

17 BAGELZ

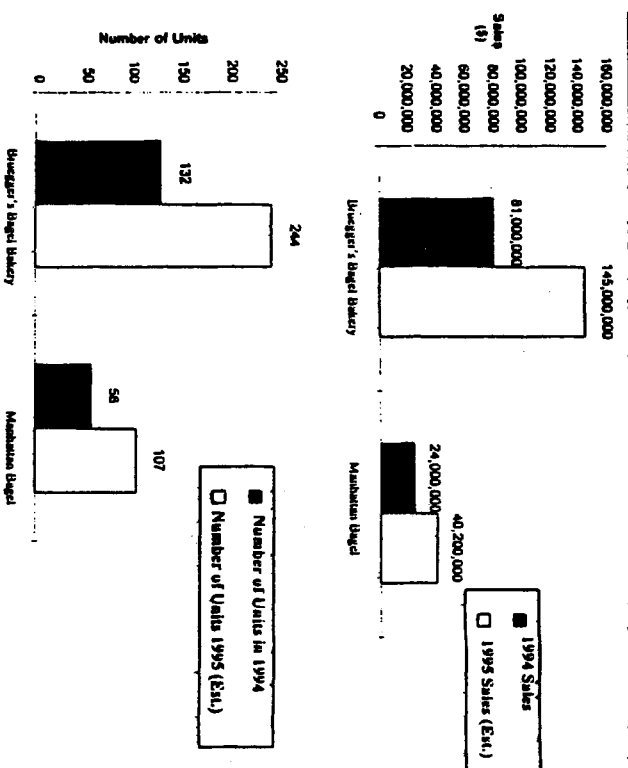
Bagel Boys was a Connecticut-based bagel chain, with seven established retail locations. In 1993, Mike Bellouanos and team members Joe Amadio, Wes Becker, and Jamie Whalen were approached by Subway sandwich franchise co-founder Fred DeLuca. He offered to buy into the company and turn them into a world-class franchise, but reaching a deal wasn't easy. Negotiations continued for six long months, during which time Bagel Boys stopped opening additional stores, and in late 1993, an agreement was finally reached. Fred DeLuca and Peter Buck (Fred's Subway partner) purchased a 50 percent stake in the franchise company. Mike, Jamie, Joe, and Wes retained the other 50 percent, and 100 percent of the commissary—a separate company founded by the four which supplied Bagel Boys franchisees with bagel dough and cream cheese.

Aligning with Fred offered numerous competitive advantages as a franchisor. Franchising offered Bagel Boys a high-growth opportunity—essential to compete against other industry players such as Bruegger's and Manhattan Bagel (see Exhibit 17.1). But the Bagel Boys team was concerned because as the company expanded, the likelihood of franchisee problems also increased. They wondered how they could best defend against this and thought that perhaps some changes were in order. Although they were unsure what that would entail, the team thought they needed to reassess at least two factors: (1) the way they selected franchisees and (2) the company's internal management structure. Furthermore, they needed to evaluate all alternatives to determine the company's best strategic direction.

This case was prepared by Andrew Ayles with assistance from Dan O'Hally under the direction of Professor Stephen Spinelli. Funding provided by the Ewing Marion Kauffman Foundation. Copyright © 1996 Babson College. All rights reserved.

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Exhibit 17.1 Comparison of Bruegger's Bagel Bakery and Manhattan Bagel.



Source: Nation's Restaurant News, July 17, 1995, Restaurant Business, July 1, 1995, and BusinessWeek, May 21, 1996.

FRANCHISING OPERATIONS

Attempts to officially register the Bagel Boys name revealed that another company had already filed for the exclusive rights to use that name. Mike and the team named the new company Bagelz. Bagelz was registered as a franchise company in December 1993 and began selling franchises in the summer of 1994. As Mike recalled:

When we began to franchise, many people thought we were already doing it because a lot of people didn't know the difference between a chain and a franchise. We had gotten dozens of letters from people asking to buy a franchise. That was where we got our first franchisees.

Charismatic and a natural-born salesman, Joe assumed the responsibility for selling stores—a critical position since the company's development strategy focused heavily on rapid growth through franchising. Jamie, Wes, and Mike concentrated on the operational aspects of the company, consulting with Fred often:

Fred was the one who really made it all happen. Without him we would have never franchised; we simply felt that we didn't know enough about it to do it on our own.

EXHIBIT 17.2 50 fastest growing U.S. restaurants 1994-1995.

