

## New York Cheek: *Cracks in Paradise* (A)

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As narrated by Mellanie Ross, Founding Entrepreneur:

December 31, 2008: *“The company I founded, New York Cheek, is thriving beyond my wildest dreams. Sales of my branded line of casual, brash, cotton clothing continue to gain momentum in the United States. My business has grown from zero to more than \$5 million in revenue in six years. But my stress level is sky high. Problems keep me awake most nights. My bank won’t extend a sufficient line of credit; my organization is overworked and can’t handle our rapid growth; quality issues are causing product returns and customer dissatisfaction; inventory and supply problems are of concern to our franchisees. Is our unbridled success leading to our inexorable failure?”*

February 2003: *“I lost my job at Macy’s Department Store in Brooklyn, NY. It wasn’t much of a job anyway. I worked as a cashier in the men’s fashion clothing department. Every sector of the U.S. and global economies were reeling from the collapse of the technology and Internet bubbles. People didn’t have discretionary money to spend on upscale clothing – Louis Vuiton, Calvin Kline, Ralph Lauren, Armani, Dolce Gabana. So Macy’s had to let me go. I have to admit I am scared. I need a job and my only skill is sewing. It became my passion in my childhood, sitting by my mother’s side as she taught me the basics of using a sewing machine. That is not much of a skill-set to land another job in a recession. At 32 years old, with only a high school education and no marketable experience, who will hire me?”*

May 2003: *“I’m feeling desperate! I have searched for 3 months – at least 30 job interviews. Nothing yet. No luck. I am going to sew a few quilts, bags and casual cotton drawstring pants and show them at a local craft fair. Maybe I can sell enough to buy groceries and pay the rent.”*

August 2003: *“Not bad. I am still surviving. I’ve been to six craft shows and flea markets this summer, and my cotton pants are selling well enough to keep me going. For the next fair, I will sew some mix-and-match cotton blouses, shirts and pants – brash, bright colors, to see how they sell. I have a good feeling that casual, loose-fitting clothing could be a winner.”*

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October 2003: *“I am overworked and exhilarated. The pants, shirts, blouses and skirts have been flying off the tables. The very large Springfield Fall Fair is coming up next month and I am feverishly refining my designs and building inventory. I think I am onto something. My designs seem to be attractive to men and women of all ages. It seems to be the comfort, the ‘attitude,’ the mix-and-match versatility and the quality. That good feeling is getting ‘gooder’ by the minute.”*

February 2004: *“I can’t keep selling at craft fairs and flea markets. I need a store front – one that would serve as a retail outlet as well as a manufacturing operation. There is a small piece of property in a very interesting location right on the waterfront in Brooklyn, New York with plenty of tourist traffic. It has a sizable basement where I could set up a sewing operation. The bank foreclosed on this property not too long ago. The real estate market has crashed and perhaps it can be bought at the right price. Next week I’ll call my loan officer and explore the possibilities.”*

May 2004: *“I’m psyched! I never dreamed I could be an entrepreneur. A friend of mine loaned me \$25,000 to help with the down payment on the property. I am now the founder, CEO, designer, sewer, and marketer for my own new venture. I’m calling my company New York Cheek because the clothing has a brash ‘attitude’ – or as the British would say: **Cheeky**. I am just barely able to make the mortgage payments. During the week, business is slow. I sew every spare moment, especially evenings. How else can I build inventory for the busy weekends.”*

October 2004: *“I have six people working with me, but I need to hire someone with clothing design experience. An acquaintance of mine, Stan Majors, has had a keen interest in my activities since I first began sewing quilts, bags and pants. Coincidentally, he worked as a clothing designer for a few years. He might just be interested in joining me. I couldn’t pay him much, but perhaps he would consider a partnership. I’ll surface the issue and ask if he would make an investment for a small slice of equity in New York Cheek. We’ll have to figure out a fair valuation for the company, and his percentage ownership. In fact, we will need a Partnership Agreement. These are things I am not familiar with, and many issues need to be defined: Minority stockholder rights, decision making, control, profit sharing, sale of his interest back to the company in case of death or disability, governance, etc. Tomorrow, I’ll call my friend who is a business lawyer.”*

