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Letter From the Editor

Welcome! I am pleased to present the Fall 2005 issue of the *Journal of Finance Case Research*, the official journal of *The Institute of Finance Case Research* (IFCR). 2005 has been a year of transition for the *Journal* and the *Institute*. In 2004, we changed the structure of the editorial staff to more easily deal with the volume of submissions we receive each year, and the intervening period has been consumed with moving (physically) and re-establishing the *Journal*, editors and review process. Thanks go to all of the folks who have helped Bob Stretcher and me over the last two years.

The IFCR provides an avenue for the writing of cases and their submission for peer review. Cases accepted for publication in the *Journal* have met the quality requirements of a double-blind review process, and are available for use through *Journal* subscriptions or by contacting the *Institute* for multiple copies (for a small fee per copy of the case). Teaching notes are available to instructors desiring to use each case by contacting the *Institute*. Our acceptance rate is 25%. The *Journal* is listed in *Cabell's Directory of Publishing Opportunities in Economics and Finance*, and it is also listed in many other quality informational references.

In addition to the *Journal*'s activities, the *Institute* continues to promote the interaction of case writers in a conference setting. Cases submitted for conference presentation are eligible for the review process for the *Journal*. Our overall objective is to create an outlet for case writers, and a source of high quality cases for case users.

As the new managing editor, I would like to personally invite case writers and case teachers to participate in the activities of the *Institute*. Our case sessions have been held at a variety of finance conferences, and they provide an excellent opportunity for interaction with others with similar interests. The journal has sponsored or participated in case or teaching sessions at annual meetings of the Southwestern Case Research Association, the Financial Management Association, the Southwest Finance Association, the Midwest Finance Association, the Academy of Economics and Finance and the Financial Education Association. Personally, I find that cases presented at conferences have a better chance of final acceptance for journal publication, perhaps because of the scrutiny and comments they receive from other educators.

The *Journal* contains cases of all types, as is evident from the variety of cases in this issue. Primarily, though, we want the *Journal* to be an outlet for interesting and representative cases. We have focused on decision cases in the past, both "textbook"-style directed cases and also more involved, open cases. In every instance, we are seeking cases that will be relevant and engaging for students and professors alike. Looking ahead to 2006, I can promise tutorial articles and detailed industry-background research in addition to our traditional case lineup. I expect to produce at least two issues in calendar 2006, and perhaps three if we can get some of the pending cases through the revision process more quickly.

In addition, I plan to create an outlet for shorter "one-pager" problems and classroom exercises. Some of our colleagues have been using short exercises in class for years and years, and I would like to encourage folks to send those in and have them editorially reviewed and published.

Finally, as the "new guy" I want to encourage all of our readers to consider volunteering to review manuscripts when you have time. Finding reviewers is a key part of the managing editor's job, and it is becoming more and more difficult as the volume of manuscripts increases.

This issue of the *Journal of Finance Case Research* contains eight outstanding cases. I hope you find them useful. Again, I want to encourage those of you who are interested in the production, promotion, and use of cases in finance to become active participants in the IFCR. Please go to the JFCR Web site for additional membership and author information.

Timothy B. Michael, Managing Editor
Journal of Finance Case Research
www.jfcr.org

PREMIER CORPORATION: ESTIMATING THE COST OF CAPITAL FOR A CLOSELY-HELD FIRM

Winner of the Institute for Finance Case Research/Financial Management Association Distinguished Case Award for 2003

Marcelo L. Eduardo, Mississippi College
Billy C. Moore, Delta State University
Lloyd E. Roberts, Mississippi College

It had been a dizzying 6 months for Jane Young. A CPA by training, Jane had started with Premier Corporation right out of college as a payroll accountant. In the ensuing seven years since she started working for Premier, she had become a CPA and moved all the way up the accounting side of the company. In the past year, Jane was named the firm's new controller, finished her MBA and got married. Last week she received a call from Jack Pruitt, the company's founder and Chief Executive Officer (CEO) asking her to take the Chief Financial Officer (CFO) position. In offering her the job, Mr. Pruitt had emphasized the critical nature of upcoming product line expansion decisions that the company was considering. Jane felt that her primary task would be to ensure that the right decisions were made. Jane was also certain that the starting point for these decisions would be a correct estimate of Premier's cost of capital. She knew it was time to go back and use her MBA preparation and take on this crucial task. All in all, it was an exhilarating time for her but it was also a stressful time.

THE COMPANY

By 2001, Premier Inc. had been an ongoing business for twelve years and although it always viewed itself as a manufacturer of appliances, only recently had Premier put forth a clear mission statement. In it, the company declared itself to be a part of the "ultra high-end appliance" industry offering a line of professional-style kitchen equipment. In that context, it had always been Jack Pruitt's aspiration to place Premier as the leader in the commercial-type cooking equipment for the home.

The company's mission statement reads:

> It is the stated goal of the company to endeavor to possess a product line that represents the finest in heavy-duty, commercial-type construction, performance, and appearance, providing designers, builders, and homeowners with features available only from Premier Inc." To that end, Premier's product line now included professional-style cooking, ventilation, and kitchen cleanup equipment. Now the company was considering adding new products (a line of refrigerators and freezers, a line of high-end cookware, and a line of outdoor grills.)

Premier's growth over the years had been steady. The company was founded in 1989 in Savannah, GA. From its outset, Premier was organized and remains an S-corporation (Subchapter S of the Internal Revenue Code) to this day. Subchapter S status allows a company to be taxed as a proprietorship avoiding the problem of corporate double taxation and yet the company retains limited liability and other benefits of the corporate form of organization. Jack Pruitt was the principal founder and majority owner but there are twelve other shareholders. Over time and under the leadership of Jack Pruitt, sales have progressed from $233,345 to just over $66.7 million. Exhibit 1 provides the financial statements for the company's last two years of operation. Today, the company's products are sold through a network of premium appliance distributors throughout the United States and Canada and in more than 60 countries internationally.

COST OF CAPITAL

As Jane approaches the decision of whether or not to undertake the new product lines, she knows that a discounted cash flow analysis using the appropriate cost of capital as the discount factor must be carried out in order to make the correct decision about these capital projects. The immediate problem she faces is that since its inception, Premier has not undertaken a systematic process to determine its cost of capital. The determination of an appropriate cost of capital is critical since it provides the company with a "hurdle rate" which future projects must clear in order to be undertaken. That is, in order for the company to proceed with a potential project, it must earn a rate of return that exceeds ("clears") the cost of the capital financing such project– thus the term "hurdle" rate.

Convinced that the closely-held nature of the enterprise made cost of capital estimation unreliable, the previous CFO had simply used a "ball-park" estimation of this cost to determine the company's hurdle rate. That is, he simply came up with a minimum return rate that in his view Premier should earn. His latest proclamation on this subject had been an 18% minimum return on investment. Jane's recent graduate training, however, has made her skeptical of such a subjective approach and she is determined to undertake a more systematic process and estimate Premier's cost of capital. To approach this issue, Jane is aware that the opportunity cost of capital for investments of similar risk can be estimated through the weighted-average cost of capital (WACC), defined as:

$$WACC = W_d*K_{d(at)} + W_s*K_s$$

where W_d and W_s are respectively the proportions of debt and equity that will be used in raising the capital, and K_d and K_s are the respective costs of debt and equity. Essentially, the WACC brings together the requirements of the different providers of capital.

CAPITAL STRUCTURE WEIGHTS

In approaching the preferred mix of debt and equity, Jane believes that book-value weights provide a helpful starting point. Exhibit 2 gives the market value weights for two publicly-held companies that are in limited competition with Premier.

Cost of Debt

Exhibits 3 and 4 list Premier's current debt obligations and corresponding interest charges. Information on Premier's lease obligations is also included. One of Jane's main questions as she approaches this task involves whether to disregard or use the data on the company's leasing obligations. She's unsure of their place in the company's capital structure and wonders if its lease financing should even be part of estimating WACC.

Furthermore, Jane's previous experience in the accounting side of the company has shown her that Premier uses commercial banks as the source of both short-term and long-term debt financing. In fact, a recent lunch she had with James King , AmSouth Bank's chief loan officer, left her with the strong impression that the bank would be willing to continue to lend to Premier using similar terms as in the past. That is, Mr. King felt that the previous relationship between the prime rate and the actual lending rate paid by Premier was likely to be maintained for any future loans that the company may request. Moreover, Jane is aware that as an S-corporation, the effective tax rate that will be used to compute the after-tax cost of debt will depend on the different tax rates of the company's owners. Jane's MBA has come in handy here. At first light, she knows that many people would not use the after-tax cost of debt given that an S-corporation itself is not taxed. Nevertheless her MBA courses taught her that the tax code allows companies to treat interest payments as an expense and this has the effect of reducing the amount of taxes paid. In turn, this tax advantage has the effect of reducing the actual cost of debt regardless of the business form. Exhibit 5 -Statement of Shareholder's equity for the company- provides Jane with an idea of the level of distributions that the owners have enjoyed and thus their likely marginal tax rates.

Cost of Equity

From her MBA finance courses, Jane understands that there are several methods that could be used for estimating the cost of equity. She is keenly aware that even in the best of cases, the cost of equity estimation involves a significant degree of subjectivity. This being the case for a publicly traded company, it is even more so for a closely-held one like Premier. In starting her work, a review of the financial statements reminds Jane that Premier has raised equity through retained earnings.

One approach to estimate the cost of equity is based on the capital asset pricing model (CAPM). This model explicitly sets required returns given the risk of the investment with respect to a well-diversified portfolio. This risk is called "beta" and it measures the variability in the returns of the stock compared to the returns of the market as a whole. Therefore beta captures the true risk of a stock that is held in a diversified portfolio. Of course, the lack of a beta value given the closely-held nature of Premier renders a direct application of this model useless. In the absence of directly using the CAPM model, Jane finds two possible alternatives that may be applicable to a closely-held firm:

1. Use the CAPM model but adjust it by including a proxy for Premier's beta, which preferably would come from a "pure play" company. That is, the estimation would use the beta of a publicly traded company with an identical line of business and similar risk.

2. Use of the so-called "build up" approach whereby a series of subjective risk premiums are added to a government bond rate and an overall equity risk premium. This model takes the form of:

K_s = risk free rate + equity risk premium (systematic risk) + investment-specific risks (small size risk + liquidity risk, etc)

Exhibit 6 contains pertinent financial information about the two publicly traded companies that manufacture the same type of products as Premier. The exhibit also contains information from Ibbotson Associates on the historical market data inputs that can be used to estimate the CAPM model. Ibbotson Associates is a widely used source of historical financial information and it can be found in most libraries. Note that this information from Ibbotson can provide Jane with an implicit estimate of the premium for small company risk.

In the context of the build up model, Jane is also concerned with having to account for Premier's specific risks that are not built into the general equity risk premium. More specifically, her brief exposure to valuation has reminded her of the need to include a small-company risk premium and a liquidity risk premium. Jane is uncertain about the degree to which Premier's stock is illiquid. Given the fact that Premier is not publicly traded, Jane knows that the stock lacks the liquidity of stock traded in the open market. On the other hand, the company is profitable and she does not consider it far-fetched that one of the closely-held stockholders could sell his shares rather easily although this has never happened. In the middle of these considerations, Jane recalls an article that she read for her finance class in which empirical evidence was presented supporting average discounts of around 40% to the value of a non-liquid asset when compared to that same asset once it became publicly traded. Exhibit 7 contains a summary of these results.

CONCLUSION

With time fast approaching to make decision about undertaking the new product lines, it is imperative for Jane to estimate a base cost of capital for Premier to use as a "hurdle" rate. With this information in hand, a discounted cash flow process for capital budgeting can be carried out and a systematic decision made. Given the closely-held nature of the company, how can Jane arrive at an appropriate rate for Premier's cost of capital?

DISCUSSION QUESTIONS

1. Describe the WACC model and discuss its implementation in a closely-held framework.
2. In estimating the mix of debt and equity that Premier should use, what issues must be also considered?
3. Develop an estimate for the cost of debt and discuss the treatment of historical data in this computation.
4. Estimate Premier's cost of equity.
5. Determine Premier's WACC.

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Exhibit 1

Premier Inc.
Financial Statements

Consolidated Balance Sheet

	December 31 2000	December 31 1999
Assets		
Current assets:		
Cash and cash equivalents	$3,665,773	$1,576,336
Accounts receivable	5,903,396	4,476,699
Inventories:		
Finished goods and accessories	2,327,296	981,187
Raw materials, parts, and work in progress	4,828,223	2,618,792
Service parts	262,177	175,590
	7,417,696	3,775,569
Prepaid expenses and other assets	844,801	682,868
Due from Premier Specialty Products	107,563	528,098
Due from Premier Culinary Arts Center	157,977	-------------
Total Current Assets	18,097,206	11,039,570
Property, plant and equipment:		
Land	35,002	15,001
Buildings and improvements	4,183,854	3,075,555
Airplane	2,622,381	--
Equipment	10,471,882	6,868,937
	17,313,119	9,959,493
Less accumulated depreciation and amortization	3,798,926	2,550,149
	13,514,193	7,409,344
Construction in progress	1,217,223	639,782
	14,731,416	8,049,126
Goodwill, less accumulated amortization of $855,988 in 2000 and $720,648 in 1999	4,408,482	4,543,823
Due from Premier Specialty Products	2,776,102	--
Other	46,446	48,446
Total assets	40,059,653	23,680,965

Consolidated Balance Sheet (continued)

	December 31	
	2000	1999
Liabilities and shareholders' equity		
Current liabilities:		
Note payable to bank	$ --	29,863
Accounts payable	3,942,956	3,076,011
Accrued expenses	3,708,719	1,812,727
Current portion of long-term debt	480,842	310,452
Current portion of capital lease obligations	552,252	136,859
Total current liabilities	8,684,770	5,365,912
Long-term debt, less current portion	6,115,756	3,143,777
Capital lease obligations, less current portion	2,201,925	572,240
Shareholders' equity:		
Class A voting common stock, par value $.10 per share: Authorized, 1,000,000 shares		
Issued and outstanding, 66,670 shares	6,667	6,667
Class B non-voting common stock, par value $.10 per share: Authorized, 1,000,000 shares		
Issued and outstanding, 600,030 shares	60,003	60,003
Additional paid-in capital	6,600,330	6,600,330
Retained earnings	16,390,202	7,932,037
Total shareholders' equity	23,057,202	14,599,037
Total liabilities and shareholders' equity	40,059,653	23,680,966

Premier Inc.
Consolidated Statements of Income

	Year ended December 31	
	2000	1999
Net sales	70,180,139	40,209,675
Cost of Goods Sold	43,781,170	24,452,912
Gross margin	26,398,969	15,756,763
Selling, general and administrative expenses:		
Operations	2,357,290	1,556,472
Selling	1,393,422	847,096
Advertising and promotion	6,331,922	3,829,819
Marketing	1,896,974	1,614,320
Research and development	497,398	461,504
Administration	2,044,802	1,586,509
Amortization	137,340	135,673
Other income	(272465.62)	(87731.05)
Total selling, general, and administrative	14,386,682	9,943,663
Operating income	12,012,287	5,813,100
Interest expense	372,258	312,234
Net income	11,640,030	5,500,866

Premier Inc.
Consolidated Statements of Cash Flows

	Year ended December 31 2000	1999
Operating activities		
Net Income	11,640,030	5,500,866
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,594,621	1,115,082
Increase in accounts receivable	(1,426,696)	(828,072)
Increase in inventories	(3,642,126)	(1,341,688)
Increase in prepaid expenses and other	(161,932)	(239,181)
Increase in accounts payable	866,946	595,117
Increase in accrued expenses	1,895,993	953,625
Other	244,675	128,738
Net cash provided by operating activities	11,011,511	5,884,487
Investing activities		
Purchase of property, plant, and equipment	(6,720,102)	(1,958,427)
Advances to Premier Specialty Products	(1,750,762)	(468,931)
Advances to Premier Culinary Arts Center	(157,977)	
Net cash used in investing activities	(8,628,841)	(2,427,358)
Financing activities		
Net increase (decrease) in	(29,863)	1,862
Revolving line of credit		
Proceeds from long-term borrowing	3,469,716	20,001
Principal payments on debt, including capital leases	(551,216)	(503,883)
Distributions paid to shareholders	(3,181,864)	(1,539,726)
Net cash used in financing activities	(293,227)	(2,021,746)
Increase in cash and cash equivalents	2,089,437	1,435,382
Cash and cash equivalents at beginning of year	1,576,336	140,954
Cash and cash equivalents at end of year	3,665,773	1,576,336

Exhibit 2

Market Value Weights for Maytag's and Whirlpool's Capital Structure (2000)

	Wd	Ws
Maytag	16%	51%
Whirlpool	19%	48%

Exhibit 3
Premier Inc.
Consolidated Statements of Shareholders' Equity

	Common Stock Class A	Class B	Additional Paid-in Capital	Related Earnings	Total
Balance at January 1, 1999 Net income	$6,667	$60,003	$6,600,330	$3,970,897 5,500,866 (1,539,726)	$10,637,897 5,500,866 (1,539,726)
Shareholder distributions Balance at December 31, 1999 Net income	6,667	60,003	6,600,330	7,932,037 11,640,029 3,181,864	14,599,037 11,640,029 (3,181,864)
Shareholder distributions Balance at December 31, 2000	$6,667	$60,003	$6,600,330	$16,390,202	$23,057,202

Exhibit 4

Premier Inc.
Debt Schedules

	For December 31 2000	1999
Net payable @ 7.60%, payable $31,092 per month, including interest, to April 2002, balance due April 2002.	$3,093,871	$3,213,127
Note payable @ 6.90%, payable $266,668 per month, including interest, to December 2005, balance due December 2005.	2,622,181	
Note payable @ 7.11%, payable $16,829 per month, including interest, to October 2003.	824,017	
Note payable @ 7.38%, payable $14,424 per month, including interest, to March 2001.	28,584	192,920
Note payable @ 10.00%, payable $425 per month, including interest, to January 2003.	17,043	20,001
Note payable to the estate of a former director @ 10%, payable $1,610 per month, including interest, to July 2001.	10,903	28,181
	6,596,598	3,454,229
Less current portion	480,842	310,452
	6,115,756	3,143,777

Exhibit 5

Premier Inc.
Debt and Lease Schedules

	Long-Term Debt	Capital Lease Obligations
2001	$480,842	$727,309
2002	468,759	712,626
2003	3,133,376	712,627
2004	362,322	668,576
2005	350,244	404,962
Thereafter	1,801,055	
Total future payments	6,596,598	3,226,099
Less amount representing interest		471,922
Principal balance	6,596,598	2,754,177
Less current portion	480,842	552,252
	6,115,756	2,201,925

Exhibit 6

Comparisons Between Public and Closely-Held Companies (2000):

Company	Sales (000's)	Assets (000's)	ROI	ROE	Beta	Growth (forecast)
Whirlpool	$10,000,000	$2,650,000	11%	15%	1.05	6.5%
Maytag	$4,000,000	$872,000	37%	55%	1.20	10%
Premier	$105,000	$60,000	29%	50%	NA	NA

Ibbotson's Historical data

K_{rf} = 5.4% (current yield on a 30 year T-bond)
K_m = 12.7% (historical large company return ('26-'96))
K_{rfh} = 5.3% (historical long term treasury bond return)

Exhibit 7

Transaction Discounts due to Lack of Marketability

Study	Average Discount on the Transaction
1990-1992	42%
1989-1990	45%
1987-1989	45%

BRANSON DOOR COMPANY, INC.

James B. Bexley, Sam Houston State University

This case raises issues that face every organization seeking to borrow money to operate their company as well as every bank that is called upon to examine financial data about a company for the purpose of evaluating the creditworthiness of the company. It presents the loan officer and credit analyst an opportunity to evaluate the company and make a decision that the typical bank would have to address.

INTRODUCTION

The Branson Door Company, Inc. (hereinafter referred to as "BRANSON") has been in business since 1940, and is 90% owned by Bill Hanson. Hanson purchased the company in 1981. The employees under an Employee Stock Option Plan (ESOP) own the other 10%. The company is a Sub-Chapter S Corporation.