Name of restaurant	City and state	Type of restaurant	Does the company franchise?	1994-1995 % change systemwide sales	1994-1995 % change in avg. unit sales	1994-1995 % change in units
1 East Side Mario's	Dallas, TX	Casual Dinnerhouse	Y	126.3	-2.0	59.1
2 Boston Chicken	Golden, CO	Fast Food	Y	106.7	5.8	55.2
3 Kenny Rogers Roasters	Fort Lauderdale, FL	Fast Food	Y	106.5	2.4	45.6
4 Planet Hollywood	Orlando, FL	Entertainment	N	101.2	13.0	57.1
5 St. Louis Bread Co.	Boston, MA	Fast Food	Y	87.8	-2.8	59.5
6 Old Chicago Restaurants	Boulder, CO	Brewpub	N	82.4	-20.5	64.3
7 Hometown Buffet	San Diego, CA	Buffet	Y	71.6	-4.5	48.3
8 Johnny Rockets	Los Angeles, CA	Fast Food	Y	69.9	2.7	129.4
9 Manhattan Bagel	Easton, NJ	Fast Food	Y	67.5	10.0	175.9
10 Hops Grill & Bar	Tampa, FL	Brewpub	N	67.4	3.6	50.0
11 Starbucks	Seattle, WA	Fast Food	N	66.9	9.0	55.6
12 Landry's	Houston, TX	Casual Dinnerhouse	N	66.3	-6.3	60.0
13 Chesapeake Bagel Bakery	McLean, VA	Fast Food	Y	65.7	0	122
14 Fazoli's	Lexington, KY	Fast Food	Y	64.0	2.6	72.6
15 Mozzarella's	Mobile, AL	Casual Dinnerhouse	N	62.7	-12.8	41.2
16 Don Pablo's	Bedford, TX	Casual Dinnerhouse	N	55.3	5.7	33.3
17 Bruegger's Bagel Bakery	Burlington, VT	Fast Food	Y	55.0	-0.1	84.8
18 Papa John's	Louisville, KY	Fast Food	Y	51.1	-0.9	38.9
19 Lone Star Steakhouse	Wichita, KS	Casual Steakhouse	N	52.4	1.6	39.1
20 Outback Steakhouse	Tampa, FL	Casual Steakhouse	Y	45.4	0	38.8
21 Schlotzsky's Deli	Austin, TX	Fast Food	Y	45.3	16.1	30.5
22 Pollo Tropical	Miami, FL	Fast Food	Y	44.5	4.9	23.5
23 Country Harvest Buffet	Bellevue, WA	Buffet	N	42.0	2.2	13.3
24 Applebee's	Kansas City, MO	Casual Dinnerhouse	Y	40.9	0	31.2
25 Damon's—The Place For Ribs	Columbus, OH	Casual Dinnerhouse	Y	39.7	10.5	26.8
26 Cheesecake Factory	Redondo Beach, CA	Casual Dinnerhouse	N	36.7	2.4	40.0
27 Papa Murphy's Take 'N' Bake Pizza	Vancouver, WA	Fast Food	Y	35.7	5.7	34.3
28 Crab House	Hollywood, FL	Seafood Dinnerhouse	N	35.5	6.7	53.8
29 Peter Piper Pizza	Phoenix, AZ	Fast Food	Y	33.3	2.5	38.9
30 Cici's Pizza	Dallas, TX	Fast Food	Y	32.8	2.6	21.0
31 Romano's Macaroni Grill	Dallas, TX	Casual Dinnerhouse	N	31.3	-3.5	40.0
32 Donatos Pizza	Blacklick, OH	Fast Food	Y	30.7	3.2	21.6
33 Blimpie	New York, NY	Fast Food	Y	30.0	2.0	54.3
34 Italian Oven	Latrobe, PA	Casual Dinnerhouse	Y	29.9	-11.4	25.7
35 Steak-Out	Huntsville, AL	Fast Food	Y	29.8	2.0	16.9
36 Ninf's	Houston, TX	Casual Dinnerhouse	N	29.4	-10	32.1
37 California Pizza Kitchen	Los Angeles, CA	Casual Dinnerhouse	Y	27.7	24.6	22.4
38 Burgerville U.S.A.	Vancouver, WA	Fast Food	N	27.3	31.3	2.6
39 Cinnabon Cinnamon Rolls	Seattle, WA	Fast Food	Y	26.7	2.5	11.7
40 Claim Jumper	Irvine, CA	Dinnerhouse	N	26.5	8.3	13.3
41 Champps Americana	Wayzata, MN	Casual Dinnerhouse	Y	25.3	2.9	28.6
42 Levy Restaurants	Chicago, IL	Entertainment	N	25.0	23.2	0
43 California Cafe Restaurant	Corta Madera, CA	Casual Dinnerhouse	Y	25.0	2.0	28.6
44 Green Burrito	Newport Beach, CA	Fast Food	Y	25.0	2.3	52.4
45 Auntie Anne's	Gap, PA	Fast Food	Y	24.2	1.7	9.9
46 Rio Bravo Cantina	Marietta, GA	Casual Dinnerhouse	Y	24.0	3.0	25.0
47 Old Country Buffet	Eden Prairie, MN	Buffet	Y	23.7	-0.9	16.4
48 Chevys	Irvine, CA	Casual Dinnerhouse	Y	23.6	-3.8	28.3
49 Ruby Tuesday	Mobile, AL	Casual Dinnerhouse	Y	23.6	-4.5	18.0
50 Steak 'N Shake	Springfield, MO	Fast Food	Y	23.5	5.0	21.3

Source: Restaurant Business, July 1, 1995.