March 2004: *“We are on a roll (or should I say roller coaster?)! Stan Majors joined the company. He acquired a 5% ownership position in the Company. I now have a minority partner. It makes me uncomfortable to have another stockholder, but his \$10,000 was sorely needed, and Stan is a valuable team member. He is really doing exceptional design work. He is passionate, motivated, talented, a self-starter and he is easy to work with. Together, we are expanding the product line: Bright colors, laid back style, comfortable, mix-and-match, all ages, uncompromising quality – and CHEEKY. Our clothing has an attitude! We are focusing exclusively on cotton garments because that trend is growing more rapidly than all other fabrics combined (silk blends, wool, synthetics, fleece). Stan has set up an advertising agency function within the Company. He hires the models, experiments with new fashions, fabrics and colors. He does all the photography and creates the ad layouts. Great partner!”*

May 2005: “I have been thinking about how our product line fits into the clothing industry, and why we are gaining momentum. I don’t have the answers, but the industry itself is very mature. Everyone who wants or needs clothing is able to find adequate supply. Trends come and go, but what we have seems to resonate with a large segment. I think it is because of the total package. Men, women and even children can find shirts, pants and dresses that feel and look good on them. I am sure other clothing companies could copy us at some point. It wouldn’t be difficult.”

July 2005: “We can’t keep going like this. Sales growth has far exceeded our ability to manufacture and I am still doing much of the sewing. But I have an unconventional idea. Home sewers! We can assemble manufacturing lots from all the parts of each garment in our store basement. Then we can hire local women to sew them into finished garments in their own homes. They will not be paid an hourly rate, but on a ‘finished-garment’ basis. We will need to buy sophisticated cutting, stitching, button-holing and riveting machines. This will unblock manufacturing as a limiting factor to our growth. It will give us the ability to expand even more rapidly. I am confident that we will be well-positioned for future growth. Quality from individual home sewers may be unpredictable.”

September 2005: “Having no previous business education or background, I don’t know how quickly a business can grow just from internally-generated profits. We are seriously limited by lack of money. I know there are three sources of capital: Equity, Debt and a Miscellaneous, less traditional category (see APPENDIX C). Selling stock in NY Cheek (Equity) is possible, but do I want more partners and further dilution of my ownership? I already have two partners: Stan Majors and now my dentist, Myron Waldman. Having known me for many years, Dr. Waldman was eager to invest in New York Cheek as a private “Angel” investor, so I let him acquire 5% of the company for \$10,000 also. I have heard that venture capitalists and ‘Angel’ funding sources can be very demanding investors. They want rapid Return On Investment (ROI). But right now I need money from any source. I have drained my credit cards, friends and family to the maximum. Debt is the route that I prefer, but the bank won’t lend my company adequate money, no matter how many times I have explained our phenomenal growth of sales. Isn’t that what banks are for – to loan money? I don’t have enough experience with financial statements to understand where the banks are coming from. Our Statement of Operations and Balance Sheet look exceptional to me. What do the banks see that I don’t? That leaves Guerrilla Financing.\* These sources might offer unconventional approaches to getting capital for growth. If all else fails, I have another idea: Selling franchises! After all, if my branded product line is so accepted in the marketplace, why not offer to sell franchises to other business people in exclusive territories. This is definitely worth exploring.”

July 2006: “Unbelievable! We got our first franchisee within one year from the idea! Can you imagine what we had to go through to establish this first customer in our new distribution channel? We had been keeping a list of people who had been interested in our dramatic success. So we reached out to fifty potential franchisees. One was very interested, and signed up under the following conditions:

Franchising Fee:	\$50,000
Royalties:	None (According to Mellanie: "As manufacturers, we make good profit margins on the sale of clothing, and therefore we do not need to charge royalties.")
Territory:	Exclusive five-mile radius from the center of Chicago, Illinois.
Real Estate:	Responsibility of franchisee with New York Cheek approval.
Store Layout:	New York Cheek designs and builds the store layout. Materials and labor are charged back to the franchisee.
Other Terms	Standard conditions of franchising apply (Term, renewal, death or disability, dispute resolution, cancellation, sale or transfer of franchise, advertising expenditures, purchasing of materials,

*"We need to develop a comprehensive Franchising Operations Manual to define the relationship."*

