h3: Cooking growth or grilling it?

by

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A Work Project presented as part of the requirements for the Award of a Masters Degree in Finance from the NOVA School of Business and Economics

A project carried out under the supervision of:
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January 2017

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Rev: January 06,2017

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Synopsis

Founded in 2007, h3 is a Portuguese company in the retail sector, which challenged the *status quo* of the fast food industry by introducing a new segment into the food court, the "not so fast food". h3 sells 200 grams' gourmet burgers with a homemade sauce, accompanied by freshly cut French fries and Thai rice, served in a hot porcelain plate and metal cutlery at an affordable price. Being one of the most successful companies in the Portuguese market, h3 experienced an exponential growth in the first three years, which led them to open more than 30 restaurants. With an established position in the Portuguese market and having tapped all of the relevant shopping malls, the company pursued three international expansions in 2011. The company now owns more than 60 restaurants in two countries and employees around 600 people. This case discusses the difficulties found by three founders to enter into the competitive retail sector, the sacrifices entrepreneurs' need to make to fund their early-stage ventures, the different sources of funding used for internal and external expansion, as well as, the measures needed to take to stimulate growth.

h3's example can be seen as both the good and the bad on what a retail startup should do and how a company should act when they are extremely successful on an initial stage.

This case can be used in Creating and Financing New Ventures, Entrepreneurial Finance and Entrepreneurship courses, as it relates to issues of financing new ventures, how to deal with exponential growth and expansion strategies.

João Lopes Raimundo (MSc Finance '17) developed this case under the supervision of Prof Paulo Soares de Pinho. It was written solely as a basis for class discussion rather than to use a source of primary data or to illustrate either effective or ineffective management handling.

Assignment Questions:

- What is the value proposition of h3? Highlight the differentiating characteristics of their business model.
- Analyze the background of the 3 founders. Was it suitable to open a restaurant chain? What does this prove?
- How can an early-stage venture finance itself? Did h3 choose the most suitable one for their type of business?
- How did h3 finance its initial expansion?
- Analyze h3's franchising system and whether it was the correct choice of expansion for the company, as well as, the associated costs. Discuss the advantages and disadvantages of franchising.
- What did h3 do wrong in their 3 expansion strategies? Analyze each expansion separately.
- Taking into consideration past experiences, what advice could be given for further international expansions?
- Based on what's given by the case, do a breakeven analysis of a typical restaurant in Portugal in 2015? Assume that h3 buys the meat at 9.90 €/kg and that remaining cost of sales represent 10%. Use the price of the Tuga menu (each menu has 200 grams of rice and/or 200 grams of French fries).

Discussion Analysis

This case can be used as a mean to enlighten students regarding the difficulties in starting their own business and the characteristics needed to be a successful entrepreneur. Furthermore, it should be discussed the different sources of financing of an early-stage venture, as well as, the related issues with each single one of them. By emphasizing the risks of franchising one should also show the positive side of it. Finally, the expansion strategies of h3 should be thoroughly analyzed and corrected, asking students if there has been any improvement as strategies were being pursued.

What is the proposition value of h3? Highlight the differentiating characteristics of their business model.

An h3 restaurant can be defined as a place people go to when they want to have a gourmet burger at an affordable price. h3 adds value to the market by opening a new niche in the Portuguese market, which they described as being "not so fast food". This concept consists in offering clients a high quality, healthy meal at the same price and time as a fast food restaurant. By using a strict inventory and supply chain management system, h3 is able to deliver a gourmet burger to its clients in less than 30 seconds from the moment it is ordered.

h3 only works with fresh products, starting with 200 grams of pure burger meat. The gourmet burgers are served in a hot porcelain plate or in bread, with steal cutlery. The restaurant chain goes a step further by focusing, not only, on its main raw material, the meat, but also, on the remaining. The lemonade its made out of fresh lemons and the French fries are freshly cut and fried just before the order. The gourmet sauces that enrich h3's menu gives it the needed edge over the other restaurants in the food court. This way of preparing burgers is called "new hamburgology".

