Cafes Monte Bianco: Building a Profit Plan

"We are facing a decision that may well affect the future of our company. I expect that each of you has adequate information to support your arguments. I don't want to spend our time talking about what might be without actual data."

Giacomo Salvetti, CEO of Cafes Monte Bianco, had called the second meeting to delineate the future of the company. Manufacturing private brand coffees for supermarkets in Italy had saved Cafes Monte Bianco three years ago. However, it was not clear to him whether the company should continue to invest in this market.

Cafes Monte Bianco's top management team was all in the room with the exception of Roberto Bianchi, R&D manager, who was in Colombia. The rest of the team were Giovanni Calvaro, marketing director; Paolo Cantara, manufacturing director; Dino Bastico, financial officer; and Carla Salvetti, director of strategic planning.

Cafes Monte Bianco, located in Milan, was a manufacturer and distributor of premium coffee. Monte Bianco coffees, distributed throughout Europe, had a reputation for producing some of the finest coffees on the continent. The company had been founded in the early part of the century by Mario Salvetti, grandfather of the current CEO. Mario Salvetti, after spending several decades in South America working at coffee plantations, had come back to Italy to combine the best beans that he had encountered during his career. Quickly, Monte Bianco's coffee became known around Milan for its taste and high quality. Mario passed this knowledge to his son, Ruggero, who passed it on to Giacomo. The Salvetti's family had owned the company for over eighty years.

Every year, Giacomo spent two months traveling around the world visiting coffee plantations, learning about new beans, and maintaining his relationships with coffee producers. The company also had a laboratory with five people who tried new combinations of flavors and tested quality standards for products already in the market. These people were in close contact with producers and also traveled frequently to visit plantations.

The Future of Cafes Monte Bianco

Giacomo, intent on surpassing his grandfather's success and making a name for himself, wanted to grow the business aggressively. Over the past five years, he had expanded capacity by building an expensive, state-of-the-art facility. The performance of Cafes Monte Bianco had been

Doctoral Candidate Antonio Dávila and Professor Robert Simons prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

excellent during 2000 (see **Exhibit 1** for pro forma financial statements). An important reason for the success was the manufacturing of private brands for two supermarket chains in Italy. Although Giacomo had at first opposed the idea, the market downturn in 1998 convinced him that private brands were a good alternative to fill up capacity and cover fixed costs.

Several retailers had approached Monte Bianco with requests to supply coffee that could be distributed under their private brand label. If the company was to serve them, however, it would have to reduce its presence in the premium coffee market in 2001 to handle increased private brand capacity requirements. The theoretical capacity of all coffee production for 2000 was 350,000 kilograms per month. The last phase of the expansion, just finished in December 2000, had added additional capacity of 150,000 kilograms per month. The cost of this expansion was six billion liras with an expected life of 15 years.

The previous week, Giacomo had met with his top management team to discuss how to allocate manufacturing capacity. The discussion had been very emotional, with managers arguing passionately in favor of their view. Carla Salvetti, Giacomo's cousin, argued forcefully for a full transition to private brands. Private brands, she said, had saved the company during the last recession when the demand for premium coffee dried up. On the other side, Roberto Bianchi argued that premium coffee was the essence of Monte Bianco. He believed that giving all production capacity to private brands would betray the mission of the founder. As evidence to support the merits of the current business strategy, Roberto pointed to the profits shown on the 2000 financial statements.

Although Giacomo could sympathize with both views, he was frustrated and confused. He needed more facts about the profitability of a private brand strategy. He was loath to change the direction of the company so drastically without fully understanding the financial consequences. He had adjourned the first meeting by sending his team to collect and analyze the data required for the decision.

Giovanni Calvaro, marketing manager, opened the conversation at the beginning of the second meeting:

"I have the data that you asked for, Giacomo. (He distributed **Exhibit 2** around the table). The marketing department has been working all week putting together this information. What we've done is estimate volume in the premium market for the next year for different prices and advertising expenditures. I agree with Roberto that the premium market builds on our traditional strengths. But the premium market is very volatile, as we all remember too well."

"The private brands' market is much more stable. We can be guaranteed full capacity at the current price of 8,800 liras. But if we decide to stay in it, we have to commit for the long term. Customers bargain hard on price, but they expect stability in supply. If we don't give them consistent on-time service, they will move to another supplier and won't take us back under any circumstances. Prices in the private market are much lower than those of the premium market and the volume in this market depends on how many retailers we decide to serve. During 2000, we sold a good part of our capacity to two retailers. Every additional retailer needs at least 500,000 kilograms per year."

