Smithfield Motors: A case in lending, strategy, and value

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ABSTRACT

The primary subject matter of this case is financial statement analysis. Issues examined include analysis of risk, pro forma statement construction, business valuation, strategic planning, and small business growth. The case has a difficulty level of three to four, appropriate for junior or senior level. The case is designed to be taught in 2 to 3 class hours and is expected to require 4 to 6 hours of outside preparation by students, depending on their level of understanding of financial statements.

This case describes the lending relationship between an independent car dealership and a community bank. It describes a series of loan renewals and credit requests over a three year time period. Smithfield is a successful business with significant growth, but this growth also poses some issues for bank. The case is designed to be used in three parts, with new issues presented in each which demonstrate how lending relationships change over time. Part 1 can be used as a stand-alone introductory lending case, or it can be easily incorporated into part 2 for a slightly more advanced stand-alone case. Alternatively, the cases can be assigned in order to provide students a progression in dealing with a single client. Students learn how to present and analyze financial statements and how credit risk changes over time. They also develop an understanding of the complexities of pro forma statements.

Keywords: Banking, Lending, Financial Statement Analysis

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PART 1: LOAN REVIEW

Current Date: January 2013

Smithfield Motors is a used car dealership that has operated in Webster, TX for the past five years. Smithfield is a Limited Liability Partnership, equally owned by David Smith and Roger Field. David and Roger worked for about 10 years a local Ford dealership, where they were consistently top salesmen. They then decided to open their own dealership specializing in late model, low mileage, high quality used vehicles. The have been renting a 40,000 square feet sales lot close to the town square for $1500 per month. Roger and David are the primary salesmen. They also hired an office manager to handle title transfers, take credit applications, and complete other office duties. Their staff also includes a part time sales person. The combined salaries of their two employees are $55,000.

First Bank of Webster (FBW) works with Smithfield in two main areas. First, Smithfield maintains a line of credit with FBW that they use to purchase cars at auctions or through other channels. When a car is sold, the line is paid. Collateral for this line is the inventory of cars, for which the bank holds the physical titles. Titles are not actually put in the bank's name because that would delay the selling process; the bank simply holds all titles until the car is sold. Therefor, a car cannot be sold without the bank giving the title back to Smithfield. Roger and David maintain an inventory of around 30 cars, and the line currently has a limit of $400,000 which has been increased several times over the past 4 years as the business has grown. The line is also personally guaranteed by both owners.

The bank also benefits from the relationship with Smithfield by providing a large portion of the car loans to their customers. FBW is the primary lender to which they send their customers' credit applications, and the bank processes on average about 15 to 20 new car loans per month from Smithfield. Since they sell higher quality used cars, this has been a profitable business for the bank with very few losses on loans. On the rare occasion that a car is repossessed, Smithfield will sell the vehicle for the bank on their lot at no charge.

Roger and David use a local accountant to prepare their annual statements, and provide a copy to the bank each year (see exhibit 1). Sales have been increasing each year the company has been in business. In a recent meeting with the owners, they shared their thoughts on current operations and plans for the near future. Their current goal is to sell 30 cars per month, while also averaging an inventory of 30 cars. The average sales price varies, but is currently around $20,000. They try to make a gross profit of $1500 per sale, which is up from $1000 per vehicle over the past few years. In 2012, they began to try to increase the average sales price per vehicle and the gross profit per sale. They have also requested an increase in their line of credit to at least $450,000, but would rather see it increased to $500,000 so they can have more flexibility in expanding inventory as needed. They have never been late with a monthly interest payment.

Assignment Part 1: Loan Review

Part 1 of the case allows students to begin the financial statement analysis process by the construction of common size and year-over-year statements, as well as a statement of cash flows. By assigning students the role of bank lender, they will have the opportunity to see risk from the point of view of creditor rather than owner. Sample assignments and discussion questions are listed below.

Financial Statement Analysis

Using the financial statements provided by the owners, construct balance sheets and income statements for 2009 to 2012, using raw numbers, common size, and year over year growth. Also construct cash flow statements for 2010 through 2012, and perform a ratio analysis of the company for 2009 to 2012.

