

CAFÉ XARAGUA

Robert Lehnert wrote this case under the supervision of Mary Gillett solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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In the spring of 2011, Rob Lehnert, a 21-year-old native of Miramichi, New Brunswick, was in his final year of the HBA program at the Richard Ivey School of Business and in the process of deciding what he would do after graduation. When the opportunity to visit Haiti during reading week of his final year presented itself, Lehnert jumped at the chance and took off on an adventure.

While on this first visit to Haiti, Lehnert realized the potential for economic development in a country that was rich in certain resources and virtually unexplored by the private sector. Initial Internet-based research led him to believe that tourism and coffee could be major industries with the help of foreign investment. Entry into the Haitian tourism industry required a large upfront capital investment, so Lehnert decided coffee would be a more feasible business opportunity.

Upon his return, Lehnert invited fellow graduate Jordan Peckham and friend Scott Schneider to take a trip to Haiti. Through Google, they found old maps of coffee plantations and planned to rent a truck and visit the producing regions. The three friends packed up and hopped on a flight to Port au Prince in search of the elusive best coffee on the island. Dirt roads, river crossings, rain storms and dead ends were all part of the adventure. Eventually, they arrived at the village of Thiotte in the highlands of southern Haiti where they found a world-class coffee bean.

Lehnert returned several times following the partners' initial trip to secure supply and get a better understanding of the local culture and business environment. The three partners imported their first burlap sack of coffee in September 2011 and contracted out the roasting process. By November 2011, they began offering their product for sale, quickly generating over \$20,000 in revenue via online sales and selling out of product within three months, particularly in Lehnert's home town.

Given this success, by early spring 2012, Lehnert and his partners were ready to make an additional investment and build on the brand and story they had created. They thought a café focused on their own brand of coffee from Haiti would be a great way to generate sales and further develop their product offering before pursuing a grocery store strategy. However, they also knew that such an investment would be a risky one.

HAITI'S COFFEE INDUSTRY

The Caribbean island of Haiti was discovered by Christopher Columbus in 1492. French colonists first planted coffee in Haiti in 1734. Coffee production quickly grew, and by 1788 Haiti was supplying half of the world's coffee.¹ During the slave revolution that began in 1791 (and was one of the only successful major slave revolutions in world history), many plantations were burned and many coffee experts were massacred.

Haitian coffee made a comeback during the 1900s and reached a peak for the century in 1949 when Haiti was the third largest coffee producer in the world.² As time went on, coffee production again fell due to many reasons such as political instability, the need for charcoal (resulting in deforestation), dropping international prices and lack of foreign investment.

As of 2012, with a population of just under 10 million, Haiti's potential production was estimated at 300,000 60-kilogram bags.³ The International Coffee Organization projected global production of coffee for 2011 to be 127.4 million bags,⁴ placing Haiti's current production at 0.2 per cent of global production.

The Haitian coffee industry's returned success was not without challenges. Each year, coffee speculators from neighbouring Dominican Republic were estimated to smuggle an estimated 120,000 bags of Haitian coffee, avoiding Dominican Republic taxes and resulting in growers receiving pennies on the pound.⁵ As well, some critics believed that while Haitian farmers had little long-term vision and had to better focus on quality and quantity, the international community had to help the country's growers by focusing less on the traditional subsidies model and more on sustainability.⁶

The poorest country in the Western Hemisphere, Haiti has been plagued by political violence for most of its history. As well, the country is located in the middle of the hurricane belt and experiences severe storms resulting in flooding and earthquakes. A massive magnitude 7.0 earthquake struck Haiti in January 2010 with an epicentre about 25 kilometres west of the capital, Port-au-Prince. Over 300,000 people were killed and some 1 million left homeless. The earthquake was assessed as the worst in the region over the last 200 years.⁷

THE CAFÉ XARAGUA CONCEPT

During that first trip to Haiti, it became very clear to Lehnert that consumer coffee choices had a substantial impact on coffee farmers and the environment around the world. He and his partners quickly developed a mission statement for their company: "To source high quality coffee while maintaining a focus on Haitian culture, reforestation and most importantly meeting the needs of the local people." Lehnert explained, "By adopting smart techniques that benefit the coffee and the environment, our goal is to prove that you can grow a world-class coffee while rebuilding the local habitats and developing an ecosystem. It's a win-win scenario for the farmers, the roasters, the coffee lovers and, of course, the environment."

¹ Mark Pendergast, *Uncommon Grounds: The History of Coffee and How it Transformed Our World*, Basic Books, New York, 2010.

² Charles Arthur, *Haiti: A Guide to the People, Politics and Culture*, Interlink Books, New York, 2007.