Giacomo: "All right…but what about the other side of the equation? How do our manufacturing costs look?"

Paolo (manufacturing director): "My department has put together the information you requested on expected unit costs (**Exhibit 3**). As you can see, costs vary with volume and the quality of the beans. These costs are based on our current experience."

Dino (financial officer): "Am I right to assume that these costs include only manufacturing expenses?"

Paolo: "Yes. They include the cost of beans and labor as well as fixed costs that we allocate based on volume. You notice that if we sold only private brands our fixed costs would be 781 million liras lower. Another advantage of manufacturing private brands is that it simplifies the manufacturing plan because we can hold private label production in inventory. We cannot stock premium coffee if we want to maintain our standards of freshness."

Carla (director of strategic planning) [eagerly]: "Giacomo, it gets even better if we consider advertising, selling, administrative, and R&D expenses. My estimation is that if we go to private brands, we can save 65% of selling costs, 75% of R&D costs, and 50% of administrative costs.

Giacomo: O.K., but how will our cash flow look if we switch entirely to private brands?

[There was an awkward silence around the table.]

Giacomo: Hasn't anybody looked at our cash flow?

Dino: Well, you can see by our 2000 sales (Dino distributed **Exhibit 4**), that our summer demand is much lower. This may be a problem. We will be at our full credit line limit of 25 billion liras by the end of the year. This is because private brand retailers pay much more slowly—90 days instead of our usual 30-day policy.

Giacomo [visibly angry]: How can you expect me to make this decision? You want me to change the direction of the company! Some of you are arguing that we should give up our premium business and fill the plant with private label brands, but you can't even tell me how this will affect our liquidity?

[Silence around the table.]

Carla: Giacomo, perhaps we…

Giacomo: No! [He threw down the pages.] Carla, I want you and Dino to tell me exactly what the implications are if we fill the plant with private label. Put together a profit plan for 2001 including the extra 1,800,000 kilograms capacity and produce only private label. I want to see what the financial health of the business would look like. Am I clear?

Carla: Yes.

Giacomo: When can you have it for me?

Dino: By the day after tomorrow…

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Assignment: Evaluate the attractiveness of the private-brand strategy.

1. *Using the projected production plan for private-brand coffee (**Exhibit 5**), estimate key accounting variables for the profit wheel, cash wheel, and ROE wheel.*

   Based on your analysis, what recommendations would you make to Giacomo Salvetti?

Exhibit 1 Cafes Monte Bianco's 2000 Financial Statements (estimated as of December 15, 2000)

Note: 1 U.S. dollar = 1,800 Italian liras

Income Statement for the year ending December 31, 2000
(thousands of Italian liras)

Revenues		56,112,408
Private brand	9,934,848	
Premium brand	46,177,560	
Costs of goods sold (*)		33,233,867
Gross margin		22,878,541
Marketing expenses		4,155,980
R&D expenses		3,328,130
Selling expenses		3,574,710
Administrative expenses		4,752,000
Interest expense		3,825,000
Profits		3,242,721
Taxes (40%)		1,297,089
Net profit		1,945,632

(*) includes 2,593,700 depreciation

Balance Sheet at December 31, 2000
(in thousands of Italian liras)

Assets		**Liabilities and Shareholders' Equity**	
Cash	1,121,450	Accounts payable	487,331
Raw material inventory	2,907,963	Credit line	25,000,000
Finished goods (174,000 kg.)	1,148,400		
Accounts Receivable	9,368,467	Long term debt	10,000,000
		Shareholders' Equity	9,165,869
Property, plant and equipment (*)	42,374,000		
Depreciation	(12,267,080)		
	44,653,200		44,653,200

(*) includes vacant land with a cost of 13,000,000

Exhibit 2 Estimated Yearly Volume (in kilograms) for Different Prices / Grades and Advertising Expenditures

