Cyberplay

case eight

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The boutiques on the hill overlooking Lake Dora were all adorned in their Christmas regalia. Gazing out his office window toward the lake, Steve Shamrock, founder and CEO of Cyberplay faced a plethora of financing options for his four-year-old company. After three years of mostly nickel-and-dime fund raising from friends and family, he now had three substantial investors willing to contribute over $5 million in capital. This infusion would allow the company to pay off its debt of over $5 million (some at an agreed upon discount) on which it had defaulted, give the company a positive net worth, plus provide enough working capital to carry the company for a year as operating cash flows took off. Shamrock's objective was an IPO or merger in about 12 months. Despite all of the good news on the financing side, Shamrock had two concerns about operations that bore directly on the value of a potential IPO or merger, and even on the survival of the company. The cash burn rate was about $250,000 per month and the company's capabilities no longer seemed to match its strategy. Unless these issues were carefully resolved, he feared he would run through the $5 million before he achieved a positive operating cash flow, or at least before significant revenues materialized. Such a scenario would seriously jeopardize the future of the company.

Company Concept and History

After a family visit to Discovery Zone, a children's recreational center with lots of juvenile diversions, Shamrock wondered whether or not an educational, computer-based center might not make an excellent business concept. Shamrock raised about $800,000 from friends and family and opened the original Cyberplay store in October 1995, in Winter Park, Florida, an Orlando suburb.

The store coupled state-of-the-art computer hardware and software with an award-winning futuristic store design. The original Cyberplay business model was based on three related revenue streams: pay-for-play services, software sales, and software training. Pay-for-play services allowed users to play the latest software games on state-of-the-art computers. Educational games for younger children were in one area, while combat and competitive games were in another. Additionally, users could use e-mail and Internet capabilities, as well as the full complement of Microsoft Office products. Time could be purchased by the hour, day, or month, and usage was debited on a magnetic-strip debit card that was issued to new customers. This revenue stream was anticipated to have been the largest of the three. Software sales occurred as customers liked programs that they had just tested on Cyberplay's network. Software training services included classes in Microsoft Office software applications.

Cyberplay soon began receiving very high profile awards for its store design including the Retail Innovation Technology Award (RITA), and the Retail Store of the Year award from *Chain Store Age*, a prominent retail trade publication. Perhaps the most prestigious award was the Smithsonian Medal, received for integrating technology into education. Among other things, the judges were impressed with the company's proprietary technology that allowed multiple users to simultaneously use a single CD.

By June 1996 Intel had become a modest investor in Cyberplay with an investment of around $300,000 and an option to invest more based on company performance. A second store was opened in Atlanta where Intel had set up its pavilion for the 1996 Summer Olympics. Later that year Cyberplay was invited by Sony to build a center at Sony's Wonder Technology Lab, its premier promotional exhibit, on Madison Avenue, New York City. Cyberplay was the only other brand name at this site, visited by 200,000 people per year.

Concurrent with the opening of the new stores, Cyberplay hired two software specialists with Ph.D.s to develop training programs for popular software appli-

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cations. Recounts Shamrock, "Most corporate training modules came in six-hour blocks. From talking to training managers, we learned that few employees were willing to be out of the office for a whole day. As a result, corporate training budgets were often not spent. We developed a three-hour module that would cover the most commonly used functions, complete with a reference book and delivered by an instructor. This way, trainees could get off work at, say, 3:00 p.m., go to the training, and still be home in time for supper. We launched these courses through our Winter Park facility. One of the great strengths is our curriculum and its developers. Another is our retail store design and awards. The exposure and industry contacts that the store design brought us allowed us to make the shift to the corporate training market."

A Strategic Shift

It soon became apparent to Shamrock that the original business concept was not going to be financially successful. After tweaking the marketing "200 different ways," Shamrock concluded that other revenue streams had to be pursued. Commenting on the reasons for not being able to make the "edutainment" business work, Shamrock speculated, "Between 1995 when we first got the idea of Cyberplay, and 1997, the cost of computer hardware dropped dramatically from about $2500 for a great machine to about $1250. This resulted in many of our potential retail customers buying their own hardware."