³ <http://dev.ico.org/prices/po.htm>, accessed July 26, 2012.

⁴ <http://www.bloomberg.com/news/2011-11-10/rainfall-cuts-global-coffee-output-estimate-in-2011-12-ico-says.html>, accessed July 26, 2012.

⁵ <http://articles.latimes.com/2011/dec/01/business/la-fi-coffee-haiti-20111201>, accessed July 26, 2012.

⁶ Ibid.

⁷ <https://www.cia.gov/library/publications/the-world-factbook/geos/ha.html>, accessed July 29, 2012.

They chose the name Café Xaragua (pronounced Café Zaragua) because it was the name that once represented the geographical region from where they planned to source their coffee.

Lehnert and his partners were deeply committed to sustainability and reforestation. Café Xaragua's packaging was not only simple but very eye-catching, including a "hang tag" that highlighted the company's commitment to plant one coffee tree for every bag of coffee sold and encouraged purchasers to register their trees with the company online so that they could receive updates as the trees progressed through their life cycle (see Exhibit 1). Lehnert continued, "By purchasing Xaragua coffee, you are providing the final link for coffee farmers in Haiti and beginning the push towards sustainable and ethical development. Planting coffee trees is directly in line with the long-term vision for our company. Coffee trees can produce coffee for 50 to 70 years and hence represent a source of long-term and sustainable income for farmers."

In addition to the partners' emphasis on sustainability, they also believed they had an excellent product with a distinct gourmet taste. They focused on Arabica Typika coffee, which was fair trade certified, shade grown and sun dried at an elevation of 1,300 metres in the Blue Pine Forest of Southeastern Haiti. The coffee was produced by a cooperative network of coffee farmers that was founded in 1999 and had a well-established base of 5,000 farmers operating in seven smaller cooperatives. The chosen medium-dark roast profile produced a full round body with complex floral, vanilla and cocoa flavours that was extremely rare in North America and was primarily sold as a premium coffee in Italy and Japan.

The product and the focus on sustainability proved to be a quick success, and Lehnert and his partners began discussing next steps in furthering their brand. They believed that most coffee shops were focused on image and the illusion of a premium product, yet the reality was much different. Lehnert discovered that, in fact, most companies in this market purchased their coffee from the same importers and same general regions without a real knowledge of where it came from. There were a select few companies that had strategically developed a strong connection between the product and the consumer. Lehnert had a vision for a café that drew such a connection, something he believed was essential to succeed in the long term and an excellent fit for the Café Xaragua branding. He and his partners knew that they had an opportunity to bring a very rare and unique product to the premium coffee café market and that they would be the only ones in Canada importing coffee from Haiti in 2012.

Lehnert, Peckham and Schneider looked at cities across Canada as potential markets to launch their business, and Calgary presented itself as a great place to start as well as a place where they would enjoy working and living. Calgary had a strong economy, and the partners thought they could benefit from the city's higher prices, which would be important with a premium product. Peckham and Schneider grew up in a small town just outside of Alberta, giving them a strong understanding of the local environment and some connections in the private sector that would be valuable in the long term.

In order to create a robust experience with the product for their customers, the partners decided to roast fresh coffee in the café in a small 20-pound roaster. This roasting process would no doubt intrigue customers and also provide a unique offering in the Calgary market.

The partners knew that their biggest competition would be Starbucks, but felt that with a strategy focused on an in-house roasted product rather than just the café's atmosphere, they would have a competitive advantage and a shot at succeeding in downtown Calgary.

If they were successful with the coffee shop, the partners planned to pursue a growth strategy beginning with the province of Alberta.

CALGARY, ALBERTA

Alberta's economy was one of the strongest in Canada, supported by the petroleum industry and, to a lesser extent, agriculture and technology. Alberta's 2011 GDP was \$286.6 billion, leading all of the Canadian provinces in economic growth during the past 20 years with an average annual growth rate of 3.4 per cent per year. With a population of 3,817,980 in 2011, Alberta boasted of its modern infrastructure, political stability, low taxes and a young and skilled workforce, to name a few advantages.⁸

Calgary's GDP at \$64,509 million accounted for almost 23 per cent of the province's economy. With a population of close to 1.4 million,⁹ Calgary boasted both business and lifestyle advantages. Certainly the proximity to the Rocky Mountains made the city an enviable place in which to work and live. In addition, the unemployment rate was 5.7 per cent in July 2011, down from 6.9 per cent the previous year and impressive compared to the national rate of 7.3 per cent.¹⁰ Average hourly wages were \$26.28 in 2011,¹¹ and average annual salaries — \$64,939 in 2011 — were consistently the highest of Canada's six largest cities.¹²

With 65 per cent of Canadians drinking coffee on a daily basis,¹³ Alberta presented a large population with a market where price sensitivity would not be a big concern. On the other hand, it was very expensive to do business in Alberta, and Lehnert knew that some retail companies found it very hard to compete for talent with the petroleum industry.

