

This case draws on material from Chapters 14 and 15.

On May 8, 1984, Hannah Eisenstat graduated from Louisiana State University. She set to work opening a coffee shop in Baton Rouge called HannaH and found a perfect location in a new development. Using a \$50,000 inheritance to finance the venture together with her own sweat equity, she started the business on August 1, 1984 as a sole proprietorship. The shop was profitable in the first year. Hannah found, however, that the quality of her coffee was not as high as she had initially envisioned. She discussed this issue with one of her regular customers, Natasha Smith. On the spot, Natasha offered to help finance the purchase of a roasting machine. By roasting the beans herself, Hannah could produce higher-quality coffee and, in addition, expand the business by offering beans for sale.

Expansion. After looking carefully at the financials, Hannah determined that she would need an investment of \$75,000 from Natasha to undertake this expansion. In exchange for this investment, Hannah offered her a 40% share in the business. Natasha accepted the offer and the business was incorporated with two owners. The equity consisted of 1,000,000 shares in total, with Natasha owning 400,000 shares and Hannah owning 600,000 shares.

By the end of the second year, the business was doing extremely well. Revenue from the sale of beans soon began to rival beverage sales. In response to this success, Hannah and Natasha decided to expand to five stores over the next two years. Rather than using equity financing, they decided to seek bank financing. Each new store required an investment of \$100,000. Opening the stores took longer than planned, but by the end of 1999, there were five HannaHs in Baton Rouge employing 30 people. As planned, this expansion was financed solely with debt that was ultimately consolidated into a \$500,000 term loan due in 2004.

Venture Capital. In early 2000, the two owners decided to take a weekend retreat and reevaluate their initial business plan. Perhaps the biggest surprise was the popularity of beans; almost 80% of revenue was attributable to bean sales alone. Furthermore, a buyer from a local supermarket chain had approached HannaH with a proposal to sell the beans in the chain's stores. However, HannaH was currently at its capacity limits—it could barely roast enough coffee for its five stores. More importantly, to enhance the coffee quality further, Hannah proposed that they buy beans directly from coffee farmers in Costa Rica, where she would be able to monitor quality closely. However, the supermarket proposal would require a significant increase in the production of roasted beans. By the end of the retreat, Hannah and Natasha had decided to change the focus of the business from retail beverage and bean sales to wholesale roasted coffee beans. Rather than build new stores, they decided to invest in a state-of-the-art roasting facility.

In the next few weeks, Hannah approached Dixie Partners, a local venture capital firm. On the strength of the commitment from the supermarket chain to carry the coffee, Dixie agreed to invest \$3 million to finance the construction of a high-capacity roasting facility in exchange for a 50% share of the company. To accomplish this, 1,000,000 new shares in HannaH were issued to Dixie.

Further Expansion. Hannah's intuition was correct—the quality of the coffee increased significantly. Within eight years, the company had grown to almost 200 employees and its strong reputation allowed it to sell its coffee for a 50% premium over other brands. To

finance the expansion, Dixie made two more equity investments: It paid \$4 million for 1,200,000 shares in 2003 and \$8 million for 1,500,000 shares in 2006. Further, the term loan was renewed for another five years when it came due in 2004, and in 2007 an additional 400,000 shares were issued to employees as part of their compensation.

IPO. At the beginning of 2008, the board of directors decided to expand the distribution of the coffee throughout the United States and finance this expansion from the proceeds of an IPO. The plan was to initially raise \$20 million in new capital at the IPO and then, within a year or two, raise an additional \$20 million in an SEO. Dixie planned on selling 10% of its stake in HannaH at the IPO and subsequently liquidating the rest of its investment by the end of 2009. The IPO was successfully undertaken in August 2008. All told, the company sold 2,000,000 shares for \$12 per share at the IPO, including 10% of Dixie's stake (no other existing shareholder sold any shares at the IPO).

SEO. A year later, in August 2009, the company did a cash offer SEO, selling an additional 4,000,000 shares for \$20 per share, which included 400,000 shares from each original owner, Hannah and Natasha, and 2,000,000 of Dixie's shares. Thus, of the shares sold, 2,800,000 shares were existing shares and the rest were new shares. Some of the proceeds were used to repay the term loan that matured at the same time as the SEO and the remaining proceeds were used to finance the continued national expansion. Dixie had been selling additional shares in the secondary market over the prior year, so that issue represented the liquidation of Dixie's final stake—after the sale, Dixie no longer owned shares in HannaH. During this time, an additional 50,000 shares were issued to employees as part of their compensation.

LBO. By 2010, the fortunes of the company had changed. Although HannaH coffee still had a strong brand name and sales continued to grow the company, it was experiencing significant growing pains. Hannah herself was no longer directly involved in operations. Soon after the SEO a new CEO, Luke Ignion, was hired to take over the day-to-day running of the company, but he proved to be a poor fit. By late 2010, the company's share price had dropped to \$5 per share. Hannah was distressed to see the value of her remaining stake drop to this level, so she decided to take advantage of what she saw as a buying opportunity. Together with six other key employees, she undertook an LBO of HannaH. At the time of the LBO, the firm had 8,000,000 shares outstanding because an additional 20,000 shares had been given to key employees. Hannah and the other key employees had already started purchasing shares, so by the time of the LBO announcement Hannah owned 500,000 shares and the other key employees together owned an additional 100,000 shares. The group issued a tender offer to repurchase the remaining 7,400,000 shares for \$7.50 per share. To finance the repurchase, the group combined an additional equity investment of \$7,000,000, bank debt, and a (rule 144A) private placement of a \$30 million semiannual, ten-year coupon bond. The plan was to register this privately placed debt publicly within a year. The debt was convertible and callable (at par) in five years. It had a conversion ratio of 50, a face value of \$1000, and coupon rate of 5%.

Case Questions:

1. Natasha is an example of what kind of an investor?
2. At each funding stage prior to the IPO (that is, 1985, 2000, 2003, and 2006), calculate the pre-money and post-money valuation of the *equity* of the company.
3. What fraction of the IPO was a primary offering and what fraction was a secondary offering?
4. Immediately following the IPO the shares traded at \$14.50.
 - a. At this price, what was the value of the whole company? Expressed in percent, by how much was the deal underpriced?
 - b. In dollars, how much did this underpricing cost existing shareholders?
 - c. Assuming that none of the owners purchased additional shares at the IPO, what fraction of the equity did Hannah own and what was it worth immediately following the IPO?
 - d. What was the company's debt-equity ratio—the ratio of the book value of debt outstanding to the market value of equity—immediately following the IPO?
5. Address the following questions related to the SEO:
 - a. What fraction of the SEO was a primary offering and what fraction was a secondary offering?
 - b. Assuming that the underwriters charged a 5% fee, what were the proceeds that resulted from Hannah's sale of her stock? How much money did the company raise that would be available to fund future investment and repay the term loan?
6. Immediately following the SEO, the stock price remained at \$20 per share.
 - a. Once the term loan was repaid, what was the value of the whole company?
 - b. What fraction of the equity did Hannah own?
7. Assume the LBO was successful.
 - a. How much bank debt was required?
 - b. What was the debt-equity ratio immediately following the LBO?
8. A year after the LBO, just after the second payment was made, the convertible debt traded for a price of \$950.
 - a. What was its yield to maturity?
 - b. What was the yield to call?
9. Assume that in the five years following the LBO Hannah was able to turn the company around. Over the course of this period, all the bank debt was repaid and the company went public again. The price per share was now \$60/share. Predict what the holders of the convertible debt would do. What would their investment be worth?