SPILLED MILK

When the Chicken Doesn't Deliver It's the Balance Sheet that Counts

by Gordon Yale

"With the discovery and playing out of every financial scandal, the financial press invariably runs post mortems about lessons learned which, invariably, never are," says the author. Nevertheless, some lessons learned when Boston Chicken laid an egg are offered here as a caveat to lenders.

By December 1995, Boston Chicken, the parent of Boston Market and Einstein Bagel restaurants, was laying golden eggs. With nearly 900 franchise stores, earnings exploded from $.06 per share in fiscal 1993 to $.66 per share for the year ended December 31, 1995. Shares, which had been initially offered to the public at $10 in 1993, commanded in excess of $33 in the company's 10.3 million share offering in late 1995, netting the company approximately $342 million just prior to year-end. Within months, fueled by record earnings and a stream of sanguine announcements, the company's share price climbed to an all-time high of $41.50, conclusively demonstrating that Boston Chicken's management was perhaps more facile at fricasseeing its investors and lenders than it was its chickens.

In fact, before the stock price began to collapse in the spring of 1997, Boston Chicken raised nearly $827 million of equity capital and $311 million from publicly offered notes as well as securing $300 million in senior debt from major money center banks. And despite some very disturbing disclosures in both the 1996 10 K and a prospectus that would eventually land Boston Chicken, its officers, underwriters, and auditors in court, the company raised an additional $287 million from the sale of convertible debentures.

What is most compelling about the Boston Chicken scandal is not the company's ability to conceal highly adverse disclosures from its lenders and shareholders, but Wall Street's mass suspension of disbelief. The simple fact was that Boston Chicken was not so much a franchiser of quality take-home foods as it was a high-risk lender to a small group of nondiversified, highly leveraged restaurant operators who had far less to lose and substantially less to gain

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than Boston Chicken did. In fact, much of Wall Street and thousands of its investors were apparently hypnotized by the company's income statement when they should have been paying attention to its balance sheet. Boston Chicken's SEC filings never concealed that the company self-funded almost all of its earnings, but the disclosures, until the spring of 1997, did conceal that a substantial amount of the company's receivables were a write-down waiting to happen.

Franchise Losses Aren't Chicken Feed

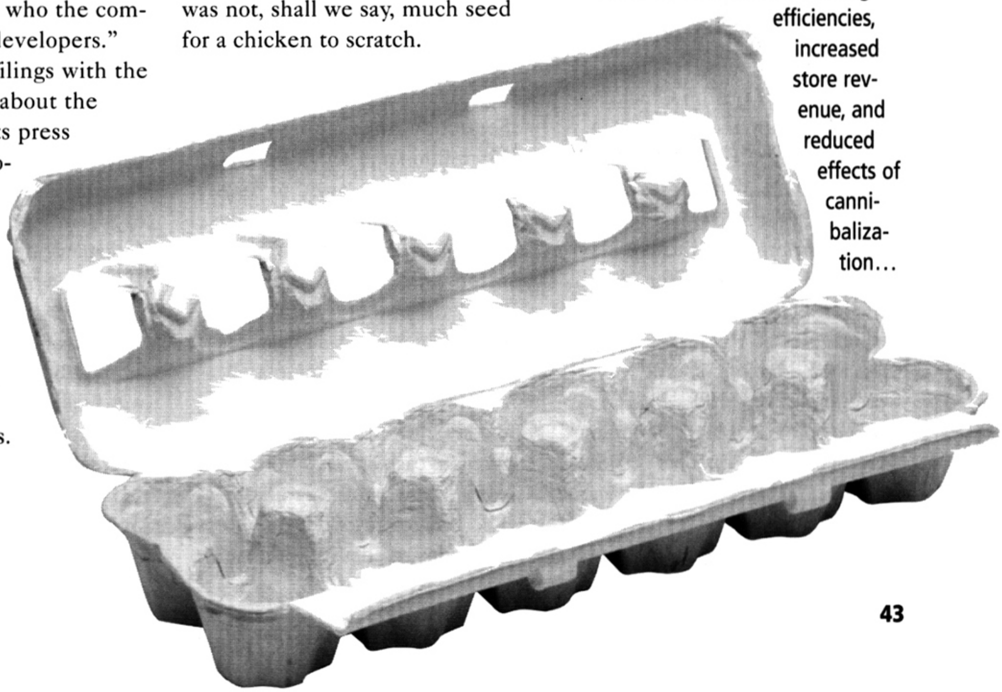
It was no secret to investment bankers, lenders, and investors that the very structure of Boston Chicken and its way of doing business made its balance sheet highly material to a proper analysis of the company. Almost from its beginnings as a public company, Boston Chicken's strategy was to raise debt and equity capital and, in turn, loan it to its franchise operators who the company called "area developers." Boston Chicken's filings with the SEC were explicit about the relationships and its press releases cock-a-doodle-dooed about the company's breakthrough strategy of financing that permitted area developers to operate restaurants instead of chasing lenders or investors. By the end of 1994, the company had notes receivable of $185 million and an additional $79 million of assets leased to others. Literally, its entire net worth was in the hands of its 15 or so area developers who were permitted to borrow up to 75% of their total capital needs from Boston Chicken. By the end of 1996, the company had nearly $1 billion of assets dedicated to area developers, slightly more than its net worth.