Franchising had become increasingly popular throughout the U.S. restaurant industry. In 1995, 34 of the top 50 fastest growing U.S. restaurants were franchisees (see Exhibit 17.2). By 1996, twelve Bagelz franchised locations were operating and six other franchised sites were under development. Additionally, one franchisee was planning to open multiple nonbake satellite units. A nonbake location is one in which there is no oven on the premises and bagels must be supplied from another Bagelz store. The first nonbake location had been opened in Saybrook, Connecticut, in 1993, in response to a bet: a landlord challenged Mike and his team to build a store in three weeks' time, to meet the start of the summer tourist season. They accomplished this feat in exchange for lower rent, and the store became an instant success. Sales revenues were comparable to those of traditional stores, but rent, labor, and equipment costs were significantly less—as was the population needed to support the unit. Population issues were also why Mike and his team sold only site-specific locations:

We didn't sell territories or give assurances that we wouldn't open a store next door. The problem was different population densities. For example, a mile radius in New York City could have supported many locations, but in much of Kansas, a mile just wouldn't be large enough to support even one store. Also, if there was one store in the Massachusetts Turnpike and one in the nearest town, although located in close proximity of each other, they would clearly serve two different markets of customers. We looked very carefully at each individual situation when we developed stores near each other. We weren't looking to annoy franchisees—we knew they were the key to successful development.

Franchising was expensive. As a franchisor, Bagelz needed to open a minimum of 50 locations before there existed the potential to obtain a profit. Developing stores was a cash-intensive process, and it often took as long as two years to build a steady customer-base (see Exhibits 17.3 through 17.6 for financial statements.) Additionally, Bagelz asked for a lower franchise fee than its competitors. Mike limited this fee to \$10,000 because, although less income for Bagelz in the short term, he wanted to attract mom-and-pop franchisees. He felt that they were the most motivated to make a Bagelz store succeed.

To help minimize corporate costs, Mike used Subway's legal department to write the Uniform Franchise Offering Circular (UFOC)* (see Exhibit 17.7) and their architects for designing new stores. Because of this, Bagelz's corporate franchise-development costs were significantly lower than what they otherwise would have been.

* A UFOC contains information including: a description of the business, estimated development costs, fee schedules, franchisee and franchisor obligations, other businesses affiliated with the franchise, and pending lawsuits. The Federal Trade Commission requires franchisors to furnish a UFOC to prospective franchisees. Additionally, thirteen states require state office UFOC filings for franchisors who franchise in that state.

EXHIBIT 17.3 Bagelz Franchising balance sheets December 31, 1995 and 1994.

	1995	1994
ASSETS		
Current assets	\$ 3,230	\$ 2,590
Cash	11,916	3,450
Accounts and other receivables	2,281	2,281
Other current assets	16,356	8,321
Property and equipment	95,412	95,412
Less accumulated depreciation	(14,964)	(3,230)
Other assets	89,448	92,182
Due from affiliates	88,318	44,091
Other assets	12,853	16,991
Other assets	101,171	61,082
	<u>\$197,975</u>	<u>\$161,585</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities	\$ 44,425	\$ 58,824
Accounts payable and accrued expenses	42,855	96,679
Due to affiliates	1,210	2,281
Other current liability	500	250
Income taxes payable	88,990	158,034
Loans payable—stockholders	87,976	38,217
Deferred franchise fee revenue	13,000	28,700
Stockholders' equity (deficit)		
Common stock, no par value, 20,000 shares authorized,	1,000	1,000
200 shares issued and outstanding	184,217	56,000
Additional paid-in capital	(187,208)	(180,366)
Accumulated deficit	\$ 8,008	\$ (63,366)
	<u>\$197,975</u>	<u>\$161,585</u>

JOE'S DEPARTURE

At this time, Joe left to pursue other interests:

Joe was an entrepreneur in the truest sense of the word. We didn't want Joe to go, but his passion was starting companies. His attitude was go, go, go, and he loved to get the company going, but then, when it came to dealing with day-to-day stuff, Joe got completely bored out of his mind. He got us to grow, but he didn't want to deal with the real tape of being a franchisor.

EXHIBIT 17.4 Bagelz Franchising Corporation (an "S" corporation) statements of loss for the years ended December 31, 1995 and 1994.

	1995	1994
Revenue		
Royalties	\$265,313	\$157,144
Initial franchise fees	76,700	66,300
Other revenue	16,802	6,489
	<u>\$358,815</u>	<u>\$149,943</u>
Selling, general and administrative expenses	(409,383)	(262,486)
Loss before depreciation and amortization	(50,476)	(112,553)
Depreciation and amortization	(14,372)	(5,857)
Loss from operations	<u>\$(64,850)</u>	<u>\$(118,410)</u>
Other income (expenses)	5,350	—
Interest income	(7,092)	(1,306)
Interest expense	—	(150)
Penalties	<u>\$(1,742)</u>	<u>\$(1,456)</u>
Loss before state income tax	(66,592)	(119,866)
State income tax	(250)	(500)
Net loss	<u>\$(66,842)</u>	<u>\$(120,366)</u>

The price for Joe's interest in the company was quickly agreed upon and divided equally among Mike, Wes, and Janie. Fred and Peter's 50 percent ownership stake remained unaffected. Wes then became president, Mike, vice president, Janie became director of training and manager of territory development.

ORGANIZATIONAL STRUCTURE

The company was growing so rapidly that each team member had to perform multiple functions, making it difficult to define an organizational structure. By 1996, however, the team wanted to develop a more formal management infrastructure. For the present time, Mike, Wes, and Janie worked as a team with Janie ultimately reporting to Mike more than Wes. In addition to the five partners, there were four other full-time corporate employees: a bookkeeper, a controller, a marketing director, and a receptionist.