BRANSON has been profitable since its inception, but its earnings were drastically impacted by the slow down in the construction business during the mid 80s. This is what prompted Mr. Hanson to dispose of his other business interests and concentrate on BRANSON.

The company has a 60,000 sq. ft. office/warehouse building in Houston, Texas. It has from 35 to 40 employees, depending upon production requirements. In addition, it has a sales staff of four inside sales personnel and five outside sales personnel. Approximately 60% of its sales are in Houston, 20% equally divided between the three Texas cities of Austin, Dallas, and San Antonio, and the remaining 20% in the Asian markets.

The company and two other divisions of the firm, Houston Door and Hanson Enterprises, either build or supply all of the components for commercial door applications. These doors are used primarily in commercial applications.

MANAGEMENT

Prior to 1990 Carl Branson, whose family established the company, ran the organization for Mr. Hanson. Bill Hanson did not become active in BRANSON until 1990, when he became the President and Chief Executive Officer. The need for a turnaround after the construction decline in the mid 80s prompted Hanson to become active in the day-to-day activities of the company. He also brought in Tom Johnson from a prior association to be Vice President and Sales Manager of the company, and retained Phillip Thompson as the Vice President and Chief Financial Officer of the company. In addition, the company has two CPAs employed to prepare all of the internal financial statements.

Assets have increased 31% in the past three years, with accounts receivable moving from $713,000 to $1,161,000 in the same three-year period. Inventory has increased from $802,000 to $906,000 in the last three years. During this time, net worth increased 36%, while revenues rose 35%. Over the last three years, the company has been on an upward trend.

The company enjoys a good reputation in the construction industry, and it is a leader in the Houston market. Management forecasts an increase in sales ranging from $8,000,000 to $8,500,000 for the coming year.

BANKING RELATIONSHIPS

BRANSON had been a customer of the First State Bank for over 20 years, but the bank sold about six months ago, and Mr. Hanson and Mr. Thompson feel that the new ownership does not understand the company nor do they seem real interested in developing an understanding.

In addition, there has also been some question about First State Bank's ability to meet the increasing credit requirements of the company. Therefore, Mr. Thompson has been given the challenge of seeking a new banking relationship.

Commerce National Bank in Houston has had BRANSON as a prospect for a number of years, and recently, Ms. Marie Lawson, who formerly handled the company's business when she was a loan officer at First State Bank, has joined Commerce National Bank as a commercial loan officer. Ms. Lawson called Mr. Thompson to discuss the company's possible banking needs.

Mr. Thompson visited with Ms. Lawson and advised her that the company currently has a revolving line of credit in the amount of $500,000, which needs to be increased to $750,000 due to the increase of sales and accounts receivable. He indicated that the company would be willing to pledge accounts receivable and inventory as collateral for the revolving line of credit.

Ms. Lawson will present the loan request to the loan committee at Commerce National Bank and inform the company of the outcome as soon as she has evaluated the data and put into loan presentation format.

FINANCIAL INFORMATION

Financial statements of BRANSON for the past three calendar years are presented in Exhibits 1 through 8. All of the financial information needed to make the loan decision and calculate ratios and perform other analyses is included in the Exhibits. Accounts receivable aging and inventory analysis is also attached.

QUESTIONS

1. Ms. Lawson needs to calculate the following ratios and use them to evaluate the loan request, and she has called upon you as her credit analyst to perform the task:

    Current ratio
    Quick ratio
    Working capital
    Sales growth
    Profit margin
    Debt to equity ratio
    Debt service coverage ratio
    Debt to tangible net worth
    Times interest earned ratio
    Dividend payout ratio

Day's accounts receivable ratio
Day's inventory ratio
Day's accounts payable ratio
Gross margin
Return on assets ratio
Return on equity ratio

2. As a credit analyst, suggest some loan covenants that Ms. Lawson should include in the presentation, if the loan is made.

3. Ms. Lawson needs your assistance in preparing a list of questions to be asked of the company about their request, and any additional information that might be needed before a loan decision is made.

4. Before the Loan Committee of Commerce National Bank will consider the loan presentation, they have requested that Ms. Lawson follow policy by preparing a list of strengths and weaknesses of Branson Door Company, Inc.

5. As Ms. Lawson's credit analyst, calculate eligible accounts receivable and inventory and determine the borrowing base.

6. As a member of the loan committee for Commercial National Bank, would you make the loan, and if so, what additional terms or conditions would you impose?

EXHIBIT 1. BRANSON DOOR COMPANY, INC. ACCOUNTS RECEIVABLE AGING SUMMARY AS OF 3/30/03

Days	$ Amount	% Total
Current under 30 days	$427,637	50%
Over 30 days	$248,603	26%
Over 60 days	$75,695	8%
Over 90 days	$36,240	4%
Over 120 days	$106,544	11%
Total Accounts Receivable	$940,719	100%

EXHIBIT 2. MAJOR ACCOUNTS/CUSTOMERS AS OF 3/30/03

Name	Balance	% of Total	Comments if not current
Certain Doors, Inc.	$37,185	4%	Over 30 $2,826
Acorn International	$32,155	3%	Over 120 $23,654
ABC Contractors	$20,361	2%	Over 30 $18,434
Apache Corp.	$18,277	2%	Over 30 $1,687, over 90 $2,864
Byrd Co.	$37,712	4%	Over 30 $18,824
CBR Builders	$23,163	2%	Over 30 $6,885, over 60 $6,612, over 90 $5,191
Consolidated Contractors	$38,201	4%	Over 90 $500, over 120 $37,701
Glass Incorporated	$27,403	3%	All current
Howard Doors	$18,415	2%	Over 30 $4,179, over 60 $1,261
Privilege Contractors	$24,315	3%	Over 30 $6,877, over 90 $3,511, over 120 $13,029
Reveal, Inc.	$19,834	2%	Over 30 $1,356, over 60 $9,377, over 90 $4,215, over 120 $3,602
Sunflower Builders	$21,465	2%	Over 30 $21,465
Walden-Johnson Co.	$48,343	5%	Over 30 $38,047, over 60 $6,355, over 90 $3,300
Totals for Major Accounts	$366,829	39%	

EXHIBIT 3. BALANCE SHEET (SPREADS)

Statement Date	12/31/2000		12/31/2001		12/31/2002	
	$	%	$	%	$	%
CURRENT ASSETS						
Cash	28,182	1.7	28,006	1.6	785	_
Accts/Notes Rec. Trade	712,711	41.7	896,901	49.8	1,161,397	51.7
Bad Debt Reserve (-)	6,965	0.4	6,908	0.4	9,347	0.4
Total Accts/Rec-Net	705,746	41.3	889,993	49.4	1,152,050	51.3
Accts/Notes Rec-Other	7,277	0.4	6.642	0.4	17,827	0.8
Inventory	801,821	47.0	708,956	39.4	906,358	40.4
TOTAL CURRENT ASSETS	1,543,026	90.4	1,633,597	90.7	2,077,020	92.5
NON-CURRENT ASSETS						
Machinery & Equipment	312,557	18.3	369,169	20.5	365,117	16.3
Furniture & Fixtures	30,828	1.8	45,873	2.5	45,873	2.0
Leasehold Improvements	53,371	3.1	28,011	1.6	49,712	2.2
Gross Fixed Assets	396,756	23.2	443,053	24.6	460,702	20.5
Accumulated Depreciation(-)	272,583	16.0	304,165	16.9	313,976	14.0
TOTAL NON-CUR. ASSETS	164,740	9.6	166,581	9.3	167,425	7.5
TOTAL ASSETS	1,707,766	100.0	1,800,178	100.0	2,244,445	100.0
CURRENT LIABILITIES						
Sht. Term Loans Payable-Bank	330,000	19.6	340,000	18.9	560,000	25.0
Current Portion LTD-Bank	4.845	0.3	5,459	0.3	2,622	0.1
Accounts Payable-Trade	430,053	25.2	506,050	28.1	458.801	20.4
Other Accruals	49,530	2.9	74,355	4.1	74,487	3.3
TOTAL CUR. LIABILITIES	814,428	48.0	925,864	51.4	1,095,910	48.8
NON-CURRENT LIABILITIES						
Sht. Term Loans Payable-Bank	7,429	0.4	2,008	0.1	_	_
Due to Officers/Stockholders	50,000	2.9	_	_	_	_
TOT. NON-CUR. LIABILITIES	57,429	3.4	2,008	0.1	_	_
TOTAL LIABILITIES	871,857	51.4	927,872	51.5	1,095,910	48.8
NET WORTH						
Common Stock	8,175	0.5	9,000	0.5	9,000	0.4
Paid In Capital	_	_	41,745	2.3	41,745	1.9
Retained Earnings	827,734	48.5	821,561	45.6	1,097,790	48.9
TOTAL NET WORTH	835,909	48.9	872,306	48.5	1,148,535	51.2
TOT. LIAB. & NET WORTH	1,707,766	100.0	1,800,178	100.0	2,244,445	100.0

EXHIBIT 4. INCOME STATEMENT (SPREADS)

	12/31/2000		12/31/2001		12/31/2002	
	$	%	$	%	$	%
Sales Revenues	4,917,723	100.0	5,280,543	100.0	6,753,093	100.0
Cost of Sales/Revenues	3,724,806	75.7	3,980,814	75.4	5,092,574	75.4
GROSS PROFIT	1,192,917	24.3	1,299,729	24.6	1,660,519	24.6
Selling Expense	76,769	1.6	88,516	1.7	112,249	1.7
General & Admin. Expense	171,462	3.5	191,260	3.6	238,529	3.5
Salaries/Sales & Office Exp.	404,423	8.2	472,570	8.9	537,920	8.0
Commissions	39,876	0.8	48,601	0.9	41,575	0.6
Officers' Compensation	167,796	3.4	305,000	5.8	380,300	5.6
Lease/Rent Expense	24,268	0.5	21,075	0.4	28,686	0.4
Depreciation	9,791	0.2	13,527	0.3	19,731	0.3
Bad Debt Expense	29,929	0.6	52,376	1.0	37,595	0.6
TOT. OPERATING EXPENSE	924,314	18.6	1,192,925	22.6	1,396,605	20.7
NET OPERATING PROFIT	268,603	5.5	106,804	2.0	263,914	3.9
Interest Expense (-)	45,155	0.9	50,535	1.0	32.962	0.5
Other Income	43,505	0.9	51,929	1.0	45,277	0.7
TOTAL OTHER INCOME(EXP)	-1,650	_	1,394	_	12,315	0.2
NET PROFIT	266,953	5.4	108,198	2	276,229	4.1
Withdrawals			-114,371			

EXHIBIT 5. CASH FLOW STATEMENT

	12/31/2001	12/31/2002
	$	$
Sales/Revenues	5,280,543	6,753,093
Chg. In Accts/Notes Rec-Trade	-184,190	-264,496
Chg. In Bad Debt Reserve (-)	-57	2,439
Cash Collected From sales	5,096,296	6,491,036
Cost of Sales/Revenues	-3,980,814	(5.337.225)
Change in Inventory	92,865	-197,402
Chg. In Accounts Payable-Trade	75,997	-47,249
Cash Paid to Suppliers	-3,811,952	-5,337,225
CASH FROM TRADING ACTIVITIES	1,284,344	1,153,811
Selling Expense	-88,516	-112,249
General & Administrative Exp	-191,260	-238,549
Salaries/Sales & Office Exp	-472,570	-537,920
Commissions	-48,601	-41,575
Officers' Compensation	-305,000	-380,300
Lease/Rent Expense	-21,075	-28,686
Bad Debt Expense	-52,376	-37,595
Chg. In Prepaids/Deferrals-LTP	10,420	7,354
Chg. In Other Accruals	24,825	132
Cash Paid for Operating Costs	-1,144,153	-1,369,388
CASH AFTER OPERATIONS	140,191	-215,577
Other Income	51,929	45,277
Chg in Operating Non-Cur Assets	2,454	-360
Other Income(Exp) & Taxes Paid	54.383	44.917
NET CASH AFTER OPERATIONS	194,574	-170,660

EXHIBIT 6. RECONCILIATION OF RETAINED EARNINGS

	12/31/2001	12/31/2002
BEGINNING RETAINED EARNINGS	827,734	821,561
Net Profit	108,198	276,229
Withdrawals	-114,371	
ENDING RETAINED EARNINGS	821,561	1,097,790

EXHIBIT 7. RECONCILIATION OF NET WORTH

	12/31/2001	12/31/2002
BEGINNING NET WORTH	835,909	872,306
Net Profit	108,198	276,229
Dividends & Withdrawals-Cash	-108,198	276,229
Increase(Decrease) in Common Stock	825	_
Paid in Capital	41,745	_
ACTUAL ENDING NET WORTH	872,306	1,148,535
INCREASE(DECREASE) IN NET WORTH	36,397	276,229

EXHIBIT 8. RECONCILIATION OF WORKING CAPITAL

	12/31/2001	12/31/2002
BEGINNING WORKING CAPITAL	728,598	707,733
Decrease(Increase) in Non-Current Assets:		
Total fixed Assets Net	-14,715	-7,838
Prepaids/Deferrals-LTP	10,420	7,354
Operating Non-Current Assets	2,454	-360
Increase(Decrease)in Non-Current Liabilities:		
Long Term Debt	-5,421	-2,008
Due to Officers/Stockholders	-50,000	
Increase(Decrease) in Net Worth	36,397	276,229
ENDING WORKING CAPITAL	707,733	981,110

EXHIBIT 9. BILL HANSON'S PERSONAL FINANCIAL STATEMENT

	12/31/2002
ASSETS	
Cash	16,996
Marketable Securities	436,257
Real Estate (Home)	600,000
Branson Door Company (90%)	1,033,681
Personal Property	210,000
TOTAL ASSETS	2,296,934
LIABILITIES	
Notes to Banks	25,000
Mortgage on Home	71,000
TOTAL LIABILITIES	96,000
NET WORTH	2,200,934
TOTAL LIABILITIES & NET WORTH	2,296,934

GREAT ENDEAVOR SPORTING GOODS

Garland Simmons, Stephen F. Austin State University

GREAT ENDEAVOR SPORTING GOODS is a family owned business. The owner, Mr. Sam Cage, is seventy years old and wishes to retire at the end of the year, December 31, 2004. Sam, his wife Mary, and their four grown children, their spouses, and all of the grandchildren are very close. The oldest son, John, continues to work alongside his father as he has done since elementary school. John Cage has been approached by his Dad and asked to consider taking over the business. Sam Cage is willing to finance the sale of the business to his son John. Other family members are supportive, and there is no reason to believe that any will be disappointed that John will be given the opportunity to continue in the business, even though he may (or may not) enjoy a transfer of wealth from his parents that other siblings will not participate in. The details have yet to be worked out, but there is general agreement that this deal can and should be accomplished by the end of the year, 2004. John's wife, Jane, does the accounting for the business. (She also manages her own very successful CPA firm.) Sam and John Cage both look to her for direction on how to structure the sale of the business. Jane Cage begins to collect and organize information relevant to the creation of a cash budget to see if the business can generate enough cash flow to pay Sam Cage's asking price.

Describing Customers

There are three kinds of customers served by GREAT ENDEAVOR. The largest number are American middle-class parents of school-age children who live in or near the small town where GREAT ENDEAVOR is located. They are price sensitive, but their needs are often fixed by the requirements of athletic teams to which their children belong. Participation in athletic leagues by children is important to many families of this town. Approximately sixty-five percent of customers whose purchases are related to team sports are women shopping for their son/ daughter's sporting clothes and equipment. Most customers shopping for their children use or can choose to use credit cards to make purchases, and most can be contacted by e-mail and cell phone after a sale is made to modify their initial purchase decisions. Service after the sale is very important to this group: often goods are to be returned and exchanged with these customers.

A significant number of customers are not shopping for their children. Of these, most are men in their thirties or forties. Customers in this group typically hunt quail and ducks; or they are fly-fisherman; or they play softball and/ or basketball in an organized league. They very much rely upon sales personnel for advice as they choose equipment. Much of the equipment which they eventually purchase is quite expensive. So, it is not unusual for these customers to make repeated visits before a sale is made. Customers of this group typically make large purchases of $200 and up. They are not as price sensitive as team-sports customers, but they will refuse to pay more than what they would at a discounter for commonly available items. For customers in this category, the holiday season is an important shopping time. As is the case with team-sports customers, most of these customers use or can choose to use credit cards to make purchases, and most can be contacted by e-mail and cell phone after a sale is made to modify their initial purchase decisions. Often goods are to be returned and exchanged with these customers.

A third group of customers are adults who want to stay physically fit. These people have exercised for many years. They buy running shoes, tennis shoes, tennis and racquet-ball equipment. Having once bought equipment from high-volume discount retailers when they first started exercising, they now buy from GREAT ENDEAVOR where they find only equipment of the very highest quality. They are not price sensitive. About one-half of customers who fit in this third category are women. As is the case with team-sports customers, most of these customers use or can choose to use credit cards to make purchases, and most can be contacted by e-mail and cell phone after a sale is made to modify their initial purchase decisions. However, requests for product exchange or other kinds of service after sale is very unusual for customers of this category.

Describing Cash Flows

The business which serves these three customers is reasonably simple to understand. Eighty percent of the business is retail, and twenty percent is with local school districts. Retail customers pay at the time of sale with cash, check, or credit card. Most choose to use their credit card. On the other hand, school districts do not pay with a credit card. They pay by electronic funds transfer one month after delivery of merchandise. For both their retail and school district customers, there is no measurable bad debt experience to contend with; both the school districts and the vast majority of retail customers have done business with GREAT ENDEAVOR for many years. A Sales History and a Forecast for 2005 are given in the exhibits below. The Cage family, and Jane Cage in particular, feel that these sales forecast numbers are very reliable.

Exhibit 1. Great Endeavor Sporting Goods Monthly Sales Forecast

January	$ 120,000	July	$ 120,000
February	120,000	August	120,000
March	180,000	September	150,000
April	200,000	October	150,000
May	150,000	November	180,000
June	120,000	December	200,000
		January 2006	120,000

Exhibit 2. Great Endeavor Sporting Goods Monthly Sales in 2004.

January	$ 118,000	July	$ 121,000
February	119,000	August	120,000
March	179,000	September	149,000
April	199,000	October	151,000
May	150,000	November	180,000
June	122,000	December	200,000

The sales numbers reported in Exhibit 2 do not include the collection of sales taxes. An eight percent sales tax is collected on all sales. These taxes are remitted to state government in the month following collection.

Credit card companies charge a percentage of sales when their card is used. These fees are collected immediately via electronic funds transfer. For planning purposes it is estimated that credit card fees average three percent of sales and the sales tax collected from all customers, thus three percent of 108 percent of sales.

There are cash outflows associated with salary and wages. These are considered as a component of fixed costs. John's brother and sisters and their spouses occasionally work in the store as they are needed to fill in for those on vacation. College students also work in this business. It is estimated that gross monthly payroll for all employees, both occasional and regular, will average $20,000 per month next year. Payday is the last business day of every month. Many of these working arrangements are expected to continue after Sam Cage retires, and it is not anticipated that the size and timing of payrolls will change as a result of retirement.

In addition to labor costs there are rental costs. GREAT ENDEAVOR is currently located in a first class shopping center near residential areas and a large shopping mall. Rent is due the last business day of every month. The previous rental contract called for monthly payments equal to $900 per month. However, this contract expired in October of 2004. GREAT ENDEAVOR currently pays monthly an amount equal to the minimum of $1,000 or one percent of the previous month's sales.

The business has changed locations several times in the last fifteen years. Each time the trouble and expense of moving has been significant. Also, as far as anyone can tell, moving in the past has never served to increase sales revenue. In any event, the rental agreement currently in-force will be binding until the end of 2006.

Beyond the rent and the payroll expenses previously mentioned, there are other fixed costs: $2,000 per month advertising, about $1400 per month for utilities, and $600 for insurance. These costs are paid for as they are incurred. Also, there is depreciation expense associated with the investment in the silkscreen machine, a device that is used in lettering and decorating team jerseys, caps, and shirts, and depreciation expense is also taken on computer equipment used in ordering. Total depreciation expense per month is equal to $100.

There are also income taxes. GREAT ENDEAVOR is incorporated, paying a corporate tax rate estimated by Jane Cage for planning purposes to equal thirty-five percent.