With this massive concentration of capital employed in more than 1,000 stores by the end of 1996, it would be reasonable to expect substantial disclosure in Boston Chicken's SEC filings concerning the profitability of the area developers and of its own company-operated stores. After all, large investments in relatively small, homogeneous, and not particularly well-capitalized businesses entail some risk and require detailed due diligence at the store and area developer levels. But until the release of the 1996 10 K in April 1997, there was not, shall we say, much seed for a chicken to scratch.

Cannibals Ate the Capital

In fact, disclosures in the 1995 10 K, released in March, 1996 were cryptic. Results of operations for the company-owned stores were not reported separately in the income statement, its footnotes, or in the narrative sections of the 10 K. As for the area developers, the 1996 10 K disclosed little more than the following:

> The area developers have incurred, and the Company anticipates that its area developers will continue to incur, substantial net losses during their expansion phase, which is anticipated to result, and in the majority of cases has resulted, in negative net worth. The Company believes that such losses can be recovered as the rate of expansion moderates by reduction or elimination of development costs, increased operational efficiencies as a result of post-expansion operational focus, greater economies of scale, increased advertising efficiencies, increased store revenue, and reduced effects of cannibalization…



Boston Chicken press releases clucked over the company's rapid expansion and its earnings growth, but said nothing specific about area developer losses, which totaled, in the aggregate, approximately $51.3 million in fiscal 1994 and a whopping $148 million in fiscal 1995. Such grievous losses left a number of area developers with negative net worth and made some of them largely dependent upon the company for fresh infusions of cash.

Two dynamics were at play here. First, the faster the company grew, the more impressive its earnings growth became because Boston Chicken's income statement was not burdened by its area developers' losses. With an increasing stock price and the quick build-up of what proved to be uncollectible receivables and phony equity, Boston Chicken fed at the trough of others people's money. That same rapid growth, however, produced a ravenous appetite for cash, not only to fund the construction of new units but also to cover the all-too-real cash losses being incurred at increasingly alarming rates. Net loan advances from Boston Chicken to its area developers were $156.4 million in fiscal 1994, $210.2 million in 1995, and would expand to $378.3 million in 1996.

What permitted these dynamics to continue was Boston Chicken's failure to provide any loss reserves on the loans or leases to its area developers. Not only were no area developer loss reserves provided in 1994, none were taken in 1995. This is somewhat curious, given even the vague disclosures in the 1995 10 K. In the calculus of audit and accounting standards, negative cash flows and negative net worth add up to a "going concern" qualification for a number of Boston Chicken's area developers. And it doesn't take a senior examiner to recognize some losses are likely from entities whose continued existence is imperiled.

The Chicken Comes Home to Roost

Nevertheless, Boston Chicken continued to grow rapidly in 1996. Earnings for fiscal 1996 were nearly $67 million, or $1.01 per share, up from $33.5 million, or $.66 per share a year earlier. Some 273 Boston Chicken and 266 Einstein Bagel stores opened in 1996—a record number of units. Nevertheless, those economies of scale and advertising efficiencies apparently had not yet materialized. The 1996 10 K, released in April 1997, quantified area developer losses for the first time. In the aggregate, Boston Chicken area developers lost $156.5 million and, in the aggregate, possessed negative net worth of nearly $103 million. Total Boston Chicken area developer debt to the company was $555 million and an additional $129 million was owed to third parties. Einstein Bagel area developers also were dependent on Boston Chicken for fresh cash.

By the end of fiscal 1996, Boston Chicken's cash balances had dwindled to approximately $101 million. During that year, Boston Chicken area developers' aggregate cash *outflows* from operations were nearly $129 million while Einstein area developer operations consumed an additional $16 million. Despite increasing debt to the company, persistent cash flow deficits and expanding negative net worth, Boston Chicken provided no loss reserves on almost $700 million of area developer receivables in fiscal 1996. Moreover, Boston Chicken's auditors issued a clean opinion and when the company announced 1996 earnings on January 28, 1997, the stock closed at $36, down $.75 for the day.

