

Envy Rides

Case Synopsis

- In January 2010, Scott Miller, newly appointed manager of commercial accounts at the Genesis Bank of Canada, was considering the latest loan request from Jacob Hessels, dealer principal of Envy Rides Incorporated (Envy), a recreational motorsport dealership.
- Hessels has requested a \$60,000 long-term loan for a partial renovation to his current dealership to accommodate a tattoo parlor and a \$450,000 working capital loan for operations and to help manage seasonal fluctuations in sales.
- Without the requested loans, Hessels was uncertain whether he could continue to operate Envy Rides. Hessels was eager to know whether his loan requests would be approved because, if not, he would need to contact other banks.

Qualitatively, we need to understand the following:

- This is a relatively new business in a struggling market, and it is trying to succeed in a competitive metropolitan Toronto market;
- This business has a passionate and motivated leader who, having been denied bank financing during the start-up phase of his business, sought out and received investor financing instead;
- The business has a sizable trade debt and requires a significant cash flow to support its inventory levels;
- The business could fail quickly if financing is not secured.

Quantitatively, we will be required to do the following:

- Assess past financial performance using selected ratios;
- Analyse the statement of cash flow;
- Project two years of financial statements;
- Decide on the type and term of the loan needed, considering factors such as seasonality and sensitivity;
- Perform a risk assessment using the 4 Cs analysis (collateral, capacity to repay, conditions and character); and
- Construct a well-supported decision.

SUGGESTED ASSIGNMENT QUESTIONS

1. As Scott Miller, analyse the past financial performance of Envy Rides Inc.
2. Prepare two years of projected statements for fiscal 2010 and 2011. Use the line of credit as the “plug” figure on the projected balance sheets.
3. Perform a risk assessment for Envy Rides Inc. by examining the company’s collateral, capacity to repay, conditions and character.
4. If Miller were to extend the loan, what type and term of loan should he recommend? Why?
5. As Scott Miller, what is your decision? Be prepared to justify your decision. Or
6. As Scott Miller, do whatever analysis and make whatever recommendation(s) you deem appropriate. Fully support and justify your recommendations.

ANALYSIS - Statement of Cash Flow

- When analyzing the Statement of Cash Flow, students may find the following questions helpful to recognize different trends and patterns:
 1. Was cash generated from operations?
 2. Is net income a source of cash? What does this tell us?
 3. What are the sources and uses of cash from operations?
 4. What are the remaining major sources and uses?
 5. Recommendations for the future?

Operations

- A positive cash flow from operations was generated in fiscal 2008, but this turned to a negative figure in fiscal 2009. The significant increase in accounts payable during fiscal 2008 created a large source of cash in that year, which directly contributed to fiscal 2008's positive net cash flow from operations.
- We will realize that this is not the best way to generate cash since it appears that Envy is financing its business by extending its trade debt. This view of the business is also supported by the simultaneous changes in accounts payable sources and inventory uses of cash. Inventory purchases are being funded by the growth in accounts payable.
- Further proof comes from the fact that there are no bank loans on the balance sheet (or statement of cash flow). It is no surprise that Hessels is funding through trade debt: his charismatic personality likely helps persuade his suppliers of later payment, and he has no bank financing.

AM

- We will recognize that extending lenient payment terms to customers could cause potential problems in terms of collecting funds. However, with a new business, this practice may be necessary to sustain sales in a tough economy. Although this approach may be a short-term solution, we should know/discuss the long-term repercussions of continuing this action.
- Amortization is insignificant since it is such a small amount, given Envy's small investment in fixed assets (no land and no building).
- Additionally, accounts receivable is an insignificant component of this business, contrary to what we might think would be the case. Typically, recreational vehicles are sold and paid for immediately, so customer accounts receivable are not necessary.
- As a new business, Envy may have offered internal credit terms to a few trustworthy customers; therefore, the accounts receivable amounts (also shown on the balance sheet and statement of cash flow) may represent payments outstanding to Envy based on customer deposits or services rendered through its vehicle servicing department.