Mike and his team called Fred for advice but maintained final authority. For example, Fred advised allowing the sale of nonbake units to franchisees who didn't already own a bake unit. He reasoned that, as a function of demand, bake units would naturally open to support nonbake ones. The team ultimately decided against allowing franchisees to own only nonbake locations. Doing so would put nonbake franchisees in a potentially weak negotiating position—they would then be at the mercy of

EXHIBIT 17.5 Bagelz Franchising Corporation statement of cash flows for the years ended December 31, 1995 and 1994.

	1995	1994
Cash flows from operating activities		
Net loss	\$(66,842)	\$(120,366)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	14,372	5,857
(Increase) decrease in Accounts and other receivables	(8,466)	(3,450)
Other assets	2,571	(2,940)
Increase (decrease) in Accounts payable and accrued expenses	(14,389)	58,824
Other liabilities	(1,071)	—
Income taxes payable	250	250
Deferred franchise fee revenue	(15,700)	29,700
Net cash used in operating activities	<u>\$(99,285)</u>	<u>\$(33,134)</u>
Cash flow from investing activities		
Advances to affiliates	(44,927)	(44,091)
Purchase of property and equipment	—	(95,412)
Acquisition of intangible assets	—	(15,669)
Net cash used in investing activities	<u>\$(44,927)</u>	<u>\$(155,172)</u>
Cash flows from financing activities		
Advances from affiliates	51,075	96,679
Capital investment	100,000	56,000
Repayment of advances from affiliates	(104,899)	—
Loans from stockholders	87,976	38,217
Net cash provided by financing activities	<u>\$134,152</u>	<u>\$190,896</u>
Net increase in cash	640	2,590
Cash—beginning of year	2,590	—
Cash—end of year	<u>\$ 3,230</u>	<u>\$ 2,590</u>
Supplemental disclosure of cash flow information		
Cash paid during the year for:		
Income taxes	—	\$ 250
Interest	—	125
Supplemental disclosure of non-cash transactions		
Total capital investment	<u>\$138,217</u>	

franchisees who operated bake locations to supply their bagels. Supplier-franchisees would have the power to raise wholesale bagel prices, drive nonbake franchisees out of business, and acquire the nonbake facilities. For nonbake franchise locations, franchisees were given the option of purchasing bagels from other franchisees, but all still had the ability to supply a nonbake location internally.

EXHIBIT 17.6 Bagelz per store earning claims 1995 (est.).

	Total revenue	
	Weekly	Annually
Total revenue per store	\$8,000.00	\$416,000.00
Sales	\$8,000.00	\$416,000.00
Total revenue		100.00%
Cost of goods sold		100.00
Salaries and wages	1,760.00	91,580.00
Food	1,520.00	79,040.00
Beverages	720.00	37,440.00
Paper supplies	320.00	16,640.00
Total cost of goods sold	\$4,320.00	\$224,640.00
Gross profit on sales	\$3,680.00	\$191,360.00
Operating expenses		
Loyalties	640.00	33,280.00
Payroll tax	136.00	7,072.00
Payroll service	20.00	1,040.00
Rent	480.00	24,960.00
Electric	200.00	10,400.00
Gas	120.00	6,240.00
Telephone	24.00	1,248.00
Advertising	200.00	10,400.00
Local advertising	80.00	4,160.00
Promotions	4.00	208.00
Insurance	80.00	4,160.00
Linen and laundry	16.00	832.00
Repairs and maintenance	80.00	4,160.00
Rubbish removal	40.00	2,080.00
Office supplies	40.00	2,080.00
Uniforms	16.00	832.00
Professional fees	40.00	2,080.00
Miscellaneous	20.00	1,040.00
Total operating expenses	\$2,236.00	\$116,272.00
Total income from operations	\$1,444.00	\$ 75,088.00
		18.05

* All figures have been estimated based on industry data and do not necessarily represent the actual financial performance of a Bagelz store operation.

The franchisee made up the final part of the organization. There were seven franchisees, and plans were underway to open 53 new franchises by August 1997, and 2,000 by the year 2000. Mike was aggressively recruiting new franchisees and selling multiple units to existing ones. Ultimately, the number of stores sold to a particular franchisee would depend on the number of stores that the franchisee wanted and the number the team felt the individual could efficiently operate.

EXHIBIT 17.7 Bagelz's UFOC highlights.

