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SKYLINE CHILI: A CASE FOR SMALL BUSINESS GROWTH AND MANAGEMENT

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ABSTRACT

Skyline Chili produces the secret-recipe chili for its restaurants and several frozen chili products for local grocery stores in Cincinnati, Ohio and other areas. An interview with Mr. Kevin McDonnell, new CEO of Skyline Chili in the case discusses the past, present, and future of the company. Can the company sustain its growth and competitiveness in the 1990s? If so, what can you recommend for the company?

SMALL BUSINESS GROWTH AND MANAGEMENT

Small businesses account for more than half of total U.S. workforce and over eighty-seven percent of employment growth in the past decade. They also embrace ninety-seven percent of the enterprises in the U.S. Thus, small businesses are truly the mainstay of the U.S. economy (Handbook of Small Business Data, 1988). Recognizing the preponderance and relative impact of small businesses as major contributors to job creation and economic growth, academic research on small business management practice has grown dramatically over the past decade. In particular, topics of 'strategic growth' of small businesses have received much attention from researchers (Bygrave, 1994; Jennings, 1994). Presenting the past and present of Skyline Chili, therefore, this study examines the topic of small business growth and management.

O'Farrell and Hitchens (1988) examined the alternative models/perspectives of small business growth and tried to find the characteristics of successfully growing businesses. Portraying the characteristics of successful small businesses, they emphasized that small businesses should be able to identify the key criteria upon which to compete in certain segments. Then they must build a competitive advantage based upon these criteria. According to them, many small businesses employ different types of growth strategy as a way to achieve their competitive advantages.

Previous literature on small business growth has yielded three groups of studies: (1) a group of studies examining the relationship between certain management/organizational characteristics and business growth (Bracker, Keats & Pearson 1988; Covin 1991; Lyles, Baird, Orris, & Kuratko, 1993); (2) a group of studies examining the relationship between management/organization characteristics and various stages of growth (Birley & Westhead

1990; Hanks 1990; Kazajian & Drazin 1989); (3) a group of studies examining the relationship between the dynamics of growth and various aspects of management of that growth (Fombrun & Wally 1989; Shuman & Seeger 1986). Using an interview with a small business executive as well as secondary sources of information (annual reports and industry data base), the current study attempted to reveal the relationship between management and small business growth.

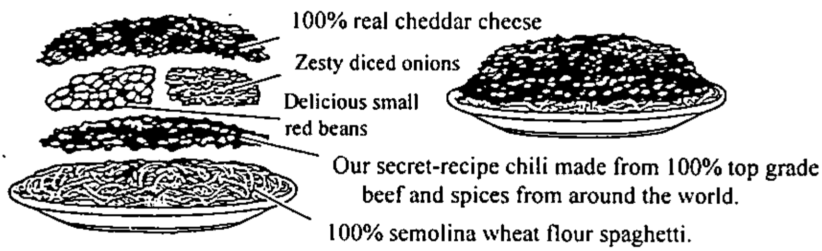
Merz and Sauber (1995) provide several reasons why it would be appropriate to investigate the management activities (including a formulation and implementation of growth strategies) of executives in small businesses. First, it extends the 'upper echelons perspective' arguing that a firm's strategic, structural choices and performance levels are influenced by top managers' characteristics (Hambrick and Mason 1984). Second, it is consistent with the trend in small business research emphasizing the executives' behaviors and activities instead of their personal characteristics (Stevenson and Jarillo 1990). Third, the use of managerial activities as a predictor or an indicator of future strategy has a greater applicability in understanding the strategic growth and success of small businesses (D'Amboise and Muldowney 1988).

SKYLINE CHILI, INC.

