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Rocky Mountain Chocolate Factory International

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Introduction

As he sipped his hot tea and looked at the translucent curtain of white obscuring the 14th Green below his house, the muffled sounds heralded by the season's first snowstorm put Bryan Merryman in a pensive mood. As the CFO of Rocky Mountain Chocolate Factory (RMCF), a publicly traded premium chocolate company created in 1982 and headquartered in Durango, Colorado, Bryan recognized a significant challenge to the growth and future vibrancy of the company. He knew only too well that the 2007-2008 financial crisis had a significant impact on the growth of the firm and that he must rely on all his financial and strategic skills to continue an incredibly successful track record of growth and financial profitability. Bryan understood that growth needed to continue, but that it was his responsibility to manage the risk of that growth.

Bryan was proud of the Rocky Mountain Chocolate brand. RMCF nurtured their brand image by primarily selling their product through franchise outlets. Bryan believed that the careful layout of the store, the hand mixing of fudge on a marble table so customers could watch, and the smell of fresh chocolate had contributed greatly to product sales. While other chocolatiers sold their boxed product online and through department stores, he believed that limiting their sales to brilliantly lit display cases of fresh chocolate in their franchise stores had been a major contributing factor toward the high quality image of the product.

Bryan recalled the recent 2007-2008 financial crises and how it resulted in the decision by the U.S. Small Business Administration to toughen up its loan standards. This tightening of credit reduced the available capital to his potential franchise owners, which resulted in a decrease in domestic expansion. The number of new franchises for his company had plummeted from 30-40 annually down to 5-10 annually. He anticipated that this trend would continue for some time, which prompted him to consider refocusing company expansion to international communities. Bryan knew that, given the size of the company and the resulting limited financial and human capital resources, any expansion of the company into foreign markets must be smartly managed and risk mitigated.

Bryan had loosely contemplated expansion in to a variety of countries and regions such as India, Japan, Hong Kong, Singapore, China, Taiwan, South Korea, New Zealand, and Australia.

However, Bryan could not stop thinking about the more than 1 billion potential customers in India. He saw customers falling like snowflakes to RMCF franchises to purchase their chocolate. Given the current state of franchise expansion in the U.S. Bryan knew that he needed to decide soon if the firm should embrace the Indian market or move on to other potential countries (B. Merryman, personal communication, May 10, 2013).

Profitability

Contrary to other premium chocolate producers, RMCF derived most of its sales from on-premise purchase from within their retail outlets. Many of the on-premise purchases, such as caramel apples, were also immediately consumed. This was in contrast to other fine chocolate stores that earned much of their sales from products intended as gifts. Approximately 68% of RMCF's revenues came from sales of chocolates, which were manufactured in Durango, to franchisees. Some products, such as fudge, were hand made in the retail outlet, but all still used only the raw materials manufactured in Durango. The collection of initial franchise fees and royalties from franchisees accounted for around 17% of their revenues. The remainder came primarily from sales at company-owned stores. Table 1 below illustrates this breakdown.

Table 1

Approximate Percentage Sales Revenue by Type for Rocky Mountain Chocolate Factory During 2009

Franchise Chocolate Sales	Franchise Royalties/Fees	Company-Owned Stores Chocolate sales
68%	17%	15%

Products prepared on the premises of a typical RMCF franchised store generated an average of 55% of the store's revenues. These in-store products included fudge and caramel apples. RMCF believed this on-site production process was a key factor that differentiated their product from competitors. In their estimation, "in-store preparation of products creates a special store ambiance, and the aroma and sight of products being made attracts foot traffic and assures customers that products are fresh." All products that were made in franchised stores were produced with RMCF proprietary recipes and from ingredients purchased directly from RMCF or approved suppliers.

Demand for RMCF products had a distinct seasonality to it. They had significantly higher demand during the holiday season (mid-December through Easter) and through the summer vacation months. Many of the purchases made during this high season were boxed items that were used for gifting.

International Expansion

At this time, RMCF had 10 company-owned, 49 licensee-owned and 296 franchised stores. They had a presence in 40 states in the U.S. In addition, they had stores in Canada, Japan and the United Arab Emirates (UAE). Although 97% of their revenues were derived from domestic sources, much of their recent expansion activities had been overseas.

RMCF's international expansion began ten years after its incorporation. In 1992 RMCF entered into a franchise development agreement with a partner in Canada who was granted the exclusive right to franchise and operate RMCF stores in Canada. To this point, RMCF had 53 Canadian stores operating under this agreement. Bryan knew the success that such expansion could provide. His mind contrasted this success with a similar agreement in 2000 with a partner in the UAE that resulted in a total of only four RMCF franchise stores to date. Although the UAE had ranked 4th in GDP/Person at just over $48,000, he had suspected that the UAE population of 5.4 million had driven that slower development. At that time, the United States had a population of almost 312 million.

Bryan uncomfortably recalled the effect on his firm of the 2007 - 2008 financial downturn in the United States. Previously, RMCF's strategy of expansion provided roughly 30-40 new franchises each year, and allowed entrepreneurs an opportunity to become part of the RMCF family with only $50,000 in liquid assets, with 90% of store build-out costs financed by the U.S. Small Business Administration (USSBA). This technique minimized RMCF's needs for capital to finance expansion. However, since then, the loan rule changes instituted by the USSBA after the crisis significantly decreased the pool of potential domestic franchisees. Now potential retailers needed between $100,000 and $150,000 of liquid assets and the remaining borrowed build out costs, between $250,000 - $300,000, that needed to be secured by an asset of equal value. As a result, RMCF new domestic franchises fell to 5-10 new stores each year. The type of entrepreneurs that had driven RMCF's domestic success in the past could no longer afford to become part of the RMCF team. So Bryan felt they needed to consider expanding internationally.