Estimated initial investment for a Bagelz Franchise Operation

Initial Investment	Lower cost	Mid-cost	Higher cost
Initial franchise fee	\$ 10,000	\$ 10,000	\$ 10,000
Real property	2,500	4,000	8,000
Leasehold improvements	37,000	40,000	46,000
Equipment	55,000	60,000	65,000
Security systems	1,000	1,500	2,000
Freight charges	2,100	2,100	2,500
Outside signage	1,500	2,000	2,500
Opening inventory	5,000	5,000	5,000
Insurance	1,000	1,000	1,000
Supplies	500	750	1,000
Training expenses	600	1,100	2,600
Legal and accounting	1,000	1,000	1,000
Grand opening advertising	2,000	2,000	2,000
Miscellaneous expenses	5,000	5,000	5,000
Additional funds (3 months)	23,000	41,000	54,000
Total	\$146,800	\$176,450	\$207,600

Fees for a Bagelz Franchise Operation

Type of fee	Amount
Royalty	8% of total gross sales
Advertising	2.5% of total gross sales
Local advertising	1% of total gross sales
Opening advertising	\$2,000
Audit	Cost of audit plus interest
Late payments	Interest up to the legal maximum rate
Transfer	\$5,000, plus \$1,000 for any satellite
Extension	\$500 (does not apply to satellite location)
Location rent	Varies
Insurance	Varies
Non-competitive violation	\$10,000 for each competing store plus 8% of its gross sales
Confidentiality violation	Bagelz's damages
Trademark violation	\$250 per day
Dispute resolution	Half of mediation and arbitration fee
Equipment ordering administrative fee	Up to 4% of the equipment

OPERATIONS

Stores opened at 6 a.m. and closed at 5 p.m. during the week and 2 p.m. on the weekends. The majority of business was done in the morning, but lunch hours were a significant source of revenue. Originally, there was no dinner business, but management's goal was to extend the days to 7 p.m. To achieve this, they were first looking to develop

the 2-to-5 afternoon coffee-hour business, and were testing several pastries and snack products to complement their cappuccino offerings.

The operations manual was in its fourth revision due to dramatic changes in the company's operational procedures throughout the past several years. For example, previously, bagel-making was a boil-and-bake operation, but now Bagelz had found a way to make it a bake-only operation without compromising the product's taste. To do this, they used a newly developed baking technology, able to provide the same taste as a boil-and-bake bagel without the boiling:

In one store, we replaced the regular oven with a new type that was only being used in 17 other retail operations throughout the country. We were number 18, and after installing it, we noticed that sales continued to climb. To us, this was a clear indication our customers approved.

Boil-and-bake was a difficult process; it was a hard, hot job and the baker played an important role in store operations. This role was so critical that the management team had store alarms installed, set to alert the team member on-call. If the store wasn't opened by 3 a.m., further complicating the situation was that baking required skilled labor. If the scheduled baker didn't show up, a skilled replacement had to fill in.

Management worked to reduce other costs for the franchisee, as well. Mike formulated a series of bagel demand charts based on sales patterns. These charts took much of the guesswork out of bagel inventory management for franchisees. The implementation of the new oven technology also reduced costs. Bagels could be made faster; therefore baking could start later in the morning. There were other benefits as well:

Before we started installing the new ovens, they baked with the oven door open. And it was hot! In one of our stores, we were having a ventilation problem and it was so hot in the baking area that the light fixtures on the ceiling melted. After installing the new oven, baking could be done with the door closed; it was much cooler in the baking area and there was a utility savings as well: the new oven used only 25 percent as much energy.

Other improvements to production systems further reduced costs. For example, poppy seeds could cost as much as \$80 for a 50-pound bag. In the past, bagels had been boiled, placed on seeded boards, seeded on the top, then baked. After baking, seeds left on the boards had to be discarded because baking seeds more than once produced a burned-tasting product. Management refined the process by dampening the bagels with a sponge, then dipping them in seed bins. Leftover seeds remained in the bin, effectively eliminating waste and reducing costs. Bagels were then defrosted and baked. Stores had a double-defrost rack and a single-bake oven because, while defrost took 30 minutes, bake only took 15. The double defrost-rack kept the production process continually flowing.

THE COMMISSARY

The commissary, which sold bagels, cream cheese, and other products to franchisees, was wholly owned by Mike, Jamie, and Wes. Franchisees were required to purchase

cream cheese and bagel dough directly from the commissary, but were permitted to buy other items either from the commissary or from an approved vendor and product list. Because of the commissary's bulk-purchasing power, franchisees were unlikely to obtain a lower price, effectively discouraging them from purchasing products from outside vendors. Maintaining high quality standards was also important, because the commissary needed large orders to receive large price discounts. In early 1986, the commissary's cream cheese sales volume averaged approximately 3,500 pounds per week:

A lot of people cut cream cheese with water; at the commissary, we don't. We also make larger bagels—four and a quarter ounces—when others use a four-ounce standard. Because of this, we will never be a cost leader, but the goal is to be seen as a product leader. You see, although you can't tell the difference between a four and four-and-a-quarter ounce bagel, the larger one has a longer shelf life, so we hope the customer will get a fresher bagel.

In the early days of the commissary, there was only one dough-producing machine. Production was started early in the day, so in the event there was a mechanical problem, it could be repaired in time. An additional machine was purchased in 1985, but production still started early in the day, so that in the event of an emergency, a store's order could still be met. As the sole source of bagel dough, the commissary had to deliver. Then in 1986, they developed frozen dough in conjunction with several large manufacturing companies:

Originally all our stores were doing fresh dough because we weren't able to formulate a frozen dough that tasted the same. But fresh dough only has a shelf life of three days and, therefore, there was a minimal distance from the commissary that a store could be located. Because commissaries are a nightmare to set up, this in effect, limited company growth potential. Frozen dough has a shelf life of about three months, and cream cheese 30 days, so growth was no longer limited to clusters around commissaries.