The cash position is closely tied to inventory management. Inventory balances at GREAT ENDEAVOR are carefully monitored by both Sam and John Cage. Current month purchases average eighty percent of the next month's estimated cost of goods sold. And cost of goods sold averages seventy-two percent of sales. Inventory and supplies are ordered from various vendors. At the end of every month purchases made in the previous month from these vendors are paid for in full.

There is almost no theft loss associated with inventory. Employees, often a theft problem in a large business setting, are either trustworthy family members or honest college students that are well managed. College students come and go, but most work three or more years while they are in college, and many maintain friendly ties with the Cage family after they graduate. Customers are often friends of long standing. Shopping at GREAT ENDEAVOR is a family tradition for many. The children of some customers can remember their parents buying them sports equipment from the Cage's years ago. Theft is no problem.

The management of cash balances is an important matter to Sam Cage. Years ago Sam Cage instituted a rule to hold a minimum cash balance equal to ten percent of next month's estimated sales. In this regard, any cash balances over and above this target are used to repay any outstanding bank borrowing and, if this is fully accomplished, then excess funds are invested in a money market mutual fund. Currently this fund pays one-quarter of one percent a month. The current effective rate for this fund is equal to 3.04 percent. At year-end 2004 the investment in this money market mutual fund will equal zero.

Borrowing is done at a local bank. This bank has agreed to continue this practice after John Cage retires, perhaps because Sam Cage is willing to remain responsible for paying off any business debt owed the bank and because he is also willing to provide whatever collateral the bank requires. The bank has agreed to provide loans of up to $50,000, charging one-half of one percent per month on the previous month's borrowing. The effective annual interest rate for this source of financing is 6.17 percent. At year-end 2004, Jane Cage projects that the balance owed the bank will be zero.

Describing the Competition

The gross profit margin target for GREAT ENDEAVOR is only twenty-eight percent, low by industry standards. The Cages devote time to pricing decisions, pricing products available to retail customers at nearby discount centers as low as these discounters, so their customers need not worry about paying more than they should were they shopping at a discounter.

GREAT ENDEAVOR deliberately chooses not to duplicate a sporting goods department of large discounters. The Cage family does not sell swim wear, skating equipment, golfing equipment, bow-hunting gear, hunting and fishing licenses, most kinds of fishing gear, most kinds of football equipment, most finds of firearms, and they sell no ammunition whatsoever. GREAT ENDEAVOR sells merchandise connected with the sports of baseball, softball, basketball, soccer, fly fishing, duck hunting, tennis, racquetball and very little else.

GREAT ENDEAVOR does things that no volume retailer can hope to emulate. The artistic ability of the owner's family permits them to make team jerseys for the many local baseball, basketball, softball, soccer, and football teams; and to make flies for fly fisherman and decoys for duck hunters. These handmade wooden decoys could never be found at a volume retailer. They also re-string tennis and racquetball rackets, and rehabilitate old bamboo fly rods.

Exhibit 3. Estimates of Tangible Asset Values as of Year-End 2004.

Cash		$12,000
Accounts Receivables		40,000
Inventory		69,120
Silkscreen Equipment		5,000
Computers, Telephones, Copier		10,000
	Total	$136,120

Analyzing Data

Every year after Christmas-eve GREAT ENDEAVOR closes and does not reopen for business until the first business day after New Year's. It is a tradition that during this time members of the Cage's extended family travel to Sam and Mary Cage's vacation home in the Blue Ridge Mountains of North Carolina. This year during this family time together Jane Cage will assist both her father-in-law and her husband negotiate the transfer of ownership. The first question is about the value of the business. The total value of tangible assets as of year-end 2004 is estimated to be equal to $136,120. The only liability owed at year-end 2004 is an accounts payable of $97,920. All agree that the business is worth significantly more than the value of its net tangible assets of $38,200. Nevertheless, Sam Cage, knowing that John and Jane are currently putting their two children through college, cheerfully agrees to sell the business to his son John for only $40,000. This amount could be paid in equal quarterly installments of $10,000 each, the first payment scheduled for March 31, 2005. Sam Cage also is willing to take less if Jane feels that the business could not afford to generate the cash flow to make such an agreement work. Both John and Jane would hate to see Dad have to take less than $40,000.

As the rest of the family leaves to go eat dinner at a local restaurant, Jane fires up her personal computer and pulls up her electronic spreadsheet package to get an answer to question number two. Will John Cage be able to take these quarterly payments out of the business without jeopardizing its survival?

FIXED COST AND EXPANSION: READINGWARE PUBLISHING

Robert Stretcher, Sam Houston State University
Joe James, Sam Houston State University

Readingware Publishing Company (RPC), a book publisher in Houston, Texas, faces a decision concerning several alternative operating strategies. Each strategy involves different operating cost structures. The decision will affect RPC's ability to leverage its position and will affect the variability of its operating profit.

Readingware Publishing Corporation is a specialty publisher located in Houston, Texas. RPC serves a growing market for publishing soft and hard-bound books and periodicals. RPC mainly serves the market for educational books, small-run company publications (such as catalogs), and books that are not expected to sell large quantities in bookstores (called "specialties"). RPC's niche is in the development of markets for specialty products, and cost effective production of small production orders. RPC is a cost leader for small-run hardbound books, and is an effective competitor for softbound books.

RPC has limited its publishing to physical book production and marketing. The virtual (electronic) publishing arena appears to be beyond RPC's capabilities and is not an area involving their competitive advantages. RPC also has avoided trying to compete with large publishers because of pricing disadvantages and higher per-unit costs on large production jobs. Fortunately, these large publishers are not particularly interested in smaller jobs that RPC can easily handle.

RPC deals with customers in two distinct ways. For 'custom publishing' customers desiring to either market their product themselves or who seek RPC's services for printing and bookbinding, RPC will submit bids based on cost coverage plus an acceptable markup. Other customers approach RPC for the purpose of manuscript evaluation, and upon acceptance, marketing of their works (acquisitions). The manner with which RPC deals with each scenario is very different.

Barry Morrison is associate manager in charge of the acquisitions division. He decides which manuscripts are worthy of publication and marketing, and oversees the process from selection to delivery (to book retailers). Barry considers himself an 'underwriter' of sorts since the company takes the risk (concerning future sales) resulting from his decisions about manuscript submissions. Barry considers a book that meets or exceeds sales expectations a 'winner' and ones that fail to meet these expectations 'losers.' This is almost always a self-fulfilling prophecy, since Barry's pricing methodology is based on expected product sales.

Angela Hahn manages RPC's other division, custom publishing. Angela deals with customers desiring to have their own work published and sometimes marketed. Custom publishing differs from acquisitions in that the custom publishing customer bears the initial or the entire cost of production. Under this arrangement, RPC incurs little risk, since payment is received in advance. There exists the possibility for incremental income, though, from a markup on all units sold beyond an established minimum paid for by the customer.

COST STRUCTURE DECISIONS

RPC's general manager, Danielle Baird, has been with the company since its chartering in 1993. She has taken the firm from its infancy with only four acquired titles and ten custom publishing accounts to its current levels. The firm now has 830 titles and 2,390 active custom publishing customers. With its initial purchase of equipment in 1993, only marginal investment in additional equipment has occurred in the past eleven years. Now Danielle faces a relatively severe need for additional capacity; a situation calling for considerable fundraising. RPC has had to 'farm out' some of its larger projects to bookbinding services in the area. While these 'larger' jobs were not 'large' according to industry standards, lengthier production runs tended to outstrip RPC's production capacity. These larger jobs were becoming too numerous to manage using other firms, however, and Danielle is convinced that an expansion to a more modern production facility would solve these issues.

RPC is a private corporation, and is closely held by the Wallen family in Houston. Danielle has already found another investor willing to assume a minority shareholder position, holding 20% of the firm's stock. To make the stock attractive to the new shareholder, the Wallen family shareholders all agreed to forego dividend receipts on their shares for two years. The new shareholder also agreed to receive dividends as a percentage of net income, relieving RPC of the burden of dividend expense if earnings were low or negative. The new investor will receive 200,000 shares of RPC stock for a price of $60 per share. RPC will receive $12 million from the sale, less 1% fee for legal and other related costs. The new shareholder agreed to reduce the total amount to be invested if Danielle decided that less was necessary. One condition, however, was that at least 100,000 shares would be available at the $60 price. Danielle's only alternative to raising between $6 and $12 million in equity was not to raise equity funds at all. This would cause the entire amount of any expansion to be financed with debt.

In addition to the equity from the sale of stock, the firm needs an additional $4 million to carry out the full expansion. Danielle has secured a letter of intent from a large bank in the area for up to $3 million. The equipment would involve a chattel mortgage on all of the new equipment purchased, not just the portion purchased directly with borrowed funds. A lower interest rate can be attained on the loan if the value of the pledged assets exceeds the balance on the loan by a wide margin. The equipment will be fully depreciated by the end of the tenth year, although estimates of useful productive life are almost 20 years. Payments would be monthly on the ten-year loan, and the bank has offered a competitive 7.75% fixed rate of interest.

To complicate matters, a prior $1 million bond issue will mature during the current month. RPC will need to refinance this, no matter which alternative they follow for expansion.

The bank requires that RPC specify the portion of the approved financing they need by the end of the current month. In order to specify a borrowing need for the fixed assets involved in the expansion, Danielle needs to decide on one of the possible operational/financing alternatives, outlined below. In the event that RPC needs more funding than provided by the bank for both the expansion and for refinancing of the prior bond issue, the additional amount will have to be raised.

OPERATIONAL ALTERNATIVES

Three proposals have been forwarded by RPC's cost accountant as alternative ways of structuring operations. They each involve differing levels of fixed investment, and thus differing levels of other productive inputs. Danielle asked that all operating expenses be placed in fixed or variable categories (with respect to sales levels). A summary of costs under each of the three proposals appears in exhibit 1.

Exhibit 1: Operational Alternatives

FULL EXPANSION ($16,000,000 investment)
Additional Annual Revenues and Operating Costs:

Revenues	$21,600,000
Fixed Cost	$4,000,000
Variable Cost	$ 200,000

PARTIAL EXPANSION (A) ($10,500,000 investment)
Additional Annual Revenues and Operating Costs:

Revenues	$14,175,000
Fixed Cost	$2,520,000
Variable Cost	$ 198,000

PARTIAL EXPANSION (B) ($8,000,000 investment)
Additional Annual Revenues and Operating Costs:

Revenues	$10,800,000
Fixed Cost	$2,048,000
Variable Cost	$ 156,000

PARTIAL EXPANSION (C) ($3,200,000 investment)
Additional Annual Revenues and Operating Costs:

Revenues	$ 4,320,000
Fixed Cost	$ 864,000
Variable Cost	$ 68,000

*Direct Costs are assumed to remain at the same percent of sales
**Tax rate is a constant 34%
***Total Asset Turnover on newly purchased assets is 1.35X
****Depreciation is straight line with a ten year asset life, and is included in fixed costs.

Exhibit 2. Abbreviated Financial Statements.

Income Statement for the year ended 2002

Net Sales (Titles)		$16,600,000.00	
Net Sales (Custom Publishing)		$4,790,000.00	
	Total Net Sales		$21,390,000.00
Expenses:			
Direct Materials Cost (Titles)		-$8,843,000.00	
Direct Materials Cost (Custom Publishing)		-$4,124,000.00	
	Total Direct Materials Cost		-$12,967,000.00
Total Variable Costs		-$6,320,000.00	
Total Fixed Costs		-$1,006,000.00	
	Total Operating Cost		-$7,326,000.00
Earnings Before Interest and Taxes			$1,097,000.00
Interest Expense		$102,000.00	
Tax Expense		$372,980.00	
NET INCOME			$622,020.00

Balance Sheet December 31, 2002

Current Assets:			
Cash and Equivalents		$91,000.00	
Accounts Receivable		$818,000.00	
Inventory		$3,301,000.00	
Prepaid Items		$109,000.00	
	Total Current Assets		$4,319,000.00
Fixed Assets			$4,102,000.00
TOTAL ASSETS			$8,421,000.00
Liabilities:			
Accounts Payable		$898,000.00	
Short-Term Loan		$12,000.00	
Bonds Payable		$1,000,000.00	
	Total Liabillities		$1,910,000.00
Equity:			
Common Stock		$2,000,000.00	
Retained Earnings		$4,511,000.00	
	Total Equity		$6,511,000.00
TOTAL LIABILITIES + EQUITY			$8,421,000.00

SADDAM HUSSEIN AND THE PRICE OF OIL

Fred N. Hendon, Samford University
Marlene M. Reed, Samford University

The scenario for the case centers around the musings of Cedric Tate, an economics professor at a university in the Southeastern part of the United States, concerning the possibility that his students could look at the following: historical data on crude oil production in selected countries and throughout the world; the variability of the price of crude over the past several decades; the trends in consumption of petroleum worldwide over the past several decades; and the variation in production, consumption and net exports of crude oil by Iraq over the past 30 years and make astute calculations about the price elasticity of demand for crude oil in the short run, predict the impact on the price of crude oil of a war with Iraq and draw conclusions about the worldwide market for crude oil based on these data.

INTRODUCTION

The headlines in the October 14, 2002, edition of the *Wall Street Journal* proclaimed, "Consumer Sentiment in U.S. Tumbles to a Nine-Year Low" (Greg Ip, October 14, 2002). The author suggested that a recent index of consumer sentiment fell to a nine-year low of 80.4 in early October from 86.1 in September. Most of the decline was due to concern over the erosion of value in the stock market and a possible war with Iraq. Cedric Tate, a professor of economics at a university in the Southeastern part of the United States, read this news and pondered the possible effect of a war with Iraq on the price of crude oil.

Cedric reflected upon the way the formation of O.P.E.C. in the early 1970s and later the 1991 Gulf War had strongly impacted the price of crude oil; and if President Bush's controversy with Saddam Hussein over the removal of weapons of mass destruction erupted into a war, he was concerned that the price of crude oil would again increase. He thought it might be interesting to challenge his students to look at the price elasticity of demand for oil in the short run and also to speculate on various oil supply scenarios that might come out of a war with Iraq. For instance, they might look at the variation in the following factors over the last several decades: the price of crude oil, the production of crude oil by the U.S. and some of the countries of the Middle East, the total production of crude oil by all nations of the world and the consumption of petroleum worldwide over that period of time. He went to the Internet and pulled together some figures that he thought would be helpful in making those calculations (see Exhibits 1 through 7). By studying these numbers, he believed his students might be able to calculate the price elasticity of crude oil and the expected increase in the price of crude if the war did occur. He also noticed some interesting trends in the production of crude oil by the countries of the Middle East and the United States over the last few decades.

O.P.E.C.'S BEGINNINGS

Cedric knew that most of his students believed the beginning of the current preoccupation with oil began with the O.P.E.C. Cartel formation in the 1960s and its growing strength as a world force in the early 1970s. However, Cedric was aware that at least as early as World War II, the availability of oil played a major role in world affairs. A primary motivation for the invasion by the German Army into Central Europe and the Japanese conquest of Southeast Asia was to achieve access to reliable oil supplies (Hervey, October 1994). The rationing of gasoline during the war to benefit the war effort and the vast United States reserves of oil also contributed to the success of the Allies.

From the end of the war in 1945 until the early 1970s, the United States had come to expect that there would always be abundant supplies of cheap oil. Before O.P.E.C. was formed initially in 1960, oil production and distribution was controlled by the companies that made up the oil industry in the United States and Europe. By keeping the price low at the wellhead, the oil companies had become very profitable. During the decade of the 1950s, the United States' annual importation of crude oil and refined oil products increased by 176 percent, and the domestic consumption of petroleum products rose by 65 percent (Hervey, October 1994). To counter the oil companies' control of pricing, the O.P.E.C. Cartel was founded in September of 1960 in Baghdad. However, differences in language, culture, religion and politics among the oil exporting countries prevented the alliance from having any serious strength until the early 1970s. During the year of 1970, the Western oil companies announced to the O.P.E.C. nations that they were going to reduce the price that they paid for crude oil. Suddenly all of the barriers that existed to cooperation between the O.P.E.C. nations in the past disappeared in the face of declining profits and O.P.E.C., as a significant world organization, emerged.

From 1969 until 1972, the petroleum situation in the United States changed dramatically. The production of crude oil domestically was at its highest point in 1970 and then a gradual decline began as domestic oil fields became less productive. At the time that the domestic supply of oil was declining, the domestic demand was increasing. It was then that the United States became more reliant upon imported oil—at the very time that O.P.E.C. was gaining strength. The higher oil prices and the attempts by the United States government to deflate the over-inflated economy of 1972 and 1973 led to a recession in 1974 and 1975 in the United States which ultimately grew into a worldwide recession.

The O.P.E.C. Cartel was successful at constricting supply and forcing prices up because of its cohesiveness, the fact that it accounted for 50 percent of the world's crude oil production and the lack of any viable substitute products. In October 1973, the Persian Gulf members of O.P.E.C. cut production which doubled the price of crude oil; and then in January of the next year, they cut production and prices doubled again. By the late 1970s, the presence of higher crude oil prices induced increased oil production by non-O.P.E.C. sources in Mexico, the North Sea and the North Slope of Alaska. Realizing that they were risking the loss of control over the market, O.P.E.C. cut production once again in 1979 which significantly raised prices. The uncertainty was further increased in the Middle East by the 1979 Iranian Revolution in 1979 (Hervey, October 1994).

POST OIL SHOCK MARKET ADJUSTMENTS

By the late 1980s, world oil markets had recovered from the two price shocks in the 1970s that had helped generate stagflation (simultaneous inflation and recession) in the mid to late 70s and early 80s. In effect, O.P.E.C. by drastically cutting production to raise world oil prices in the 1970s inadvertently weakened its own monopoly position.

Over time, high oil prices generated by O.P.E.C.s production cuts had demand and supply side effects that weakened the Cartel's ability not only to keep prices high but to keep them from falling—and fall they did. On the demand side, a weak economy in the United States and elsewhere reduced the demand for oil and also set into motion attempts by both consumers and businesses to economize on the use of products derived from oil. For example, high prices of automobile gasoline created incentives for people to buy more fuel efficient (in many cases foreign) automobiles and at the same time induced domestic producers to design and produce more fuel-efficient cars. Industrial users of derivative oil products such as plastics producers took steps to reduce their dependence on the product. In general, businesses with large petroleum inputs took steps to economize on their products. As a result, the United States' dependence on imported oil fell in the 1980s.

Supply side effects were also strong. High prices allowed producers to reopen marginal wells (long since closed) where prices rose far above the costs of extraction. Known oil reserves such as the North Slope of Alaska and the North Sea, where costs of extraction are in the $12 to $15 a barrel range, became profitable to develop and exploit at prices above $20 per barrel. Other oil sources around the world were likewise brought into production. Thus, higher prices had generated a large non-O.P.E.C. supply response. As a result of weakened demand and strong positive supply response, oil prices began to fall in the 1980s. Economic recovery beginning in 1983 increased demand, but the increase in non-O.P.E.C. supply kept downward pressure on prices.

Now O.P.E.C. was in a box. No longer would a cut in production raise prices and simultaneously increase the revenue of the O.P.E.C. countries. In fact, in the face of economizing by oil users and a large non-O.P.E.C. supply response, a substantial cut in production by O.P.E.C. would be necessary just to maintain prices and would result in a negative effect on the Cartel's revenue. As a result, oil prices fell from $34 a barrel in 1982 and 1983 to $13.15 in 1989 on the eve of the Gulf War in the summer of 1990.

THE OIL MARKET AND DESERT STORM

In June 1990, Saddam Hussein moved his troops to the border of Kuwait. At that time, oil prices were relatively low at about $16 per barrel and total world production was approximately 60 million barrels per day. In fact, low oil prices was one of the issues that angered Saddam Hussein, the Iraqi President, who ruled the country with the world's second largest oil reserves. In early August, Iraq invaded Kuwait in an attempt to annex the country into Iraq. If the effort had been successful, the combined reserves of Iraq and Kuwait would have given Saddam Hussein control over a sizeable portion of the world's oil reserves. Iraq already held more than 112 billion barrels of oil—the world's second largest proven reserves (behind Saudi Arabia). They also had roughly 220 billion barrels of probable and possible resources.