While visiting the Atlanta facility, Shamrock received a call that a very close friend had died suddenly of a heart attack at age 36. He caught the next flight to Orlando. Noticing Shamrock's fallen countenance, the man in the seat next to him asked if something was the matter. As it turned out, the man was on the board of directors for Prudential Insurance, and had heard of Cyberplay through a recent article in *Business Week*. Their conversation converged on Prudential's corporate computer training needs, and the flight ended with the board member promising to have someone contact Shamrock.

"I didn't expect to hear from anyone again, but amazingly, several days later I did receive a call. Within a few months we had an agreement in principle to offer training at their site in Jacksonville to some 6000 employees. Nevertheless, it took one year before we received a signed training contract from them. We were, of course, slowly starving to death for lack of cash." So Cyberplay began its migration from being in the "edutainment" business at the retail level, to being in the computer-training business at the business-to-business level.

Shamrock noted, "We had similar success with AT&T in that we became an approved vendor with the highest scores ever awarded to a software training company. By June of 1998, we signed a contract to become the preferred provider for ADP, and they wanted to market our training to their enormous customer base." Later that summer, Cyber Technology Engineering (CTE), an outfit that specialized in computer simulation training for police officers, selected Cyberplay as the medium through which to deliver their training. CTE's simulations would be enhanced greatly by the absolute latest in technology, and for this reason they were particularly impressed with Cyberplay's innovative Winter Park facility. Since the police officers would be required to complete a certain amount of training annually, training usage rates were estimated at 50% of eligible officers per year.

By September, EVC, a company that supplied college-level courses from established universities over the Internet, signed with Cyberplay to use its courses for teaching software applications. In sum, in one year Cyberplay had moved from being a retail "edutainment" company to being a corporate training firm. Appendix A shows pricing and revenue assumptions that emerged from contract discussions with each of the major clients.

Recounts Shamrock, "By this time, we were in default on several million dollars of bank and corporate debt. Our legal counsel advised us to file bankruptcy and basically start over as a new business. I really grappled with this question, but decided to seek forbearance agreements with the bankers for two reasons. First, I believed that we were very close to being very successful. Second, most of the shareholders and bondholders were community people to whom I felt I had more than just a legal obligation. The banks agreed to cooperate, so we rested our future on the corporate training market." The alternative to this strategic shift was bankruptcy, and the opportunities had emerged fortuitously, so successfully concluded contracts substituted for systematic market entry analysis.

The Training Industry

In 1998, the information technology and training market was estimated to be about $12 billion worldwide and $5 billion in the U.S. These numbers were expected to grow to about $17 billion and $7.5 billion, respectively, by the year 2000.

The industry was highly fragmented, with no competitor having a significant share of the market. The industry was subdivided according to the medium of delivery: (1) classroom-based training organization

(Executrain, New Horizons, Productivity Point), (2) retail-based training organizations (Best Buy, CompUSA, Gateway Country Stores), (3) client-site training companies, and (4) Internet-based training companies (Ziff Davis). Significantly, Cyberplay had beaten all of the major training companies in landing the AT&T, ADP, and Prudential accounts. It had been particularly successful against CompUSA, which was the largest training provider in the country. Moreover, CompUSA recognized the strategic importance of the training market and was eager to expand its share. Initially, Shamrock believed that the target market, the *Fortune* 1000, did not want Internet-based training, preferring instead the personal touch of a trainer. Some companies had their own in-house training departments that provided competition for Cyberplay.

Cyberplay felt that one of its competitive advantages was its ability to secure excellent trainers. Cyberplay had used a national search firm to find qualified applicants in the various cities in which it was training. These individuals were required to have strong interpersonal and communication skills in addition to being technically competent. A. R. Robinson, VP of operations, put it this way, "We are looking for a very special person—someone who is energetic, pleasant, and knowledgeable." Although the rapid acquisition of trainers would be critical to success, Robinson believed the firm had a proven method for securing such employees.

Operating Strategy

If Cyberplay could not provide training facilities quickly, it would soon lose credibility with its customers. Building Cyberplay centers would not be feasible due to capital costs and time constraints, unless a franchising structure was utilized. Shamrock pursued the franchising route, talking with some of the most experienced consultants and franchisers in the U.S. Eventually, he decided that there was a better way to access training facilities than through franchising.

