The Winning Edge, Inc.

Case Analysis

Authors: Ben H. Nunnally, Jr. & Anthony Plath, Title: "Cases in Finance", 2nd Edition, 1997. Material is reproduced with permission of the McGraw-Hill Companies.

Mike Cramer was fit to be tied. He was screaming at his general sales manager, screaming at his executive assistant, and screaming into the telephone at his manager of executive travel. As founder, president, and CEO of The Winning Edge, Inc., a $60 million sporting goods retailer with sales outlets located in 42 states, you might think that Mike's flare-up would intimidate his staff. In fact, they were used to his sudden outbursts. When he was out of the office, the firm's headquarters staff quietly joked that you could tell when Mike was getting ready to blow by watching his ears. Whenever his blood pressure started to rise, the tips of Mike's ears would turn bright red and start to twitch. The angrier he became, the more they twitched. Yes, Mike was a hyperactive kind of guy, and The Winning Edge was a high-stress place to work.

As Mike slammed down the phone, none of the corporate officers in the room needed to check Mike's ears - it was quite clear that he was apoplectic. Here he was, he complained loudly to anyone within earshot, sitting at corporate headquarters in Amarillo, Texas, and he need to be in Peoria, Illinois in just three hours for the regional sales meeting. The executive travel manager just informed him that this was physically impossible because the next scheduled flight to Peoria wouldn't leave Amarillo until 9:00 the next morning. He'd just have to miss the manager's meeting at the Peoria Store - unless he chartered a private jet out of Amarillo. Unfortunately, chartered jets were tough to come be in Amarillo with little more than an hour's notice.

As Mike started to calm down, he began to realize that it might be a good time for The Winning Edge to consider a permanent change in the firm's corporate travel arrangements. At present, the firm's steadfast travel policy required all executives to fly coach on scheduled commercial airline flights - no chartered jets, no first-class upgrades, no ostentatious luxury. By 1993, however, the firm had grown to include retail locations spread across the better part of the continental United States, and most stores were located in modestly populated states like Iowa, Wyoming, Utah and Arkansas. Trying to reach the far-flung corners of the corporate empire using commercial airlines was becoming a logistical nightmare, and The Winning Edge's executives were wasting far too much time sitting in airports waiting for connecting flights to their final destinations.

While Mike had an excitable personality, he was also fairly astute business manager. He realized that corporate jets were quite expensive, and until recently, The Winning Edge had been unable to justify such an extravagant purchase. On days when the plane sat parked at the airport, the firm would have to pay its full-time flight crew anyway. When the chief pilot got sick or the plane went into the shop for maintenance, managers would still have to resort to commercial airline flights. Even worse, Mike knew that the no-nonsense institutional investors who owned a large block of The Winning Edge's common equity would take a dim view of pampered managers flying in corporate luxury at their expense. This thought made Mike's ears twitch.

Still, he realized that it was vital for the headquarters staff to communicate regularly with retail managers in the field, and more often than not, the best way to communicate was a face-to face meeting. After all, the store managers needed to know when the boss was unhappy, and you couldn't see Mike's ears twitch over the telephone. To accomplish these site visits, Mike and his senior management staff were spending an increasing amount of time in the air. Table 1 provides a summary of current travel statistics at The

Winning Edge, showing that executives made 48 round-trip flights from the Amarillo headquarters during the year. Even with careful efforts to reduce executive travel, airline usage at The Winning Edge was growing by 5 percent each year. Table 2 summarizes the firm's expected travel plans in each of the next 10 years.

Upon further investigation, Mike was able to assemble all of the travel cost and pricing data shown in Table 1. At this point, he was sincerely interested in establishing a new corporate travel policy for the coming decade at The Winning Edge. The change would be difficult because the various options confronting him were somewhat technical and not directly comparable to one another. Moreover, Mike's ears began to twitch when he remembered that the Winning Edge just spent $250,000 in the previous fiscal year to revamp the way the firm managed executive travel, adding expensive computer hardware and a proprietary software scheduling system to help coordinate the busy executive travel schedule at the firm. Changing the corporate travel policy at this junction would most likely make the firm's recent investment obsolete.

In spite of this potential loss, Mike felt it was time for a change. The software management system was simply not able to keep up with the frenetic schedule of The Winning Edge's executives, and the headquarters team needed to spend more time in the field. After reviewing his options, Mike identified three alternative courses of action he would consider:

1. Contract Flight Time on Commercial Carriers

This option would require the smallest change to The Winning Edge's current travel policy. Executives would continue to fly coach on scheduled commercial flights, but under a series of annually renewable contracts with a major domestic airline. The Winning Edge's average ticket price would be $1,000, and first-class upgrades would be available for an additional $300 per ticket. The frequent flier discounts shown in Table 1 could be used to reduce both of these fares. However, ticket prices were subject to annual price increases under the terms of the contract.

Even worse, The Winning Edge would be required by the airline holding the contract to book reservations at least three business days in advance of the intended departure date, and the firm's executives would be required to make all connecting flight arrangements through the same carrier. This final limitation meant that The Winning Edge's traveling executives could look forward to an average delay of four hours per round-trip flight as they awaited connecting flights in airport terminals. In addition, the firm would need to continue staffing the executive travel manager's position to coordinate executive travel arrangements. Given these drawbacks and the cost uncertainty associated with annual ticket price increases, Mike viewed this option as the most risky solutions to the firm's travel woes.

