET CASH USED IN INVESTING ACTIVITIES	(3,282)	(2,237)	(1,581)
Cash flows from Financing Activities:			
Issuance of common stock	1,801	489	420
Common stock repurchases			
Increase (payment) in long-term debt	200	(10)	0
NET CASH PROVIDED BY FINANCING ACTIVITIES	2,001	479	420
Net increase in cash and equivalents	247	274	100
Cash and equivalents, beginning of year	580	306	206
CASH AND CASH EQUIVALENTS, END OF YEAR	\$827	\$580	\$306