To quickly access the facilities needed to meet the demands of their clients, Cyberplay entered into a strategic alliance with Computer City (CC), the second-largest retailer of computer equipment, to train at their facilities. CC was thrilled with the alliance as it gave them a strong presence in the training market where they had lagged behind CompUSA. The agreement allowed for a 50-50 split of revenues, with Cyberplay being responsible for the curriculum, teaching, and marketing, and CC being responsible for the location, hardware, and software. Hours before this alliance was to close on July 1, 1998, CompUSA purchased CC, and the Cyberplay–CC deal was placed on hold. Eventually, CompUSA agreed to essentially the same deal, but this delayed the start-up of Cyberplay's training contracts by about two months. Given the cash flow needs, this was precious time wasted. Furthermore, Shamrock had some reluctance about being associated with one of Cyberplay's closest competitors, fearing that CompUSA would dump them as a partner once they were able to imitate the bases for Cyberplay's competitive advantages.

By the end of 1998, the Prudential contract was up and running at the projected levels, and the ADP contract was producing about two-thirds of projected amounts. The employee at ADP charged with overseeing the training had not received an expected promotion, and had been traveling a bit, so Cyberplay found themselves in the all-too-frequent position of waiting for someone else to do something. Shamrock remarked, "We are learning the realities of dealing with office politics. We have asked ADP to give us another person to work through, and they said they would do something about it in January of 1999."

The CTE contract, while approved at the Cyberplay end, awaited final approval and adoption from various federal, state, and municipal law enforcement agencies at the CTE end. Because this training would be required of law enforcement officers, this contract was potentially huge.

The EVC contract had yet to produce material income, as EVC was also a new company. Nevertheless, Cyberplay felt that through this association, it could take its training online using EVC's proprietary interactive technology that allowed all class participants to interact with all others from multiple locations. Shamrock wondered whether the clients would prefer shifting all of Cyberplay's training to online delivery. He sensed it would result in another major strategic shift because of the implications it would have for staffing, organizational structure, and the cost to deliver.

Finally, Shamrock had to determine what to do with the original Cyberplay retail store. Cyberplay had two retail facilities that were significant drags on earnings and cash flow. These facilities had won the firm international recognition and had been the subject of articles in *Business Week* and other leading periodicals. Cyberplay's market had evolved, however, from a retail business concept to a corporate-client business, and it was not clear how these facilities would fit into the new strategy. In June 1998, the Atlanta facility was closed, and only the Winter Park facility remained. The facilities were very significant in securing the contract with CTE. Should the Winter Park facility be closed also? Appendix B provides the profit and loss statement for the Winter Park facility.

The Personnel

The executives and entire headquarters staff seemed very personable, and the work pace seemed laid-back. Most everyone lived in the rural area just north of Orlando, and all seemed sensitive to Cyberplay's role and reputation in the community. Several of the executives attended the same conservative church, and there was a sense that the "old values" of honesty, fair play, commitment, hard work, and congeniality formed the shared values of the firm.

Steve Shamrock, 38, chairman and CEO, had been involved as a managing partner in a real estate development and construction company for about 12 years prior to starting Cyberplay. He was regarded as an experienced, honest businessman in his community and had outstanding "people skills." These attributes figured prominently in his ability to raise so much money from the community without having to go the venture-capital route.

Shamrock felt the pressure of ensuring that the company succeeded since virtually everyone he knew in his community—not to mention his family members—were investors. His people skills were largely responsible for initiating the discussions that resulted in the major training contracts. By his own admission, he "barely knew how to turn a computer on," but he felt that gave him the perspective of many of his clients who would require training. He was totally dedicated to seeing the business succeed, and had over $1 million of his own money in the venture. Remarked Shamrock, "I cannot describe all of the hurdles we have had to overcome, but we have singular focus on making this venture be successful. 'Can't' is not in our vocabulary." Shamrock's annual salary was $200,000.

Bruce Lagravinese, 31, was the chief information and technology officer. He had managed national accounts with Data General Corporation, and was largely responsible for the technology that won Cyberplay the Smithsonian Medal. He had expertise in information systems design, management, and training. He was a good complement to Shamrock in that he was completely comfortable in the world of cyber-speak on both the hardware and software fronts. His current responsibilities focused around three areas. First, he maintained the proprietary information system that provided reports to Cyberplay's clients on the employee utilization and client billings. Second, he was the systems designer for new delivery networks that might be installed in a client's on-site training facility. Third, he evaluated the technological and cost features of potential contracts. Lagravinese's salary was $82,000.