The value proposition comes in a new serving method adopted by the company, which is called "not so fast food". After analyzing the variety of restaurants encountered in a "food court", the management team soon realized that they all had one thing in common, the fast speed at which the meals were served hindered the quality of the product. h3 did not believe that these two factors were mutually exclusive. They found out that it was possible to serve gourmet food in less than 30 seconds at an affordable price. By serving gourmet food at non-gourmet prices, an h3 restaurant retails a menu, which includes burger, side order and drink, at an affordable price of €7.20 (Tuga Menu).

The ability to serve clients under a 30 second time frame from the moment the order is put comes through the highly efficient and strict inventory and supply chain management, which is followed rigorously throughout all the restaurants. Furthermore, h3 developed a technique that enabled them to quickly serve their clients to reach their 30 seconds serving goal. By counting how many people are waiting in the cue, they can start grilling the burgers beforehand so that the waiting time since they have paid is reduced. Through the diversification of using fresh and gourmet ingredients instead of the normal, frozen ingredients that clients are expecting to eat when going to a shopping mall for lunch, h3 was able to captivate their customer's attention and appetite in exchange for a small premium.

Analyze the background of the 3 founders. Was it suitable to open a restaurant chain? What does this prove?

Albano, António and Miguel have three different backgrounds. Albano and António both studied law, but only António exercised it. Albano worked for a company in the publishing industry where he gained a variety of awards for his creativity. On the other hand, António went on the become a manager at Cosmic Chili. Miguel studied at Escola do Comércio de Lisboa, upon finishing his studies he became a merchandising supervisor for EMIP and then moved on to become a real estate consultant for Cushman and Wakefield.

As you can see, none of them have any common characteristics and at a first glance, none of them seem to have any interest or experience to become owners of a gourmet burger chain. In a startup, the team is as important as the idea itself, but also, besides the academic background and work experience, it is of the utmost importance that the team knows and relies on each other, that they are passionate about what they are doing and they are goal-driven to success. It can be said that these three men all possessed these characteristics, which led them to become successful entrepreneurs. Furthermore, the diversity in their prior experiences allowed them to give different views on each others thoughts and complement each others weaknesses.

To become a successful entrepreneur, you don't have to be top of your class or to have top jobs at the best firms, you need to be results-driven, passionate, humble and resilient. If the founders did not have these characteristics they would have stopped after the failure of h3. Instead, they left their jobs and put together their life savings to create h3. An entrepreneur can not see failure as something bad, it should be seen as a lesson, which will allow you to become better and do better. The same happened with the international expansion of h3, they learned from their mistakes and got better each time, not giving up on their dream to become a worldwide known gourmet burger chain.[1]

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[1] Leach, J. Chris, & Melicher, W. Ronald, (2011). Entrepreneurial Finance

How can an early-stage venture finance itself? Did h3 choose the most suitable one for their type of business?

There are various alternatives for early-stage ventures to finance themselves. Below you can find a list of the various funding options:

- Government Funding
- Founders
- Family & Friends
- Angel Investors
- Angel Circles
- Early-stage VC's

The first round of financing in an early-stage company is called "seed round". It is the initial capital that is used to start a business. It either comes from the founders' personal assets, such as, savings or credit cards, or from friends and family. The first option is riskier and less dependent on a third party, but might need some sacrifice to work, many entrepreneurs take a second mortgage on their home to fund their business. The second option has third party risks associated with it.

Although, very unlikely for a retail startup, a third option for seed funding is crowdfunding. Crowdfunding is a way of increasing the capital of your new business venture through monetary injections by a large number of individuals. It uses social media and crowdfunding platforms as marketing and awareness platforms for your business and allows you to expand your circle of investors.

Another way of financing a new venture on such an early stage is through internally-generated cash-flows. Companies should strive to generate cash-flows from sales and, not only, focus exclusively on R&D. Cash management is of the essence for this to happen, cash is a very scarce commodity, early-stage companies should treat it as such.

- Limit costs to an absolute minimum
- Negotiate paying terms with suppliers
- Do not sell on credit
- Minimize inventory

In the seeding phase of a company, debt is also a valid option. Although debt can be a risky instrument, due to the obligations towards the debtor, it is a very efficient tool to finance a venture.

