George Bailey had to make an important business decision. Should he quit his job with a food processing company and go into business himself by starting a chain of bagel shops? After graduating in 1991 with an undergraduate business degree with a minor in economics, he had joined a food processing company and spent two years learning the business of selling a product line of bakery goods to supermarkets and small bakery shops in the Madison and Green Bay, Wisconsin markets.

As 1993 drew to a close, George noticed that a few of his accounts were beginning to carry bagels as a takeout item. Not only did George like to eat bagels, he began to think that bagels had the potential to become a mass-market item penetrating the breakfast and lunch trade. He thought that he could make profits by opening several bagel stores in and around the Madison, Wisconsin metropolitan area. He talked to several of his close business associates about his proposed venture. Some didn’t know what he was talking about, not being familiar with bagels, and others thought that bagel idea had limited potential outside of New York City and a few other East Coast markets. They couldn’t see a market for bagels developing in the Madison area, or for that matter, in the more conservative Midwest and thought that bagels would always remain an ethnic food with limited potential. Many of his friends thought that George was foolhardy to start a chain of bagel stores. They argued that the bagel industry was an easy entry industry and anyone could come into the market. As one of his closest college friends warned him, “You’ll never make profits in an easy to enter market. You’re better off staying with your current employer until a better business prospect comes along.”

George came from a family of entrepreneurs. His father had had a successful business career by starting a variety of business ventures. He encouraged George to strike out on his own and said to him, “You’ll never become rich working for someone...
George Bailey was willing to supply equity when George came up with a reasonable business venture. After two years learning the ropes, George was becoming restless working for the food processing company and thought that he had learned as much as he was going to learn staying with the company. The more he thought about his proposed venture, the more convinced he became that a well-run bagel chain would be success. He had learned that bagels are produced with flour and a high-speed spiral mixer. After the dough is mixed, the bagels are formed in machines. The last step is to either boil the bagels in kettles or steam them in ovens to give the bagels their finished look. The kettles and the ovens are readily available from suppliers.

Not only were bagels cheap, but they were nutritious. George had read about the nutritional benefits of bagels and believed that youthful consumers were becoming more and more concerned about what they were putting in their stomachs. He believed that more American consumers would be looking for low fat, no cholesterol alternatives to more traditional breakfast and lunch. Madison seemed to be the ideal market to enter because there were many young consumers attending the University of Wisconsin in Madison, and it was the state capital with many college-trained state government workers. Even though most of his friends thought that he was taking too much of a risk by going into bagels, George did not let this bother him and took this overwhelming negative assessment as a positive signal. If most of his potential rivals thought similarly, it would mean that few would come into the industry, at least for a time, if they thought that bagels were a fad at best. In the meantime, he felt he could rack up some impressive returns even though the industry was an easy entry industry. Of course, all this depended on bagels becoming a mass market item and not remaining an ethnic food.

George contacted the American Bagel Association and took an East Coast trip to talk to owners of bagel shops in New York City to obtain more information about operating a bagel chain and the growth prospects for bagels. From his conversations, he found little publicly available data about bagel consumption. The ABA estimated that bagel consumption per person was 14.2 bagels in 1993, and they predicted that it would grow rapidly, perhaps by 100 percent by 1996. George had some reservations about the 1996 prediction since it seemed to be based on a crude extrapolation rather than a systematic model. If the 1993 figures were correct, some consumers were already eating bagels. The question remained whether the market would grow by still more and whether the demand for bagels would expand into mid-western markets and in the Madison market in particular. George felt that growth in the bagel market was critical for the success of his business venture. He talked to some owners already selling bagels in other markets and found them optimistic. They anticipated growth rates of 30 percent per year and didn’t think that new entrants would become a major problem because of the 30 percent growth rate in market demand. Some didn’t think that new entrants would come into the market in large enough numbers to create serious price competition until 2000 or beyond. Many were convinced that 30 percent annual growth rates would be a harbinger for still more profits.

1994 – 1996: BOOM YEARS FOR BAGELS

George Bailey entered the bagel business in March of 1994 when he opened his first store. By the end of 1996 he had expanded to a 10-store chain. Each store offered take-out or sit-down service. Each store sold a variety of bagels as well as specialty coffees, cream cheeses, and sandwiches. From the beginning, the stores were a hit, especially with the young crowd, with same store sales growing by an average of 30 percent per year. Students and young college-trained office workers frequented his stores just as he had forecasted. In July 1996 he received an offer from a larger bagel chain to buy his ten stores. If he accepted the offer, his original investment would be
worth 50 percent more. George brushed off the offer because he thought there was still substantial potential left in the bagel market. He felt vindicated. His expectations about the growth prospects of the bagel market had been correct. He thought that prospects for the next three years were bright. George even began toying with the idea of expanding his chain. He felt that he had little to worry about as long as the market for bagels continued to grow at 30 percent per year. As George was fond of saying, “Growth solves many problems.”