With the invasion, oil prices increased to $24 a barrel as world markets were deprived of almost 4 million barrels per day due to an embargo on Iraqi and Kuwaiti crude.

Subsequent to these events, the price of oil continued to rise although at a slower rate due to the hoarding based on uncertainty as to the actions of the United States and, even more importantly, speculation about whether Saddam Hussein would try to seize the Saudi oil fields which were close to the Kuwaiti border. By mid-September, oil was selling at $38. From October until early January 1991, while President Bush was assembling a military coalition to confront the actions of Saddam Hussein, the price of crude declined to $28 per barrel—mainly as a result of increased production by other nations. In this period prior to military action, there were widespread concerns about the economic impact of rising oil prices. Economists worried that the United States would be hit by another supply side shock from oil prices as it had in the 1970s when abrupt increases in the price of crude had thrown the country into a period of stagflation which took several years to cure. Businessmen and women (particularly oil executives) wondered, among other things, what might happen to the price of oil if, prior to getting the coalition in place, Saddam Hussein was able to successfully invade and seize the Saudi fields and gain control of that country's production of 6.5 million barrels per day.

In early January, Desert Storm began. Hostilities were over in a matter of days, and quickly thereafter oil prices began to fall finally reaching $15.90 per barrel a year after the invasion had taken place. After the Persian Gulf War, the ensuing recession and slow economic growth in the leading industrial nations of the world resulted in weak oil markets, and prices ranged from $15 to $20 throughout most of the 1990s. Meanwhile, Iraq withdrew from the O.P.E.C. quota system (which restricted the production of crude oil in the participating countries) beginning in August of 1990. By April 2000, Iraqi's export volumes were 2.34 million barrels a day (see Exhibit 8). In addition, global oil demand fell in the spring and summer months during the decade of the 1990s by an average of 2.7 million barrels a day.

IRAQ'S CURRENT INFRASTRUCTURE

With increased oil production in Iraq since 1996 (see Exhibit 8), the result was an estimated real GDP growth in the country of approximately 12 percent in 1999 and 11 percent in 2000. However, in 2001 net oil exports were relatively flat and Iraq's real GDP growth fell to 3.2 percent. By 2002, with higher oil prices but lower oil exports, Iraq's real GDP growth was expected to be only 1.5 percent (Department of Energy, Country Analysis Brief on Iraq, October 2002).

Although Iraq possessed the second largest proven oil resources in the world, the country's reservoirs, wells, pipelines and loading platforms were crumbling suggested Saybolt International, a Dutch company that studied the Iraqi oil sector for the United Nations. Saybolt further suggested that oil production could fall 15 percent a year unless Iraq was able to get spare parts and technology in a timely fashion..

It was estimated that Iraq would have to raise around $40 billion to find new sources of oil and get it out of the ground. In order to do that, it would need to enter into a deal with one of the major oil companies in the world. In a scenario that would include the toppling of Saddam Hussein (either by an internal coup or by external force), it was suggested by experts that the country was so desperate for income that it might ignore the O.P.E.C. Cartel's production quotas after his fall to generate additional income. Also, with increased foreign investment and aggressive oil policies, a new Iraqi government could increase production up to 8 million barrels a day--compared to 6 million barrels a day by the Saudis--within a decade (Cox, November 11, 2002).

A SECOND PERSIAN GULF CRISIS

Cedric returned his attention to the *Wall Street Journal* sitting on his desk and rethought his assignment for his students. From the data he had gathered and would deliver to them, he thought they should be able to compute a reasonable estimate of the price elasticity of demand for oil—at least in the short run. They should also be able to predict to a reasonable certainty the impact on the current price of crude under the following scenarios: (1) no war with Iraq; (2) a brief war with Iraq similar to the 1990 Persian Gulf War; and (3) an extended war with Iraq that would interrupt crude oil production in the countries of the Middle East. There were also some interesting trends that were noticeable in the data that he hoped his better students would notice and cause them to ask questions.

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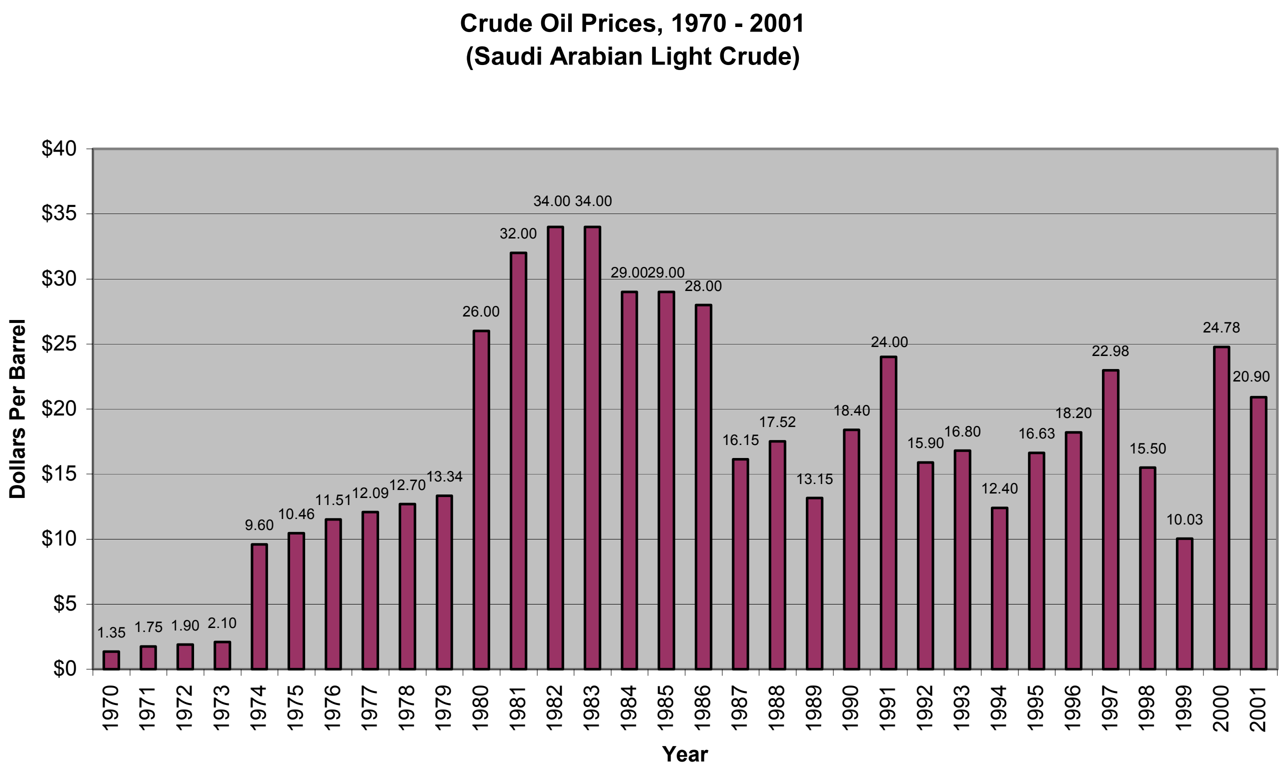
Exhibit 1



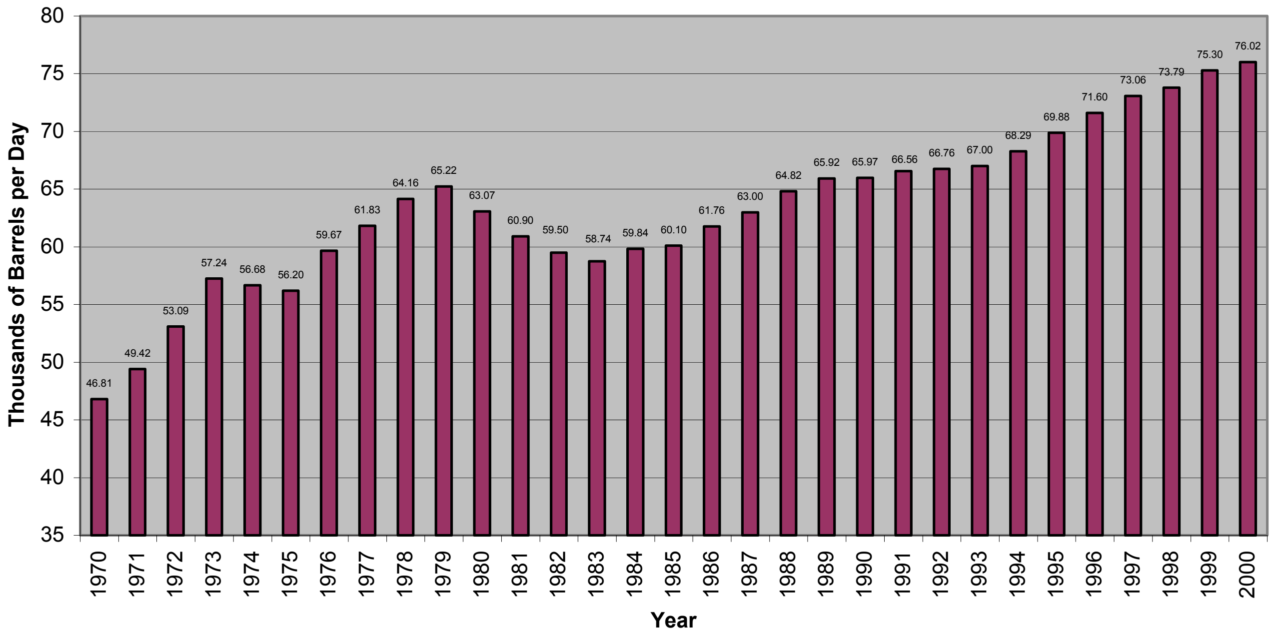
Energy Information Administration, Department of Energy

U.S. Government Web Site:

http://www.eia.doe.gov/emeu/

Exhibit 2

World Petroleum Consumption
1970 - 2000



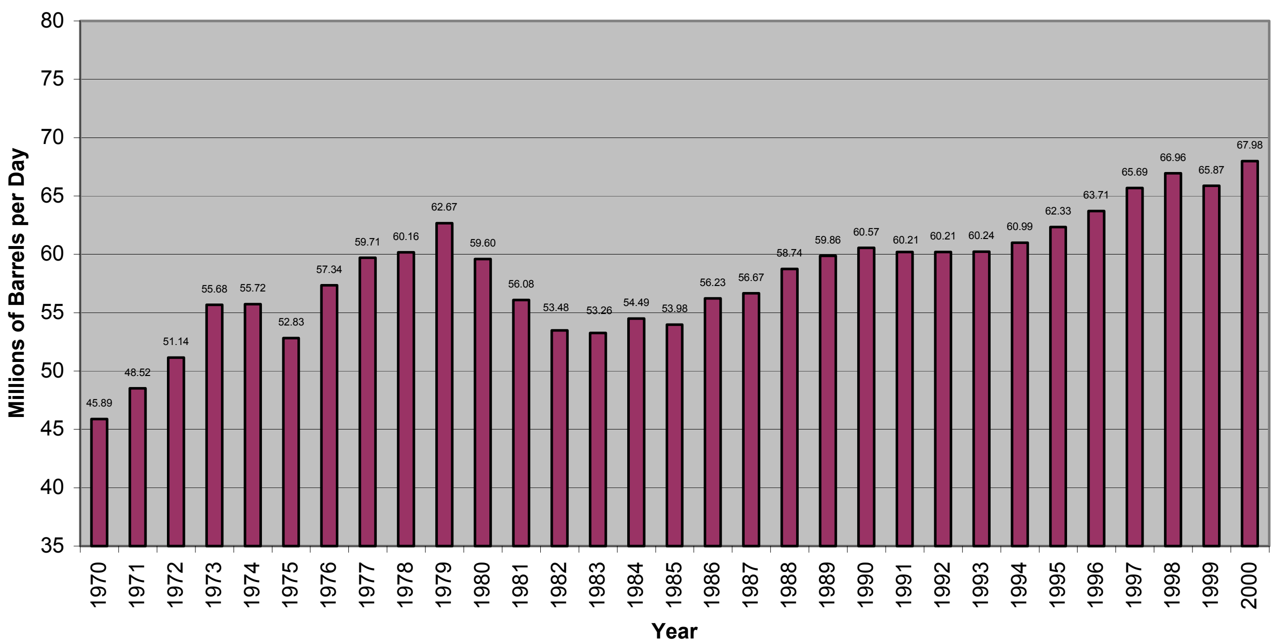
Energy Information Administration, Department of Energy

U.S. Government Web Site:

http://www.eia.doe.gov/emeu/

Exhibit 3

Total World Production of Crude Oil
1970 - 2000



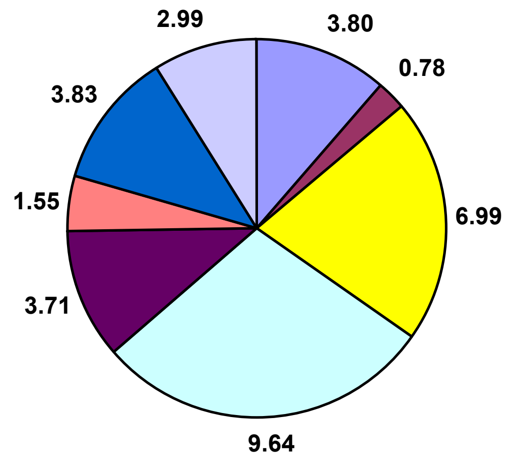
Energy Information Administration, Department of Energy

U.S. Government Web Site:

http://www.eia.doe.gov/emeu/

Exhibit 4

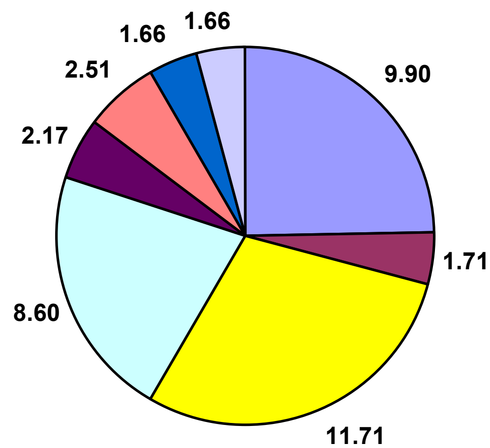
Crude Oil Production for Selected Countries, 1970
(Millions of Barrels Per Day)



Energy Information Administration, Department of Energy
U.S. Government Web Site:
http://www.eia.doe.gov/emeu/

Exhibit 5

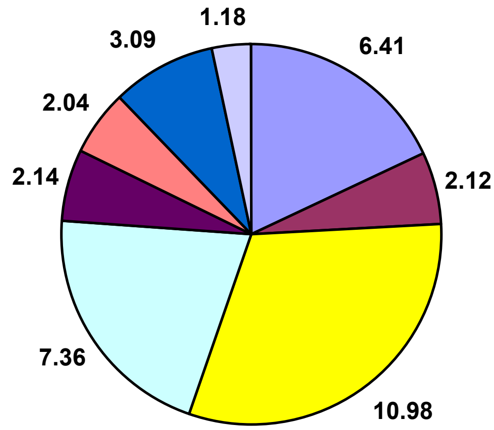
Crude Oil Production for Selected Countries, 1980
(Millions of Barrels Per Day)



Energy Information Administration, Department of Energy
U.S. Government Web Site:
http://www.eia.doe.gov/emeu/

Exhibit 6

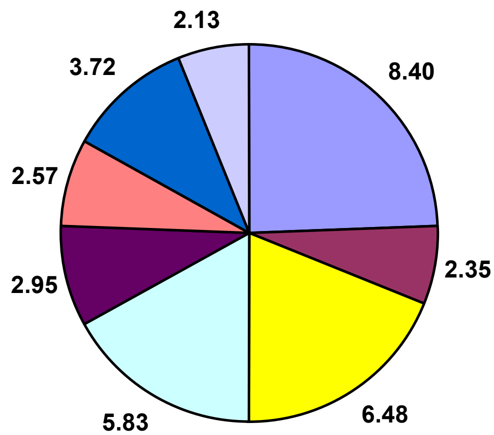
Crude Oil Production for Selected Countries, 1990
(Millions of Barrels Per Day)



Energy Information Administration, Department of Energy
U.S. Government Web Site:
http://www.eia.doe.gov/emeu/

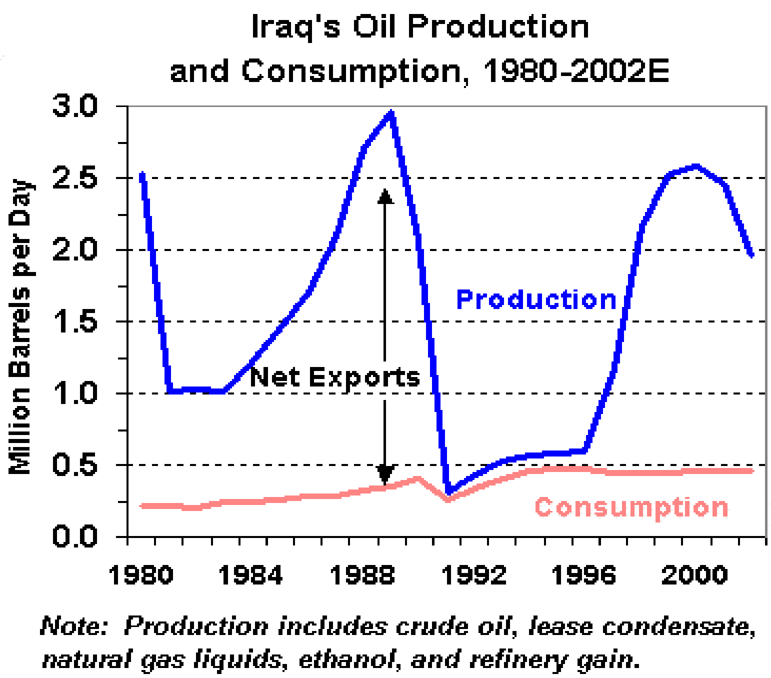
Exhibit 7

Crude Oil Production for Selected Countries, 2000
(Millions of Barrels Per Day)



Energy Information Administration, Department of Energy
U.S. Government Web Site:
http://www.eia.doe.gov/emeu/

Exhibit 8
Iraq's Oil Production, Consumption and Net Exports
(1980 - 2002 Estimated)



Energy Information Administration, Department of Energy
U.S. Government Web Site:
http://www.eia.doe.gov/emeu/

A CALAMITY OF MONUMENTAL PROPORTIONS: THE COLLAPSE OF HIH INSURANCE

Bonnie Buchanan, University of Melbourne
Tom Arnold, University of Richmond
Lance Nail, University of Alabama - Birmingham

"The culture of apparent indifference or deliberate disregard on the part of those responsible for the well-being of the company set in train a series of events that culminated in a calamity of monumental proportions".
Justice Neville Owen
Head of HIH Royal Commission

The collapse of HIH Insurance on March 15, 2001 was regarded as the biggest financial collapse in Australian corporate history, mirroring that of Enron and WorldCom in the United States. Six months before its collapse HIH Insurance was Australia's second largest insurer. Liquidators estimated that the deficiency for the HIH Group was between A$3.6 billion and A$5.3 billion. The fallout since the HIH collapse has been immense, causing personal hardship, community distress and concern about the integrity of the insurance market. As a publicly traded stock, HIH Insurance had only a ten-year history – growing rapidly through a series of acquisitions. The failure of HIH Insurance is attributed to a series of events: its last major acquisition (FAI Insurance), unprofitable operations in its overseas markets, the failure of operations in its overseas market, the failure of premium income to meet its long-tail liabilities, and aggressive accounting practices that were used to conceal the true state of HIH's profitability. A subsequent investigation also raised many questions as to the role of directors, senior management, and auditors. The case explores how poorly executed business decisions, questionable accounting practices, a lack of independent critical analysis, and the failure of corporate governance mechanisms can lead to a drastic fall from grace.