Financing

loan by shareholders
↓
repaid in future
↳ not free loan

- With no loans at present, there is not a lot of activity within the financing section.
- The term shareholder advancement, is self-explanatory. We should assume that the advance is a valid debt that needs to be repaid in the future. (If it were a contribution to the corporation's capital, it would be in capital.) It is not unusual for shareholder advances to exist, particularly in new businesses.
- Hessels is asking for a line of credit (LOC) and a long-term bank loan in order to start building credit. If Hessels is approved for bank financing, a bank loan and an LOC will be shown in the financing section for future years, replacing the dependence on accounts payable to generate cash. The resulting decrease in accounts payable should reflect a much better situation in terms of the "matching principle," reducing concerns around unpaid accounts (and potential steep interest rates for financing overdue accounts charged by suppliers).

we want

Investing

- Initial investments covered start-up purchases such as shop equipment, furniture and fixtures, leasehold improvements and computer equipment and software, and have sustained the business to this point.
- Small investments appear to have been made in terms of shop equipment and small leasehold improvements, but nothing major has been purchased, renovated or expanded since the business started.
- This makes sense since the business has been operating for only three years; however, it appears it is time to look at renovating and expanding to help sales growth. Fiscal 2010 will reflect these investing activities (tattoo parlor) on the statement of cash flow. Additionally, students may point out that there is no land or building, raising the question of Hessels' long-term commitment to the business (and fewer assets as collateral for a loan).

2010
↓
high
investments

Ratio Analysis

Profitability

- As can be seen in Exhibit 5 in the case, cost of goods sold (COGS) remained quite steady around 78 per cent of sales for the three-year period. While there is no change in this ratio, we should know that this percentage is quite high compared to other retail sales businesses, and in this business, COGS is a critical “piece of the pie” towards profitability. We shall also compare to industry ratios and see that Envy is approaching industry standards. We may conclude that this is a difficult time for this specific industry, given the COGS and gross profit ratios.
- Rent has decreased as a percentage of sales. With relocation to a 14,000-square-foot facility in 2008, this may seem unreasonable, since rent (as a dollar amount) would generally be more expensive in a larger facility. While the rent dollar value did increase (see income statement), the percentage decreased. we need to understand that this scenario is a result of the sales figure growing faster than the rent value. This same trend has occurred with salaries and wages.

Paying tax means you have profit

- Net income after tax has improved because Envy moved out of the "red" and into the "black." Since 2007 was Envy's first year of operations, it is not shocking to see a deficit in the first year. We should also know and question how Envy could generate earnings so quickly in its second and third year of operations. They need to remember that Envy acquired operations from an existing dealership (Milton Motor Sports) in 2007, and, therefore, Envy was not a brand-new business; Hessels simply rebranded an existing business. The net income ratio is quite impressive compared to current industry ratios. Students may wonder whether this is a result of a downward trend and is not expected to continue at this level.
- Return on equity (ROE) is also improving and we need to further investigate this ratio and will discover the increasing trend is due to the increasing net income in the business. From Miller's perspective, this is a favorable trend, showing that Hessels has started generated earnings for the business.

- Overall, the profitability section has been quite impressive. Hessels appears to have operated the dealership effectively and has shown strong managerial skills and good control over the business; nevertheless, Envy's COGS percentage is quite high. This could be a result of operating in an industry that experiences inventory with small margins slightly higher than the industry ratio, meaning that Envy's margins on its revenues are lower than the average industry's margins on revenues.

Liquidity

huge diff in current & Acid
- test

↓
because of huge inventory

- Both the current ratio and the acid test have remained relatively constant from 2007 through to 2009. However, there is a large discrepancy between the current ratio and the acid test values. For example, in 2009, the current ratio is shown at 1.12 (meaning there is \$1.12 in assets for every \$1 in liabilities — a healthy number, since Envy has a higher value in assets than liabilities). The acid test is \$0.09 in assets for every \$1 in liabilities, which is very weak and far below the benchmark of may be 1:1 (\$1 in assets to cover \$1 in liabilities). This is due to the root cause of this discrepancy to the enormous investment in inventory. This information further confirms how this business is heavily reliant on and invested in inventory.
- In summary, the business is liquid if it were able to sell its entire inventory in stock. We should recognize that having a lot of money tied up in recreational motorsport equipment may cause short-term liquidity problems, especially since this type of inventory can become obsolete when new models are constantly being introduced. Hessels' ability to move his company's inventory is certainly a key consideration for Miller when deciding whether to grant the loan(s) to Envy. We will recognize that Envy is moving away from the industry ratio of 1.3:1, further confirming Envy's increasing investment in inventory.