As market demand for bagels expanded between 1994 and 1996, it began to attract the attention of new entrants. More bagel chains entered the market. The booming sales of bagels convinced many skeptics that bagels were not simply a fad. Among the early regional entrants into the industry were Bruegger’s Corp., Manhattan Bagel, Einstein Bros., and Big Apple Bagel. By 1996, even Dunkin’ Donuts, the world’s largest coffee and donut retailer, joined in when it announced a $25 million investment with the goal of becoming the leading bagel seller. It planned to have all of its 3,150 shops equipped with bagel ovens by 1999. The American Bagel Association reported that in 1996 bagel store sales were $2.7 billion, up from $670 million in 1994, and bagel sales were expected to hit $6 billion in 2000. By one estimate, the whole bagel market grew by 35 percent from 1995 to 1996, and continued growth rates between 20 percent and 30 percent per year were expected. The ABA reported that bagel consumption per person increased from 14.2 bagels in 1993 to 26 bagels in 1996, an 83 percent per capita gain over three years. Clearly, George’s prediction had been correct. Bagels were no longer an ethnic food but were on the way to becoming a mass-market breakfast and lunch convenience item.

1997: A FATEFUL YEAR FOR GEORGE’S BAGEL CHAIN

In spite of these rosy forecasts, 1997 started out on a disturbing note. Same store sales of George’s chain grew by only 15 percent over the first quarter of the previous year. Competitors began to enter the market by opening new bagel stores in the Madison market area, and same store sales of his ten-store chain grew by only 10 percent in the second quarter over the previous year. Nationwide, the number of bagels outlets increased from 1,000 in 1995 to 6,000 in 1997, and George saw the same disturbing trend developing in the Madison market area. George’s outlets charged 50 cents for a plain bagel. The newer chains came in with a 45 cents per bagel price. George believed that his customers had become accustomed to the friendly and fast service at his stores and would remain loyal and be willing to pay a 5-cent premium price. Quickly, he found that the takeout trade was very sensitive to price, much more than he expected. As his stores lost volume to the recent entrants, George realized that he could not maintain a 5-cent premium price. Reluctantly, he eliminated the premium by matching the price of his competitors on all of the more popular bagels. Profits declined with the price reductions.

The rapid entry of competitors took George by surprise. He had realized entry by rivals would occur eventually but did not expect it to take place until 2000 or 1999 at the earliest. Several market analysts at investment banking firms reported the total market was still growing by 30 percent per year. But George’s chain was not. With more outlets selling bagels in the Madison market, George’s stores could not be as profitable as they were in the 1994–1996 period. Although George was an optimist at heart, perhaps his business associates had been right to say, “You can’t make profits in an easy entry industry”. He began to think that the time had come for him to sell out. Reluctantly, he concluded that his wonderful, if daring, bagel experiment was over. By the end of 1997 George received another but reduced offer to sell his ten store chain. If he accepted the offer, his equity would be only 22 percent higher than his original
investment. Clearly, 1997 was not the banner year that George had anticipated. In December 1997 he accepted the offer and sold his chain to a larger bagel chain.

What had happened to George's chain of ten stores was a microcosm of what was happening in the industry. Even though market demand was continuing to grow by 30 percent per year, the firms in the industry were earning lower profits and some were reporting losses. Up to late in 1996, the bagel market was so hot that bagel chains were going public by selling their shares to finance their growth. Then, stock prices of bagel retail chains nose-dived. New York Bagel, a bagel retailing chain, went public in 1996, and its stock was first quoted at $9.375 per share in September 1996. By June 1997, its stock was trading at $4.25 a share. This stock price decline suggests that the stock market is predicting lower future profitability for bagel chains. Table 1 shows that New York Bagel was not an isolated example. The stock prices of other bagel franchising firms fell over the same period, some by even larger percentages. In contrast, the S&P 500 stock index and the Russell 2000 stock index, a stock index of smaller companies, increased between 1996 to 1997.