Ron Young, 38, executive vice president, had built a career designing custom aircraft interiors for Page Avjet Corporation. His expertise had contributed to the award-winning design of the Cyberplay centers, and his familiarity with modular design allowed them to be installed in seven days. He also had experience in the real estate industry and was part of Cyberplay's founding management team. Ron also had excellent people skills. He was in charge of the office staff and was a longtime friend of Shamrock's. Young's salary was $62,000.

A. R. Robinson, 43, vice president of operations, had extensive experience in store rollout, having worked for 12 years with Target during that company's rapid expansion. He had been in charge of bringing new stores on line. He also had a successful stint with Blockbuster Video, where he had turned around one of the least profitable regions. He was in charge of managing the facilities rollout for Cyberplay, for ensuring the recruitment of the trainers, and for ultimate customer satisfaction. Robinson, like Shamrock, had magical people skills, and conveyed a genuine warmth, enthusiasm, and confidence. Robinson's annual salary was $70,000.

Rick Barron, 46, the vice president of finance, was responsible for assessing the financial effect of potential operating and financial decisions, for ensuring the control function, and for producing the necessary accounting statements. Barron had worked for 12 years as the finance VP of Filene's Basement, a publicly held retail company. Barron had a pleasant personality, especially for a controller, but was not quite as outgoing as Robinson or Shamrock. Barron's annual salary was $60,000.

Bob Kolter, 27, vice president of marketing, had worked for a label company selling to national accounts. His present responsibilities focused on getting smaller local companies to use Cyberplay training. These accounts offered a shorter sales cycle compared to the national accounts, and since cash flow was still a problem, such accounts were deemed a priority. Kolter's annual salary was $45,000.

Appendix C shows the organizational chart.

Marketing

The Prudential account came to Cyberplay through Shamrock's fortuitous meeting with a Prudential board member on a plane. The ADP account was the result of a cold call while visiting the Prudential office in New Jersey. Again, Shamrock was the force behind this call, assisted by Bob Kolter. EVC was a referral to Cyberplay when a contact at ADP recommended that Cyberplay handle EVC's computer training. The CTE contract was also a result of a referral when a former employee assisted in getting the two sides together to discuss CTE's need for training sites.

Managing national accounts required that Cyberplay have someone to promote and coordinate the training within the companies. Client employees needed to be prodded to take the training, otherwise it tended to be something that would be done "tomorrow." Cyberplay billed its clients on a per-student per-course-taken basis; hence, it needed to be working with its clients to ensure that employees received the training.

Lagravinese had developed a database program that could be accessed by client companies and that allowed managers to identify each eligible employee, what the company's training standards were for that person, whether the employee had taken the training, and how he had done on the test. Shamrock remarked, "This is like having someone from our office pressing the managers to make sure their employees go to the training. In light of our recent ADP experience though, there may be more we can do." ADP was running significantly behind expectations, and getting the training back on track seemed out of Cyberplay's control.

Financial Performance

Cyberplay had losses totaling about $6 million over its first three years of operations. As of the beginning of 1999, it had a negative net worth of about $2.5 million. In the past year alone, it had lost $3.6 million. It was in default on over $3 million of bank debt and had arranged a forbearance agreement whereby the bank would be paid off with the proceeds from the new funding at $0.50 on the dollar. It was also in default on about $2.5 million of corporate debt that would be paid in full at the refinancing.

Appendix D shows the financial statements for the past year.

Appendix A (previously referenced) shows the projections for the next three years. Clearly, if Cyberplay grew as rapidly as anticipated, it would be profitable after 1999, and would need about $1.5 million in external financing for 1999—an amount that would be provided by the financing options already being considered. However, the enormous revenue growth projections, while viewed as realistic and based on successful implementation of current contracts, carried an amount of uncertainty with them.