HISTORY OF HIH INSURANCE

The development of HIH Insurance from a modest underwriting agency to a multinational insurance company paralleled the development and growth of Enron (which started as a small pipeline company in Texas) and WorldCom (which was originally a small telephone company in Mississippi). Through aggressive acquisition, lack of oversight, and questionable accounting practices, all three corporations became giants in their respective industries. Unfortunately, much of what built each company's growth eventually led to financial disaster. In the wake of each of these financial collapses, many are still deciding at what level, does poor decision-making by management constitute a punishable offense.

HIH Insurance began as a "spin off" under the name CE Heath International in 1992. The CEO, Ray Williams, had been with the parent company for almost thirty years. By 1995, CE Heath engaged in a major acquisition of another insurer, CIC Insurance. In a due diligence report by Ernst and Young for CIC, CE Heath was found to have understated liabilities by A$18 million and was under-reserved by A$41 million (much of this is a "prudential margin" in which a firm reserves 20% more than what is required; it is considered a "good business practice", but is not required by law). Williams saw no real justification for a prudential margin and after a second independent audit was performed by Alan Davies of Arthur Andersen, the acquisition occurred. By 1996, CE Heath would change its name to HIH Winterthur International Holdings Australia Ltd. and Alan Davies would become HIH Winterthur's lead auditor.

By 1998, more acquisitions occurred and the Winterthur Swiss Insurance Company sold its 51% stake in the company to the public. Consequently, HIH Winterthur became HIH Insurance by October of 1998. However, it would be in September of 1998 that the particularly fateful acquisition of FAI Insurance Limited occurred. In this acquisition, the CEO of FAI, Rodney Adler, became a director at HIH after the Adler family had aided the acquisition with the sale of its sizable 14.2% stake in FAI to HIH. Poor business conditions and extensive losses from FAI policies would lead to a declining credit rating for HIH over the next two years. The financial status of FAI was not fully known by HIH because HIH never had due diligence performed during the acquisition.

Throughout 1999 and 2000, HIH would divest itself of a number of assets while recording extensive losses and suffering multiple credit rating downgrades. Ray Williams attempted to support HIH's stock price with a large purchase of shares, but was unsuccessful. Williams would resign in October of 2000 with a A$5 million payout. During this time, Rodney Adler began selling his stake in HIH and the HIH board was reduced from 11 members to 7 members by excluding Australian executives from the board. Adler would resign in February of 2001 after completely selling off his stake in HIH (an investigation of insider trading followed shortly thereafter).

In the two years preceding the cessation of trading, HIH's share price dropped rapidly. This can be seen in Figure 1. This was largely due to a combination of poor financial results and significant asset sales that were intended to improve the balance sheet position, as well as fund insurance claims.

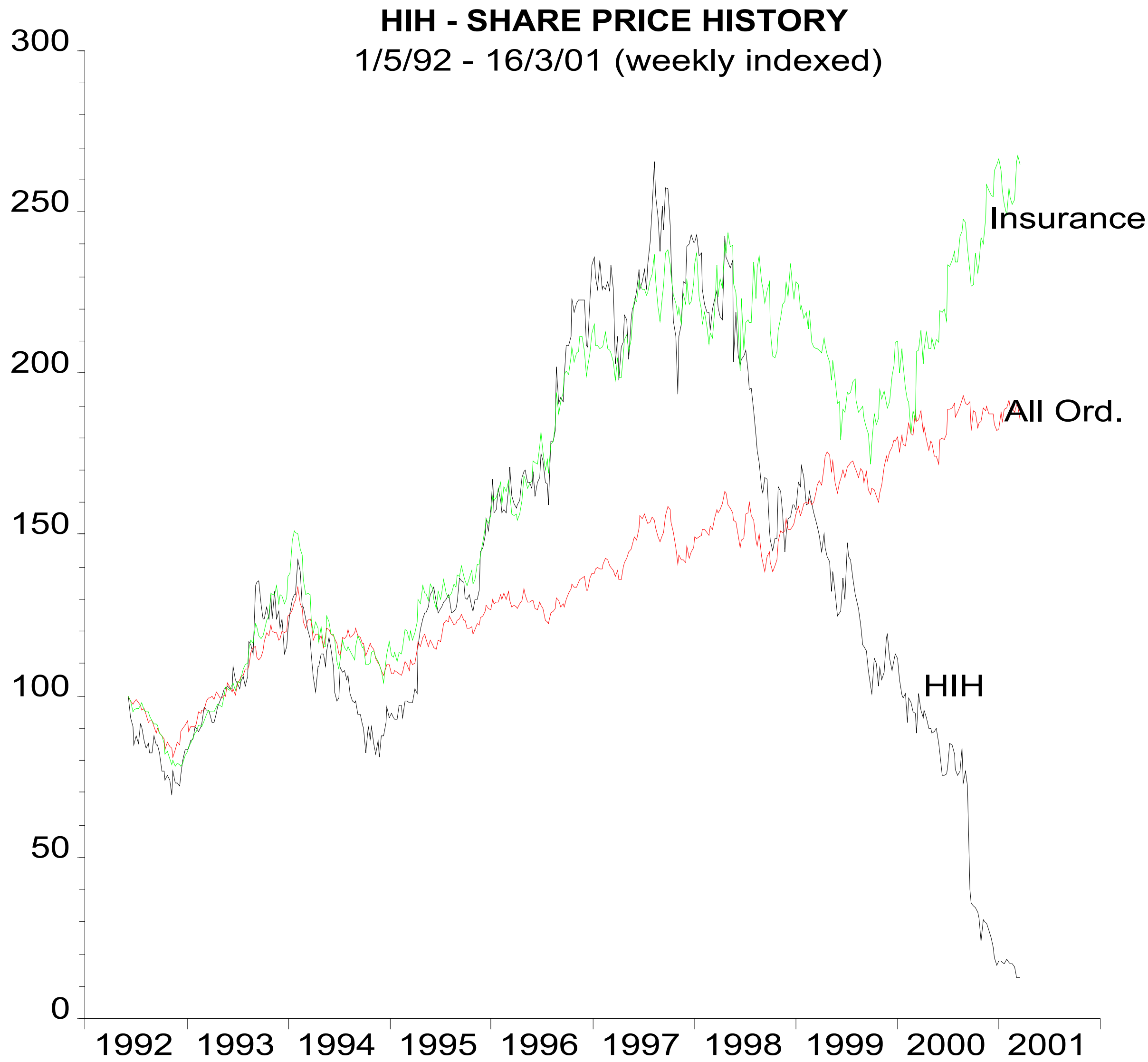


Figure 1 Source: DATASTREAM

In 2001, the bad news continued for HIH with anticipated half-year losses of A$800 million despite selling off more assets. On March 15th, HIH went into provisional liquidation making it the largest bankruptcy in Australia's history. Two months later, a federal investigation of HIH's activities began that concluded in a Royal Commission that commenced December, 2001. The findings of the HIH Royal Commission were delivered in April 2003. A more detailed chronological history of HIH Insurance can be found in Exhibit 1.

WHAT WENT WRONG AT HIH?

The major reasons attributed to the failure of HIH Insurance are under-reserving (the failure to provide adequately for future claims) and the failure to properly manage risk.

According to the HIH Royal Commission, poorly executed business decisions and mismanagement were the reasons for the failure to properly price risk and under-reserving. Poor corporate governance was the major reason for mismanagement and the poor business decisions that were made. In this section, this sequence of factors is analyzed in more detail.

Under-Reserving and Reinsurance

A prudential margin means a proportion of funds received by the company are maintained as a buffer in the event of unpredictable claims, such as natural disasters. Most companies have prudential margins such that there is a substantial probability of covering future claims. HIH Insurance discontinued this practice in 1997, choosing instead to adopt a reinsurance program. The practice of reinsurance allows a direct insurer to manage its own risk by placing part of that risk it has accepted with another insurer (called the reinsurer). The reinsurer is then paid a premium by the insurer. In the event of a claim, the insurer and reinsurer share the cost of the claim in accordance with their agreement. The use of reinsurance is not uncommon, however, the structure of the reinsurance policies used by HIH (and FAI) was effectively not for the mitigation of risk.

FAI and HIH structured their reinsurance policies to conceal the extent of their under-reserving problems. The HIH Royal Commission heard that in 1998 during a deal with General Cologne Re, two "side letters" were structured in such a way that guaranteed FAI would not make a claim. This effectively turned a reinsurance deal into a loan, making the reinsurance pact devoid of any measure of risk management. Furthermore, the deal allowed FAI to turn a A$50 million loss into a A$8.6 million pre-tax profit. Additional reinsurance deals were also not properly "booked". HIH booked a profit of A$92.4 million in its June 30, 1999 accounts in relation to reinsurance agreements that were to be entered later that year in August 1999. This practice is not appropriate under Australian accounting standards.

Imprecise accounting and suspect reinsurance policies were not the only reasons for the under-reserving that occurred at HIH Insurance. A number of poor business decisions also generated significant losses. Of particular note, is the acquisition of FAI Insurance. These decisions are investigated in the next section.

Business Practices

There are four business ventures which were critical to the collapse of HIH Insurance. One venture involved HIH's US operations. HIH Insurance bought back into the California Workers' Compensation Market in 1996, after making a profitable exit in 1994. When HIH re-entered the market, at a price of US $59 million, workers' compensation premiums in California had been deregulated and had fallen sharply, depleting profits. The business, along with Great States Insurance business in Arizona (which was purchased in 1998 for US $16 million), were placed in runoff in 2000 generating total estimated US losses of A$620 million.

In 1995, the chief executive of UK operations (started in 1993) moved into areas of business in which the underwriters had little experience. Dismal profitability occurred in many areas: marine reinsurance, film financing, the provision of personal accident coverage to members of the Taiwanese military, and motor vehicle physical damage coverage – without terrorism exclusions – to an Israeli insurer. Other reasons attributed to the failure of UK operations include poor management, poor internal controls, a major international downturn, and personality differences. Losses from UK operations are estimated to be A$1.7 billion.

In 1998, HIH initiated a formal takeover of domestic insurer FAI Insurance Ltd. in September of that year, completing the takeover in January 1999. According to its annual report, HIH's strategy was to secure a major market share position in the Australian general insurance industry as well to diversify its distribution channels. The FAI acquisition was valued at approximately A$300 million. After the FAI takeover, the HIH group accounted for more than 10 percent of the general insurance business in Australia. The HIH offer for FAI Insurance was at a 43% premium to FAI's market capitalization. Of the A$300 million HIH paid for FAI, A$157 million was for net assets and A$143 million came in the form of goodwill (47.6% of the purchase price). By June 30, 2000, HIH's goodwill had increased to A$555.9 million and analysts estimated that A$405.3 million (135.1% of the purchase price) of that total was related to FAI assets. Thus, within 18 months of FAI takeover, the net assets acquired from FAI were valued at a loss of over A$100 million.

This revelation prompted the managers of HIH to consider legal action to determine if the financial position of FAI had been intentionally overstated at the time of the acquisition. Ironically, HIH had never performed any due diligence prior to the acquisition which would have revealed FAI's true financial status. Interestingly, FAI had the same accounting firm as its auditor as HIH, Arthur Andersen. In 1997, it was Arthur Andersen that had agreed with CEO Williams about not needing a prudential margin for extreme losses.

HIH Insurance was not equipped to handle the unexpected losses that arose from serious and undisclosed under-reserving in FAI's long tail portfolios (a situation where outstanding claims provision is large relative to premium income). By June 30, 2000, HIH recognized more than A$530 million of these losses. Estimated losses from the failed FAI acquisition amount to A$590 million. The combined losses from all three ventures amounted to A$2.91 billion.

The fourth critical business venture was the joint venture with Allianz that took place in January 2001. Negotiations had started in September 2000 and involved the sale of HIH's profitable retail insurance business acquired from FAI. There was a lack of full and accurate analysis of the cash flow implications before HIH entered into the joint venture with Allianz. The result was an immediate cash flow crisis and within 10 weeks of the joint venture starting, HIH Insurance entered provisional liquidation.

When reviewing the business ventures that aided in the downfall of HIH Insurance, critical management issues appear. Such issues include: a lack of due diligence in the FAI acquisition, a lack of oversight in the UK/US markets, and a lack of risk mitigation in reinsurance policies. There is no single answer but many reasons for the failure in the management of HIH. These issues are explored in the following three sections.

Mismanagement

In Australia, directors are classified into three categories: executives, independent non-executives, and non-independent non-executives. Directors are deemed independent only if they have no current or prior relationship with the firm as an employee, professional advisor, or having no other contractual relationship to the company. The average remuneration for non-executive directors in Australian listed companies was $A52,760 as of 2000.

The direct compensation of the directors of HIH was well above the average compensation for directors, despite poor business performance. Additionally, several directors held substantial equity stakes in the firm which could lead to a disproportionate focus on short-term performance and a pre-occupation with supporting the share price. Also of concern was the fact that HIH Insurance was led by its founders. A non-executive board member, Rodney Adler, was the son of the founder of FAI Insurance. Consequently, the management of HIH may have lacked an objective outside opinion. In fact, the board itself became more concentrated with founding members when it was reduced from 11 to 7 between 1999 and 2000. The board of director structure is demonstrated in Exhibit 2.

Amongst other board failings was the attendance of some directors at board meetings. Throughout 1998 and the first six months of 1999, the retired co-founder and CEO of HIH and chairman of the reinsurance committee (Payne), attended only 4 of 24 board meetings. This is illustrated in Exhibit 3.

Compromised Auditor Independence and an Ineffective Audit Committee

The case of HIH also refocused attention on the controversial issue of the independence of the auditors from their clients. The board of HIH had three former partners of Arthur Andersen, HIH's auditor. One Andersen partner was the chair of the board and continued receiving fees under a consultancy agreement.

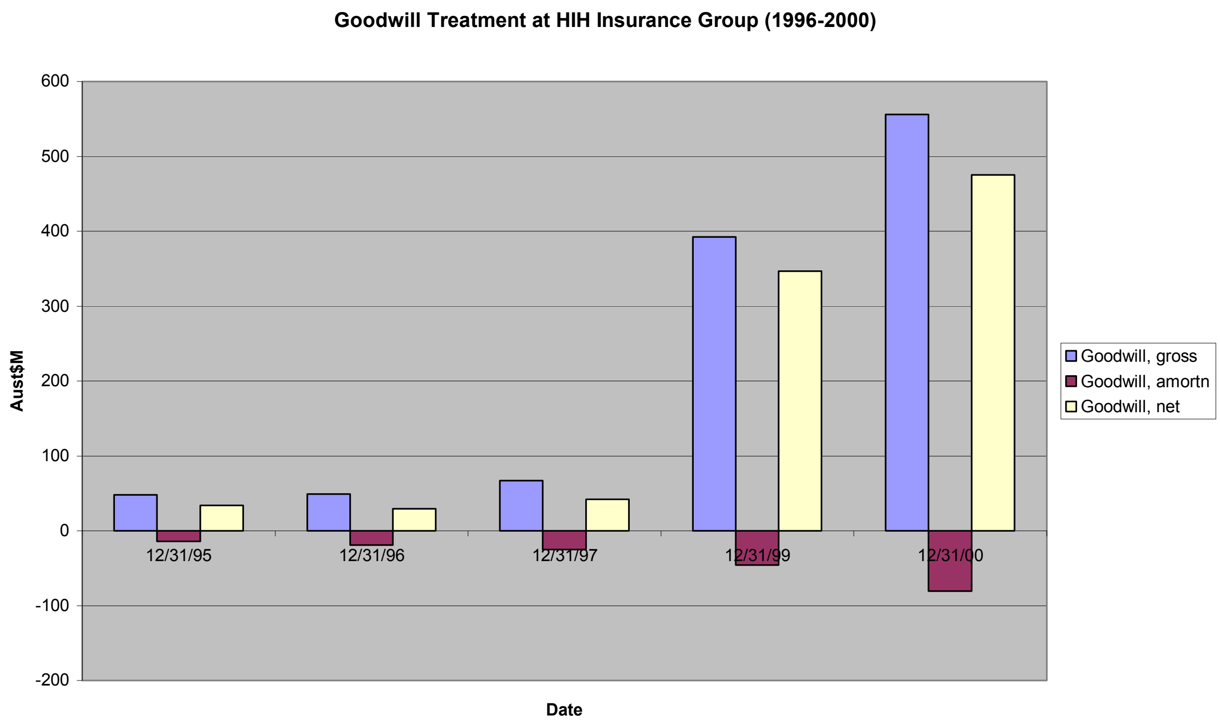
In October 2000, the auditor signed off HIH financial statements, despite some of the aggressive accounting practices discussed later. The 2000 financial statements indicated the company had assets of A$8.32 billion against liabilities of A$7.38 billion, giving it net assets of approximately A$940 million. Andersen received A$1.7million for its work as auditor to the HIH group for the 12 months ending June 30 2000. Arthur Andersen also derived significant fees from non-audit work.

Aggressive Accounting Practices

Shareholders funds in the 2000 annual report were estimated to be A$939 million, but the supporting assets appear weak (intangibles of A$500 million, A$405.3 million from FAI). On the liabilities side, there is approximately A$500 million in borrowings. Compared with the previous year, HIH's debt had risen by A$170 million in 1999-2000. According to its cash flow statements, HIH's premium income dropped 15%, or A$486 million.

One accounting issue that received scrutiny from analysts was the decision by HIH to treat its increase in reserving as a goodwill item, which while it is an acceptable accounting treatment, it should really be taken through the company's profit and loss statement. The growth in goodwill can be seen in Figure 2.

Figure 2



Source: Worldscope Extel

This figure illustrates the change in goodwill treatment at HIH Insurance for the period 1996-2000.

For the years ending 30 June 1999 and 30 June 2000, the HIH Group incurred significant income tax losses. Despite this, HIH continued to record as an asset in its financial statements the full value of the future income tax benefits associated with these income tax losses, as well as future income tax benefits associated with timing differences. The financial statements as of 30 June 1999 showed future income tax benefits resulting from timing differences at A$145 million and those resulting from tax losses at A$27 million, a total of A$172 million. The comparative figures for 30 June 2000 are A$91 million, A$137 million and A$228 million respectively.

"Reserving" (the amount of liability for future claims) is standard practice for insurance companies. The process requires an actuarial forecast of future claims, an inflation rate, and a discount rate. The values are subjective and when determined, the practice is to scale the value up 15% to 20% (i.e. a prudential margin). As mentioned previously, HIH did not apply a prudential margin to its reserves after 1998. Possibly worse, HIH began to "game" values within the subjective calculation of the reserves. In 1999, HIH used 5% for inflation and 6.1% as the discount rate for its reserve calculation. In 2000, the inflation number lowered to 3.8% and the discount rate increased to 6.4%. Consequently, the reserve calculation would be lower than if calculated with the 1999 parameters. Despite such tactics, HIH's outstanding claims liability still increased while being overly optimistic.

The Aftermath

At the time of the HIH collapse, the Australian regulatory structure received some criticism. The Federal regulatory structure is made up of three key authorities: the Treasury, the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investment Commission (ASIC). ASIC's responsibility in regard to HIH deals primarily with the public disclosure of financial reports, corporate executive conduct, and the conduct of market participants.

The HIH Royal Commission hearings commenced in early December of 2001. Initially, it was thought it would take six months to present findings to the HIH Royal Commission, however, an extension was granted. The HIH Royal Commission concluded after 14 months on February 4, 2003. On April 17, 2003, Justice Neville Owen (who presided over the Royal Commission) provided his assessment of the collapse (1500 pages and three volumes) and recommended deferring 56 suspected breaches of the law to prosecuting authorities – to ASIC (Australian Securities and Investment Commission) and the New South Wales Director of Public Prosecution. The HIH Royal Commission cost an estimated A$40 million and heard evidence from 100 witnesses during 220 sitting days.

In his assessment of the HIH collapse, Owen stated, "*HIH is not a case where wholesale fraud or embezzlement abounded*". Rather, there was "*a series of business decisions that were poorly conceived or even poorly executed*". Owen also recommended a review of the Australian Corporations Act and the Australian Stock Exchange (ASX) rules. However, he was reluctant to recommend a "one size fits all model". In the area of corporate governance, one recommendation was to force a greater disclosure of directors' pay and benefits.