The 1996 financial statements also were contained in the April 1997 Prospectus for a $250 million convertible subordinated debenture offering. Disclosure in that document stated that Boston Market purchased several of its area developers and the now company-operated stores were generating positive cash flows of approximately 18.9% of sales. Such cash flows, however, did not include royalties, unallocated capital charges, income taxes and nonstore overhead costs. In other words, if area developer stores could manage themselves as tax-exempt organizations with no royalty obligations, they might generate some cash.

As alarming as the 1996 10 K and other disclosures were, Boston Chicken failed to report same-store data that demonstrated those elusive economies of scale and post-expansion operational efficiencies. A disparaging article in the March 1997 issue of *Esquire* and a series of unflattering pieces in *Fortune* and other financial publications were among the signs that Wall Street was finally catching on to Boston Chicken's game. It was a full year after the first disclosures in the 1995 10 K that area developers were losing an unspecified amount of money.

With the release of the 1996 10 K and the prospectus in April 1997, pressure on the company's stock began to build. By mid-April, the stock price had declined to $26, down from the 1997 high of $38, and the company added 100 basis points to the coupon of its convertible subordinated debenture offering to sell the issue out. On May 13, when Boston Chicken announced first quarter earnings had increased 33% over the prior year, the stock closed at $22 per share. By the end of May, the stock was trading at $18 per share.

The Chicken Is Flicked

Throughout the second and third quarters of 1997, Boston Chicken reported positive earnings, but at declining or negative rates of growth. Shareholders filed class action suits against the company, its officers and directors, and its underwriters and auditors in June 1997. The 1997 10 Qs provided no provision for area developer loan losses, but the stock price declined to less than $10 per share on Halloween, perhaps an indication that not everything in the Chicken's coop could be disguised as chicken salad. Then reality intervened.

In its 1997 10 K, released March 30, 1998, Boston Chicken reported a net loss of approximately $224 million, including a provision for loan losses of $128 million. These staggering sums amounted to $3.32 per share and halved the market price of Boston Chicken's shares to $5, about the price of a take-out dinner. Because Boston Chicken began reacquiring stores from its area developers, what would have been additional loan loss provisions were classified as general and administrative expense. Within five months of the release of the 1997 10 K, Boston Chicken filed for protection under Chapter 11 of the U.S. Bankruptcy Code. In addition, the key officers and directors and the underwriter have reportedly settled with the class action plaintiffs for an amount in excess of $20 million.

The Chicken's Nuggets—Some Food for Thought

With the discovery and playing out of every financial scandal, the financial press invariably runs post mortems about lessons learned which, invariably, never are. With that caveat, I offer a few of the lessons I believe should be learned from financial reporting frauds. In no particular order:

FINANCIAL ANALYSIS, COMPARATIVE ANALYSIS, AND UNDERSTANDING THE ECONOMIC, REGULATORY, LEGAL, AND FINANCIAL CONTEXTS OF YOUR CLIENTS IS ESSENTIAL TO GOOD LOAN UNDERWRITING.

1. **If it seems to be too good to be true, it often is.** Phar-Mor's purchasing power allowed the drugstore giant to consistently produce the highest profit margins in the industry. ZZZZ Best, begun by a teenage wunderkind, consistently generated the highest profits in the industry. Crazy Eddie's inventory was stated at the lower of cost or market. Your check is in the mail…
2. **It's the cash, Stupid.** As we have seen, net income without cash flows may not be net income at all. When profits are self-funded, focus on the balance sheet and your borrower's ability to realize cash from assets.
3. **Desperate people really do desperate things.** The declining financial condition of a company, the failure to comply with loan covenants, the inability to make earnings targets, and a host of other unpleasant business events can make Mr. Hydes out of the most well-meaning Dr. Jekylls.
4. **Compare, compare, and compare again.** The best Wall Street analysts aren't paid millions for nothing. Financial analysis, comparative analysis, and understanding the economic, regulatory, legal, and financial contexts of your clients is essential to good loan underwriting.
5. **If the pieces don't fit, the puzzle may be solved.** Trust your business instincts. If the transactions don't make business sense to you, or if you believe the transactions don't make sense to all the parties, then dig deeper into the transactions. Complex structures and convoluted transactions may be intended to conceal or confuse. ❐

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