The Decision

Shamrock realized that at present, Cyberplay had been spending about $250,000 a month to support about $15,000 of monthly revenue. Clearly, this situation could not last long. No amount of expense reduction could make the company profitable from its retail operations. But even as the training revenues materialized, they would need to materialize according to schedule or else large deficits would persist. Even though the financial deal that was expected to close soon would leave them with about $1.5 million in working capital—enough to cover a years' worth of negative operating cash flow and get them to a positive cash flow position—several questions troubled Shamrock:

(1) Should he reduce corporate expenses to bare-bones levels in case contracts were slow to materialize? Would such a move jeopardize the success of these contracts?
(2) If he were to reduce expenses, what should be cut?
(3) Was Cyberplay doing everything it could to ensure the growth of the current revenue streams? What should be the relative emphasis between generating additional revenues from existing accounts and generating new accounts?
(4) Were new positions necessary? Was the present organizational structure adequate?
(5) If Cyberplay could shift its clients to online training on the Internet, how would this impact staffing requirements, expenses, and organizational structure? Would such a shift be acceptable to Cyberplay's clients? Should Cyberplay pursue such a shift?

The past four years had taken a toll on Shamrock's health, and although he found challenges invigorating, he admitted that he was tired. He was eager to get the revenues and profits up to a level that would reward the shareholders for their patience. He also recognized that failure to show strong revenue and profit progress could cause the firm to lose momentum in the capital markets for future needs. The year 1999 needed to be a good year on the income statement, not just on the balance sheet.

(000's)	1999	2000	2001
Total Fiscal Sales	$ 1,773	$26,536	$54,366
Operating Margin	328	9,551	20,381
Corporate Expense	1,441	4,492	6,589
Profit Before Tax and Interest	(1,113)	5,059	13,792

Source: Company records.

Specific Revenue Assumptions:

CTE

General Assumptions: 50% officer participation rate, 3 classes annually per officer, $60.00 per officer class.

Population Base: Orlando 10,000, Remainder of Florida 32,000, Texas 56,000, Michigan 31,000, and California 139,000.

FI 1999:
Orlando: 1 additional classroom: Begin 2/99 in Winter Park, 1 additional location by 3/99.
Florida (remaining): 5 classrooms:Begin 5/99 and complete by 9/99.
Texas: 9 classrooms: Begin 4/99 and complete by 11/99.
Michigan: 5 classrooms: Begin 4/99 and complete by 8/99.
California: 23 classrooms: Begin 6/99 and complete by 5/00.

EVC

General Assumptions: 15% employee participation rate, 2 classes annually per participating employee, $60.00 per class.

Total Employee Population Base: 1,350,000
Each Phase is assumed to be in groups of 150,000 employees

ADP National Accounts

General Assumptions: 60% participation rate, 2.0 classes annually per participating employee, $55.00 per student class.

Populations: Each location 750.
Ramped up to targeted levels over 12 months.
FI 1999:
Boston (2/99), Atlanta (2/99), Chicago (2/99), Roseland (3/99).

ADP Major Accounts

General assumptions: 25% participation rate, 2.0 classes annually per participating employee, $55.00 per student class.

Population: 7,000
Begin 3/99
Ramped up to targeted levels over 12 months.

ADP Emerging Business

General assumptions: 25% participation rate, 2.0 classes annually per participating employee, $55.00 per student class.

Population: 5,000

FI 1999:
Begin 3/99
Ramped up to targeted levels over 12 months.

Prudential

General Assumptions: 25% participation rate, 2 classes annually per participating employee, $70.00 per student class.

Populations: Atlanta (2,000), Jacksonville (6,000)

FI 1999:
Atlanta (11/98), Jacksonville (10/98).
Ramped up to targeted levels over 12 months.

EVC

1st Phase of 150,000 begins 2/99
2nd Phase begins 3/99
3rd Phase begins 6/99
4th Phase begins 7/99
5th Phase begins 8/99
6th Phase begins 9/99
7th Phase begins 12/99
8th Phase begins 7/2000
9th Phase begins 8/2000

ADP Client Access

General Assumptions: 1.5% company participation rate, 15% employee participation rate within participating companies, 400 employees per participating company, 2 classes annually per participating employee, $60.00 per student class.

Total Company Population Base: 100,000
Ramped up to targets levels over 12 months.

FI 1999:
Phases are assumed in groups of 10,000 companies
1st Phase begins 6/99
2nd Phase begins 10/99
3rd Phase begins 6/2000
4th Phase begins 2/2001
Remaining 60,000 companies to be prospected after this 3 year LRP.

ADP Proprietary

120,000 Potential companies, 7.5% company participation rate, 2 employees per company, 3 classes per participating employee, $45.00 per student class.