Mike, Wes, and Jamie planned to eventually outsource all frozen-dough production. Some franchisees had complained about the commissary's monopoly on dough sales, but once frozen bagel production was outsourced, franchisees could then buy from the lowest-priced producer.

MARKETING

Bagelz was continually improving products and store design. Mike and the team felt that Bagelz needed better marketing. For example, to increase coffee revenues, they developed better coffee displays, sold porcelain mugs, and positioned the product with an upscale image:

We even looked into pumping the coffee small into the store through the air vents. You see, mine was the same exact coffee as other, higher priced coffee competitors, but these sellers displayed the product better, so people saw it as superior and as such, were willing to pay more for it.

Although they wanted to create a deli or gourmet-shop image for Bagelz, they also wanted customers to perceive it as having the convenience of fast food. To do this and speed product-assembly times, they switched to presliced meats and pre-waxed cartoon

of pasteurized eggs. These processes had additional benefits: there was no chance of employee injury from a slicer blade and no threat of salmonella. Microwaved, the eggs were always uniform in taste and appearance. They also added self-serve drink fountains and refrigerators with prepackaged cream cheeses.

To better market take-out products, cream cheese containers were custom printed with the Bagelz logo and put in a display case by the register—in case a customer forgot to get it from the self-serve refrigerator. Previously, a customer had to step out of line to get it, then step back into line, delaying other customers. Pressure from those waiting, to keep the service line moving, had resulted in lost sales.

One of the company's greatest advertising successes was travel coffee mugs with the Bagelz name on them. Early on, Bagelz gave them away in exchange for any competitor's mug that a customer brought into the store. Other advertising tactics included emphasizing the "Z" in the Bagelz name, even putting the Z in front of words, as in "Z sandwiches." (See Exhibit 17.8 for Bagelz's menu and Exhibit 17.9 for Bruegger's.)

Another thing we had been advertising was something called a quarterloaf. There were a lot of people who weren't going to go in to buy a bagel because they simply weren't filling enough. For example, when I'm really hungry, I'm a grinder type of guy: extra sauce, dripping with cheese; it's a beautiful thing. Now, that's a sandwich! At first we were thinking of giving extra-thick bread, but others were doing it. The same with submarine sandwiches. Then we came up with the quarterloaf idea, and we knew we had a winner. No one knew what the heck a quarterloaf was, but it sounded good. And most of all, it sounded large.

The quarterloaf was one-fourth the size of a loaf of bread, shaped like a roll, and for an additional 25 cents offered the same sandwich items as a bagel. Because of this, the same sandwich-making area setup could be used for both—giving the impression that Bagelz offered many different menu items without having to coordinate extra preparation processes:

We are constantly looking for items, like the quarterloaf, that you can do a lot with. For example, right now we have a chicken breast, but pretty soon it's going to be a chicken salad. Then it's going to be a chicken Caesar salad. We are using Franchisee Advertising Fund revenues to develop advertising campaigns for all these new products.

FRANCHISEE ADVERTISING FUND

The Franchisee Advertising Fund (FAF) was controlled by franchisees. Two and a half percent of gross sales went to the FAF, and these funds supported media advertising, coupon campaigns, and similar promotions. Discounts from vendors on products such as deli meats and paper goods were negotiated by Mike, and approved by FAF's franchisee buying cooperative. It was thought that as the number of store units increased, local FAF chapters would eventually be created. However, Mike planned to continue negotiating vendor-based pricing deals:

We made the deals. We looked to make as large a deal as possible with suppliers. If you could fill their trucks, you would get the lowest possible price—one unit or one truckload costs the same to transport. Because we looked to develop territory clusters of stores, ordering enough to fill a truck became possible. First, we would make a deal

EXHIBIT 17.8 Bagelz's menu.

Sandwiches		Gourmet Cream Cheese w/ Bagel:			1.79
Smoked Ham with Cheese and Spicy Mustard	\$3.69	Plain (Low-Cal Available)			
Turkey with Cheese and Honey Mustard	3.79	Veggie (Low-Cal Available)		Lox	
Roast Beef with Cheese and Horseradish Sauce	3.89	Garlic and Herb (Low-Cal Available)		Strawberry	
Nova Scotia Lox with Cream Cheese and Onion	5.69	Chive		Walnut Raisin	
Chicken Salad with Cheese	3.69	Desserts		Daily Special	
Tuna Salad with Cheese	3.69	Chips			.69
B.L.T. with Cheese	3.09	Cookies			.59
Garden Veggie with Cheese and Fat Free Honey Mustard	2.99	Muffins			1.09
Grilled Chicken with Cheese and Mayonnaise	4.49	Fat Free Muffins			1.09
(Sandwiches include Lettuce, Tomato, and Onion)		Cinnamon Twists*			
Egg Sandwiches		Beverages	Small	Med.	Large
Egg	1.49	Gourmet Coffee	\$.99	\$1.09	\$1.19
Egg and Cheese	1.69	Cappuccino*			
Egg and Ham, Sausage or Bacon	2.29	Espresso*			
Egg and Ham, Sausage or Bacon with Cheese	2.49	Hot Chocolate			.99
Bagel Choices	.49 ea.	Juice	.99	1.29	1.49
	4.99 dz.	Milk			.69
Plain		Soda			1.29
Cinnamon	Whole Wheat	Iced Coffee			.79
Egg	Poppy	Herbal Tea			
Pumpernickel	Garlic	Platters			
Salt	Onion	(Prices upon request)			
Everything	Cornmeal	8 Sandwich Platter			
Sesame	Raisin	12 Sandwich Platter			
	Daily Special	Bagel and Cream Cheese Platter (14 Bagels)			
Spreads		Bagel and Cream Cheese Platter (26 Bagels)			
Butter					
Peanut Butter and Jelly					
Cream Cheese					

* Denotes products not available at this location. Prices effective November 1, 1996 for the Fairfield, CT store location.