Efficiency

- We should recognize that the 2007 efficiency ratios may not tell the whole story because 2007 was the first year of Envy's operations. As such, there are no prior years' data to calculate these ratios. (For example, sales growth in 2007 will be inflated since Envy had no sales the year before in 2006.)
- Age of receivables has remained constant at 12 days in 2008 and 2009. Receivables are not a significant aspect of this business, so there are no immediate concerns in terms of collection.
- Age of inventory is quite inflated in 2007 due to the initial purchases of inventory at the business's inception; however, there are large fluctuations between 2008 and 2009 in the age of inventory, which may reveal Envy's lack of inventory management. In 2008, age of inventory was around 186 days, and this number increased drastically to 312 days in 2009. The latter value approaches a full year in length, and this kind of inventory (motorcycles, ATV's, etc.) may become dated and difficult to sell at current margins. For example, Envy may incur a loss on its inventory sales if it is not mindful of this ratio (i.e., having to sell current inventory below cost in order to liquidate it and replace it with new, more up-to-date inventory).
- The age of payables ratio declined from 2007 to 2008, but fiscal 2009 showed an increase. The strong "matching" correlation (mentioned earlier) between the age of payables and age of inventory reinforces the fact that inventory is being funded through accounts payable. Accounts payable have increased in 2009, potentially exposing Envy to the steep financing interest rates that are charged by this trade debt.
- Overall, working capital accounts in inventory and accounts payable have been stretched as much as likely possible. It appears that Hessels recognizes this situation and is taking action by seeking an LOC to properly finance the operation.

by
Hessels

by
Hessels

Stability

is a problem

- Net worth to total assets (NWT/A) showed fluctuations. Theoretically, Miller would expect to see this ratio improve, given the impressive increase in equity within the business over the past three years. However, the asset value is causing this ratio to oscillate due to increased inventory purchases. From Miller's standpoint, it would be preferable to have a higher NWT/A ratio for added stability (i.e., more equity in the firm relative to its liabilities).
- In summary, stability has improved, most notably, as there is no interest paid at present. Regardless, Miller may still be reluctant to grant the requested bank loan and a line of credit due to the weaker stability ratios.

Growth

given in the case

- Sales grew significantly from 2007 to 2008, largely due to the initiatives taken by Hessels to boost sales levels. We will surely link the sales growth to Envy's move to a new facility. There was a slight dip in 2009 sales, most likely attributable to the economy and its affect on the industry (i.e., the buying freeze). We may question Hessels' sales projections for fiscal 2010 and 2011, given Envy's past sales ratios and the current economic climate.
- The 2008 to 2009 net earnings growth ratio reflects impressive growth. Although 2009 sales had dipped slightly, net income improved, pointing to the control of costs, good management and/or operational efficiencies. Assets grew, with a larger increase in fiscal 2008 because of significant inventory purchases to support the sales growth (reasons for inventory purchases have already been discussed).
- Envy has experienced negative equity growth, largely due to decreasing shareholder advances (use of cash). However, Envy has reinvested net income back into the business through retained earnings, which demonstrates to Miller that Hessels is committed to the business, and hopefully, equity growth will soon reflect these actions.

Projected Financial Statements

- We shall prepare the projected financial statements for the year 2010 and 2011

We have prepared this

Interpretation of the “Plug”

- Based on the projected financial statements, the “plug” figure suggests that Envy requires a larger loan than the requested \$450,000 line of credit. In fiscal 2010, Envy requires \$601,422, and in fiscal 2011, Envy requires \$862,747.
175 days from 235 days
- This increase is expected since we have decreased the reliance on accounts payable (i.e. trade debt); however, we may comment on the tremendous size of this short-term loan and Envy’s ability to clear this account to a zero balance once each the fiscal year.

Seasonality Analysis

- We should also realize that Envy's working capital requirements are \$700,000 (the original request of \$450,000 plus the \$250,000 seasonal fluctuation amount due to slower sales in November, December, January and February) since the statements are as of December 31 of each year.

↳ less sales — amount is blocked

- Therefore, the projections (at year-end December 31) will already take this fluctuation into consideration, and no seasonal adjustment is necessary. Therefore, at the end of fiscal 2010, Envy is not within the requested LOC amount (\$601,422 is more than \$450,000), and in 2011, Envy would also exceed its request limit (\$862,747 is more than \$700,000).

hence WC may increase

- At this time, we shall also question whether reducing days of accounts payable to 175 days is realistic, and perhaps reducing this account to a more reasonable and realistic figure may reduce the gigantic working capital need.

Sensitivity Analysis

- Sensitivity analysis should be done on the aging of the two most vulnerable accounts: accounts payable and inventory.
- Since these accounts could be subject to change with the approval of new loans, from Miller's perspective, sensitivity would be worth looking into.
- The calculations provided show changes to each account; simultaneous changes to accounts payable and inventory are not shown.