Owen's second recommendation requires a clarification of executive's duties and to widen the definition of people performing functions for a company to include independent contractors and consultants. In terms of amending the Australian Corporations Act, Owen recommended that not only should the lead partner be rotated, but senior audit personnel should be rotated as well. If non-audit services are provided, then auditors should be required to explain why the non-audit services do not compromise audit independence.

As for ASX listing rules, Owen recommended that the release of announcements to the stock exchange be approved by at least one board member. In addition, "blacklisting of analysts" (practiced by CEO Williams) should be outlawed under ASX listing rules.

The Australian Prudential Regulatory Authority (APRA) also came in for heavy criticism. Justice Owen said the regulator did not recognize the seriousness of the situation at HIH until it was too late.

After the report was delivered, ASIC filed criminal charges against three former officers of FAI General Insurance Company – Timothy Mainprize, Daniel Wilkie and Stephen Burroughs. The criminal charges were in connection with reinsurance arrangements entered into by FAI with General Cologne Re in 1998. For breaching their duties as HIH directors, Rodney Adler and Ray Williams were ordered to pay combined compensation equaling nearly A$8 million in addition to penalties. Further, both were also banned from acting as directors – 20 years for Rodney Adler and 10 years for Ray Williams. At the time of writing, Adler was also facing criminal charges by ASIC, including charges of market manipulation and making false statements. Finally, the impact of the HIH collapse on the financial markets can best be described by the following:

> "*A collapse of this magnitude must inevitably shake public confidence in the insurance industry and in the regulatory system's ability to carry out its protective role properly…There will always be corporate failures but, in terms of their consequences, most are inevitably self-contained. Some collapses, though, cause the public to question the integrity of the market system itself. The failure of HIH was an event of that nature*." (Justice Owen)

Exhibit 1
Chronology of Key Events at HIH Insurance

1968	Ray Williams and Michael Payne establish M W Payne Underwriting Agency Pty Ltd.
1971	M W Payne Underwriting Agency acquired by CE Heath plc of the UK
1980	Ray Williams appointed to board of CE Heath plc
1987	CE Heath plc establishes workers compensation underwriting operation in California USA
1989	Business of CE Heath plc transferred to CE Heath International Holdings Ltd (CE Heath), with 90% shareholding retained by CE Heath plc
1992	CE Heath lists on the Australian Stock Exchange. This results in 45% of the issued capital owned by the public, 44% by CE Heath plc and 11% by CE Heath directors and staff.
1993	CE Heath commences operations in the UK.
1994	CE Heath sells its workers compensation underwriting operation in California, USA
1995	CE Heath acquires CIC Insurance Group ("CIC"). CIC Holdings becomes Winterthur Holdings Australia Ltd, a wholly owned subsidiary of Winterthur Swiss Insurance Company ("Winterthur Swiss").
1996	CE Heath changes its name to HIH Winterthur International Holdings Limited ("HIH Winterthur"). HIH acquires Utilities Insurance.
1997	HIH Winterthur repurchases the workers compensation subsidiary in California, Heath Cal, subsequently named HIH America Compensation and Liability Insurance Company ("HIH America").
1997	HIH Winterthur acquires Colonial Ltd General Insurance operations in Australia and New Zealand. HIH becomes Australia's largest writer of banking assurance.
January 1998	HIH Winterthur acquires Solart in Argentina
February 1998	HIH Winterthur establishes representative office in Beijing, China. HIH Winterthur acquires minority interest (24.46% stake) in Nam Seng Insurance plc of Thailand
April 1998	HIH Winterthur acquires the Cotesworth Group Ltd in London, UK, a managing agency of four Lloyds syndicates
June 1998	HIH America acquires Great States Insurance Co of Arizona, USA
July 1998	Winterthur Swiss announces it is selling its 51% shareholding in HIH Winterthur to the public. HIH shares trade around $2.85.
August 1998	Sale of shareholding complete
September 1998	HIH Winterthur announces proposed takeover of FAI Insurance Ltd. Adler family unloads 14.3% stake. HIH announces it had purchased the Adler family stake. Shares trade around $2.50.

September 1998	HIH blacklists stock broking analysts who disputed the assessment of the company.
October 1998	HIH Winterthur becomes HIH Insurance Ltd
January 1999	S&P downgrades HIH's corporate credit rating from A to A- FAI takeover complete.
February 3, 1999	HIH's converting notes make a strong debut on ASX
March 3, 1999	HIH enters formal negotiations for the sale of its 45% stake in FAI Life. HIH posts a 39 per-cent fall in 1998 net profit.
March 4, 1999	HIH announces it has suffered a 39% profit plunge
March 26, 1999	HIH's earnings potential receives an upward rating by stock broking analysts
April 1999	As result of Sydney hailstorm, expected total loss of $27 million. The group also estimates its net loss due to reinsurance to be no more than $10 million
April 21, 1999	HIH steps up sale of non-core asset, Oceanic Coal. Shares fall to $1.99
June 30, 1999	New financial year-end used. Changed from Dec. 31 to June 30
August 26, 1999	HIH posts $58.8 million loss in the six months to June
September 15, 1999	HIH continues to pay dividends despite heavy losses. However, dividends had been slashed in half.
February 1, 2000	HIH ceases to be a substantial shareholder in OAMPS.
February 3, 2000	A- rating confirmed by Standard & Poor's
March 2000	HIH returns to profitability for the first half of 1999/2000.
March 2, 2000	HIH announces plans to develop the St. Moritz Hotel in NY with Millennium Partners.
March 3, 2000	HIH sells about half of its St. Moritz investment.
March 28, 2000	HIH takes a 10% stake in Safe Trade, an internet insurer.
March 29, 2000	HIH decreases its interest in Armourglass (from 10.55% to 8.91%).
March 31, 2000	HIH decreases holding in Acclaim Uranium NL (12.10% to 10.8%).
April 5, 2000	HIH decreases its interest in Armourglass (8.91% to 7.64%)
May 8, 2000	HIH decreases its interest in Acclaim Uranium (10.8% to 9.60%)
June 15, 2000	Share price falls to new low of $0.96.
June 20, 2000	Announcement that Rodney Adler, a non-executive director had topped up his holding in the company to 1.86%
July 1, 2000	Goods and Services Tax (GST) introduced in Australia.

September 2000	Joint venture with Allianz announced. HIH sells part of its domestic personal lines to Allianz for $500 million.
September 12, 2000	George Sturesteps and Michael Payne resign as directors of HIH.
October 12, 2000	Dominic Fodera resigns as director of HIH. Also in October, the US business is placed in run-off. Ray Williams, CEO, announces his retirement.
November 2000	S&P downgrade HIH credit rating to BBB^{+}. Some Asian operations are also sold. HIH also enters managing general agency agreement with Gerling Group.
December 15, 2000	HIH annual general meeting. Ray Williams steps down as director of HIH and Randolph Wein is appointed the new CEO. Shareholders call for resignation of Rodney Adler from HIH board.
February 22, 2001	ASX trading halts to HIH shares. Speculation that HIH will lose up to $500million.
February 26, 2001	HIH resumes trading. Rodney Adler resigns. ASIC raids HIH offices.
February 27, 2001	Trading halted at HIH's request. ASIC hands HIH documents to ASX. S&P lowers HIH Credit rating.
March 1, 2001	HIH shares suspended until interim profit released.
March 6, 2001	QBE forms joint venture with HIH in corporate insurance, takes 60% stake.
March 9, 2001	Allianz buys remainder of retail insurance venture for $125 million.
March 14, 2001	NRMA buys HIH workers' compensation business for $130 million.
March 15, 2001	HIH puts itself into provisional liquidation and estimates $800 million half year loss.
May 16, 2001	ASIC launches it's biggest ever investigation, seizing HIH documents.
May 21, 2001	Federal Government announces a Royal Commission into what is at the time Australia's biggest corporate collapse.

Source: Australian Financial Review and HIH Royal Commission Website.

Exhibit 2
HIH Board Composition, Executive Compensation and Executive Shareholdings

1998/1999 Annual Report

Non-Executive Directors	**Key Announcements**	**Compensation ($Aust)**	**Ordinary Shares**	**Options**	**Convertible Notes**
G.A. Cohen (Chairman)		324,600	55,806		4,260
C. P. Abbott		204,386	59,647		
R.S. Adler	Appointed April 16, 1999	4,311,945	5,500,000		
J.H Gardner	Appointed December 2, 1998	31,377	46,894		
A. W. Gorrie		200,862			
N.R. Head		142,140			
E.W. Heri	Resigned effective October 15, 1998				
M.W. Payne	Retired as Executive June 30, 1998, appointed Non-Executive July 9, 1998	271,936	133,611	376,000	8,467
W.E. Schurpf	Resigned effective April 15, 1998				
R.H. Stitt		128,180	40,810		1,129
Executive Directors	**Key Announcements**	**Compensation ($Aust)**	**Ordinary Shares**	**Options**	**Convertible Notes**
R. Williams (CEO) and Deputy Chairman		1,460,350	10,336,383	500,000	19,200
T. Cassidy		916,777	6,941,213	400,000	10,000
D. Fodera		799,870	348,871	520,000	5,024
G. Sturesteps		986,294	6,242,061	320,000	9,700
H.R. Wein		517,687			

For the 1998/1999 annual report there was 12 directors on the board, three less than the maximum number provided for under the company's constitution.

1999/2000 Annual Report

Non-Executive Directors	Key Announcements	Compensation ($Aust)	Ordinary Shares	Options	Notes
G.A. Cohen (Chairman)		216,090	61,566		4,260
C. P. Abbott		86,400	209,832		
R.S. Adler		53,000	5,753,670		
J.H Gardner		57,000	112,713		
A. W. Gorrie	Resigned November 19, 1999	32,307			
N.R. Head	Resigned November 19, 1999	6,796			
M.W. Payne	Resigned effective September 12, 2000	133,317			
R.H. Stitt		63,514	140,260		1,129
Executive Directors	**Key Announcements**	**Compensation ($Aust)**	**Ordinary Shares**	**Options**	**Notes**
R. Williams (CEO)	Resigned effective December 15, 2000	1,147,692	12,222,715	500,000	19,200
T. Cassidy	Resigned effective October 12, 2000	671,900			
D. Fodera	Resigned effective October 12, 2000. Appointed Chief Operating Officer.	677,128			
G. Sturesteps	Resigned effective September 12, 2000	707,286			
H.R. Wein (new CEO)	Appointed new CEO December 15, 2000.	648,328	4,233		

For the 1999/2000 annual report, the Board of HIH had seven directors (5 Non-Executives and 2 Executives), eight less than the maximum number provided for under the company constitution.

On October 13, 2000 it was announced by HIH Chairman Geoffrey Cohen that Australian executives would no longer serve on the board. This meant that Terry Cassidy and Dominic Fodera would step down. Around this time Dominic Fodera was appointed Chief Operating Officer.

Source: Australian Financial Review and HIH Annual Reports. Data are in Australian dollars.

Exhibit 3
HIH Board Composition, Committee Membership and Meeting Attendance

Reporting Period 1998/1999 (18 month period)

Non-Executive Directors	**Board**	**Audit**	**Reinsurance**	**Investment**	**Human Resources**	**Share Transfer**	**Due Diligence (.)**
No. of Meetings Held	24	4	9	6	3	26	10
G.A. Cohen (Chairman)	23	4		5	3		10
C. P. Abbott	21	3					
R.S. Adler	2			1			
J.H Gardner	9	1			1		
A. W. Gorrie	21				3		
N.R. Head	16	4			2		
E.W. Heri	1						
M.W. Payne	4		8				
W.E. Schurpf	0						
R.H. Stitt	21	4			3		8
Executive Directors	**Board**	**Audit**	**Reinsurance**	**Investment**	**Human Resources**	**Share Transfer**	**Due Diligence (.)**
R. Williams (CEO) and Deputy Chairman	24					26	
T. Cassidy	21		9	5		26	
D. Fodera	22		8	6			9
G. Sturesteps	16		9				
H.R. Wein	9	1	4		2		

(.) Relates to the Converting Note issue/FAI

Reporting Period 1999/2000

Non-Executive Directors	**Board**	**Audit**	**Reinsurance**	**Investment**	**Share Transfer**	**Other Boards (No.) Disclosed**
Number of Meetings Held	6	3	4	4	15	
G.A. Cohen (Chairman)	6	3		4		2
C. P. Abbott	4	2				2
R.S. Adler	5			4		5
J.H Gardner	5	3				4
A. W. Gorrie	3					
N.R. Head	1					
M.W. Payne	4		4			
R.H. Stitt	5	3				
Executive Directors	**Board**	**Audit**	**Reinsurance**	**Investment**	**Share Transfer**	**Other Boards (No.) Disclosed**
R. Williams (CEO)	6				15	1
T. Cassidy	4		4	4	15	
D. Fodera	6		4	4		
G. Sturesteps	4		4			
H.R. Wein (new CEO)	4		3			

Exhibit 3 (continued)

According to the HIH Insurance 2000 annual report, the function of the reinsurance committee is to provide a forum for examining relationships with reinsurers and to review the scope and nature of reinsurance programs.

The Investment Committee considers “group asset allocation ranges, sets investment guidelines on currency and property dealings, and reviews the performance of internal and external fund managers against approved benchmarks”.

The Human Resources Committee is responsible for reviewing “total remuneration for senior executives, organization structure, succession and development plans for senior managers and issues relating to the constitution of the Board”.

Exhibit 4
HIH Insurance – Financial Highlights 1997-2000

Date:	**12/31/97**	**6/30/99**	**6/30/00**
Inflation Rate (%)	5.0	5.0	3.8
Discount Rate (%)	6.2	6.1	6.4
Outstanding Claims Details			
Expected Future claim payments (undiscounted)	$2,377.3	$4,4598.7	$4,922.9
Liability for Outstanding Claims (Aust$m)	$1,956.6	$4,051.5	$4,430.9

According to the HIH annual report, the weighted average expected term to settlement from the balance date of the outstanding claims is estimated to be 2.6-2.7 years. The inflation and discount rates displayed were used in measuring the consolidated outstanding claims liability for the succeeding and subsequent years.

Source: HIH annual report.

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DISNEY IN ASIA, AGAIN?

Raymond H. Lopez, Pace University

The Walt Disney management team has been operating theme parks in the United States, France and Japan for decades. After exhaustive study, they have narrowed down a decision to expand in Asia once again with a park in either Shanghai or Hong Kong. Analysis of data should enable students to forecast revenues, expenses and pro forma financial statements for operations at each location. They must quantify and qualify such factors as culture, weather, the economic environment, capital expenditures, costs of capital, etc. and determine how each affect the financial viability of the project. Using discounted cash flow techniques, they should be able to calculate net present values for each site and critically compare them from the perspective of each operating organization as well as The Walt Disney Company.

Early in 1999, Michael Eisner, CEO of The Walt Disney Company, voiced his opinions concerning potential markets for his firm's entertainment products and services. "We could be getting close to the time for a major Disney attraction in the world's most populous nation" (Disney Annual Report, 1998). A major thrust for the new millennium would be development in Asia. "I am completely confident that Chinese people love Mickey no less than they love a Big Mac" (Knight-Ridder/Tribune *Business News*, June 16, 1999).

The firm had achieved a certain level of experience with owning and/or managing assets and operations outside the United States. They had two competing models that would be utilized to analyze and ascertain the financial and operating structure of their next foray into the global business arena.

Their first experience was Tokyo Disneyland. Modeled after Disneyland in California and located six miles from downtown Tokyo, the park opened in 1983 and was literally a cultural and financial success from day one. However, not all of the potential financial benefits accrued to Disney shareholders, since the facility was entirely owned by The Oriental Land Company. Disney generated a large and growing stream of fee income, but did not participate as an owner. The architect of Disney's strategy was Ron Miller, CEO, son-in-law of Walt Disney and leader of a very conservative management team.

By the time a development decision for Western Europe rolled around in 1987, Michael Eisner was Disney's CEO. The new management team was convinced of the benefits of ownership. In negotiating with the governments of Spain and France, Disney's position was to maximize their ownership interest in any theme park operation. This was accomplished with their 49 percent ownership of Euro Disney which opened east of Paris in 1992.

Attendance and operating income in France were less than anticipated and a major restructuring of the Euro Disney operating company was effected in 1994. Cultural challenges as well as a European recession in the early 1990s resulted in less than anticipated success of the park and its related hotels and facilities. Renamed Disneyland Paris early in 1994, the attractiveness of the Disney experience finally achieved enhanced performance for this facility which, by the late 1990s, was the largest theme park in Western Europe!

With these two quite different experiences in operating a large theme park and resort facility outside of the continental United States, the Eisner management team was ready to move into China. Two locations were "in the running" early in 1999, representing quite different operating and financial strategies and structures. Hong Kong or Shanghai would likely be the site of the next Disney theme park. This was the challenge faced by the Disney management team with a target decision date of June 1999.

THE WALT DISNEY COMPANY

The Walt Disney Company, together with its subsidiaries, was a diversified international entertainment organization with operations in three major business segments. From humble beginnings at The Disney Brothers Studio, founded in 1923 by Walter E. and Roy O. Disney, the firm had developed into a global powerhouse in the leisure services industry (Exhibit I, History of the Walt Disney Company), (Exhibits 2-6, Recent Financial Data for The Walt Disney Company).

Creative Content

The company produced and acquired line-action and animated motion pictures for distribution to the theatrical, home video, and television markets. The firm also produced original television programming for the network and first-run syndication markets. Disney distributed its filmed products through its own distribution and marketing companies in the United States and most foreign markets.

The company licensed the name "Walt Disney," as well as the company's characters, visual and literary properties, songs, and music to various consumer manufacturers, retailers, show promoters, and publishers throughout the world. The firm also engaged in direct retail distribution principally through the Disney Stores, and produced books and magazines for the general public in the United States and European markets. In addition, Disney produced audio and computer software products for the entertainment market, as well as film, video, and computer software products for the educational marketplace.

Buena Vista Internet Group (BVIG) coordinated the company's internet initiatives. BVIG developed, published, and distributed content for narrow-band online services, interactive television platforms, interactive web sites, including Disney.com, Disney's Daily Blast, ESPN.com, ABC News.com, and the Disney Store Online. The Disney Store Online offered Disney-themed merchandise to customers over the internet.

Broadcasting

The company operated the ABC Television Network, which had affiliates providing coverage to U.S. television households. Disney also owned television and radio stations, most of which were affiliated with either the ABC Television Network or the ABC Radio Network. The company's cable and international broadcasting operations were principally involved in the production and distribution of cable television programming, the licensing of programming to domestic and international markets and investing in foreign television broadcasting, production, and distribution entities. Primarily domestic cable programming services were operated through subsidiary companies and joint ventures. These companies included ESPN, the A & E Television Network, Lifetime Entertainment Services, and E! Entertainment Television. The company also provided programming and operated cable and satellite television programming services for the Disney Channel and Disney Channel International.

Theme Parks and Resorts

This division of the company operated the Walt Disney World Resort ® in Florida, and Disneyland Park ®, the Disneyland Hotel, and the Disneyland Pacific Hotel in California. The Walt Disney World Resort included the Magic Kingdom, Epcot, Disney-MGM Studios, and Disney's Animal Kingdom, thirteen resort hotels, and a complex of villas and suites, a retail, dining, and entertainment complex, a sports complex, conference centers, campgrounds, golf courses, water parks, and other recreational facilities. In addition, the resort operated Disney Cruise Line from Port Canaveral, Florida. The company's first ship, Disney Magic, commenced operations in July of 1998 and a sister ship, Disney Wonder, was scheduled for launch in 1999.

Disney Regional Entertainment designed, developed, and operated a variety of new entertainment concepts based on Disney brands and creative properties, operated under the names Club Disney, ESPNZone, and Disney Quest.

The company earned royalties on revenues generated by the Tokyo Disneyland ® theme park near Tokyo, Japan, a facility owned and operated by an unrelated Japanese corporation, Oriental Land Development. The company also had a 39 percent ownership stake in Euro Disney S.C.A., a publicly-held French entity that operated Disneyland Paris.

The company's Walt Disney Imagineering unit designed and developed new theme park concepts and attractions, as well as resort properties. Disney also managed and marketed vacation ownership interests in the Disney Vacation Club. Included in the Theme Parks and Resorts division were the company's National Hockey League franchise, The Mighty Ducks of Anaheim, as well as an ownership interest in the Anaheim Angels, a Major League Baseball team.