Normally, it is harder for an early-stage venture to finance itself through debt, due to the higher risk of default. New ventures do not have a track-record or collateral to be able to acquire unsecured bank loans due to their high-risk. Retail startups, such as, h3 that use capital leasing, do not own any buildings, which makes it even harder to secure debt financing, due to the lack of collateral. Lending will increase the company's bankruptcy risk, it will increase the cash outflow because of interest payments and can difficult growth prospects. In more mature companies, debt can be perceived as a cheaper way of financing because the cost of debt is lower than the cost of equity. In this case, we are analyzing an early stage venture, which, on average, has a tax shield of zero, so there is no great advantage.

Asset-based lending is normally the most suitable choice for early-stage ventures, it gives them more flexibility. In capital leasing the lessee pays an installment to the lessor for the economic rights of the asset, reducing the risk of ownership and default, because they do not own the asset and are not burdened with bankruptcy risks and legal rights.

h3 was able to do what most early-stage ventures are not able to, due to their exponential success from an early-stage on, they were able to, not only, "seed" their business through their own capital by using their life savings, but also, grow through the use of a rigorous inventory management, which allowed them to have sufficient internally generated cash flow to finance their expansion and growth objectives. Obviously, this was obtained through a mix of the cash flow generated by the firm in conjunction with financial debt. Even though, they had large cash flows, h3 also opted for a debt instrument to sustain its expansion. All the restaurants except one (Parque das Nações) were under a capital leasing agreement, to reduce default risk and to be able to free more capital. In addition, to wholly-owned restaurants, h3 also used a franchising system to expand.

How did h3 finance its initial expansion?

There were three main funding sources that led h3's expansion:

1. Personal Savings

2. Bootstrapping
3. Negative NWC Requirements

After failing to succeed with their first restaurant Café 3, h3's founders, Albano, António and Miguel, put together all of their life savings and proceeded to create and open the first 2 restaurants of h3. The entrepreneurs then built the company through bootstrapping, the most effective and inexpensive way to start a business with positive cash flow. More specifically, after failing to implement Café 3 among consumers, the founder put together around €80,000 to continue their dream and create h3. By using their personal finances and revenues from the company along with bank loans, the founders were able to expand and open more restaurants. They wanted to keep control of the company and all future decisions that is why they did not want to give away any of the equity to external investors. It was a risk they took as capital could become more scarce over the years. Due to the success of the company and high cash flows, they were able to always cope with debt obligations.

Negative net working capital occurs when current operating liabilities exceed current operating assets. Although it can be seen as something negative, it can also help a business to expand. Basically, many companies in the retail industry, for instance, McDonalds or h3, where there exists no accounts receivable, because customers pay directly in cash, it is possible to generate cash very quickly, enabling it to sell a product to the customer before paying back to the vendor. A company with negative networking capital can 'borrow' from its vendors or customers as they grow, thus, being financed with customer funds, securing funding through accounts payable. The advantage of securing funding by receiving money from customers before paying to suppliers is unique to this sector and allows the company to finance itself at a faster pace than other normal sectors.

Analyze h3's franchising system and whether it was the correct choice of expansion for the company, as well as, the associated costs. Discuss the advantages and disadvantages of franchising.

A franchise is a contractual relationship between two parties in which one party (Franchisee) operates under the other party's (Franchisor) common trade name and uses its know-how, processes and trademarks to sell a product.[2] In exchange the franchise has to pay the franchisor a fee, usually composed of a fixed and variable component. The fixed fee is paid upon signing the agreement, the variable fee is a percentage of the annual sales, normally, around 5% to 9% of annual sales.

h3's management team encountered themselves in an unexpected situation, due to the unbelievable success of their gourmet burger chain, they had to adapt to market needs and expand rapidly. In order to avoid business model imitations and competitors entering the market it was of the essence to open more restaurants at an incredible speed. There were three main alternatives:

a. Equity
b. Debt
c. Franchise

or a mix between them. In the end, the company chose to finance its wholly-owned restaurants expansion by using the free cash flow together with a debt instrument. The problem lied in the fact that an equity/debt instrument was not enough to tap the whole market. The solution came in the form of a master-franchising system that would run from Coimbra up until the North of Portugal. The franchisee would have to have experience in this area, as well as, a proven record of expertise and reliability. In **Exhibit 7** of the case study you can see the rules to become an h3 franchisee. In early 2009 h3 opened its first franchised restaurant with the following specifications:

Initial investment: € 280 000

Signing fee: € 40 000

Royalties: 5% (% of annual sales)

Marketing Fee: 1% - 4% (% of annual sales)

In Exhibit 3 you will find the advantages and disadvantages of having a franchising system.