EXHIBIT 17.9 Bruegger's menu.

Bagel Sandwiches					
Tuna Salad	\$3.39	Desserts			
Grilled Chicken Salad	3.39	Bruegger's Bars		1.19	
Roasted Turkey Breast	3.79	Bruegger's Cookies		0.71	
Smoked Turkey Breast	3.79	Fresh Apples		0.71	
Roast Beef	3.79	Take-Out Cream Cheese			
Atlantic Smoked Salmon	4.39	Original		1.79	
Garden Vegetable	2.89	Smoked Salmon		3.09	
Muenster or Swiss Cheese	2.89	Others		1.99	
Bruegger's Humus	2.89	Plain	Honey Grain		
Peanut Butter	1.19	Sesame	Poppy		
		Cinnamon Raisin	Salt		
		Sundried Tomato	Onion		
		Pumpernickel	Garlic		
		Blueberry	Everything		
All Above Served with: Mayonnaise, Garlic Mayonnaise, Dijon Mustard, Honey Mustard, or Horseradish Sauce					
Additional Extras (Choice of Any Two):		Beverages	Small	Med.	Large
Tomato, Sprouts, Onion, Cucumber, Lettuce, or Green Pepper		Coffee	0.89	1.05	1.19
		Flavored Coffee	0.99	1.19	1.43
Bagels and Cream Cheese		Tea: Regular, Decaffeinated, or Herbal		0.79	
Plain	1.39	Milk		0.65	
Honey Walnut	1.69	Soda	0.70	0.89	0.99
Garden Veggie	1.69	Juice Spritzer		1.25	
Chive	1.69	Bottled Juice		1.39	
Bacon Scallion	1.69	Orange Juice	1.19	1.43	1.67
Wildberry	1.69	Mineral Water		1.29	
Smoked Salmon Spread	2.09	In Season Beverages			
Jalapeno	1.69	Hot Chocolate	1.19	1.39	1.59
Light Garden Veggie	1.69	Hot Mulled Cider	1.19	1.39	1.59
Light Plain	1.39	Fresh Cider	1.19	1.39	1.59
Light Herb Garlic	1.69				
Light Strawberry	1.69				
Butter, Margarine, Honey, or Jam	0.79				
Soup of the Day					
Cup	2.29				
Bowl	2.59				

Prices effective November 1, 1996 for the Wellesley, MA store location.

Source: Restaurants & Institutions, January 1, 1995.

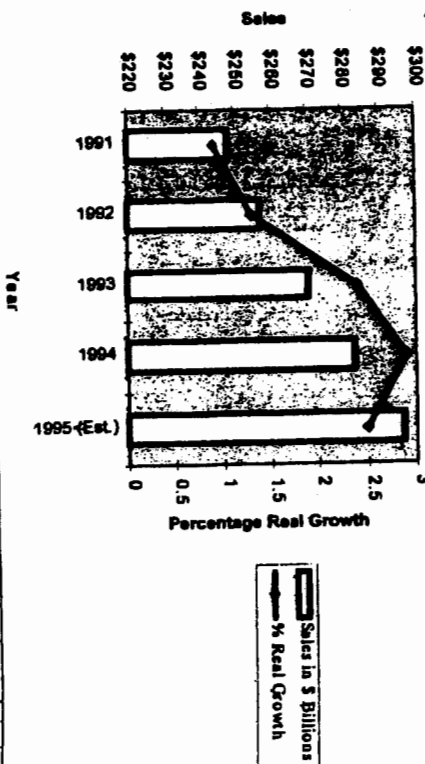


Exhibit 17.10 Foodservice industry growth statistics.

