GROUP PROJECTS

CASE 5: STRATEGIC AND COMPETITIVE ADVANTAGE: ANALYZING OPERATING LEVERAGE

Pony Espresso

Pony Espresso is a small business that sells specialty coffee drinks at office buildings. Every morning and afternoon, trucks arrive at offices' front entrances, and the office employees purchase various beverages with names such as Java du Jour and Café de Colombia. The business is profitable. But Pony Espresso offices are located to the north of town, where lease rates are less expensive, and the principal sales area is south of town. This means that the trucks must drive cross-town four times a day.

The cost of transportation to and from the sales area, plus the power demands of the trucks' coffee brewing equipment, is a significant portion of the variable costs. Pony Espresso could reduce the amount of driving—and, therefore, the variable costs—if it moves the offices much closer to the sales area.

Pony Espresso presently has fixed costs of $10,000 per month. The lease of a new office, closer to the sales area, would cost an additional $2200 per month. This would increase the fixed costs to $12,200 per month.

Although the lease of new offices would increase the fixed costs, a careful estimate of the potential savings in gasoline and vehicle maintenance indicates that Pony Espresso could reduce the variable costs from $0.60 per unit to $0.35 per unit. Total sales are unlikely to increase as a result of the move, but the savings in variable costs should increase the annual profit.

You have been hired by Pony Espresso to assist in the cost analysis and new lease options to determine a growth in profit margin. You will also need to calculate a degree of operating leverage to better understand the company's profitability. Degree of operating leverage (DOL) will give the CEO of Pony Espresso, Darian Presley, a great deal of information for setting operating targets and planning profitability.

Some Particulars You Should Know

1. Consider the information provided—especially look at the change in the variability of the profit from month to month. From November through January, when it is much more difficult to lure office workers out into the cold to purchase coffee, Pony Espresso barely breaks even. In fact, in December 2003, the business lost money.
2. First, develop the cost analysis on the existing lease information using the monthly sales figures provided to you in the file PONYESPRESSO.xls. Second, develop the cost analysis from the new lease information provided above.

3. You need to calculate the variability that is reflected in the month-to-month standard deviation of earnings for the current cost structure and the projected cost structure.
4. Do not consider any association with downsizing such as overhead; simply focus on the information provided to you.
5. You will need to calculate the EBIT—earnings before interest and taxes.
6. Would the DOL and business risk increase or decrease if Pony Espresso moved its office? *Note:* Variability in profit levels, whether measured as EBIT, operating income, or net income, does not necessarily increase the level of business risk as the DOL increases.
7. File: PONYESPRESSO.xls (Excel file).