What did h3 do wrong in their 3 expansion strategies? Analyze each expansion separately.

<u>Poland</u>

The main reason behind h3's failure in Poland was the lack of market research and amateurish way that business was led. The drive and willingness to succeed internationally by the founders rushed them to take decisions. Furthermore, the high revenue levels and high cash flows generated by the firm led them to be more confident regarding risk taking. The decision to expand to Poland without

[2] Webber, Robert, (2012). An Introduction to Franchising. Palgrave

taking any necessary precautions hindered the company badly, they were not prepared for such an expansion. The consultancy company that purposed the business and would own a majority share of 60% of the joint venture with h3 believed to know everything about the target market, but forgot most of the basics. Namely, Polish people did not have the same eating habits as the Portuguese did and the food court did not behave similarly, these two factors were not analyzed properly by the consultants and were key to success. While in Portugal people ate between 12.30 and 14.30, Polish customer ate at the time it convened them the most disregarding lunch time, they could come in to the restaurant at 10am asking for a burger and the day after come in at 16pm. h3's business model was not built to operate in such a way, typically, in rush hours, the kitchen staff would start grilling the burger 5 minutes before the customer ordered it, they would look at the queue size and would be able to analyze the order, serving the burger within 30 seconds order time. While in non rush hours the burger would take 8-10 minutes, leading h3 to loose all of its competitive edge against other fast food restaurants. Regarding the Polish shopping mall, it was divided between traditional restaurants and the food court, the problem lied in the fact that the target customer of h3 would attend the restaurants instead of the food court, people going to the food court were from a lower social class than the one h3 would target, opting for cheaper options, such as, McDonalds.

<u>Spain</u>

The expansion to Spain followed a more professional approach. With an ongoing bad experience with Poland and loosing a lot of money in the process, h3 learned that to minimize risk it would be necessary to expand via a master franchising. After receiving numerous offers to franchise internationally, h3 finally yielded and partnered with VIPS group, the largest franchiser in Spain, to open two restaurants in nearby locations to Madrid. There were two major problems with this expansion, also, there was a bit of infortune involved as well. There were no losses associated to this expansion, on the contrary, the restaurants had very positive feedback from customers, but the locations were not ideal. The second factor was the acquisition of VIPS Group by an American private equity, which decided not to renew h3's contract of franchising, due to the presence of another burger chain within the group. It is true that there were risks in this expansion that h3 could not control, but a contract should be drawn for a better location and longer franchising duration.

<u>Brazil</u>

Brazil was the last expansion of 2011, with some experience at hand, h3 decided that for things to go well, they should start by having a majority share (51%) of the joint venture with a local investment firm to have control of decisions. The licensing and other legal costs were very high when compared to Portugal and that led h3 to take much longer than expected to have a return on this investment. Furthermore, problems with the Brazilians sent from Portugal arose, because they did not like to be back in Brazil. The distances to get to work were far larger than in Portugal and living conditions were far from being good.

Even though, they had a strong product, which customers liked, the team expanded too quickly creating standardization and operational efficiency problems. To solve them the team had to send experienced personnel from Portugal to look over the restaurants.

Taking into consideration past experiences, what advice could be given for further international expansions?

Throughout the case study and towards the end it can be understood that the three founders and the company itself learned from their mistakes and improved significantly in every step of the way. Although they were very amateurish, as described by Nuno van Uden, in the beginning when they expanded to Poland via a joint venture without making any market research of their own, they learned how to reduce risk by opting for a franchising system in Spain, which did not go accordingly due to external risk factors that could not be controlled by h3. By the time they reached Brazil they had enough market knowledge to know that they needed control over their restaurants to ensure quality and standardization, but also, needed a franchising system to be able to properly expand and react to market needs. All in all, h3 learned from their mistakes and was able to improve their strategies.