Skyline Chili Inc. was founded in 1949 by the Lambrinides family. Nicholas Lambrinides, a former cook for railroad workers and native of Kastoria, Greece, used his culinary expertise to open the chili restaurant in downtown Cincinnati. Today, Skyline Chili produces the secret-recipe chili [see Exhibit 1] for its restaurants and several frozen chili products for local grocery stores. "Cincinnati-style" chili is defined by its presentation: a plate of spaghetti with sauce and shredded cheddar on top. Native Cincinnatians know it simply as a "3-Way." If onions are added, it's called a "4-Way." The addition of beans makes it a "5-Way." Skyline restaurants are located throughout Greater Cincinnati and in Dayton, Indianapolis, Louisville, Indianapolis and Columbus. The company also operates five restaurants in Florida, including two in Ft. Lauderdale and one each in Clearwater, Ft. Meyers and Naples. Of the 82 Skyline stores operating now, 30 are company-owned, and the rest are franchises. Skyline Chili opened its first franchised store in 1958. Its major competitors are Empress Chili which has been in existence since 1922 and Goldstar Chili with 118 outlets. Skyline became a publicly traded company in 1986 in an offering that raised about $4 million. Skyline currently has 500 employees. Additional information such as selected financial data is provided in the Appendix.

Exhibit 1

How We Built A Legend



INTERVIEW WITH Mr. KEVIN McDONNELL (CEO, SKYLINE CHILI)

Question 1: Could you give me a brief overview of Skyline's history?

Mr. McDonnell: Skyline began in 1949 at the Price Hill location in Cincinnati. This location overlooks the Cincinnati skyline, hence the name of the company. The first expansions came in downtown Cincinnati where it experienced good growth and success. To improve its customer base, the company expanded into the suburbs. In the late fifties, Skyline began franchising throughout Cincinnati. By 1965, the company had expanded its service by becoming a supplier of frozen products to grocery stores. Skyline's stock went public in the mid eighties at $4.50 a share and has since bounced around. Today we are experimenting with new strategies for growth outside the Cincinnati area.

Question 2: When did Skyline go public and why?

Mr. McDonnell: We went public in the mid eighties for mainly two reasons. First, we were looking for ways to gain further capital for expansion into new markets. Second, a portion of the company funds were used to retire the debt from two of the five brothers who wanted to sell their interest in the company.

Question 3: What do you consider to be Skyline's greatest strength?

Mr. McDonnell: Our greatest strengths are the quality of our products coupled with good service. This is evident in the recent surveys where consumers rated our product quality as the primary reason for coming back.

Question 4: How do you break down the business for strategic management efforts?

Mr. McDonnell: We have three distinct channels of product flow. One segment is our company-owned stores which utilize; the largest amount of assets and as a result, offers the least amount of gross margin. Our second channel, the franchise segment, uses less capital and provides a higher opportunity for growth. Our third channel, the grocery store frozen food segment, is a high growth, low capital channel. Since 1990, we have been striving to maximize our strategic management efforts in all these segments.

Question 5: What are your strategies for growth for markets outside of Cincinnati ?

Mr. McDonnell: In the late fifties we had the philosophy that as a result of having a great product which had proved itself in Cincinnati we should be able to sell it in any market. We had the philosophy that "if you build it they will come." Therefore, we entered markets such as Pittsburgh, Cleveland, Indianapolis, and Columbus. We recognized that, although there would be a desire for quality products, we could not expect the high volume that we enjoyed in the Cincinnati market. Therefore, we decided to open smaller stores in low cost spaces, such as strip malls. We controlled costs in these locations through tight controls on marketing expenses and by excluding table service.

We found this to be a mistake. Recent surveys reveal that, in addition to product quality, customer also value table service. Furthermore, locating our restaurants in strip malls did not create as much awareness among consumers as we were able to create by locating our restaurants in a free standing building. "Consumer awareness. " That's our fight. That's our challenge.

Question 6: How do you plan to leverage these findings in a new strategy for growth?

Mr. McDonnell: We are currently focusing on expansion outside of Cincinnati through the efforts of our "Project Mousetrap." We are testing this strategy in Columbus at our company-owned stores. We are operating in free standing stores which provide both table and drive-through service. We have contracted with a design firm to create a new look which will attract attention through 'tasteful garnishment.' They are decorated in checkerboard and outlined in neon, creating an attractive and eye-catching image.