December 31, 2008: *"We now have four franchisees, and three more are projected to be operational before the end of 2009. We also have four company stores: Our original location in Brooklyn; another in Los Angeles; and two mall locations – Boston and Miami. An additional company store is scheduled to open next year in San Antonio, TX. And we are strategizing about the possibilities of other revenue streams. We want to explore all strategic growth options. Each revenue stream has its own financial and operational characteristics: Profitability, growth rate, supply chain management (manufacturing, inventory control, warehousing, shipping, returns). Nagging problems continue to stress me, and the organization is mirroring my stress; my senior management team has become much less proactive. Quality control is a good example. We have 22 home sewers, and garment-to-garment variations are causing high reject levels. Should I have to solve quality problems? Everything falls on my shoulders. We are starving for lack of financial resources, yet, I can't seem to obtain adequate working and growth capital. And most worrisome is my energy level – I'M BURNT OUT. The cracks in paradise are getting longer and deeper."*

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## APPENDIX A

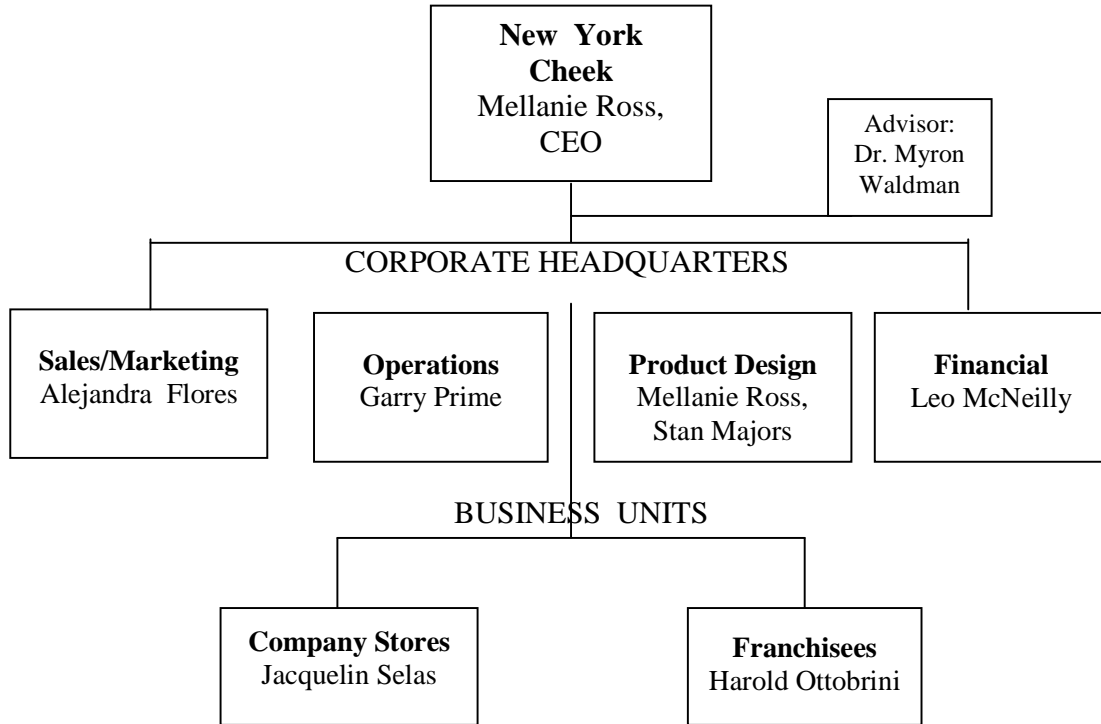
### Typical Regional, National and Global Competitors

Benneton	Gap
Ralph Lauren	Toxic Fish
Timberland	RocaWear
Banana Republic	Tommy Bahama
Georgio Brutini	Enyce
Sean John	Calvin Klein
Abercrombe & Fitch	Pelle Pelle

APPENDIX B

**NEW YORK CHEEK ORGANIZATION**

December 31, 2008



Total Number of Employees: 43

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APPENDIX C

**POTENTIAL FUNDING SOURCES**

<b>EQUITY</b>	<b>DEBT</b>	<b>MISCELLANEOUS</b>
Venture Capital	Bank	Factoring
Angel Capital	Finance Companies	Royalty
Warrants / Options	3 <sup>rd</sup> Party Signature	Leasing
Public Offerings: - Underwriters - Reverse Merge - Niphix.com (online)	Private loans - Collateral - Non-collateral	Guerrilla Financing * - To whose advantage is it? - Use your imagination - Supplier funding - Landlord funding
Combinations: - Convertible bonds	Combinations: - Convertible bonds	Franchising

