
ENVY RIDES INCORPORATED

Greg J.R. Smith wrote this case under the supervision of Elizabeth M. A. Gasby solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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In early January 2010, Scott Miller, newly appointed manager of commercial accounts at the Genesis Bank of Canada (GBC), was considering the latest loan request that was sitting on his desk. Jacob Hessels, dealer principal of Envy Rides Incorporated (Envy), had requested a \$60,000 long-term loan for a partial renovation to his recreational motorsport dealership. Hessels had also requested an additional \$450,000 working capital loan for the day-to-day operations of his business. Because of the current unstable economy, Hessels was becoming increasingly anxious about his loan request, and he wanted an immediate answer so he could approach other banks, if necessary. Without the requested loans, Hessels was uncertain whether he could continue operating Envy Rides. With the recent increase in loan requests from new and existing customers, Miller had four hours to make a decision before he was scheduled to meet with Hessels.

JACOB HESSELS

Jacob Hessels was a talented businessman, specializing in business start-ups. He prided himself on developing successful marketing campaigns and, at the age of 38, he was well known in many different industries. Hessels' career had started in the retail car sales industry, where he had worked as a car salesman. As an amiable and charismatic person, he was noticed in every role he filled. After excelling in car sales for over a decade, Hessels became the vice-president and director of marketing for Wegz Stadium Bar.¹ He stayed in this role for five years, and then moved on to accept the role of general manager for the start-up of a Hyundai dealership in a small Southwestern Ontario town.

When the opportunity arose to purchase an existing motorsport dealership that sold recreational vehicles, Hessels could not pass it up. As a motorcycle enthusiast himself, Hessel viewed this chance as a dream come true.

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Hessels had always dreamed of owning and operating his own dealership. He had looked forward to the freedom of being his own boss and setting his own working hours. The banks were unwilling to loan Hessels money because he could provide only minimal start-up capital for his business venture, so instead, in order to purchase the dealership, Hessels personally borrowed funds from his network of private investors, who believed in his talent for his new business venture. In August 2007,² Hessels bought Milton Motor Sports, an existing recreational motorsport dealership in the Milton area just outside Toronto, Ontario. Hessels immediately changed the business name to Envy Rides Incorporated, converting the business's identity and building to the Envy Rides brand.

Hessels' business grew exponentially in its early months. Sales increased, and the staff complement expanded from six to more than 20 employees in less than a year. In February 2008, Envy's growth supported a move, so the business relocated to its current store in Mississauga, Ontario.

The 14,000-square-foot leased facility focused on selling recreational vehicles, mainly in the motorsport category. Although the motorsport division consisted of a variety of vehicles, including ATVs, snowmobiles and mopeds, Envy focused primarily on motorcycles. The dealership carried many different brand names, with a large focus on Aprilia, Moto Guzzi, Suzuki and Yamaha, thereby increasing Envy's overall recreational market share by offering brands of interest to most consumers. Additionally, the dealership offered accessories and apparel (helmets, jackets, boots, etc.) that supplemented the recreational vehicle purchase. Envy provided recreational vehicle servicing by a knowledgeable and friendly parts-and-service team within the dealership (much like an automotive dealership). The dealership serviced all types of motorsport vehicles, with the exception of marine vehicles. To accommodate riders during the winter months, Envy offered storage for motorcycles and other motor sport vehicles. Envy also had a strong website presence on the Internet, with plenty of information ranging from events to the most recent news to inventory and dealer information; the site even allowed consumers to post testimonials about their buying experience.

With Hessels and his marketing expertise at the helm of the company, Envy was the subject of brilliant marketing campaigns and initiatives. Hessels had big dreams and, with the 2008 expansion, he took advantage of the dealership's grand opening with the hope of further increasing sales. The grand opening featured activities and events, including a bike wash, races, prizes, a barbecue and massive inflatable ATVs covering the new facility's lot. Envy also had a large presence on the hit radio station z103.5, a station catering to Envy's prime demographic — consumers between 18 and 35 years of age.

New to the market, Envy matched any other competitor's price (if quoted in writing), and the business relied on strong word-of-mouth advertising. As a motorcycle rider himself, Hessels possessed knowledge and expertise that played a key role in the buyer's purchasing experience. Envy strove to ensure customer satisfaction at the highest level and to represent its brands professionally at all times. Envy's mission statement sought to provide a new type of buying experience for consumers, wherein the dealership would also provide outstanding service after the sale was completed. Hessels believed Envy was the dealer that would be able to provide this kind of service.