Looking back, I would advice h3 to pursue a similar strategy to do one followed in Brazil, but with a very detailed study of the country of expansion. Pursuing an international expansion is a very efficient way to fuel financial growth. It is essential to understand the local culture, competition, market size, partners, suppliers, customers, etc. If you understand all of those factors and have a solid management team you can achieve very positive results. I would advice h3 to, once again, expand to Spain, but this time through a joint venture. Spain is, not only, a similar country to Portugal in terms of culture and values, but also, it would be very a smart move in operational and logistical terms due to the proximity of the country. Furthermore, h3 is more or less familiar with the country, because of the last pursued expansion, which will reduce market research costs.

Based on what's given by the case, do a breakeven analysis of a typical restaurant in Portugal in 2015? Assume that h3 buys the meat at 9.90 €/kg and that remaining cost of sales represent 10%. Use the price of the Tuga menu (each menu has 200 grams of rice and/or 200 grams of French fries).

First of all, we need to calculate the fixed costs of a typical restaurant, which includes rent and salaries. The rent represents 10% of total annual sales in 2015, while the salaries can be calculated by using the cost per employee and multiplying it by the average number of employees per restaurant. Rent has an average annual cost of €45.093. The salaries per restaurant is around €128.305. Regarding the variable costs, which include raw materials, such as, the meat, potatoes, rice and fresh fruits used for the freshly-made juices. We know that the meat costs h3 around €9.90/kg and the remaining cost of sales represent only 10%. If €9.90 is 90% then the total cost of sales is €11/kg. The margin earned on a "Tuga menu" is then the price of the menu subtracted by the cost of sales, which is €5.30. To calculate the breakeven point of a typical restaurant, we need to divide the fixed costs by the margin, which amounts to 32717 burgers per year. To breakeven in a month, h3 needs to sell 2726 burgers and 88 burgers a day.

Epilogue

In 2016 h3 had a very positive year, with the change in the Portuguese government and António Costa becoming prime minister the retail industry experienced a big boom. The prime minister decided to reduce the VAT from 23% to 13%, which boosted h3 sales by 10%. h3 responded to this new measure as it was expected by the government, by investing and expanding its gourmet burger chain and injecting money back into the economy. With 2016 ending, h3 is expecting to have its best year since it first started. The management team are aware of the constraints the company faces by only being allocated in food courts, that is why they decided to expand and diversify with traditional restaurants. The burger chain is going to open 4 street restaurants in the beginning of 2017.

Exhibits

Exhibit 1. SWOT Analysis

SWOT Analysis

Strengths

- Gourmet quality vs fast food quality in the food court
  First-move advantage with the "not so fast food" segment
- Know-how acquired with Café 3
- Innovative offer
- Financial leverage

Weaknesses

- Previous failure could be harmful for h3
- Higher price than the average restaurant on the food court
- Food court-based approach limits expansion possibilities
- No menu variety

Opportunities

- Concept creation and idea generation
- Attract a new client segment to the food court
- High market share and brand leverage

Threats

- Market saturation and fast food stagnation
- Economic instability
- High level of business model imitability
- Difficult to maintain heterogeneity of the business

Exhibit 2. Number of restaurants

Wholly-owned restaurants: Café 3									
Year	2015	2014	2013	2012	2011	2010	2009	2008	2007
# of Restaurants	32	33	29	27	27	23	17	6	2

Franchising: FH3									
Year	2015	2014	2013	2012	2011	2010	2009	2008	2007
# of Restaurants	14	13	13	12	11	10	4	2	0

Total Portugal									
Year	2015	2014	2013	2012	2011	2010	2009	2008	2007
# of Restaurants	46	46	42	39	38	33	21	8	2

Exhibit 3. Advantages and Disadvantages of Franchising

Advantages	Disadvantages
• Reduced growth risk • Easier access to expansion capital • Rapid market penetration • Access to talented, trustworthy individuals • Enhanced brand building	• Less control over managers • Higher risk of lack of standardization • Reduced per unit profitability • Risk of poor franchise selection • Limitation on change