Accounts Payable 2010

Sensitivity analysis

Days	Trend	Value <i>of Payables</i>	Plug Change	Plug <i>WC Requirement</i>
175 ✓	Projected	\$30,36,439	0	\$601,422
180 <i>summer</i>	Increase	\$31,23,194	\$(86,755) ✓	\$514,667
160	Decrease	\$27,76,173	\$2,60,266	\$8,61,688
261	Status Quo	\$45,28,632	\$(14,92,193)	\$(8,90,771)

↳ *maybe the payment*

Accounts Payable 2011

Days	Trend	Value	Plug Change	Plug
175	Projected	30,06,773	0	\$8,62,747
180	Increase	30,92,681	\$(85,908)	\$7,76,839
160	Decrease	27,49,050	\$2,57,723	\$6,05,024
261	Status Quo	44,84,388	\$(14,77,615)	\$(6,14,868)

W.C. loan required

4,50,000

✓
✓
✓
✓

175

✓

✓

261

\$(6,14,868)

- Accounts payable would be definitely subject to change if the loan request were approved.
 - If Envy receives the desired LOC, ^{WC} accounts payable days will decrease.
 - The projections already account for a significant decrease from 261 days to 175 days (almost in half); however, financing is still needed.
 - If the age of payables were to decrease further, additional financing would be needed. If 2009 levels (see chart for status quo) for age of payables were maintained, Envy would free up excess cash.
 - We may view this as a good sign, but they should recognize that Envy would still be reliant on trade debt in this scenario, a situation Hessels is trying to move away from.
-

Inventory Calculatio

2010

Days	Trend	Value	Plug Change	Plug
312	Projected (and Status Quo)	\$40,28,604	0	6,01,422
270 ✓	Decrease	\$34,86,292	\$(542,312)	\$59,110 ✓
350 ✓	Increase	\$45,19,267	\$490,663	\$10,92,085

decrease your inventory turnover days.

2011

WC Reg d

Days	Trend	Value	Plug Change	Plug
270 ✓	Projected	43,79,474	0	8,62,747
350	Increase	56,77,096	\$12,97,622	\$21,60,369
225	Decrease	36,49,562	\$(7,29,912)	\$1,32,835
312	Status quo	50,60,725	\$6,81,251	15,43,998

*This Inventory Sensitivity Analysis
he actually is in dangerous situation*

Inventory Management



- Changes in the age of inventory to 270 days in 2011 have already been accounted for in the projections. This scenario should give Envy better control of inventory and decreased reliance on suppliers for financing
- Because the inventory is recreational motorsport vehicles, it is undesirable to have this inventory for more than one year; however, if the economy does not improve and sales growth declines further, this specific situation could certainly arise. Therefore, we should test the sensitivity of the inventory account to see whether carrying a year's worth of inventory will greatly affect Envy's LOC requirement. Using 350 days, the LOC requirement would rise to \$1,294,643. This amount greatly exceeds the limit and is sure to weigh on Miller's mind when considering this loan request.
- Miller will need to stress the importance of inventory management to Hessels if this loan is approved. It is likely that the age of inventory will have to be lowered in the future since a lot of cash is tied up in inventory.
- We should reach this conclusion in their assessment of sensitivity and perhaps include this factor when considering covenants of the loan.

The Four Cs

Capacity to Repay

Capacity, Credit, Collateral

- We will calculate key repayment ratios to assess Envy's historical (and projected) ability to repay the loan, if granted:
 - The current ratio remains consistent with previous levels, with a slight increase in 2011, reflecting an increase in assets relative to the liabilities. We should comment on whether they expect this trend will continue.
 - The acid test, although improving slightly, is still not moving towards the comfort ratio level of 1:1, still attributable to Envy's heavy investment in inventory. Miller will certainly note this point when crafting his decision. We should comment on the type of inventory and how it will affect Envy's liquidity position.
 - Interest coverage by 2011 is exceeding 4:1 times due to the projected increases in net income. Historically, net income has been healthy and is a worthwhile point for Miller to consider when reviewing the request.

	P2011	P2010	2009	2008	2007
Current Ratio	1.19	1.12	1.12	1.16	1.39
Acid Test	0.09	0.07	0.09	0.19	0.22
Interest Coverage	4.03	4.92	N/A	N/A	N/A

Collateral Analysis

- Banker ✓

- To assess the bank's risk, Miller would perform a collateral analysis. We will use various factor values, particularly for inventory, given its current age:

Asset	2009 Value	Factor Value	Realizable Value
Accounts receivable	\$ 119,964 ✓	80%	\$ 95,971
Inventory	\$ 2,408,410 ✓	60% ↓ 50% 40%	\$ 1,445,046
Fixed assets	\$ 83,116 ✓	60% 3-	\$ 49,870
New assets	\$ 60,000	100%	\$ 60,000
Total realizable collateral			\$ 1,650,887
Less: loans requested			\$ 60,000
Excess collateral			\$ 1,590,887

Is able to ??