In our attempts to implement "Project Mouthtrap," we have added spaghetti with red sauce and fettucini, gyros, and hot dogs in order to attract the skeptic. These items not only broaden our product-line but also involve little additional investment by way of new raw materials or preparation procedures. The intention is to soon wean them off the odd products and sell only traditional skyline items that are of high quality. Customers like the design of the new store and have begun experimenting with our chili. Although we are happy that our customers have adopted the new items, we have continued to focus on our traditional items which constitute more than 85% of the total sales. We have no intention of diverting from the traditional skyline menu. We are in the business of Cincinnati chili and that is where we intend to stay.

Question 7: Who are your major competitors in Cincinnati?

Mr. McDonnell: Goldstar Chili currently has twice as many stores in the Cincinnati area as Skyline Chili. However, Skyline has a higher traffic rate. The one thing that differentiates Skyline over the other chili restaurants is the quality of our products as our research shows. Skyline has approximately twenty-two million dollars in revenues and about sixteen and a half million in assets, of which, nine million dollars have been invested in one asset, a single food preparation facility. This new facility allows us to utilize economies of scale by processing our chili in one large process and from there distributing it to our stores or the supermarkets. In Cincinnati our chili has the second fastest turnover for frozen food items, second only to orange juice. These factors have allowed us to make a very good impact in the Cincinnati market.

Question 8: How does Skyline attract potential franchise investors?

Mr. McDonnell: Today the market for investors is extremely competitive. There are so many different marketing options. In order to successfully attract potential franchise investors, you first need to learn the business so that you may be a knowledgeable teacher. This means that company stores are required to test the market and learn the potential risks and niches in any new market. It also helps by allowing increased expenditures on advertising which helps attract investors. In the fast food industry there are many strategies for the mix of franchise stores and company owned stores. Subway is 100% franchise, whereas Bob Evans is 100% company owned. We desire to maintain company owned stores but realize that our future growth will greatly be increased through franchising. The price to start up a franchise is also a factor which allows investors many options. An Outback Steakhouse costs around two million dollars to begin, a McDonald's about one point two million dollars, and a Rally's eight hundred thousand dollars. Skyline is able to initiate a franchise with eight or nine hundred thousand dollars. The current strategy of our management is to maximize efforts in our three channels of product flow, company stores, franchise, and grocery, with the major growth reliance upon franchising.

Question 9: Finally, could you describe your management and leadership style as well as Skyline's culture?

Mr. McDonnell: When I was in MBA program, I took the MBTI (Myers-Briggs Type Indicator) test. According to the analysis, I am NT (Intuition-Thinking) type executive. That is, I tend to be possibilities-oriented, impersonal, ingenious, and integrative. However, I have tried to employ SF (Sensation-Feeling) style and blend it with my NT style in my business management. I have recognized that it is very important to be a 'Coach' (a typical characteristic of SF style) as well as a 'Strategist' (a typical characteristic of NT style) in business. My colleagues, managers, and employees have also provided similar assessments. Several years ago, I attended a seminar ("The One Minute Manager") emphasizing the role of coach in today's business environment. I learned a lot from the seminar. In managing my organization, I really want to be "One Minute Manager." I also try to develop and sustain "One Minute Management" type corporate culture for Skyline Chili. Only good corporate culture can attract and keep good employees. High employee turnover is typical in this industry. There seems to be an ever-increasing number of jobs chasing a shrinking pool of people willing to work in service environments like restaurants. While finding affordable new sites is terribly difficult with all of the chains competing for attractive locations, the real battle is over employees. That's why I introduced "One Minute Management" type culture for Skyline Chili.

ASSIGNMENT QUESTIONS

1. What impresses you about this company? Is it well-managed? Why or why not? Using Skyline Chili's financial data (Appendix 1), analyze internal strengths and weaknesses.
2. How successful was Skyline Chili in defining the business and crafting a strategy to achieve performance objectives?
3. Can Skyline Chili executives stand the tests of time and growth?
4. What issues does Skyline Chili face in the years ahead? What would you recommend Skyline Chili do to successfully confront these issues?