His most recent international expansion, achieved over an agonizing three years, occurred in April 2012 by entering into a Master Licensing Agreement covering the entire country of Japan. With the right to open RMCF stores in Japan for its own account and those of franchisees, he had eagerly anticipated significant success in this new market in the near future, which would provide a solid financial base for continued international expansion. Although the cost of shipping the product overseas was higher than within the United States, it was not prohibitive: he estimated that door-to-door refrigerated shipping to deliver their product to Japan was only approximately an additional $1/lb.

Expansion Strategy

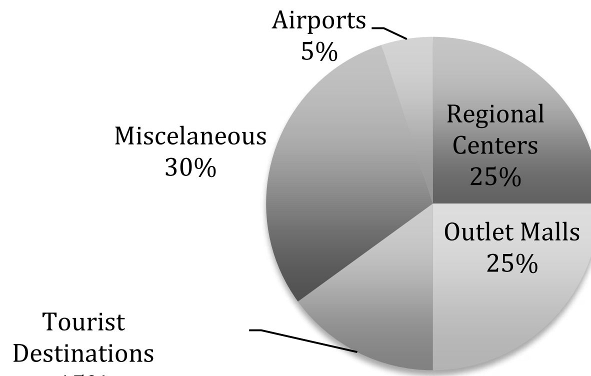
Historically, RMCF did not have to pursue business partners. Within the United States, the majority of new franchises had been granted to existing franchisees that wished to expand, individuals referred by existing franchisees, or to customers familiar with the product. With the decrease in domestic expansion, the shifting focus to international expansion lead to a different franchise process than used in the U.S.

Regardless of whether the market is domestic or international, RMCF paid careful attention to site selection of its stores. Among other things, they considered tenant mix, visibility, attractiveness, accessibility, level of foot traffic and occupancy costs. About 25% of domestic franchise locations were found in regional centers such as the Mall of America in Minnesota. Another 25% were found in outlet malls. Approximately 15% were found in tourist areas such as

Fisherman's Wharf in San Francisco and the Riverwalk in San Antonio. There were 13 airport locations accounting for 5% of domestic franchise locations. Bryan considered their target demographic group to be the "top of the middle." Table 2 following reflects this distribution.

Table 2

Retail Store Distribution by Location Type by Type for Rocky Mountain Chocolate Factory During 2009



When RMCF expanded into another nation its strategy was to sign a Master Licensing Agreement (MLA) with a firm that wanted exclusive rights to sell RMCF products in a particular geographic area. The MLA granted the right for the partner to both open corporate stores for their own account and to sell franchises, all, of course, exclusively selling RMCF product. The franchisee in a location governed by a Master Licensing Agreement would pay a franchise fee and royalty fees that accrued, in part, to the holder of the MLA and in part to RMCF.

As a result of the financial crisis, RMCF had recently chosen to also pursue a more pro-active expansion policy. First, RMCF participated in a U.S. Department of Commerce program termed the Gold Key Matching Service (United States Department of Commerce, n. d.). For a fee, the Gold Key Matching Service program matched U.S. firms with 4-6 potential partners in a particular nation. A trade specialist of the U.S. Commercial Service, located in a foreign U.S. embassy or consulate, would identify potential business partners, narrow the field to the most promising, and arrange for meetings between them and the U.S. firm. The trade specialist provided background information on each of the potential partners as well as preparing customized market research and an industry briefing prior to the business meetings. In addition to the Gold Key Matching Service program, RMCF also had increased its participation at foreign franchise trade shows. The show costs were subsidized by the U.S. Department of Commerce as well.

Together, these strategies revealed several additional international expansion opportunities in countries and regions such as India, Japan, Hong Kong, Singapore, China, Taiwan, South Korea, New Zealand, and Australia. Given the development of RMCF as a franchise operation with

entrepreneurs providing a bulk of the capital required for expansion, Bryan knew that the firm must employ its limited financial resources cautiously.

Bryan also knew that the chocolate market in India had been booming and was, at that time, primarily maintained by large multinational corporations using franchisees for new market expansion (TechSci Research, 2013). A report from the market research firm Mintel Group suggested that India was currently a fast-growing market for chocolate in the world, and presented a tremendous untapped opportunity for Western chocolate companies (as cited in Kavilanz, 2013). According to the report entitled *India chocolate market forecast & opportunities 2018* (TechSci Research, 2013), the Indian chocolate industry had shown a phenomenal growth average of 15% for several years before 2009, and was expected to continue to grow at more than 20% annually.

This untapped market opportunity did not go unnoticed by Asian chocolate makers such as Royce' Confect Co., Ltd. According to an internet-based business news called *SankeiBiz* (“Hokkaidosan choko Indo de,” 2013), Royce' Confect, a local confectionary company in Northern Japan had earned a solid reputation, establishing itself in India by having located their first Indian store in a high-end shopping mall in Mumbai. The company was doing extremely well with their unique chocolates supported by young women and upper-middle class customers. The Indian customers tended to love their chocolates even though their popular boxes of chocolates cost more than $10, in contrast to Western chocolate firms, such as Nestle, who sold similar sized boxes for less that $1.00.

The Decision Process

As the wind turned the storm into raging patterns of white and gray and he watched the shapeless figures of snow hurl effortlessly across the sky. How similar to his whirlwind of expansion activity he thought. His tea now cold with floating snowflakes, he knew that the only way to make sense of the patterns was to have a plan. Bryan felt that he must approach expansion cautiously and with a carefully outlined analysis process-a deliberate plan. As he stepped through the door and out of the raging storm, he decided that he would first gather information on the economic, cultural, and political aspects of an Indian expansion, compare that data to other market opportunities, and use this process to drive the increasingly important expansion efforts of Rocky Mountain Chocolate Factory into the future.

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