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## Salvaging a Company Before It's Too Late

There's one thing most of the experts can agree on: Schlotzskys was, or still is, a brand that could be resurrected.

"It's a good brand that was completely mismanaged," said Jeff Rosenfeld, managing partner with Kessev Finance, a financial advisory firm based in Minneapolis. Rosenfeld, along with former Arby's president and CEO Michael Howe, were part of a group that made a run at acquiring the 30-year-old sourdough sandwich chain.

During due diligence, Howe said that he found that Schlotzksky's skewed high in the customer's perception of a quality product. "The concept was sound," he said, just not the management of it.

There were others who must have thought the same thing, because Trinity Capital, an investment banking firm to the restaurant industry that represented Schlotzsky's in the sale, says they fielded inquiries from more than 60 various groups that expressed interest since the company was offered for sale. From there, Trinity whittled it down to a handful that were aggressively pursuing the company.

When a stalking horse bidder (first bidder that gets a "break up fee" if the deal falls apart) was not forthcoming, Trinity put the company up for a naked auction. In fact, what happened was that each bidding group was in a different room at the company's legal firm, with the qualifying bid at $25 million.

"This was as unusual a process as I've ever seen," said Howe.

The winning bid, $28.5 million, was announced on December 8 and was handed in by the Bobby Cox Companies. According to the company's Web site and other sources, the company was founded by restaurateur Bobby Cox and has the following interests, to name a few:

- 27 restaurants in three states, under the names Rosa's Tortilla Co., Taco Villa and Texas Burger;
- a telecommunications company;
- 36 Blockbuster Video locations;
- oil and gas interests;
- a construction business;
- a real estate development company;
- a ranching business; and
- custom food manufacturing.

The *Odessa American* newspaper reports that the Cox group came to the bidding process late in the game: A business partner of Cox's said they stepped into the bidding only a week prior to the auction. Other bidders had been working on the deal for months.

"I don't know that anyone I talked to had heard of Bobby Cox," said Rosenfeld. Cox reportedly keeps a low profile, stepping into the limelight only when one of his quarterhorses wins a big race, Craig Van Anburg, head of marketing for the company, told the Dallas-Fort Worth *Star-Telegram*.

### What now?

It will remain to be seen if Bobby Cox and his crew can turn around the struggling chain, which is riddled with problems and was close to insolvency.

When Trinity came on board in June, "the company was in severe financial distress," said Juan Alva, senior vice president with Trinity, who headed up the deal for the advisory firm. "We advised the company that they needed to come up with a solution that addressed their leverage issues."

The company had approximately $50 million in debt on the balance sheet, along with $20 million in contingent liabilities plus the costs of possible impending litigation, Alva reported, and a franchise system that was shrinking rapidly: The company had seen more than 100 franchised stores close over the course of 2002 and 2003.

Many credit the beginning of the downfall to when management changed the footprint of the stores. A few years ago, said Howe, "they took a successful format—small, inline sandwich shops—and started building freestanding, 3,500-square-foot stores. Financially, it just wasn't going to work."

Their unit economics were out of whack, agreed Dennis Lombardi, executive vice president of Technomic, a research firm specializing in restaurants. "Their stores were expensive and not as desirable as concepts like Qdoba, Chipotle and Panera."

Operations issues, such as the bread still being made from scratch on site were difficult for the current franchisees, and probably gave a few prospective franchisees pause.

"The menu was complex," he added, especially for the original smaller, cinder block stores.

Being public didn't help, either, said Rosenfeld, because along with being public comes the pressure of growing sales and profits at a rate that may be hard to keep up.

"In 1997, 1998, the stock was probably doing pretty well," he said, "but they felt pressure to do more. If they had gone private, they probably would have been a phenomenal company."

Problems started when they began the turnkey program, he added. Schlotzsky's would develop a site, and sell it to a franchisee. Then the company would sell that paper to a REIT. They got into trouble later when they recognized the gain on the sale to the REIT, when they should have been recognizing the profit over time. "They had a huge writedown and destroyed the stock price," Rosenfeld said.

And Schlotzsky's was still trying to compete in the "fast casual" arena —the big buildings cost over a $1 million to build, and they weren't selling a million dollars in sandwiches, he added. Add to that they they were guaranteeing franchisee loans—"One thing just lead to another," he said.

Schlotzsky's also didn't consult their franchisees much, said Howe, in either obtaining their input on decisions or on the direction of the brand. "It's important to keep them informed," he said.

Rosenfeld said some of the franchisees got into trouble and Schlotzsky's "began to take back stores they didn't want."

Rather than just putting out "brush fires while the whole forest was on fire," Trinity advised the board that the best way to work through the problems was to file Chapter 11 bankruptcy, Alva reported. Earlier in the year, the board had terminated John Wooley, long-time president and CEO, along with his brother, Jeff, a vice president, and hired turnaround specialist Sam Coats, former exec at Continental Airlines.

"In the days where boards sometimes sit back and don't do much, this was a bold decision," said Alva. "They had to make a tough call and fulfill their fiduciary duty as board members."

Alva, Rosenfeld and Howe praised the management team that held things together during the last six months.

"They couldn't have done more," said Rosenfeld. "The management team was one of the positives—we were impressed and felt good about them."

Alva added that the team was definitely working under difficult circumstances. "They saw this thing through the whole way and their level of dedication was extraordinary," he said.

While it will be interesting to watch Bobby Cox Companies take a stab at reviving Schlotzsky's, Rosenfeld and Howe don't intend to sit on the sidelines.

Howe said they've looked at about four opportunities in the last year, "and there are other concepts out there I think are worthwhile."