Table 1
Financial Highlights

Dollar amounts in thousands,
except per share data

Years ended	October 29, 1995	October 30, 1994	October 31, 1993
Selected Income Data:			
Total revenues	**$25,772**	$24,496	$21,626
Income from operations	**1,986**	1,346	1,191
Net income	**980**	532	431
Net income per share	**0.29**	0.16	0.13
Selected Balance Sheet Data:			
Current assets	**$4,535**	$4,889	$3,175
Total assets	**19,013**	18,423	16,902
Current liabilities	**3,180**	3,293	2,190
Total non-current obligations	**6,569**	6,846	7,070
Shareholders' equity	**9,264**	8,284	7,642

Table 2
Selected Financial Data

Dollar amounts in thousands,
except per share data

	1995	1994	1993	1992	1991
Operations:					
Commissary sales	**$10,331**	$10,817	$9,809	$10,327	$9,792
Restaurant sales	**14,231**	12,507	10,646	9,914	9,278
Franchise fees and royalties	**1,210**	1,172	1,171	1,217	1,217
Total revenues	**25,772**	24,496	21,626	21,458	20,287
Income from operations	**1,986**	1,346	1,191	1,076	1,434
Net income	**980**	532	431	327	839
Capital expenditures*	**2,484**	1,537	1,845	1,517	7,586
Per Share:					
Net income**	**0.29**	0.16	0.13	0.10	0.25
Financial Position:					
Total assets	**19,013**	18,423	16,902	16,409	16,812
Property and equipment, net	**13,825**	12,876	13,056	12,599	12,736
Long-term debt	**6,100**	6,459	6,799	7,114	7,970
Shareholder's equity	**9,264**	8,284	7,642	7,127	6,644
Ratios:					
Current ratio	**1.43**	1.48	1.44	1.61	1.52
Total liabilities to equity	**1.05**	1.22	1.21	1.30	1.53
Interest coverage	**3.83**	2.43	2.15	1.84	5.62
Restaurant Data:					
Company-owned	**31**	30	29	28	27
Franchised	**52**	50	49	50	51
Total restaurants	**83**	80	78	78	78
Other Data:					
Weighted average shares outstanding** (in thousands)	**3,419**	3,390	3,363	3,350	3,342
Number of employees at year-end					
Full-time	**153**	167	140	139	137
Part-time	**468**	404	378	344	291
Total	**621**	571	518	483	428

Table 3
Consolidated Statements of Income

Years ended	October 29, 1995	October 30, 1994	October 31, 1993
Revenues:			
Sales:			
Commissary	$10,331,000	$10,817,000	$9,809,000
Restaurants	14,231,000	12,507,000	10,646,000
Franchise fees and royalties	1,210,000	1,172,000	1,171,000
	25,772,000	24,496,000	21,626,000
Operating costs and expenses:			
Cost of sales-commissary	7,497,000	8,211,000	7,610,000
Restaurant operating costs:			
Cost of food and paper	3,945,000	3,569,000	3,220,000
Payroll costs	4,266,000	3,629,000	2,942,000
Occupancy and other expenses	3,078,000	2,690,000	2,292,000
Selling, general and adminstrative	5,000,000	5,051,000	4,371,000
	23,786,000	23,150,000	20,435,000
Income from operations	1,986,000	1,346,000	1,191,000
Other income (expense):			
Interest income	92,000	93,000	96,000
Interest expense	(541,000)	(583,000)	(607,000)
Other income (expense)	(7,000)	(24,000)	21,000
	(456,000)	(514,000)	(490,000)
Income before income taxes	1,530,000	832,000	701,000
Provision for income taxes	550,000	300,000	270,000
Net income	$980,000	$532,000	$431,000
Net income per share	$0.29	$0.16	$0.13
Weighted average common and common equivalent shares outstanding	3,419,000	3,390,000	3,363,000

Table 4
Consolidated Balance Sheets

Years ended	**October 29,1995**	October 30, 1994
Assets		
Current Assets:		
Cash and cash equivalents	**$1,910,000**	$2,709,000
Accounts receivable	**1,074,000**	726,000
Inventories	**1,224,000**	1,043,000
Prepaid expenses	**121,000**	213,000
Deferred income taxes	**206,000**	198,000
Total current assets	**4,535,000**	4,889,000
Property and equipment, at cost:		
Land	**1,469,000**	698,000
Buildings and improvements	**11,451,000**	10,556,000
Equipment and fixtures	**7,409,000**	6,753,000
Construction in progress	**61,000**	52,000
	20,390,000	18,059,000
Less accumulated depreciation	**6,565,000**	5,183,000
Net property and equipment	**13,825,000**	12,876,000
Intangible assets-net	**501,000**	534,000
Other assets	**152,000**	124,000
	$19,013,000	$18,423,000