Hessels looked back on the expansion as necessary; however, with the current economy and the everyday woes of the recreational motor sport industry, he knew it was time to do more to improve his cash position and to improve Envy's profit margin.

THE INDUSTRY

Despite having strong marketing campaigns in place since Envy's inception, the company had two major competitors: Snow City Cycle and Kahuna Power Sports. Additionally, other Honda stores provided indirect competition in this market. However, in the spring of 2008, the severe downturn in the economy (which then developed into an economic recession) brought a significant change to the recreational motor sport industry, seriously affecting the sales of new and used motorcycles.

In the past, many of Envy's previous customers had financed their purchases if they did not have the personal funds; however, following the economic downturn, banks and financial institutions had become reluctant to lend funds so it was difficult for consumers to get financing, even if they had strong credit. In the automotive industry, the economic recession led to reduced consumer spending on expensive luxury purchases such as cars, and this reduced spending filtered down to the recreational market as well. The Motor Cycle Industry Council reported that, among 12 of the leading brands, new motorcycle sales had declined by 30.5 per cent in the first quarter of 2009.³ While many businesses in the motorcycle industry remained pessimistic, some analysts were hopeful that the industry could benefit from this crisis and position itself as a fuel-efficient transportation solution.

This recreational market was further subjected to seasonal fluctuations. Inclement weather in Canada hindered motorcycling and other activities involving motorized sport, thereby deterring consumers from purchasing these goods.

THE LOAN REQUEST

Hessels believed it was time to expand once again and to restructure the financial side of the business. He viewed the current expansion as necessary for future sustainability. As well, Hessels remembered the advice of a student who had worked at his dealership during the summer months and who had taken Business 1220 at The University of Western Ontario. This student regularly stressed the importance of the working capital accounts and the risks of funding inventory through accounts payable. Because of this advice, Hessels was determined to reduce his reliance on Envy's suppliers, and he hoped to do so with a working capital loan.

Renovation Loan

Hessels was requesting a long-term loan for a small renovation within the current building. After operating in the industry for more than two years, Hessels noticed that many recreational riders, especially motorcyclists, were interested in tattoos. Hessels decided to offer tattooing services at Envy in order to maintain Envy's strong brand image in the motorsport market. He knew this service would be received favourably by his target market, but there would be barriers to entry in terms of licensing, health

³ *Motorcycle Industry Council, Thursday, April 23, 2009.*

and safety. A \$60,000 long-term loan would cover the necessary renovation and equipment⁴ to incorporate a tattoo parlor within the dealership.

As Miller reviewed the file on Hessels, he came across a printed e-mail from Hessels with the following sentence highlighted:

Preferably, financing would need to be secured by early January 2010. This is when the renovation would be scheduled to start; however, it is speculated that the project would not be completed until May 1, 2010, because of delays and the availability of the contractors.

Working Capital Loan

Hessels was also requesting a working capital loan for \$450,000. In previous discussions, Hessels had told Miller that the loan would be used to offset outstanding debts and would be necessary to help sustain operations throughout the winter months. Due to slower sales, fluctuations in working capital requirements could vary by as much as \$250,000 in winter months due to slower sales.⁵

FINANCIAL PROJECTIONS

Hessels followed the industry very closely and, based on an optimistic view of the economic climate, he projected sales would increase to \$6 million for fiscal 2010 and \$7.5 million in fiscal 2011. While these sales estimates might be viewed as quite aggressive, given the past year's sales figures, Hessels strongly believed these estimates would reflect an increase in motor sport sales through the combination of stronger marketing initiatives and Envy's expansion into the tattoo business. Conversely, Hessels was less confident in his ability to forecast sales for a newly established tattoo parlor. Even though the tattoo parlor would provide guaranteed exposure and foot traffic from the motor sport marketing, Hessels conservatively estimated sales to be \$50,000 in 2010 and \$100,000 in 2011.

Hessels projected Envy's cost of goods sold would remain at the same historical percentage of sales for the next two years, even with the addition of a tattoo parlor. Based on the previous financial information (see Exhibits 1 through 5), Hessels gave Miller reasonable assumptions regarding each projected statement for the next two years.

Since Envy had just moved to a new building that met all its needs, relocation was not anticipated in the near future. Furthermore, Hessels had a locked-in lease agreement for the next three years, wherein rent would not increase under any circumstances. With the hiring of new employees to operate the tattoo parlor and new staff members to support the increase in motor sport sales, he projected salaries would increase to 12 per cent and 13 per cent of sales in 2010 and 2011, respectively.