Coffee Grade	**D**	**C**	**B**	**BB**	**A**	**AA**	**AAA**
Price per kilogram	**8,800**	**19,500**	**26,600**	**30,000**	**35,500**	**39,000**	**42,600**
				VOLUME (kg.)			
Advertising /Sales							
0%	6,000,000	2,395,000	1,645,000	1,529,000	1,103,000	667,000	127,000
1%		2,455,000	1,696,000	1,566,000	1,145,000	717,000	157,000
2%		2,545,000	1,720,700	1,649,000	1,226,000	799,000	229,000
3%		2,665,000	1,896,000	1,760,000	1,334,000	910,000	325,000
4%		2,800,000	2,024,000	1,884,000	1,456,000	1,034,000	433,000
5%		2,950,000	2,166,000	2,022,000	1,591,000	1,172,000	553,000
6%		3,130,000	2,367,000	2,157,000	1,723,000	1,307,000	667,000
7%		3,196,000	2,417,000	2,195,000	1,792,000	1,345,000	694,000
8%		3,268,000	2,446,000	2,231,000	1,823,000	1,366,000	752,000
9%		3,310,000	2,465,000	2,258,000	1,837,000	1,495,000	875,000
10%		3,340,000	2,494,000	2,286,000	1,843,000	1,523,000	935,000

Exhibit 3 Estimated Cost per Unit for Different Prices/Grades and Volume

Coffee Grade	**D**	**C**	**B**	**BB**	**A**	**AA**	**AAA**
Prices per kilogram	**8,800**	**19,500**	**26,600**	**30,000**	**35,500**	**39,000**	**42,600**
Unit cost (liras)	**6,600**	**12,485**	**14,275**	**16,288**	**17,791**	**19,166**	**20,441**
Fixed costs (thousands of liras)*	**3,319,500**	**4,100,500**	**4,100,500**	**4,100,500**	**4,100,500**	**4,100,500**	**4,100,500**
Volume				**COST PER UNIT**			
400,000	14,899	22,736	24,526	26,539	28,042	29,417	30,692
600,000	12,133	19,319	21,109	23,122	24,625	26,000	27,275
800,000	10,749	17,611	19,401	21,414	22,917	24,292	25,567
1,000,000	9,920	16,586	18,376	20,389	21,892	23,267	24,542
1,200,000	9,366	15,902	17,692	19,705	21,208	22,583	
1,400,000	8,971	15,414	17,204	19,217	20,720	22,095	
1,600,000	8,675	15,048	16,838	18,851	20,354	21,729	
1,800,000	8,444	14,763	16,553	18,566	20,069		
2,000,000	8,260	14,535	16,325	18,338	19,841		
2,200,000	8,109	14,349	16,139	18,152			
2,400,000	7,983	14,194	15,984	17,997			
2,600,000	7,877	14,062	15,852				
2,800,000	7,786	13,949					
3,000,000	7,707	13,852					
3,200,000	7,637	13,766					
3,400,000	7,576	13,691					
6,000,000	7,153						

* Fixed costs for premium coffees include private brand fixed costs.

Exhibit 4 Sales During 2000

Year 2000	Sales Private (kilograms)	Sales Premium (kilograms)	Percent of Total
January	81,792	84,916	7.1%
February	103,680	107,640	9.0%
March	135,936	141,128	11.8%
April	86,400	89,700	7.5%
May	93,312	96,876	8.1%
June	57,600	59,800	5.0%
July	48,384	50,232	4.2%
August	38,016	39,468	3.3%
September	78,336	81,328	6.8%
October	150,912	156,676	13.1%
November	139,392	144,716	12.1%
December	138,240	143,520	12.0%
	1,152,000	1,196,000	100.0%

Exhibit 5 Dino's Production Plan for Private Brand Only

	Capacity	Production Private	Inventory Private	Sales Private	2000 Actual Sales Percent
Initial Inventory			174,000		
January	500,000	500,000	248,000	426,000	7.1%
February	500,000	500,000	208,000	540,000	9.0%
March	500,000	500,000	-	708,000	11.8%
April	500,000	450,000	-	450,000	7.5%
May	500,000	486,000	-	486,000	8.1%
June	500,000	390,000	90,000	300,000	5.0%
July	500,000	500,000	338,000	252,000	4.2%
August	500,000	500,000	640,000	198,000	3.3%
September	500,000	500,000	732,000	408,000	6.8%
October	500,000	500,000	446,000	786,000	13.1%
November	500,000	500,000	220,000	726,000	12.1%
December	500,000	500,000	-	720,000	12.0%
	6,000,000	5,826,000	-	6,000,000	100.0%