Table 4
Consolidated Balance Sheets

Years ended	**October 29, 1995**	October 30, 1994
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable	**$1,505,000**	$1,406,000
Accrued salaries and wages	**664,000**	1,032,000
Accrued interest	**65,000**	117,000
Income taxes	**101,000**	
Other accrued liabilities	**485,000**	398,000
	360,000	340,000
Total current liabilities	**3,180,000**	3,293,000
Deferred income taxes	**469,000**	387,000
Long-term debt due after one year	**6,100,000**	6,459,000
Shareholder equity:		
Common stock, no par value: 5,400,000 shares authorized; issued and outstanding, 3,345,000 shares	**5,267,000**	5,267,000
Additional paid-in capital	**19,000**	19,000
Retained earnings	**3,978,000**	2,998,000
Total shareholders' equity	**9,264,000**	8,284,000
	$19,013,000	$18,423,000

Table 5
Consolidated Statements of Cash Flows

Years ended	October 29, 1995	October 30, 1994	October 31, 1993
Operating activities:			
Net income	**$980,000**	$532,000	$431,000
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	**1,553,000**	1,373,000	1,399,000
Deferred income taxes	**74,000**	101,000	52,000
Amortization of stock award Compensation			84,000
Decrease (increase) in:			
Accounts receivable	**(348,000)**	403,000	11,000
Inventories	**(181,000)**	(504,000)	3,000
Prepaid expenses	**92,000**	41,000	(37,000)
Increase (decrease) in:			
Accounts payable	**99,000**	536,000	99,000
Income taxes payable	**101,000**		
Accrued liabilities	**(333,000)**	542,000	40,000
Other-net	**(27,000)**	(66,000)	(1,000)
Net cash provided by operating activities	**2,010,000**	2,958,000	2,081,000
Investing activities			
Capital expenditures	**(2,484,000)**	(1,537,000)	(1,845,000)
Payments for businesses acquired		(301,000)	(295,000)
Proceeds from sale of property and equipment	**54,000**	903,000	3,000
Decrease in unexpended bond proceeds			173,000
Additions to intangible assets	**(39,000)**	(47,000)	(19,000)
Net cash used by investing activities	**(2,469,000)**	(982,000)	(1,983,000)
Financing activities			
Repayments of debt	**(340,000)**	(315,000)	(300,000)
Net cash used by financing activities	**(340,000)**	(315,000)	(300,000)
Net increase (decrease) in cash and cash equivalents	**(799,000)**	1,661,000	(202,000)
Cash and cash equivalents at beginning of year	**2,709,000**	1,048,000	1,250,000
Cash and cash equivalents at end of year	**$1,910,000**	$2,709,000	$1,048,000

Table 7
Consolidated Statements of Shareholders' Equity

Years ended 10/29/95, 10/30/94, and 10/31/93.

	Common Stock		Additional		Unamortized	Total
	Number of Shares	Amount	Paid-in Capital	Retained Earnings	Stock Award Compensation	Shareholders' Equity
Balance, October 25, 1992	3,113,000	5,157,000	19,000	2,035,000	(84,000)	7,127,000
Amortization of stock Award compensation					84,000	84,000
Net income				431,000		431,000
Balance, October 31, 1993	3,113,000	$5,157,000	$19,000	$2,466,000		$7,642,000
Issuance of common stock	232,000	110,000				110,000
Net income				532,000		532,000
Balance, October 30, 1994	3,345,000	5,267,000	19,000	2,998,000		8,284,000
Net income				980,000		980,000
Balance, October 29, 1995	**3,345,000**	**$5,267,000**	**$19,000**	**$3,978,000**		**$9,264,000**

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