The Walt Disney Company had a long history of successfully managing theme parks. Not only did they operate as stand-alone investment projects; they may also be thought of as valuable marketing venues for other aspects of Disney's business. For example, from two years before it opened to five years after opening Disneyland in Anaheim, California, sales of company merchandise in the United States increased 100 percent. In the case of Tokyo Disneyland, a comparable time period produced a 200 percent increase in merchandise sales. After Disneyland Paris opened, merchandise sales in Europe over a comparable period grew by 1000 percent. China and other Pacific Rim nations had a sales potential that was very inviting.

DISNEY AND CHINA IN THE 1990s

Relations between the Disney company and the government of China had not been particularly tranquil in recent years. In late 1996, China's leaders vehemently objected to Disney's plans to distribute the movie 'Kundun,' a Martin Scorsese directed film that told the story of Tibet's exiled spiritual leader, the Dalai Lama, and China's brutal occupation of that nation. The film was released in 1997 and China's leaders made threatening statements concerning Disney's future in their markets.

Disney held firm its position on the movie. "Disney's potential business in China is infinite. But Disney has to decide whether it wants to facilitate business or stand for free speech" (Time Magazine, December 9, 1999).

Another Disney film, the animated movie 'Mulan,' about a legendary Chinese woman-warrior, proved to be a box-office disappointment in China. It was claimed that the film's Chinese characters looked too Western. In addition, pirated video versions of the film were available in China even before the film arrived in theaters (USA Today, November 2, 1999).

Yet not all of Disney's relationships with China were negative. The liberalization of China's markets had generated benefits for the firm. 'The Lion King' brought in almost $4 million in 1996 and the soundtrack sold 1.4 million copies.

POTENTIAL OF THE ASIAN MARKET

Building and investing in a multi-billion dollar theme park would represent another major, long-term commitment for The Walt Disney Company. Therefore, a great deal of research and planning were involved in this decision. In addition to the attractiveness of each of the remaining cities, Shanghai and Hong Kong, market characteristics of the demand for theme park experiences by the Chinese people would have to be evaluated carefully and completely.

Although success of the Tokyo Disney theme park strengthened the case for another facility in Asia, other data and experience brought up additional questions. In the last five years, though 1998, more than 2000 theme parks had been opened in China, developed and financed by both domestic and foreign investors. Disney management was convinced that a huge, child-loving populace would support a lively theme park business. Instead, many projects were swamped by excessive competition, poor market projections, high costs, and relentless interference from local officials.

Several hundred parks had already been closed, due to poor quality of service and less than exciting entertainment experiences. Many of the consumers who were expected to flock to these parks seemed to have gone sour on the notion of theme parks altogether (Faison, Seth, August 3, 1999). These parks had also been unsuccessful at attracting a significant number of customers from other Asian nations.

Other factors affecting the viability of an Asian theme park in China had to be evaluated. The Chinese economy was one of the fastest growing during the 1990's and was expected to experience significant growth well into the new millennium. At least one-third of the nation's 1.2 billion people resided in the rapidly developing coastal region, the industrial heartland of the nation. The largest and most developed population centers were located in this area, where an awakening and growing middle class lived and worked. Their leisure time had been growing significantly and was expected to continue to outperform the rest of the nation. With their income levels approaching $1,000 per month, China's middle class families were a prime target audience for Disney theme park experiences.

The Chinese had a cultural disposition toward pampering children, which had been accentuated by the nation's one-child per couple policy. Although many theme parks in China had not been successful, it was still generally believed that an exciting experience of high quality would attract visitors to a park. Just an ordinary experience would be unlikely to result in a second visit. Based on the repeat visitors at every other Disney theme park, management was quite confident that they would be successful in attracting Chinese visitors not only the first time, but also the second, third, and fourth times.

INTERNATIONAL THEME PARKS AND RESORTS – THE DISNEY EXPERIENCE

Foreign visitors had always been an important component of Disney's U.S. theme parks in Anaheim, California and Orlando, Florida. In 1979, the firm's management decided to take their park experience outside the country for the first time.

Tokyo Disneyland

This park, located on landfill in Tokyo Bay, was only 6 miles from downtown Tokyo. In keeping with the traditional conservative philosophy of the Disney management team in the 1970's, the park was designed as a very close approximation to the original Disneyland. A proven theme park prototype was, in effect, transplanted across the Pacific Ocean to a site where 30 million people lived within 30 miles of the new facility.

Disney's management controlled most aspects of the design and operating characteristics of the park. The successful themes of Adventureland, Tomorrowland, Frontierland, etc. were faithfully reproduced. Even the famous Disney standards of no alcoholic beverages served within the park and no food from outside the park allowed in, were transferred to the new facility. Cleanliness, neatness, and precision operations were also incorporated into the workings of the new park. The Disney application of total quality management had to be upheld, regardless of the location of the facility. Mickey would have it no other way.

In keeping with their conservative philosophy, the Disney management team, led by Ron Miller, desired to reduce the financial risks inherent in international investments. Therefore, they gave up any ownership in the park and, for a mere $2.5 million procured a 45 year contract that gave the company the rights to collect 10 percent of admission revenues, 5 percent of food and merchandise sales, and 10 percent of corporate sponsored agreements. Disney had responsibility for artistic design and development of the facility.

Tokyo Disneyland opened its doors to the public on April 13, 1983 and was literally an instant success, from both a cultural and financial perspective. In its first full year of operations, it attracted approximately 9.9 million visitors, almost equal to attendance at Disneyland, Anaheim that same year. Over the next decade and a half, attendance grew steadily to more than 15 million in 1998, making this park the largest in the world. Revenues from royalties and licensing fees were rapidly approaching an annual level of $100 million.

A number of factors contributed to the success of Tokyo Disneyland. The Japanese government was supportive of efforts to develop and promote the park. The Japanese people enthusiastically embraced the concepts, ideas, characters, and themes of the park. Tokyo Disneyland "appealed to the deep-seated Japanese passions of cleanliness, order, outstanding service, and technological wizardry" (Toy, Stewart, Ronald Groven, and Mark Maremont, "Mouse Fever is About to Strike Europe," *Business Week,* March 30, 1999).

Other forces also supported the attractiveness of the park to the Japanese people. Its opening coincided with a strong economy in Japan. Personal incomes were expanding, discretionary spending was increasing, and there was a developing focus on relaxation and entertainment by a rapidly growing segment of the Japanese population.

All these forces contributed to the initial and continuing success of this park. By the mid-1990s both the owner of the facility, Oriental Land Company, Ltd. and the Disney organization had commenced plans for a second park at that site, Tokyo DisneySea. Once again, Oriental Land would make the initial investment, estimated to be in excess of $2.5 billion, while Disney would contribute creative content and management expertise, in return for an agreed-upon fee structure.

Euro Disney (now Disneyland Paris)

When Disney management evaluated their experience in Japan they vowed to learn from it and take maximum advantage of perceived opportunities in Europe. They desired a relatively large area of land, to facilitate future parks as well as hotel and real estate development. And, with high expectations for immediate success in attracting visitors, they would build a park of similar size and capacity to Tokyo Disneyland. Finally, they would take as large an equity ownership position as was permitted under European Union guidelines (49 percent).

In order to support their visitor level forecasts in a multicultural setting they chose to localize some of the purely "American" aspects of their U.S. parks. They would incorporate the history and European roots of some of the most well known Disney characters. Pinocchio was an Italian boy, Peter Pan used to fly out of London, and Cinderella was a French girl. Disney re-emphasized these traditions in their marketing programs and theme park attractions.

The final location decision for a single European theme park complex was Marne-la-Vallee, a 4800 acre site 35 kilometers east of Paris. This region, including Paris and its suburbs, boasted 3 airports, 6 railway stations, a highly developed road network, and a link to Paris in the form of a high speed TGV train station to be constructed at the site. (Greenhouse, Steven, "Playing Disney in the Parisian Fields." *The New York Times*, February 17,1991).

The development of the site would be in stages, with Phase I including a Magic Kingdom theme park and 5,000 hotel rooms. Other retail and entertainment attractions (golf courses, convention center, water park, etc.) would be built over the next few years, to convince visitors to extend their time at the facilities. Approximately 5 years after opening, Phase II would commence with the construction of a Disney Studios theme park.

From a financial perspective, Disney management negotiated potentially lucrative contracts with the French government and Euro Disney, S.C.A. the owner and operator of the facilities. Disney invested approximately $450 million in the venture, primarily in the form of creative content, design expertise, and managerial talent. In return, they received a 49 percent ownership of the operating company, which became a public company through a highly successful IPO in November 1989. In addition, Disney received fees based on attendance and revenues from food and merchandise sales. They would also receive a "base management fee" amounting to 3 percent of gross revenues for the first five years of operations, rising to 6 percent within the next five years. And, they would receive an "incentive management fee" amounting to 30 percent of pre-tax cash flow in the first year of operations, rising to 50 percent of pre-tax cash flow from year five onward. If projected visitor attendance of 11 million were realized, with expenditures in the park at modest levels, the rates of return on Disney's "investment" could have reached 70 percent or more in the first five years of operations.

In retrospect, the best forecasts may not be achieved, even if given more time to reach expected goals. During the five year construction program for Phase I, expenditures rose from $2.4 billion to $4.4 billion, due to a variety of factors, from unexpected quality enhancements to the inherent inefficiencies of having 38 general contractors working at one site at the same time.

The financial structure of the Euro Disney operating company was highly leveraged, with $4 of debt for every dollar of equity. With high fixed operating expenses, coupled with high fixed financial charges, the breakeven level for operating profitably was more than the firm could handle or achieve.

The gates swung open to the park in the Spring of 1992, to great fanfare and heavy promotion. Yet it was not long before management realized that major problems faced this operation. Attendance was approximately 2 million per year under the most probable projected levels. Recession in Western Europe and cultural clashes between the French people and the park's managers contributed to these shortfalls. Expenditures for food and merchandise inside the park were also lower than expected, as were occupancy levels at the on-site hotels (within a year one of the hotels was actually closed).

The financial implications of these activities were unsettling for all stakeholders. The common stock price of Euro Disney shares plunged more than 70 percent in less than three years, management turnover at the operating company rose, a major financial restructuring of the company took place and The Walt Disney Company agreed to give up its fee income for more than five years. Attendance levels did not reach year one expectations until year seven of actual operations. The harsh realities of the French theme park experience were vivid reminders of the risks inherent in a large, complicated, multi year investment project. Expansion into Asia, again, would also bring with it global risks as well as uncertain opportunities.

THEME PARKS AND RESORT DIVISION – RECENT DEVELOPMENTS

In the closing months of 1998, Mr. Eisner announced a restructuring of the theme park and resort operations. Consolidation of operating control was placed in the hands of a 20 year veteran manager of the division, Judson Green. For the first time all aspects of Disney's recreation and travel business would be under one manager, reporting directly to Mr. Eisner.

The new division was renamed Walt Disney Attractions and would include existing theme parks and resorts, Walt Disney Imagineering (which designed the parks and rides), and Disney Regional Entertainment, a new unit that had been developing Disney Quest arcades and ESPN restaurants in various markets.

Mr. Green's first major task was to plot the firm's next phase of theme park expansion. Its focus was to enhance operations in foreign markets. "There are major parts of the world we are barely penetrating" (*The Wall Street Journal*, December 14, 1998).

Mr. Eisner instructed executives in all of Disney's major business units to begin planning to ramp up their overseas operations. Not only would they expand outside the U.S. but plans were being formulated to attract more foreign visitors to the domestic parks. For example, the current level of 20 percent foreign visitors to Walt Disney World was projected to grow to 50 percent in ten years. This restructuring laid the ground work for an aggressive attempt by Disney to expand its presence in foreign markets, especially China.

In order to formalize the analysis and evaluation of constructing and operating a theme park operation in China, Mr. Green assembled two teams, similar to the process utilized for the European location decision in the late 1980s. Even though, on a long term basis, the Asian market could eventually support two or more theme park operations, the decision to be made in 1999 was to identify and support only one new investment site. If both locations resulted in positive net present values, only one would be chosen now while the other could be built at a later date.

Over the last few years, operating results of the Disney Company had been less than stellar. Even with a strong economy in the U.S. and Europe, problems at the broadcasting unit and lackluster results from studio operations created challenges for Mr. Eisner. In addition, in 1998 and early 1999, there was the acceptance of two cruise ships for Caribbean operations that required outlays of approximately $350 million each.

In the theme park division "California Disney" in Anaheim was scheduled to open early in 2001, at a cost in excess of $1 billion. And, in Orlando, the fourth theme park within the Walt Disney World complex, Animal Kingdom, was completed in 1998 at a cost of $800 million. These major projects had absorbed not only large amounts of capital, but also managerial time and creative capital at the Imagineering division.

At Tokyo Disneyland, a second theme park, "DisneySea" was also under construction. Although there was no financial investment by Disney, the firm was still heavily involved in creative content, design, development, and ultimately managerial expertise. Even for a world class leisure and entertainment business such as Disney, there was just so much that could be accomplished within a given period of time. Asia would now become the focus of this division, as the board carefully reviewed and evaluated the demands of each project with the resources available at the company.

CRITERIA FOR AN ASIAN SITE

In deciding on a site for a China theme park, a number of factors had to be identified, considered, and evaluated. Mr. Green, in consultation with Mr. Eisner and the Disney Board of Directors, was looking for an "international character" for this park. A diversified visitor base would reduce the risks of problems in one country having an adverse effect on visitor flow.

Infrastructure in the area of the park and the region supporting it were also important. Visitors should be able to reach the park easily, by a variety of forms of transportation – airports, railroads, roadways, tunnels, bridges, bus lines, etc. should be well established or enhanced while the park was being constructed. An area that is easy to get to and get around in would support a park most efficiently.

The park and the region should contribute to visitors extending their time spent at the Disney facility. Convincing visitors to stay at the site, in a Disney hotel, was likely to generate greater cash flows from the park and its ancillary facilities. A stock of hotel rooms to support park visitors was also important. Rooms at a variety of price points, from economy to luxury, should be available when the park opens.

Successful theme parks in the area of the Disney facility may be viewed positively or negatively. They represent competition but, at the same time, may convince more people to visit the area to experience both facilities. This has occurred at the U.S. theme parks in Anaheim and Orlando as well as the more recent experience in Paris.

Gross and disposable income levels of the area citizens as well as foreign visitors would affect the success of the park. International visitors are more likely to be able to afford to travel and pay for attendance and in-park purchases. This is especially true of the U.S. parks. In contrast, in Tokyo, approximately 95 percent of visitors are Japanese, yet the park is tremendously successful.

Land area and its configuration contribute to the potential success of a theme park. Relatively flat areas are preferred, with extra land for expansion a definite asset. While land was plentiful in France, it did not contribute as much as originally anticipated to the success of the park. In contrast, Tokyo transformed a block of barren coastal landfill into an important economic engine for the greater Tokyo area. Hong Kong officials hoped for the same results in their potential agreement with Disney.

Support from the local government is critical to the Disney Company. Making land available in a preferred location and investing in the park, in the form of equity and/or debt guarantees is very important. Mutual respect for what each side brings to the table will go a long way towards successfully operating a theme park facility for at least the next fifty years.

Once again Disney's position is to make a minimal equity investment in any operating entity and generate most of its returns through royalty, licensing, and fee income streams. International risks would be reduced to fluctuations converting local currency cash flows into U.S. dollars.

Finally, while each city might try to convince Disney to sign an exclusivity contract with respect to future development in China, the company definitely will not sign such a document. They want the option to grow their theme park business in other cities in China or Asia, based on future economic and financial circumstances.

The Shanghai Plan

Shanghai, known in the past as the "Paris of the Orient," had emerged in recent years as the largest and most affluent city in China. It was China's most "Western city" and in the 1990s had emerged as a growing industrial and commercial metropolitan area (Exhibit 7, Background Report – Shanghai).

Formal and informal discussions concerning a theme park facility in Shanghai had been taking place for at least five years. The mayor of Shanghai, Mr. Xu Kuangdi had been pushing Disney to locate in this city and, if necessary, to build a smaller park in Hong Kong. Mayor Kuangdi also had powerful allies in Beijing, where the final decision would ultimately be made. From Disney's perspective the focus would be on the right mix of financing, available land and governmental approval. "There's no question that if they build a theme park, people will come," said Christopher Dixon, New York-based entertainment analyst for Paine Webber. "The trick is to make money, too" (Duffy, Tara Suilen, "Hong Kong, Shanghai Vie for Disney Park Deal", *The News-Times, April 17, 1999).*

Shanghai had already earmarked a site for a Disney theme park. The Pudong New Area, a 200 square mile region across the Huangpu River from downtown Shanghai was being developed as part of a plan initiated in the early 1990's. Several zones had been established to support development of finance and trade, export processing, free trade, and high technology (Exhibits 9, 10 and 11, Location Characteristics, Climate Conditions, Exchange Rates).

Infrastructure investments on a massive scale were also being made. New highways, railway facilities, and a second international airport were being built. A Disney theme park would "fit right in."

The Disney site would be just across the Huangpu River from the famous Bund. The Bund was Shanghai's world famous waterfront promenade. It was a mile long, with parks and some of the city's major historic buildings.

The city was growing in population and financial stature, to serve an increasingly affluent mainland market. A number of other growing population centers (Changzhou, Suzhou, Wuxi, Wujiang, etc.) were within a few hours drive or train ride from the Disney site. Major rail lines served the city from the North, West, and South. The Shanghai metropolitan area, as well as the bordering provinces of Jiangsu, Zhejiang, and Auhui had a total population in excess of 130 million with average per capita income slightly exceeding $2100 per year (National Census Report Number 5, National Bureau of Statistics).

The projected cost of the proposed facility in Shanghai was approximately $1 billion. A preferred course of action was to obtain a licensing deal, similar to that of Tokyo Disneyland. Technology, creative content, and managerial expertise would be exchanged for annual royalties and fees derived from admissions to the park, purchases of food and Disney products in the park, and revenues from new hotel facilities near the park (Exhibits 12-17, Development Plans and Operating Characteristics of Phase I and Phase II Theme Parks).

This facility would be designed to operate profitably with a projected 9 million visitors in year one, rising at a rate of three percent per year for the next ten years. A Magic Kingdom park would be constructed in Phase I, with the potential of an EPCOT type theme park added after at least five years of operations.

For the city of Shanghai, attracting a Disney theme park would be a vote of confidence from a high-profile foreign investor. It could serve as a signal that this city, the pride of the country's Communist Party-led government, had attained international status *(The Wall Street Journal, March 3, 1999).*

From Disney's perspective it was important to attain "first mover" advantage in exploiting the Chinese marketplace. Other global theme park operators were following them around the world and it would be important that they continue to 'follow' rather than to 'lead'. In particular, they must be aware of the operations of Seagram's Universal Studios theme park operations.

Universal followed them to Orlando, they followed expansion in Orlando, they followed Disney to Europe, and they where obviously evaluating Asian opportunities quite carefully. If Disney did not stake out a clear presence in Shanghai, it could end up following Universal into China. Disney theme parks have never had to follow any firm into a potentially lucrative market. They have been number one from day one in Anaheim, Orlando, Tokyo, and Paris. They must be number one in China. Hong Kong could wait!

The Hong Kong Plan

It had been less than two years since the Disney Company considered Hong Kong as a possible theme park location. Informal negotiations with government representatives commenced in October of 1998. Yet the process of evaluating a site had progressed rapidly. A number of unique characteristics of the former British Crown Colony had contributed to Hong Kong now being considered as a prime target for Disney development and investment (Background Report – Hong Kong).

In the 1940's and 50's, this area was primarily a trading port. Development continued and by the 1980's, it was a low-cost manufacturing powerhouse. In the 1990's, as costs increased and manufacturing moved to lower cost Asian areas, Hong Kong became a regional financial center. As each of these periods developed and then declined, transformations took place to revitalize the area. The results were new, higher levels of growth and development for the region and its population.

In the late 1990's, some analysts were projecting another decline, due to the high costs of operating in the region. It was anticipated that cheaper destinations such as Shanghai and Singapore would attract business from Hong Kong.