Co-Branded Units

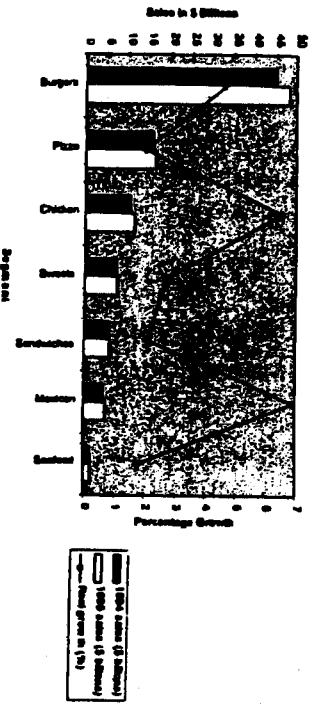
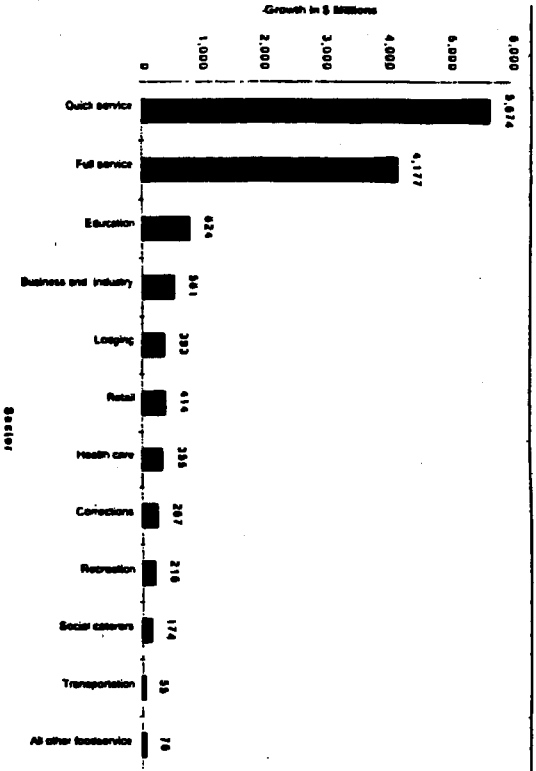
Co-branded units offer two different concepts, in the same location (e.g., KFC and Taco Bell). Bagelz opened their first co-branded store with Subway. A store adjoining one Subway location had gone out of business, and the site became available. Although they were able to combine the seating due to Subway's existing set-up, they were not able to combine the back room—something Mike and the team hoped to eventually be able to do. They thought there would be other opportunities to develop co-branded Bagelz and Subway units:

We were also looking to put together a breakfast program with Fred. Although he was already doing a breakfast program, he was having problems changing Subway's image

with a local supplier, and then with the larger house that distributed to them. We would guarantee the supplier that we would open up a certain number of stores in an area, within a given period of time. It has worked fine so far, but if we ever miss projected store openings and usage volumes, it will become a little more difficult.

The team decided to wait on television advertising. They believed that successful television advertising for food, unlike garage or gas-station advertising, depended directly on how attractive that product looked on the screen. Achieving a high-quality, professional production was expensive and simply wasn't cost-effective for the company at the time. Instead, they saw potential for using the effectiveness of television advertising without spending FAF money by forming strategic alliances with other companies that already advertised on television. Such alliances included developing co-branded units to establish brand recognition in the highly competitive foodservice industry (see Exhibits 17.10 and 17.11).

Exhibit 17.11 Food service industry statistics categorized by sector and segment.



Source: Cahners Bureau of Foodservice Research and Restaurants & Institutions, January 1, 1995.

from strictly a lunch and dinner place. We were looking to use Bagelz as a morning traffic-builder, retrofitting some Subway stores—possibly changing their color scheme to differentiate the co-branded units. If this works, it opens up an enormous number of possibilities, and shared overhead would be a tremendous competitive advantage. But Subway isn't our only option—we see them as one potential brand to do business with, but there are a lot of other franchisors we could co-brand with, as well.

One company, a Mobil franchisee, had already opened a Bagelz franchise in his gas station's convenience store. The Mobil owner didn't have the room for full-sized

baking facilities nor did he want to lease the space to an existing Bagelz franchisee, so management engineered a scaled-down version of necessary baking equipment. This gave the franchisee potential to open multiple, nonbake locations. The Bagelz team considered multiple-unit franchisees key for the company's success:

If we could be three-to-one or four-to-one nonbake to bake, we would be very happy because you don't make money in the back room—you make money by setting up counters and by getting qualified franchisees to keep them operating.

FRANCHISEE RECRUITMENT—FUTURE DILEMMAS

Franchisee recruitment was a labor-intensive process, and according to a study done by Subway and several other franchisors, the national inquiry-to-approval rate of potential franchisees was a mere 2 percent. Bagelz's approval rate, about 4 percent, was twice the national average. Despite this unusually high acceptance rate, Bagelz had encountered problems with only one franchisee, who had simply abandoned the location. The Bagelz team had known that the franchisee wanted to leave the system and found a buyer willing to purchase the store, but the franchisee had gotten impatient. Not wanting to wait for due diligence, he simply pulled all his equipment out and locked the door:

This guy was definitely a red flag. He was qualified, but there were warning signs—you can talk yourself into believing anything if you try hard enough. In the early stages of development, we talked ourselves into believing that what we needed to do was sell stores, and that little else mattered. We tried to make a deal with anyone who expressed interest. Now we're more aware of potential problems that can occur with franchisees—this is something that we're quite concerned about.

Mike and the team worried about the likelihood of franchisee problems as the company expanded. They thought that perhaps they needed to re-evaluate the way they selected franchisees and the company's management structure. After giving it some careful thought, they formulated several potential plans of action. They could either screen potential franchisees more rigorously or they could keep the screening process as it was—perhaps a small percentage of poorly performing franchisees was a price that had to be paid for continued high growth. They also could concentrate on developing an internal-management structure or possibly outsource the evaluation function. They knew they would need to carefully consider all alternatives to determine the best direction for Bagelz.