***TOO HOT TO HANDLE!***

***CASE STUDY - CAPITAL BUDGETING***

When Patsy opened her full service salon and day spa three years ago, she knew that she would have to make some difficult choices regarding the hiring and firing of qualified professionals such as cosmetologists, estheticians, nail technicians and massage therapists. However, she was confident that her salon management training at Chic University coupled with her industry experience as a stylist would serve her well.

And serve her well they certainly did! Within three years of starting her own business, and after a few setbacks, she had managed to assemble a team of 10 salon professionals who were all extremely motivated, people-oriented, and driven individuals who worked hard at retaining their clients and drumming up retail sales. Of course, Patsy had put in place an incentive plan, which the stylists found to be challenging, yet lucrative. Patsy's salon revenues had grown significantly each year to their current annual level of $500,000. On average, the salon serviced about 40 customers per day with an average ticket of $50.

However, over the past year or so a number of new salons and nail spas had opened up in the city. Competition had become much more severe and customers were being swayed by numerous discount coupons. Patsy was well aware that her current sales growth rate of 10% would not continue for very long.

At the suggestion of some of her regular clients, she decided to explore the possibility of expanding her service offerings to include tanning booths. She figured that such an addition would complement her current salon business by offering customers the opportunity to come in for about 15-30 minutes and have a worthwhile tanning experience or better still to enjoy a relaxing tan instead of waiting out in the lounge.

As Patsy began exploring the various costs and investments required, she realized that she had very little knowledge about the tanning business. What appealed to her the most was that the revenues from the tanning business would be all hers to keep unlike the other salon services where she paid the salon professional a commission of up to 50% of the revenue generated from the services rendered. What was most confusing to Patsy was whether she should go in for the tanning dome unit or the relatively cheaper tanning bed.

“Call up that toll free number that's listed on the Sun-Quest Catalog”, said her ever-resourceful husband, Alan, who worked as a sales representative for a chemical company. “It always works for me,” he added. After many hours of agonizing over the issue, Patsy finally gave in and made the call. The salesman, Mike, who answered the call was extremely helpful, courteous, and convincing. “Tanning is a great complement to a Salon and Spa,” he said. “We have shipped many units to salons all over the country, and they seem to be doing pretty well.”

“Let's say I do start the tanning service at my salon, Mike, should I go in for the less expensive tanning bed or the more expensive tanning dome?” asked Patsy, eager to sort out her dilemma. “Well,” responded Mike, “Each unit has its own pros and cons. The bed costs considerably less than the dome, but it takes longer for an equivalent tan per session. The dome on the other hand, costs more, but it does the job faster, provides for a complete body and facial tan, and lasts longer.”

“Do you have a comparison chart showing the approximate costs, features, and revenue potential of each option, Mike?” asked Patsy. “Absolutely,” said Mike. “I would be happy to email you a copy right now, if you like.” “That would be great!” said Patsy, “It would certainly help me make an informed decision. As you can see, Mike, I really want to figure out which of these two units is Too Hot To Handle!”

Exhibit 1 Some Relevant Information

Salon Hours: Sunday, Monday Closed

Tues-Thurs 9am – 7pm

Fri 9am – 5pm

Sat 9am – 2pm

Advertising Costs $300 per month (Yellow Pages Ad)

$200 per month (other advertisements)

Patsy’s After-tax cost of funds: 11% per year

Depreciation method: Straight line over 5 yrs.

Tax rate: 30%

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| --- | --- | --- |
|  | **DOME UNIT** | **TANNING BED** |
| Cost (including shipping) | $7800 | $2800 |
| Set up cost | $500 | $200 |
| Electricity cost per session | $0.50 | $0.30 |
| Number of sessions/hour | 4 | 3 |
| Number of bulbs needed | 48 | 28 |
| Cost per bulb | $22 | $22 |
| Bulb life | 1300 hours | 1300 hours |
| Unit life | 8 years | 5 years |
| Suggested price/visit | $3 | $3 |
| Space requirement | 9 ft X 5ft X 5ft room | 10 ft X 10 ft room |

Other income

Tanning Lotion 1 bottle/10 sessions

Profit per sale $5

**Questions 1-7:**

1. Develop operating cash flow forecasts for the relevant lives of each type of tanning equipment using 100% (Best case), 80% (Most Likely Case), and 50% (Worst Case) occupancy estimates for each tanning option. Assume straight line depreciation and a tax rate of 30%.

2. Calculate and comment upon the accounting, cash, and financial break-even sales for the dome unit and the tanning bed unit respectively.

3. Calculate the net present value, payback period, and the traditional IRR for each tanning option under the various scenarios. What do the decision rules indicate?

4. Can Patsy evaluate this business project by assuming just a onetime purchase? Why or why not? What other evaluation methods should Patsy use?

5. If you decide to use the replacement chain method, how do the calculation and decision change?

6. What are some externalities, side effects, and other relevant issues that could affect the decision?

7. Based upon your analysis, which of the two units is “Too Hot to Handle?” Why?