CAFÉ XARAGUA — THE CAFÉ

The partners looked to choose a location in downtown Calgary where they could roast coffee and offer premium brewed coffee and specialty coffee drinks as well as their retail bags and baked goods. The location would have one portion dedicated to roasting fresh coffee, a second dedicated to serving drinks and a third providing typical café seating.

They were considering a location in the Kensington district, which was considered a "Business Revitalization Zone" in Calgary. Lehnert felt that this trendy district, one of the city's premiere shopping destinations with over 250 shops, restaurants and services, would be an excellent location given the target market for Café Xaragua of 18- to 35-year-old college-educated men and women with above average incomes. Lehnert was further encouraged by Mike Suzuke, vice president, Alberta South District, Bank of Montreal, who in August 2011 noted, "The Kensington neighbourhood, north of Calgary's downtown core, boasts a population of young professionals and families that is expected to grow by 10,000 over the next five years."¹⁴ On the other hand, a quick Google search revealed that of the 250 shops, restaurants and services, there were more than a few "café" types of offerings. Further research showed that the majority of these appeared to be more of a full service restaurant than Lehnert's concept and so did not feel particularly threatening. But Lehnert did note that both Second Cup and Starbucks had a location in the Kensington district.

⁸ http://www.albertacanada.com/documents/SP-EH_AlbertaEconomicQuickFacts.pdf, accessed July 26, 2012.

⁹ <http://www.calgaryeconomicdevelopment.com/research/economic-indicators/historic>, accessed July 26, 2012.

¹⁰ http://www.calgary.ca/_layouts/cocis/DirectDownload.aspx?target=http%3A%2F%2Fwww.calgary.ca%2FCA%2FFs%2FDocuments%2FCorporate-Economics%2FCurrent-Economic-Analysis%2FCurrent-Economic-Analysis-2011-07.pdf&noredirect=1&sf=1, accessed July 26, 2012.

¹¹ *Ibid.*

¹² <http://liveincalgary.com/jobs/calgary-salaries-and-wages>, accessed July 26, 2012.

¹³ <http://www.coffeeassoc.com/coffeeincanada.htm>, accessed July 26, 2012.

¹⁴ <http://newsroom.bmo.com/press-releases/bmo-opens-2-8-million-branch-in-calgary-s-trendy--tsx-bmo-201108220721760001>, accessed July 26, 2012.

The average household income of residents within five kilometres of this district was \$114,748 in 2010.¹⁵ As well, the population that corresponded within this radius was 209,510,¹⁶ and with 65 per cent of Canadians drinking coffee on a regular basis, Lehnert calculated approximately 136,000 potential customers in the Kensington region. This number only included residents and did not include any of the added foot traffic that would be generated by this well-known shopping district. With more than 5.1 million tourists visiting Calgary per year,¹⁷ Lehnert estimated conservatively that 2 per cent of these tourists would visit the Kensington region.

The specific location that the partners were looking at was 1,571 square feet of retail space located next to Bernard Callebaut, a specialty chocolate shop, and Crave Cupcakes, a specialty bakery. The partners felt that they had a similar target market to both neighbouring stores, and so the location seemed to be a great fit. As well, they planned to source their baked goods from their neighbouring business on an as-needed basis and had negotiated an average cost of \$1.25 per item. Lehnert had preliminary discussions with the landlord and felt that the partners would be able to secure a competitive five-year lease for \$45 per square foot per annum. After meeting with a local contractor, they estimated that leasehold improvements would be required at approximately \$35,000.

PRELIMINARY ESTIMATES

Lehnert worked with one of his father's friends who had some experience in the restaurant business and developed a list of equipment and fixtures that would be required to open a café in such a premium location (see Exhibit 2).

He knew that they would also need very qualified and professional staff with wages at \$16.00 per hour plus 20 per cent benefits. Lehnert hoped that the \$16 wage rate compared to Alberta's \$9.40 minimum wage rate¹⁸ would be very attractive. The café would be open to the public from 6 a.m. to 11 p.m., seven days a week, and staff would be needed for 126 hours per week. The café would require two staff at all times. For the first year, Lehnert would stay on as manager and oversee all operations, but it was clear that he would need time to grow the business and continue his sourcing and outreach trips to Haiti, so the partners decided to hire a part-time manager who was a recent university graduate and train him or her to take over the position. Lehnert hoped to find a suitable candidate for \$25,000 per year. Once they required a full-time manager, they expected to pay him or her an annual salary of \$60,000.