2. **Private Aircraft Purchase**

As a second alternative, The Winning Edge could purchase a new Cessna Citation II corporate jet for 2.5 million. With a range of 1600 nautical miles on a full tank of gas, the corporate jet could reach each of the retail stores without the need for intermediate refueling. The plane would have a 10 -year useful life at the Winning Edge, and would be depreciated on a straight-line basis over an 8-year period toward a 20 percent salvage value. At the end of its ten year service life, Mike was assured that the plane would easily bring a price of $325,000 in the used aircraft market.

Unfortunately, jet ownership would require the Winning Edge to bear the costs of hiring a flight crew and maintaining the airplane. Table 1 detail the fixed and variable operating cost estimates of jet ownership, as well as the forecasted annual price increases associated with these costs. There were a few advantages provided by these options, however. By purchasing the plane now the Winning Edge would avoid any price increases associated with the rising price of jet aircraft over the next decade. In addition, a corporate jet would eliminate practically all of the "dead time" that the firm's executives were spending in airports. Even better, the plane would be available on a moment's notice, so Mike could get from Amarillo to Peoria with little advance planning. Finally the Winning Edge would no longer need an executive travel manager to coordinate and manage executives' travel plans. The more Mike considered this possibility, the better it looked. He rated it the lowest risk alternative of the three options.

3. **Corporate Aircraft Time Sharing**

A third and final option offered an intriguing possibility for the Winning Edge. For just $630,000, the firm could acquire a 25 percent ownership interest in a Citation II from Jet Share, Inc., a Fort Worth firm providing corporate clients with the time shared use of aircraft. The Winning Edge would share ownership of the jet with other firms, and the company executives could have exclusive use of the plane for flights anywhere in the continental United States with just two hours advance notice. The Winning Edge would be charged $1,060 per hour of flight time for direct operating expenses, and the firm faced fixed costs of $134,580 in each year of the time-shared contract. Each of these costs would remain constant for the duration of the timeshared contract.

The good news was that The Winning Edge could depreciate its ownership share of the plane on a straight-line basis over the five-year term of the time share contracted toward a 20 percent salvage value. At the end of the contract, Jet-Share would repurchase the plane at its book value, and establish a new five-year time share contract using a new plane. In addition, with only two hours advance notice required for departures from Amarillo, the executive travel manager's position at The Winning Edge could be eliminated. The Bad news was that the replacement time-share contract would carry prevailing market prices, and The Winning Edge would bear the risk of price increases for new aircraft, as well as aircraft operating expenditures, after just five short years. According to Jet-share's promotional literature, customers could expect these prices to increase on average by about four percent (4%) each year.

Given the novelty of the time share contract and the fact that Jet Share didn't have much of a track record, Mike was a little hesitant to endorse this option. At the same time, this plan required virtually no connecting flights, and offered greater price protection than the contract arrangement with a commercial airline. All things considered, Mike rated the risk level of this option higher than the aircraft purchase option, but lower than the contract option with a commercial carrier.

With all the facts on the table, it was time to get them organized and make a decision. The Winning Edge had enjoyed five years of steadily rising sales and profits, yet the firm's managers were not comfortable making multimillion-dollar capital acquisition at the drop of a hat. In addition, Mike always worried that a corporate jet might be viewed by outside directors and shareholders as an unnecessary extravagance. Most certainly, travel by private jet would provide first class accommodations for the firm's management team, and the corporate travel policy had always required the austerity of coach flights, even for Mike.

Finally, Mike realized that he could ill afford to disappoint the board with an inappropriate capital expenditure. Just last month, they gently but firmly admonished him to treat his employees with greater respect and control his temper. The board was clearly satisfied with the sales and profit growth The Winning Edge enjoyed under Mike's leadership, but privately many board members were beginning to express reservations that the financial end didn't necessarily justify the management means. As Mike retired to his office to consider his options, he realized he needed to make a decision - but more importantly, he needed to make the right decision.

Table 1
The Winning Edge, Inc.
Corporate Travel Statistics

I. Executive Travel Summary

Average round-trip flights per year (based on current fiscal year)	48
Average time lost awaiting flight departures (per round-trip flight)	4 hours
Annual growth in executive travel (percentage of flights per year)	5%
Average airtime per round-trip flight	4 hours
Average number of executive travelers per trip	4

II. Commercial Airline Cost Data

Average ticket price (round-trip; coach)	$1,000
Average frequent flier discount available to coach passengers	$200
Average ticket price (round-trip; first-class)	$1,300
Average frequent flier discount available to first-class passengers	$200

III. Internal Travel Costs

Executive travel manager (annual salary)	$40,000
Executive travelers (average annual salary per person)	$208,000

IV. Jet Aircraft Ownership Costs (Cessna Citation II)

Acquisition cost	$2,500,000
Range (nautical miles)	1600
Passenger seating capacity (excluding crew)	7

Direct operating cost summary (per hour of flight)

Fuel	$400
Crew	$250
Maintenance	$167
Total direct operating costs	$817
Annual Fixed costs	$204,528

Table 1
(continued)

V. Projected Annual Price Increases for Travel-Related Expenditures (%)

A. Salaries:	
Travel Office Personnel	4%
Flight Crew	6
Executive Travelers	8
B. Commercial Air Fares	
Coach Tickets	6
First-Class Tickets	6
C. Capital Expenditures	
Jet aircraft prices	3
Fuel costs	8
Maintenance costs	5
Fixed expenses	4
Capital costs	3

VI. Risk-Adjusted Corporate Capital Costs (after-tax)

Low-risk projects	7%
Average-risk projects	10
High-risk projects	14
Corporate tax rate	40

Table 2
The Winning Edge, Inc.
Executive Travel Forecast

	Year									
	1	2	3	4	5	6	7	8	9	10
Number of round trip-flights	50	53	56	59	62	65	68	71	75	79