↳ 450,000 asking for

- The collateral analysis shows that Miller has enough securable assets that would reduce the risk of granting the loans. Much of the excess collateral is attributed to the inventory. We should note this
- However, we may conclude that the collateral analysis is not as promising as it looks (since Envy has no building, land or any worthwhile equipment to secure), concluding there is more risk in granting the loan(s). This point can be argued by a review of the factor value used for inventory: for the purposes of the present solution, a 60-per-cent factor value was applied to inventory. We may drop this figure to as low as 25 per cent to ensure they are accounting for the risk involved with this analysis. Even with a 25-per-cent factor value, there remains approximately \$750,000 excess collateral.

~~SWOT~~ *analysis - qualitative*

Strengths	Weaknesses
Located in a well-populated area, serving the target market.	Weak economy, customers not buying luxury goods, customers cannot borrow; waterfall effect from recent recession.
<i>Condition S.U.O.T</i>	Competition is fierce in the Greater Toronto Area (GTA) market, and Envy is trying to break in with a new brand image. Envy benefited from a grand opening campaign, but must figure out how to sustain sales levels.
	Envy, and the motorsport industry, is subjected to highly seasonal sales fluctuations.

analysis

Conditions

- Overall, the recreational motorsport industry is not flourishing. we should recognize that Hessels has acknowledged this fact, and to combat the problem, he is including a tattoo parlor to “set apart” his business and, in turn, sustain overall sales levels. With fierce competition, it will be important for Envy to distinguish its brand among its competition.
- We may question the aggressive sales figures forecasted for 2010 and 2011. It is unlikely that this increase will come from the tattoo parlor. However, the addition of a tattoo parlor could spark additional sales for motor sport vehicles, and this potential could be the basis for Hessels projections. It may be a useful in-class exercise to project lower sales figures and calculate the impact these figures would have on net income and the loan plug amount.
- Seasonal sales fluctuations are also a large part of this industry. Miller will need to consider this fact, since slower months will lead to an increased reliance on the line of credit.

Character Analysis

- Hessels' key strengths and weaknesses may be identified as follows:
- Strengths
 - Many years of experience in entrepreneurial and marketing roles to help make this business a success.
 - Great relationship with private investors, who helped finance expansions and new ventures.
 - Strong marketing campaigns targeted at the key demographic.
 - Creative and innovative (i.e., putting a tattoo parlor in a dealership is quite unique!)
 - A motorist himself – knows exactly what the customer is looking for.
 - Knowledgeable of this industry.
- Weakness
 - No personal financial investment put into the business (other than net income, which was reinvested).
 - No existing relationship with any bank

- In summary, Hessels is passionate, dedicated and well educated on the industry.
- He has exhibited strong leadership and has successfully met many of his goals. Not only is he heavily involved with all aspects of the recreational motorsport industry, but he is also constantly educating himself about the business, and he relates to private investors to achieve his goals.
- Hessels does not appear to have any personal assets available for collateral, and it is likely he has tapped out his private investor sources.
- We may conclude that the business is ready for its first set of bank loans to build credit, and this may be the necessary step.
 - Note: we may highlight certain strengths or weaknesses relating to the business conditions and character, but the key learning points will be drawn from the implications, and why these certain strengths or weaknesses are important for decision-making.

Alternatives

- The following alternatives will likely be identified:
 1. Provide the requested \$60,000 long-term loan and the required working capital needed (the plug figure). ✓
 2. Deny the \$60,000 long-term loan and deny the required working capital loan request.
 3. Grant the long-term loan for the renovation, but not the line of credit.
 4. Deny the long-term loan for the renovation but grant the line of credit to help reduce age of payables.
 5. Grant both loans with a set of conditions (i.e., must reduce age of accounts payable or age of inventory to a certain level).
- We should also discuss whether the tattoo parlor is a good fit for Envy, stating their opinions regarding the company's ability to increase overall sales and profitability. ↪ covenants
- Miller is newly appointed to his current position at the Genesis Bank of Canada, so in their role as Miller, we should be cognizant that any decision and action plan should include the downside risk — to Miller and to the bank — of granting or not granting the loan request.
- If the loan request is granted, we also need to discuss the business risks in detail, along with the potential interest that can be earned by the bank. If the loan request is not granted, we should be able to offer Hessels a strong rationale for their decision.