Questions for Discussion

1. What are the strengths and weaknesses of this credit request?
   Strengths:
2. How big of a concern is the net loss for 2011?
3. How much does it appear the owners initially invested in the business?
4. How much did the owners pay themselves in salary in 2012? What are your thoughts on this amount? How do you think this amount is determined?
5. Do their comments about their gross margins match their financial statements? Are their projections for increased margins realistic?
6. Do you have any concerns with the collateral or the current process of holding titles?
7. What other issues should be addressed; what questions do you have for Roger and David?
8. Based on the analysis, would you recommend renewing/increasing the line of credit?

PART 2: BUILDING PURCHASE & LOAN REQUEST

Current Date: Late January 2013

This case describes a loan request of Smithfield Motors and builds upon Part 1, with the assumption the line of credit was increased to $500,000.

You have just met with the owners of Smithfield Motors to sign the paperwork for their loan renewal. During the meeting, the indicated they would like to purchase a lot and small building along a feeder road next to the interstate that runs along the edge of town. They would like to move from their rented lot to this location and believe the better visibility will improve sales, plus they can build more equity in the business by owning rather than renting. The purchase price is $250,000, and they will need to add about $50,000 in improvements to suit the lot and building to their needs.

They would like to borrow the full amount and set up a loan for a 20 year repayment. However, bank loan policy calls for at least a 20% down payment. If approved, the loan would be amortized on a 20 year basis, with equal monthly payments. The initial rate would be 7% to be adjusted annually.

With the larger lot and improved visibility, they believe average monthly vehicle sales will increase from the current volume of 30 vehicles per month to a target of 35 to 40 vehicles per month (a 20% to 25% increase). The new facility will also allow for continued growth over the next several years. Initially, they will keep the target gross margin the same, until the new location has been established and sales grow. They then plan to boost the margin as well. Operating expenses other than cost of goods sold should be about the same in 2013 as they were in 2012, with the exception of advertising which will increase to about $30,000 to promote the new location.

Concerning the balance sheet, inventory will increase about 20%, but other current assets (other than cash) will remain about the same. Liabilities other than the new bank loan will also remain about the same.

Part 2: Assignment - Building Purchase and Loan Request

Part 2 of the case give the students an opportunity to evaluate a new project (real estate purchase) that a business is considering. Students prepare pro forma financial statements based on the information gathered from the business owners, while also making some assumptions on their own. They see the relation between the financial statements on a deeper level as they prepare and balance each statement. One point of discussion is how much faith we put into projections of the owners. We also discuss the importance of long term strategic planning and attempt to predict what future credit needs may be.

Financial Statement Analysis

Using the past financial statements provided by the owners and the information above, prepare a projected common size balance sheet, common size income statement, cash flow statement, and ratio analysis.

Questions for discussion:

1. Do you have any additional questions for the owners?
2. What assumptions did you make in your preparation of statements?
3. What are the strengths and weaknesses of the credit?
4. What collateral is available for this loan?
5. How will this purchase and loan affect the balance sheet?
6. Will their current line of credit be sufficient for the expansion?
7. Is buying the new lot a building a good move for the business?
8. Should you grant the loan request? If so, what should be the amount of the loan? What is a potential source of the down payment?

PART 3: PARTNER BUYOUT

Date: January 2014

Smithfield Motors had a very successful 2013, surpassing expectations of the owners. They acquired the new lot in January of 2013, and were up and running by late February. Total costs of acquisition and modifications to the land were $312,000. The bank loaned $240,000, each owner contributed $20,000, and the remaining $32,000 was supplied by cash in Smithfield's account. As the financial statements show, sales and profits were even better than projected expected for 2013 (exhibit 2). Income was so good, in fact, that the owners paid themselves each a $100,000 bonus, which is reflected in the increases in salaries.

Despite the success of the business, Mr. Smith has decided he would like to get out of the hectic car sales business and pursue other interests. He realizes that a successful business has value, so he would like Mr. Field to pay him for his half of the business which he helped to create. Smith believes the business will generate profits (excluding owner salaries) of at least $200,000 per year. Smith is familiar with some basic finance principals, and he believes a fair way to value the business is to discount the profits over the next 10 years back to today's value at a 10% discount rate. His figure is about $1.2 million for the value of the business, so he would like to be paid half of that amount, or $600,000.