Hessels had strong relationships with his suppliers; however, funds from the working capital loan would reduce Envy's reliance on this trade debt. If Hessels received the working capital loan requested, Envy could immediately reduce its accounts payable to 175 days. Furthermore, Hessels wanted to improve Envy's management of inventory over time. He projected that fiscal 2010 would remain the same in terms of inventory days, but this term would decrease to 270 days in fiscal 2011. He expected the

⁴ *Equipment is expected to last 15 years, depending on usage.*

⁵ *Slower sales were experienced in November, December, January and February.*

addition of a tattoo parlor would have negligible impact on accounts receivable and predicted no change in the days of Envy's 2009 accounts receivable levels.

Hessels admitted that advertising and promotion were large expenditures in a new business, but he expected advertising for fiscal 2010 and 2011 to remain at the same percentage of sales as 2009 levels. All other expenses associated with the cost of sales would remain at the same percentages of sales, and all other non-sales associated accounts would remain at the same dollar level as in 2009.

In the past, banks had not been receptive to Envy's loan requests. If Envy were granted the loans, this would be the company's first experience at leveraging debt. Although the terms of the loan were not finalized, Miller felt a five-year repayment schedule with a nine per cent annual interest rate on the long-term loan would be favourable to both parties.⁶ Furthermore, Miller estimated Envy would incur \$45,000 in annual interest charges on the working capital loan in both 2010 and 2011.

THE DECISION

Hessels' excitement about the future and his commitment to his business were definite reasons for Miller to favour granting this loan request; nevertheless, Miller would need to crunch the numbers and consider the assumptions behind the numbers to ensure he had all the necessary financial pieces for this decision. He would need to give special consideration to Envy's statement of cash flows and ratio analysis. Miller also wanted to give a fair assessment of the entire file, including Hessels' leadership. Before he could make today's decision, Miller would need to draw up an analysis of the numbers and make a projection of Envy's financial statements for the next two years, along with an analysis of all other loan-related factors.

⁶ Interest to be calculated on the outstanding balance owing as at December 31st.

EXHIBIT 1
INCOME STATEMENT
for the year ended December 31

	<u>2009</u>	<u>2008</u>	<u>2007</u>
Sales	\$ 3,613,959	\$ 4,885,958	\$ 434,463
Cost of Goods Sold	<u>2,816,295</u>	<u>3,823,864</u>	<u>341,394</u>
Gross Margin	797,664	1,062,094	93,069
Expenses			
Rent and utilities	120,900	187,402	46,850
Salaries	284,121	404,994	46,040
Advertising and promotion	53,424	97,431	16,302
Automotive	26,129	43,704	11,243
Telephone	10,750	25,741	6,038
Insurance	7,258	13,034	4,481
Licence fees and dues	9,533	10,430	5,770
Office expense	10,270	20,645	5,334
Professional fees	2,092	3,000	5,300
Amortization	<u>15,348</u>	<u>15,098</u>	<u>6,062</u>
Total expenses	539,825	821,479	153,420
Net earnings from operations	257,839	240,615	(60,351)
Income Tax ⁷	<u>64,460</u>	<u>45,154</u>	<u>—</u>
Net Income	<u>\$ 193,379</u>	<u>\$ 195,461</u>	<u>\$ (60,351)</u>

Source: Company files.

Exhibit 2
STATEMENT RETAINED EARNINGS
for the year ended December 31

	<u>2009</u>	<u>2008</u>	<u>2007</u>
Beginning retained earnings	\$ 135,110	\$ (60,351)	\$ —
Add: Net income	193,379	195,461	(60,351)
Less: Dividends	<u>—</u>	<u>—</u>	<u>—</u>
Ending retained earnings	<u>\$ 328,489</u>	<u>\$ 135,110</u>	<u>\$ (60,351)</u>

Source: Company files.

⁷ 2007 and earlier losses were carried forward for tax purposes in 2008. For 2010 and beyond taxes were expected to be paid at a rate of 25 per cent on net earnings.