APPENDIX D

NEW YORK CHEEK

**Statements of Operations**

(Years ending December 31)

( All numbers in \$ 000 )

	2003	2004	2005	2006	2007	2008
<b>Sales</b>						
Company Stores (#)	1	1	2	2	3	4
Company Store Sales (\$000)	92	330	620	1,100	1,800	2,800
Franchisees (#)	0	0	0	1	2	4
Franchise Sales	0	0	270	700	1,500	2,500
<u>Total Sales</u>	92	330	890	1,800	3,300	<b><u>5,300</u></b>
<b>Cost of Goods Sold</b>						
Company Stores (\$000)	30	120	220	380	630	1,000
Company Stores (%)	35%	35%	35%	35%	35%	35%
Franchisees (\$000)	0	0	180	450	970	1,700
Franchisees (%)	0	0	65%	65%	65%	65%
<u>Total COGS</u> (\$000)	37	120	400	830	1,600	<b><u>2,700</u></b>
<b>Gross Profits</b> (Combined)	55	210	490	970	1,700	<b><u>2,600</u></b>
<b>Gross Profit</b> (%)	60%	64%	55%	53%	51%	49%
<b>GS&amp;A</b> (Combined)	180	290	420	630	1,160	<b><u>1,800</u></b>
<b>Profit From Operations</b>	<b>(65)</b>	<b>(80)</b>	170	310	520	<b><u>800</u></b>
(Operating Profit also known as EBITDA: Earnings Before Interest, Taxes, Depreciation, amortization)						
<b>Profit From Operations</b> (%)	--	--	19%	18%	16%	16%
<b>Net Profit After Taxes</b>	<b>(65)</b>	<b>(80)</b>	160	190	310	<b><u>480</u></b>
(NPAT): Deduct Interest, Taxes, Depreciation, Amortization from Profit From Operations						
<b>Net Profit After Taxes</b> (%)	--	--	18%	11%	9%	9%

APPENDIX E

NEW YORK CHEEK

**Balance Sheet**

December 31, 2008

(all numbers \$ 000)

**Current Assets:**

Cash	\$190
Inventory	970
Receivables	1,330
<u>Total Current Assets</u>	<u>2,490</u>

**Long Term Assets:**

Property, Plant, Equipment	830
Other Long Term Assets	60
<u>Total Long Term Assets</u>	<u>890</u>

**TOTAL ASSETS** **\$ 3,380**

**Current Liabilities:**

Accounts Payable	980
Bank Loan – Line of Credit	750
Other Short Term Debt	200
<u>Total Current Liabilities</u>	<u>1,930</u>

**Long-Term Liabilities:**

Long-Term Debt	800
Deferred Taxes	80
<u>Total Long Term Liabilities</u>	<u>880</u>

**TOTAL LIABILITIES** **\$ 2,810**

**NET WORTH (Shareholders Equity) = ASSETS - LIABILITIES = \$ 570**

**NUMBER OF SHARES OWNED:**

**Mellanie Ross: 90,000; Stan Majors: 5,000; Dr. Myron Waldman: 5,000**

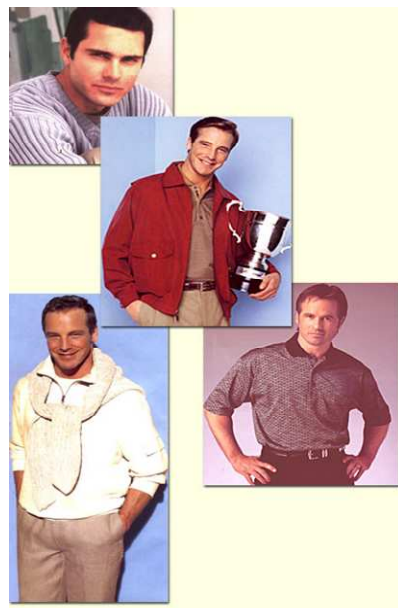
APPENDIX F

New York Cheek Product Line

***Teens***



***Simple & Comfortable***





## ***Men's Drawstring Casual***



## ***Young Attitudes***



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- \* *"Guerrilla Financing,"* Bruce Blechman and Jay Conrad Levinson, Houghton Mifflin,
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  - \*\*\* Story parallels *"Kettle Creek Canvas Company,"* Richard Ivey School of Business Case #9A87M016
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