Roger Field actually thinks this is a good idea. He believes he is the better salesman and business manager of the two and could run the business just as well by himself. He will have to hire another salesman at $50,000 per year, but total salaries will decrease to about $350,000. He believes that total sales will be at least as good in 2014 as there were in 2012, while the gross profit margin will be the same percentage as 2013. Other operating expenses will be about the same for 2014 as 2013. No significant new asset purchases are planned for 2014. Field has come to you to explain the situation and request a loan of $600,000.

Part 3: Assignment - Partner Buyout

The final part of the case deals with the issue of a partner buyout. We are not given a complete reasoning for the requested departure of one of the owners, so again we make assumptions and discuss possible solutions. The main factors from the point of view of the lender are the weakening balance sheet and lack of equity in the firm, while cash flow remains very strong. We discuss our options for the bank, and while we cannot force the partnership to continue, we do not have to allow the departing owner to simply walk away from his obligation.

Financial Statement Analysis

Using the past financial statements provided by Field and the information above, prepare a projected common size balance sheet, common size income statement, and ratio analysis for 2013 actual numbers and projections of 2014. Also prepare a cash flow statement for 2013 and projected cash flow statement for 2014.

Questions for discussion:

1. Overall, how would you compare to Smithfield's actual performance for 2013 to the projections completed in the last case? What caused cash flow to be so much better than the projections for 2013?
2. What are your thoughts on the valuation of the business? Is the method valid? Are there any suggestions you would make?
3. What are your main concerns of this request?
4. What collateral is available for this loan?
5. What other issues should be addressed; what questions do you have for Mr. Field?
6. What would happen to the business if the loan request is denied?
7. Should you grant the loan request? If so, what should be the amount of the loan?

Exhibit 1: Financial Statements, Parts 1 and 2

Balance Sheet

Period Ending	**12/21/2009**	**12/31/2010**	**12/31/2011**	**12/31/2012**
Current Assets				
Cash and Equivalents	8,863	22,977	1,053	3,770
Short Term Investments	0	0	0	0
Net Receivables	23,521	25,684	22,856	32,651
Inventory	242,560	289,234	424,650	428,620
Other Current Assets	4,574	5,684	6,254	7,126
Total Current Assets	279,518	343,579	454,813	472,167
Gross Fixed Assets	10,000	10,000	15,000	15,000
Less: Depreciation	4,000	5,000	11,000	12,000
Net Property Plant and Equipment	6,000	5,000	4,000	3,000
Intangible assets	0	0	0	0
Other Long Term Assets	0	0	0	0
Total Long Term Assets	6,000	5,000	4,000	3,000
Total Assets	285,518	348,579	458,813	475,167
Current Liabilities				
Accounts Payable	1,200	1,560	1,420	2,350
Line of Credit	225,840	274,630	386,520	395,680
Income tax payable	0	0	0	0
Other Current Liabilities	5,230	4,215	6,985	5,642
Total Current Liabilities	232,270	280,405	394,925	403,672
Bank Loan	0	0	0	0
Long Term Debt	0	0	0	0
Total Liabilities	232,270	280,405	394,925	403,672
Capital Stock	50,000	50,000	50,000	50,000
Retained Earnings	3,248	18,174	13,888	21,495
Total Stockholder Equity	53,248	68,174	63,888	71,495
Total Liabilities and Stockholders Equity	285,518	348,579	458,813	475,167

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Income Statement

Period Ending	**12/21/2009**	**12/31/2010**	**12/31/2011**	**12/31/2012**
Sales	2,910,720	3,470,808	5,359,200	6,048,000
Cost of Goods Sold	2,668,320	3,185,952	5,031,600	5,571,000
Gross Profit	242,400	284,856	327,600	477,000
Operating Expenses				
Salaries	125,000	160,000	200,000	325,000
Advertising	6,000	8,000	12,000	12,000
utilities	16,845	17,952	18,695	29,652
Depreciation	1,000	1,000	6,000	1,000
Insurance	40,000	42,000	45,000	50,000
Rent	18,000	18,000	18,000	18,000
Misc.	5,000	6,500	9,000	10,000
Total Operating Expenses	211,845	253,452	308,695	445,652
Operating Income (EBIT)	30,555	31,404	18,905	31,348
Interest Expense	19,256	16,478	23,191	23,741
Interest Income	0	0	0	0
Income Before Tax	11,299	14,926	-4,286	7,607
Income Tax	0	0	0	0
Net Income	11,299	14,926	-4,286	7,607