Begin 2/99

Ramped up to targeting levels over 12 months.

APPENDIX B

Income Statement, 1998-9
Winter Park Retail Facility

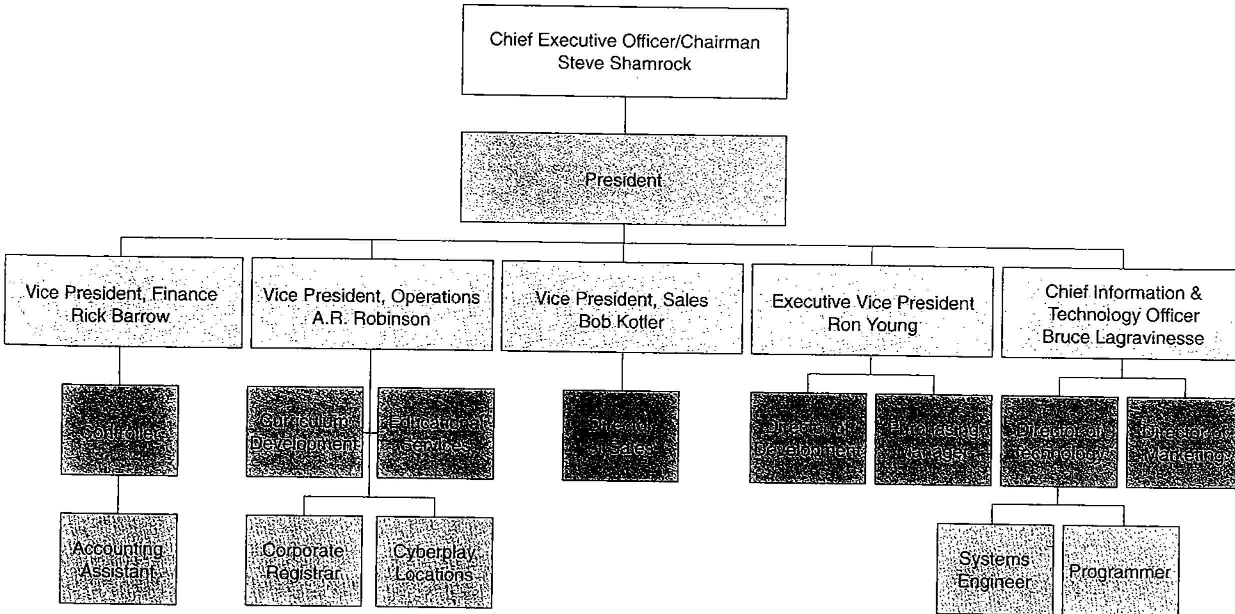
(in $)

Net Revenue	$ 347,706
Cost of Goods Sold	206,365
Gross Profit	141,341
General and Admin. Expenses	
Payroll	96,716
Rent	72,626
Advert. and Mkt.	23,840
Communications	24,033
Deprec. and Amort.	124,957
Other	58,100
Total Expenses	400,272
Operating Profit (loss)	$(259,930)

Source: Company records.

APPENDIX C

Cyberplay Organizational Chart



APPENDIX D Income Statement

Year End June 30, 1998

Net Sales	$ 579,027.75
Cost of Goods Sold	252,524.00
Gross Profit	326,503.75
Expenses	
Payroll	1,541,709.38
Rent	255,168.94
Advertising and Marketing	78,390.85
Payroll Taxes	189,814.13
Utilities	31,024.08
Depreciation and Amortization	264,150.98
Property Tax	29,237.28
Atlanta Closing Costs	131,874.95
Other GSA Expenses	671,222.00
Total Expenses	3,163,355.40
Operating Profit	(2,836,851.65)
Other Income & Expenses	
Project Income	99,407.60
Interest Expense	465,415.56
Loss on Disposal of Assets	395,528.65
Misc. Incl. Expenses	11,647.00
Total Other Income & Expenses	749,888.50
Profit Before Taxes	(3,586,740.15)
Net Loss	($3,586,740.15)

Balance Sheet Highlights

(Unaudited; approximate)

Cash	1,000
Total Current Assets	2,500
Total Current Liabilities	350,000
Long-term Debt	5,000,000

Source: Company records.