The partners estimated that they would spend an initial \$10,000 on marketing and promotion prior to opening and continue with a \$1,000 monthly budget for the first year. They anticipated that annual utilities would run approximately \$15 per square foot in addition to telephone and Internet charges of \$300 per month. Lehnert's father had helped him obtain a quote from an insurance company to insure the contents of the café for a premium of \$250 per month. Miscellaneous administrative costs were estimated to be \$350 per month.

Other upfront costs would be legal fees, incorporation costs, licenses and permits, which were estimated at \$10,000, plus a \$2,000 utilities deposit and another \$6,000 rental deposit. In addition, they would need to

¹⁵ <http://kensingtoncalgary.com/wp-content/uploads/KG-Lease-Flyer-1115-Kensington-Rd-NW.pdf>, accessed July 26, 2012.

¹⁶ *Ibid.*

¹⁷ http://www.visitcalgary.com/sites/default/files/pdf/3-visitor_volumes_and_spending_in_calgary_cma_2006-2010.pdf, accessed July 26, 2012.

¹⁸ <http://www.cbc.ca/news/canada/calgary/story/2011/06/01/edmonton-alberta-minimum-wage.html>, accessed July 26, 2011.

have someone professionally install and certify the roaster, which would cost approximately \$10,000. Monthly maintenance on the machines would be roughly \$500.

PRICING

Lehnert spent considerable time working on his menu and figured an average price of \$3.00 for regular drip coffee and \$4.00 for specialty drinks such as espresso and lattes would be reasonable, particularly when compared to the average price of \$5.25 at their closest competitor, Starbucks. There were numerous drink possibilities and numerous different sizes that Lehnert believed would be an important aspect when choosing the menu.

Their chosen location had decent foot traffic and was near a popular park, so the partners estimated they could sell between 200 and 300 drinks per day evenly split between regular drip and specialty drinks. The estimated average cost of a beverage would be 20 per cent of the selling price.¹⁹ They expected that 50 per cent of their daily customers would purchase a baked good along with their beverage at a price of \$2.50. The partners further estimated that 10 per cent of their daily customers would purchase a bag of coffee for home use at \$16.50 per 10-ounce bag. This price was identical to the planned online price and generated a 60 per cent margin.

RAISING CAPITAL

As the partners discussed their venture, they thought that between the three of them and their families they could raise \$75,000, but this would clearly not be enough capital to get started. Lehnert was approached by one of his very wealthy friends who was interested in investing and was offered \$250,000 for a 60 per cent stake in the business. The partners also considered the option of taking on either a line of credit or a fixed-rate term loan for the remaining capital needed.

After several long meetings discussing the potential financing options for the café, the partners decided that their best strategy would be taking on debt to finance the investment rather than giving up 60 per cent of their equity. With \$75,000 in equity, they decided that they would need \$250,000 in debt and that they were interested in a term loan with an interest rate of 13 per cent per annum plus a line of credit for any financing requirements above this amount. The partners had no doubt that the bank would require a guarantee from at least one of their parents to secure this level of debt.

The partners knew they would need a detailed business plan before any serious decisions could be made and before approaching a bank. Though they felt reasonably confident with their cost projections, they worried that their daily sales projections were more a “gut feel” rather than based on strong data. After many long hours and too many cups of their delicious coffee, the partners sat down to pull together their business plan and see if their café was just a dream or a dream about to come true.

¹⁹ Including the cost of coffee, milk, sugar and cups.

Exhibit 1

THE PRODUCT — CAFÉ XARAGUA



Exhibit 2

EQUIPMENT REQUIREMENTS

General Equipment	Units	Cost per Unit	Total
Telephone System	1		2,000
Computer System	2	\$4,000	8,000
Espresso Machines	1		8,000
Regular Coffee Machines	4	\$1,000	4,000
Coffee Grinders	2	\$1,500	3,000
Stereo System			3,000
			28,000
Roasting Equipment			
Roaster	1		50,000
Packaging Heat Sealer	1		4,000
Scales / Scoops	5	\$50	250
			54,250
Furniture			
Bar / Roasting Station			20,000
Tables	15	\$1,000	15,000
Chairs	60	\$100	6,000
Couches	4	\$500	2,000
Shelves			4,000
			47,000
Other			
Décor			10,000
Dishes, cutlery			5,000
			15,000
Total			\$ 144,250