Exhibit 2: Part 3 Financials

Balance Sheet

Period Ending	12/21/2009	12/31/2010	12/31/2011	12/31/2012	12/31/2013
Current Assets					
Cash and Equivalents	8,863	22,977	1,053	3,770	5,628
Short Term Investments	0	0	0	0	0
Net Receivables	23,521	25,684	22,856	32,651	35,840
Inventory	242,560	289,234	424,650	428,620	527,203
Other Current Assets	4,574	5,684	6,254	7,126	7,265
Total Current Assets	279,518	343,579	454,813	472,167	575,936
Gross Fixed Assets	10,000	10,000	15,000	15,000	315,000
Less: Depreciation	4,000	5,000	11,000	12,000	17,500
Net Property Plant and Equipment	6,000	5,000	4,000	3,000	297,500
Intangible assets	0	0	0	0	0
Other Long Term Assets	0	0	0	0	0
Total Long Term Assets	6,000	5,000	4,000	3,000	297,500
Total Assets	285,518	348,579	458,813	475,167	873,436
Current Liabilities					
Accounts Payable	1,200	1,560	1,420	2,350	2,462
Line of Credit	225,840	274,630	386,520	395,680	486,820
Income tax payable	0	0	0	0	0
Current portion of LT					5,709
Other Current Liabilities	5,230	4,215	6,985	5,642	5,894
Total Current Liabilities	232,270	280,405	394,925	403,672	500,885
Bank Loan	0	0	0	0	0
Long Term Debt	0	0	0	0	234,291
Total Liabilities	232,270	280,405	394,925	403,672	735,176
Paid In Capital	50,000	50,000	50,000	50,000	90,000
Retained Earnings	3,248	18,174	13,888	21,495	48,260
Total Stockholder Equity	53,248	68,174	63,888	71,495	138,260
Total Liabilities and Stockholders Equity	285,518	348,579	458,813	475,167	873,436

Income Statement

Period Ending	**12/21/2009**	**12/31/2010**	**12/31/2011**	**12/31/2012**	**12/31/2013**
Sales	2,910,720	3,470,808	5,359,200	6,048,000	7,862,400
Cost of Goods Sold	2,668,320	3,185,952	5,031,600	5,571,000	7,103,025
Gross Profit	242,400	284,856	327,600	477,000	759,375
Operating Expenses					
Salaries	125,000	160,000	200,000	325,000	525,000
Advertising	6,000	8,000	12,000	12,000	30,000
utilities	16,845	17,952	18,695	29,652	38,500
Depreciation	1,000	1,000	6,000	1,000	5,500
Insurance	40,000	42,000	45,000	50,000	52,000
Rent	18,000	18,000	18,000	18,000	0
Misc	5,000	6,500	9,000	10,000	10,000
Total Operating Expenses	211,845	253,452	308,695	445,652	681,000
Operating Income (EBIT)	30,555	31,404	18,905	31,348	78,375
Interest Expense	19,256	16,478	23,191	23,741	51,610
Interest Income	0	0	0	0	0
Income Before Tax	11,299	14,926	-4,286	7,607	26,765
Income Tax	0	0	0	0	0
Net Income	11,299	14,926	-4,286	7,607	26,765
Dividends	0	0	0	0	0

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Ratio Analysis

Ratio	Formula	Industry Average
Current	CA / CL	2
Quick	(cash + securities + AR) / CL	0.25
Working Cap	CA - CL	na
CL to Equity	CL / Equity	5
Debt to Assets	Debt / Assets	4
Debt Service Coverage	(income + depr) / Current mat of LT debt	6
TIE	(income + interest) / interest exp	5
Days AR ratio	AR / Avg sales per day	5
Days Inventory	Inv / Avg COGS per day	25
Days Payable	AP / Avg purchases per day	10
return on sales	net profit before tax / sales	0.25%
return on assets	net profit before tax / assets	5%
return on equity	net profit before tax / equity	20%

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