Exhibit 3

BALANCE SHEET
as at December 31

	<u>2009</u>	<u>2008</u>	<u>2007</u>
ASSETS			
Current Assets			
Cash	\$ 138,640	\$ 175,661	\$ 126,717
Accounts receivable	119,964	163,801	77,990
Inventory	2,408,410	1,957,362	886,840
Prepaid expense	5,231	7,393	2,013
Supplier deposit	<u>17,250</u>	<u>17,400</u>	<u>15,750</u>
Total Current Assets	2,689,495	2,321,617	1,109,310
Fixed Assets			
Shop equipment	48,729	46,229	42,729
Computer equipment	7,087	7,087	7,087
Computer software	22,713	22,713	22,713
Furniture and fixtures	20,148	20,148	20,148
Leasehold improvements	<u>24,999</u>	<u>24,999</u>	<u>22,999</u>
Total Fixed Assets	123,676	121,176	115,676
Less: Accumulated amortization	<u>36,508</u>	<u>21,160</u>	<u>6,062</u>
Net Fixed Assets	<u>87,168</u>	<u>100,016</u>	<u>109,614</u>
TOTAL ASSETS	<u>\$2,776,663</u>	<u>\$2,421,633</u>	<u>\$1,218,924</u>
LIABILITIES			
Current Liabilities			
Accounts Payable	\$2,107,815	\$1,839,921	\$ 743,027
Customer Deposits	<u>3,131</u>	<u>15,438</u>	<u>5,850</u>
Total Liabilities	2,110,946	1,855,359	748,877
SHAREHOLDERS' EQUITY			
Shareholder Advance	337,128	431,064	530,298
Capital Stock	100	100	100
Retained Earnings (Deficit)	<u>328,489</u>	<u>135,110</u>	<u>(60,351)</u>
Total Shareholder's Equity	<u>665,717</u>	<u>566,274</u>	<u>470,047</u>
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	<u>\$2,776,663</u>	<u>\$2,421,633</u>	<u>\$1,218,924</u>

EXHIBIT 4

STATEMENT OF CASH FLOW
for the year ended December 31

	<u>2009</u>	<u>2008</u>
OPERATIONS		
Net earnings	\$ 193,379	\$ 195,461
Adjustment to Cash Basis		
Amortization	15,348	15,098
Accounts receivable	43,837	(85,811)
Inventory	(451,048)	(1,070,522)
Prepaid expense	2,162	(5,380)
Supplier deposits	150	(1,650)
Accounts payable	267,894	1,096,894
Customer deposits	<u>(12,307)</u>	<u>9,588</u>
Net Cash Flow From Operations	59,415	153,678
FINANCING		
Shareholder advancement	<u>(93,936)</u>	<u>(99,234)</u>
Net Cash Flow from Financing Activities	(93,936)	(99,234)
INVESTING		
Shop equipment	(2,500)	(3,500)
Computer equipment	-	-
Computer software	-	-
Furniture and fixtures	-	-
Leasehold improvements	<u>-</u>	<u>(2,000)</u>
Net Cash Flow from Investing Activities	(2,500)	(5,500)
Net Cash Flow	(37,021)	48,944
Beginning Cash, January 1	<u>175,661</u>	<u>126,717</u>
Ending Cash, December 31	<u>\$ 138,640</u>	<u>\$ 175,661</u>

Source: Company files.

EXHIBIT 5
RATIO ANALYSIS

VERTICAL ANALYSIS

	<u>2009</u>	<u>2008</u>	<u>2007</u>
Sales	100.00%	100.00%	100.00%
Cost of goods sold	<u>77.9%</u>	<u>78.3%</u>	<u>78.6%</u>
Gross margin	22.1%	21.7%	21.4%
Expenses:			
Rent and utilities	3.3%	3.8%	10.8%
Salaries	7.9%	8.3%	10.6%
Advertising and promotion	1.5%	2.0%	3.8%
Automotive	0.7%	0.9%	2.6%
Telephone	0.3%	0.5%	1.4%
Insurance	0.2%	0.3%	1.0%
Licence fees and dues	0.3%	0.2%	1.3%
Office expense	0.3%	0.4%	1.2%
Professional fees	0.1%	0.1%	1.2%
Amortization	<u>0.4%</u>	<u>0.3%</u>	<u>1.4%</u>
Total expenses	14.9%	16.8%	35.3%
Income tax	<u>1.8%</u>	<u>0.9%</u>	—
Net income (loss)	5.35%	4.00%	(13.9%)
Return on equity	29.05%	34.52%	N/A
Current ratio	1.27	1.25	1.48
Acid test	0.12	0.18	0.27
Working capital	\$578,549	\$466,258	\$360,433

EFFICIENCY

Age of receivables	12.1	12.2	38.3
Age of inventory	312.1	186.8	558.3
Age of payables	235.5	137.2	184.9

STABILITY

Net worth/Total assets	23.98%	23.38%	38.56%
Interest coverage	N/A	N/A	N/A

GROWTH

	2008-2009	2007-2008
Sales	(26.03)%	557.37%
Net income after taxes	(1.07)%	N/A
Total assets	14.66%	98.67%
Equity	17.56%	20.47%