**Table 1: Price per Share of Selected Bagel Chains, 1996 - 1997**

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**1998: CRANBERRIES: A NEW OPPORTUNITY**

In September 1998 George received a telephone call from his uncle. His uncle owned a series of cranberry peat bogs in northern Wisconsin. He told George that another bog owner was retiring and planned to sell his land. He thought that this could be a great opportunity for George because peat bogs do not come up for sale often. Because of the limited supply of land, he thought that there would be considerable interest in the property. George was surprised by the call and exclaimed that he knew little about peat bogs or how to grow cranberries. His uncle said that George could learn the business fast. In the meantime, George could hire the experienced manager who currently ran the cranberry farm until he learned the ropes. George said that he would research the market and get back to his uncle soon.

George reviewed several USDA publications to determine how fast the market for cranberries was growing. Figure 1 shows domestic production of cranberries in millions of barrels per year from 1976 to 1997. Production had steadily increased, rising from less than 2.4 million barrels in 1976 to slightly more than 5.5 million barrels in 1997. One requirement for growing cranberries is the availability of sandy peat soil along with low cost water. Water was used intensively when harvesting the cranberries. Because sandy peat soil is not readily available in supply in most parts of the country, most cranberries are produced in only a few states, such as Wisconsin,
Massachusetts, and New Jersey. The growth rate of the industry has not been as spectacular over the last decade as that of the bagel industry, but the cranberry's industry's steady growth could not be ignored. What impressed George even more were the higher prices those cranberry growers received in each of the last three years. Figure 1 shows that the price received by growers had increased from less than $40 per barrel in 1976 to more than $67.90 per barrel in 1997. In the last three years, the price received by growers had set successive records rising from $50 per barrel in 1994 to $67.90 per barrel in 1997, a 36 percent increase in the last three years.

Figure 1: Production and Price per Barrel of Cranberries

There appears to be several reasons for the higher prices. Ocean Spray, the industry leader, and others were successfully introducing more sweetened mixed cranberry drinks such as cranapple and cranrasberry, as well as a slew of cranberry snacks that have been favorably received by younger consumers. Some medical studies indicate that cranberries, as part of a nutritious diet, can help prevent urinary tract infections. Thanks to the favorable reception of these new drinks and snacks, cranberry consumption no longer peaks during Thanksgiving but is now spread out over the year. Average annual production increased by 107 percent from 1976-1978 to 1995-1997, or by an average of 5.6 percent per year. In 1997, harvested acreage set a record of 35,500 acres. With record cranberry prices, more growers were converting their land from the production of other crops to cranberry production, an expensive conversion requiring three to five years. In addition, water policy and environmental concerns about polluted water runoff from farms have made it more costly to develop new bogs in some states.

George was intrigued by the opportunity. He was impressed with the sharp rise in the price that growers had received in the last three years. If he could get into the cranberry market now, and if the market continued to grow, he felt that the land he would own would continue to appreciate. He could earn a hefty capital gain. George reasoned the prospects for a capital gain looked good because there was not a lot of sandy peat acreage available. He had talked to several growers in Wisconsin and they
thought that they could sell their land at higher prices now than 3 years ago. They had heard rumors of higher land prices in Massachusetts and New Jersey. The limited supply of sandy peat bogs meant that rivals would have difficulty entering the market. Because of this, George reasoned that he would not face the stiff price competition that his bagel stores faced in the Madison market when rivals entered the market. With less to fear from entry, George might be able to make a go of it.

However, would prices continue to rise? He remained troubled by the slower growth rate in market demand for cranberries. He still liked to invest in fast growing industries because he firmly believed that growth overcomes many problems.

As 1998 came to a close, George Bailey was about to make another important but difficult business decision. Should he risk entering the cranberry market with the uncertainty over its future growth prospects? If he did not enter now, when would another opportunity to buy a cranberry farm come up again?

**STUDY QUESTIONS**

1. Economists classify competitive industries with (1) a horizontal long run supply curve (a constant cost industry), (2) a upward sloping supply curve (an increasing cost industry), or (3) downward sloping long run supply curve (a decreasing cost industry). In which category would you put the bagel industry? The cranberry industry? Explain your selections.

2. What is the key disagreement between George and his associate, who said “You’ll never make profits in an easy to enter market”? What difficulties do managers face in adopting an “enter early - earn profits – exit when rivals enter?”

3. In the case, George said, “Growth solves many problems.” What problems was George referring to? Does it matter if demand growth is anticipated or unanticipated?

4. How would you explain the stock price behavior of bagel chains up to the last quarter of 1996? In 1997?

5. Since land prices appear to be increasing in the last three years, would you expect growers like George will earn profits if they enter the cranberry industry?

6. If you were in George’s shoes, would you enter the cranberry market? Explain why or why not.