For a while these predictions seemed to be coming true, especially when Hong Kong stumbled into a deep recession in the aftermath of the Asian financial crisis of 1997-1998. Real estate and equity values declined sharply, firms went bankrupt and unemployment levels reached 20 year highs.

Yet, Hong Kong seemed destined to transform itself once again. Government officials and private business owners and managers staked out another new role for the region: an information technology center serving greater China. The Special Administrative Region (SAR), established when control of Hong Kong reverted to China rule from Great Britain in July 1997, had been quite successful in attracting a growing number of new investments in software, e-commerce, and dot com companies.

Hong Kong was the “City of Life.” It had always had an international character, with a high percentage of tourists and visitors in relation to its indigenous population. The infrastructure needed to support a Disney theme park was already in place, with a new world-class airport, as well as commitments for enhanced railroad and ferry service between Lantau Island and the mainland. The supply of hotel rooms and restaurants could easily support the international visitors expected to be attracted to a Disney facility. While relatively expensive they had a strong Chinese flavor and would compliment the All-American theme of a Magic Kingdom where Mickey reigned supreme (Exhibits 9, 10 and 11, Location Characteristics, Climate Conditions, Exchange Rates).

A Disney theme park in Hong Kong would be expected to draw visitors from China and South East Asia. The area has had some experience with theme and amusement parks. In Hong Kong, Ocean Park had become a popular amusement park while in Shenzhen, just across the boarder in China; there were several attractions for children. The most well known and successful facility was Splendid China, which featured replicas of the Great Wall, the Forbidden City, and other famous tourist sites from around the country. A more recent park, Window of the World, featured miniaturized tourist sites like Moscow’s St. Basil’s Cathedral.

Hong Kong was located at the mouth of the Pearl River Delta of south-eastern China’s Guangdong Province. This region had, over the last two decades, achieved the fastest economic growth of any in China. Seventy million people now lived in the province, with an average per capita income approaching $2000 per year. The capital, Guangzhou (formally Canton) with almost 7 million people, was 60 miles up river. In contrast, the annual per capita income levels in Hong Kong were approximately $22,000.

Hong Kong had always been a center for business travelers and “we’ve always had lots of exciting things to do for adult visitors,” said Mike Rowse, Commissioner for Tourism. “Our shopping, dining, and hotel facilities are world renown. But one thing missing has been an attraction that would make families sitting down together to plan their holidays think of Hong Kong as a good destination. A Disney theme park would fill that gap in our tourist product” (Press Release, *Hong Kong SAR*, November 2, 1999).

After analyzing the experiences of Disney’s other international theme park performances the following plan had been established for a Hong Kong theme park. A world class facility would be constructed on Lantau Island, at Penny’s Bay, a location between the new international airport and downtown, a distance of only six miles. The facility would be designed to accommodate approximately five million visitors per year. More than three million of them would be expected to come from the mainland as well as Taiwan, Southeast Asia, and Australia (Exhibits 12-17, Development Plans and Operating Characteristics of Phase I and Phase II Theme Parks).

Growth would be expected as the park matured and positive experiences were shared by visitors. Between 17 and 20 major attractions, all proven at other Disney theme parks would be developed, with additions as visitor levels increased. Within 5-10 years an estimated 10 million visitors per year would be coming to the park, and a second park would then be built on adjacent land.

The site also had room for Disney-theme hotels. They envisioned 2 or 3 hotels with 1400 rooms, adding another 700 rooms over the next 5 to 10 years. As part of this resort complex, retail, dining, and entertainment facilities would also be built.

This approach to development would reduce the risks to The Walt Disney Company, yet allow for a large and growing return on their investment. Incremental enhancements to facilities would be added as the visitor market developed, resulting in a balanced approach between investment and visitor demands.

DECISION TIME

Mr. Eisner and his management team were well prepared for the evaluation of the two sites in China. Experienced financial executives at The Walt Disney Company were quite comfortable working with cost of capital estimation, forecasting of entertainment expenditure demand, and various methods of project evaluation.

Within the Disney corporate organization division hurdle rates were used regularly to evaluate investment projects within each of the firm's operating units. Each of the teams representing the alternative sites, Shanghai and Hong Kong, were instructed to incorporate country and/or political risk factors and adjustments, either to their revenue streams or cost of capital estimates and calculations of net percent value for each site. Since only one location was to be chosen for a new theme park at this time, the Disney board of directors would have to evaluate each team's proposal and come to only one choice, which would be announced to the world by Mr. Eisner. Let the presentations begin!

Exhibit 1. History of the Walt Disney Company

1923	The Disney Brothers Studio is founded as a partnership by Walter E. Disney and Roy O. Disney on October 16 when Walt signs a contract with M.J. Winkler to produce a series of animated short subjects entitled the Alice Comedies
1926	The Disney Brothers Studio moves from its office on Kingswell Avenue to a new studio complex located at 2719 Hyperion Avenue, at the corner of Hyperion Avenue and Griffith Park Boulevard, on February 8
1928	Steamboat Willy, Disney's first animated film with sound effects and dialogue, starring Mickey and Minnie Mouse in their first public appearance, is released November 18
1929	Four companies are formed December 16 to replace the Disney Brothers partnership: Walt Disney Productions, Ltd. to carry on the production of films; Walt Disney Enterprises to oversee licensing of cartoon characters; Liled Reality and Investment Company to manage the Disneys' real estate; and the Disney Film Recording Company
1930	Pluto first appears in The Chain Gang, delivered on August 18, although he did not receive the name Pluto until The Moose Hunt, delivered on April 30, 1931
1932	At the 1932 Academy Awards, Flowers and Trees, the first full-color animated film, released on July 30, earns Walt Disney his first Academy Award for Best Cartoon Short Subject. At the same ceremony, Walt Disney receives an honorary Academy Award for the creation of Mickey Mouse Goofy first appears in Mickey's Revue
1933	The first Mickey Mouse watch is sold by Ingersoll in June
1934	Donald Duck first appears in The Wise Little Hen, released June 9
1937	On December 21, Walt Disney Productions, Ltd. premiers Snow White and the Seven Dwarfs, the first feature-length animated film
1938	Walt Disney Productions reorganizes on September 29 under the name of Walt Disney Enterprises to absorb three of the companies created in late 1929: Liled Realty and Investment Company, Walt Disney Enterprises, and Walt Disney Productions, Ltd. On December 27, Walt Disney Enterprises changes it name to Walt Disney Productions

1940	On April 2, Walt Disney Productions becomes a public company on the over-the-counter market by issuing 155,000 shares of 6% cumulative convertible preferred stock. Walt Disney Productions completes its move to its new studios in Burbank, located at the corner of Alameda Avenue and Buena Vista Street, on May 6th. Fantasia is released on November 13th.
1949	The Walt Disney Music Company is formed
1952	WED Enterprises is founded as a private company owned solely by Walt Disney to design and create the Disneyland theme park
1953	Walt Disney Productions forms its Buena Vista Distribution subsidiary to distribute motion pictures
1954	Disneyland, a one-hour weekly television program produced by Walt Disney Productions for ABC, first airs on October 27
1955	The Disney theme park opens, July 17. With an investment of $500,000, Walt Disney Production owns 34.5% of Disneyland, Inc., the company that owns Disneyland. On October 3, The Mickey Mouse Club, a daily one-hour program, first airs on ABC.
1957	Walt Disney Productions exercises options to purchase an additional 31.0% stake in Disneyland, Inc. from Walt Disney, WED Enterprises, and Western Publishing, and Litho Co. for a total cost of $528,810.
1958	The Disneyland television show changes its name to Walt Disney Presents on September 12
1960	Walt Disney Productions purchases the remaining 34.5% stock interest in Disneyland, Inc. from American Broadcasting-Paramount Theaters, Inc. for $7.5 million
1961	Walt Disney Productions' first color television show, Walt Disney's Wonderful World of Color (formerly Walt Disney Presents), begins airing nationally on September 24 on NBC
1964	Four Disney attractions, "It's a Small World," "Great Moments with Mr. Lincoln," the "Magic Skyway," and General Electric's "Carousel of Progress," debut at the New York World's Fair on April 22

1965	Walt Disney Productions acquires WED Enterprises from Walt Disney for approximately $4 million on February 3. Walt Disney Productions purchases 27,443 acres of land for approximately $5 million in Orange and Osceola counties, 15 miles southwest of Orlando, Florida
1966	Walt Disney dies on December 15
1967	The Florida State Legislature passes a bill that provides for the Reedy Creek Improvement District, with responsibilities that include building codes, zoning regulations, water control programs, utilities, and other necessary services for Walt Disney World properties.
1971	Walt Disney Productions issues to the public 500,000 shares of common stock in January to raise $74 million to finance the Walt Disney World project. The 100 millionth guest is welcomed at Disneyland on June 17. The Magic Kingdom at Walt Disney World opens on October 1. Roy Disney dies on December 20.
1972	The Walt Disney Company forms the Walt Disney Travel Company to market tour packages to Walt Disney World, Disneyland, and other vacation destinations.
1976	River Country, a water recreation park, opens at Walt Disney World in June.
1979	Walt Disney Productions finalizes an agreement with the Oriental Land Company to construct Tokyo Disneyland, specifying that the Oriental Land Company will finance, own, and operate the park. In return for design and master planning, Walt Disney Productions receives a royalty percentage of all admissions, merchandise, and food revenue.
1982	EPCOT Center opens on October 1. Walt Disney Productions acquires the rights to the name, likeness, and portrait of Walt Disney and the steam train and monorail system at Disneyland from Retlaw Enterprises for 888,461 shares of Walt Disney Productions' common stock valued at $46.2 million.

1983	On April 1, Walt Disney Pictures is incorporated as a separate company responsible for the development, production, and marketing of all live action films and commercial television programming. Tokyo Disneyland opens on April 15. The Disney Channel first broadcasts cable TV programming on April 18.
1984	Saul Steinberg affiliates acquire 4.2 million shares of Walt Disney Productions' common stock between January and June at an average cost of approximately $70 per share. Touchstone Pictures, a new label of Walt Disney Pictures, releases its first film, Splash on March 9. On May 17, Walt Disney Productions' Board of Directors approves the purchase of Arvida Corporation, a Florida-based community planning and development firm. On May 25, in a filing with the SEC, Steinberg formally announces that he might acquire as much as 49.9% of Disney's stock, declaring that the proposed acquisition of Arvida, which "was not in the best interests of shareholders," made it impossible for him to remain "merely a passive investor." Walt Disney Productions acquires Arvida corporation on June 6 from Bass family interests and Arvida's management for $200 million payable in 3.3 million shares of Walt Disney Productions' common stock. On June 8, MM Acquisition Corporation, formed by Saul Steinberg announces its interest to take over and dismantle Walt Disney Productions by offering $67.60 a share for Disney stock effective June 11. On June 11, Walt Disney Productions repurchases 4.2 million shares (approximately 11.1%) of Disney common stock from Reliance for $328 million ($77.50 per share). Walt Disney Productions welcomes new Chairman/Chief Executive Officer Michael D. Eisner and new President/Chief Operating Officer Frank G. Wells on September 23.

1985	Walt Disney Productions announces plans for the Disney-MGM Studios Theme Park at the Walt Disney World Resort in Florida. Silver Screen Partners II formed to raise funds for film production. The venture raises over $193 million and finances such films as Down and Out in Beverly Hills, Ruthless People, and the Color of Money. The Golden Girls first airs on NBC-TV on September 14.
1986	Walt Disney Productions changes its name to The Walt Disney Company on February 6. On March 1, WED Enterprises' name changes to Walt Disney Imagineering. The 500 millionth Disney theme park guest is welcomed on March 25. Silver Partners III is formed on September 25 to raise funds for film production. The venture raises over $300 million and finances such films as Three Men and a Baby, Good Morning Vietnam, Who Framed Roger Rabbit, and Honey, I Shrunk the Kids.
1987	On January 29, The Walt Disney Company sells Arvida Corporation to a JMB Realty affiliate for approximately $400 million in cash, notes, and other receivables. The Walt Disney Company re-incorporates in Delaware on February 11. The Walt Disney Company signs an agreement with the French government to proceed with the development of the Euro Disney Resort on March 24. The first Disney Store opens at the Glendale Galleria in Glendale, California.
1988	The Walt Disney Company acquires the Wrather Corporation, whose assets include The Disneyland Hotel, for approximately $161 million in cash and $89 million in debt. The opening of Disney's Grand Floridian Beach Resort ushers in a new era of accelerated hotel buildout at Walt Disney World during which 12 new hotels have been added to date.

1989	The Disney-MGM Studios Theme Park and Pleasure Island entertainment complex open at Walt Disney World. 51% of Euro Disney's S.C.A.'s 170 million shares are offered to European investors at ₣72 per share. A subsidiary of The Walt Disney Company owns the remaining 49%.
1990	The first international Disney Store opens on London's Regent Street.
1991	The Walt Disney Company replaces USX Corporation in the Dow Jones 30 Industrials.
1992	On April 12th, Euro Disney (later renamed Disneyland Paris) opens 20 miles east of Paris, France. The National Hockey League awards Disney a franchise that would later become The Mighty Ducks of Anaheim.
1993	Buena Vista Pictures Distribution acquires Miramax Film Corporation.
1994	Disney commits $500,000 to create Disney GOALS, a program designed to offer organized athletics, supplementary education, and community service to local underprivileged youths. President and Chief Operating Officer Frank G. Wells dies. Disney's first Broadway stage show, Beauty and the Beast: A New Musical, officially opens, breaking attendance and box office records. Walt Disney Pictures releases The Lion King domestically, which becomes Disney's most profitable film ever. The Lion King soundtrack hits Number 1 on the Billboard chart, where it stays for nine consecutive weeks. On September 6th, Disney theme parks welcome their one billionth guest. The Walt Disney Company sells a portion of it shares in Euro Disney S.C.A., operator of Disneyland Paris, to a Saudi Arabian investor, reducing it ownership interest to 39%.

1995	The Lion King becomes the top-selling video of all time, selling over 30 million units domestically and surpassing the record set in 1994 by Snow White and the Seven Dwarfs. The Walt Disney Company announces it intention to acquire Capital Cities/ABC for approximately $19 billion.
1996	Stockholders of Disney and Capital Cities/ABC approve the merger in their respective special meetings of shareholders held in New York City. On February 9th, the acquisition of Capital Cities/ABC becomes effective and CCB stock trades for the last time. Disney Online launches Disney.com, a Website designed to promote a vast range of Disney products on the Internet. Disney forms a partnership with the California Angels baseball team, in which Disney has a 25% interest. The world's largest Disney Store to date, at 40,000 square feet, opens on New York's Fifth Avenue and sets the all-time record for single-day volume in a Disney Store. Disney joins McDonalds' in a 10-year multinational marketing alliance linking McDonalds' 18,700 restaurants to Disney's theme parks, films, and home video releases. The Walt Disney Company announces plans to open Disney's California Adventure Theme Park in 2001, as part of the expanded Disneyland Resort in Anaheim. ESPN Inc. launches ESPNEWS, a 24 hour a day sports news network. Radio Disney, a live music-intensive radio network for children, debuts offering fun, high-energy entertainment and family-oriented programming for kids under the age of 12. Disney sells Los Angeles Television Channel 9, KCAL, as a condition of the ABC acquisition, to Young Broadcasting, Inc., New York, for $387 million.

1997	Comcast Corporation and ABC Cable Networks agree to form a new organization to acquire a majority interest in E! Entertainment Television. Club Disney, an interactive children's development play center, and Disney's first regional entertainment concept, opens its first unit in Thousand Oaks, California. Disney announces a joint venture with Pixar to create five animated films over the next 10 years. Disney announces that its employees will commit one million hours of volunteer service through the year 2000 in response to the President's Summit on America's Future. Disney purchases a significant equity stake in Starwave Corporation, a leading producer of Internet media, and assumes operational control of the company. Knight-Ridder, Inc. announces an agreement with Disney to purchase four newspapers owned by ABC, Inc. for $1.65 billion. Disney agrees to purchase Mammoth Records, one of the top independent labels in the music industry. ESPN reaches an agreement to acquire Classic Sports Network, which features the greatest games, heroes, and stories in the history of sports.
1998	Disney's Animal Kingdom opens as the fourth gate at Walt Disney World. Disney records a three-for-one stock split. Disney Magic, the company's first cruise ship, departs on its maiden voyage. Disney's second cruise ship, Disney Wonder is scheduled to launch the following summer. Disney completes its acquisition of a 43% equity interest in Infoseek, a leading Internet navigation company.
1999	Disney and Infoseek launch the Internet portal Go.com. Disney agrees to sell Fairchild Publications, Inc., a subsidiary of ABC, Inc. and publisher of W, Jane, and Women's Wear Daily, to Advance Publications, Inc. Euro Disney S.C.A. announces the launch of its second theme park, Disney Studios, scheduled to open in the spring of 2002 at the Disneyland Paris site.

Source: *Fact Book*, The Walt Disney Company, 1992 and 1998

Exhibit 2. The Walt Disney Company Consolidated Balance Sheet (in millions)

Year Ended September 30

		1998	1997	1996
Assets	Current Assets			
	Cash and Cash Equivalents	$127	$317	$278
	Receivables	3,999	3,329	3,012
	Inventories	899	853	876
	Film and Television Costs	3,223	2,186	1,539
	Deferred Income Taxes	463	482	526
	Other Assets	664	486	1,273
	Total Current Assets	$9,375	$7,653	$7,504
	Film and Television Costs	2,506	2,215	1,720
	Investments	1,814	1,914	1,022
	Theme Parks, Resorts, and Other Property, at cost			
	Attractions, Buildings, and Equipment	14,037	11,787	11,019
	Accumulated Depreciation	(5,382)	(4,857)	(4,448)
		8,655	6,930	6,571
	Projects in Progress	1,280	1,928	1,342
	Land	411	93	118
		10,346	8,951	8,031
	Intangible Assets, Net	15,769	16,011	18,045
	Other Assets	1,568	1,753	1,019
	Total Assets	$41,378	$38,497	$37,341
Liabilities and Stockholders' Equity	Current Liabilities			
	Accounts and Taxes payable and Other Accrued Liabilities	$4,767	$4,748	$5,055
	Current Portion of Borrowings	2,123	897	183
	Unearned Royalty and Other Advances	635	631	531
	Total Current Liabilities	7,525	6,276	5,769
	Borrowings	9,562	10,171	12,159
	Deferred Income Taxes	2,488	2,161	1,269
	Other Long Term Liabilities, Royalties, and Other Advances	2,415	2,604	2,058
	Stockholders' Equity			
	Common Stock	8,995	8,548	8,590
	Retained Earnings	10,981	9,543	7,919
	Cumulative Translation and Other	13	(12)	39
		19,989	18,079	16,548
	Treasury Stock	(593)	(462)	(462)
	Shares Held by TWDC Stock Compensation Fund	(8)	(332)	0
		19,388	17,285	16,086
	Total Liabilities and Stockholders' Equity	$41,378	$38,497	$37,341

Source: *Annual Report*, The Walt Disney Company, 1998

Exhibit 3. The Walt Disney Company Statement of Income (in millions, except per share data)

Year Ended September 30

		1998	1997	1996
				Pro Forma[3]
Revenues	Creative Content	$10,302	$10,098	$9,564
	Broadcasting	7,142	6,501	6,009
	Theme Parks & Resorts	5,532	5,014	4,502
		22,976	21,613	20,075
Costs and Expenses	Creative Content	8,899	8,405	8,129
	Broadcasting	5,817	5,216	4,925
	Theme Parks & Resorts	4,245	3,878	3,512
		18,961	17,499	16,566
Operating Income	Creative Content	1,403	1,693	1,435
	Broadcasting	1,325	1,285	1,084
	Theme Parks & Resorts	1,287	1,136	990
		4,015	4,114	3,509
	Gain on Sale of KCAL	0	0	0
	Accounting Change for SFAS 121	0	0	(300)
	Total Operating Income	4,015	4,114	3,209
Corporate Activities and Other		(236)	(367)	(249)
Net Interest Expense		(622)	(693)	(698)
Acquisition-related Costs		0	0	0
Income Before Income Taxes		3,157	3,054	2,262
Income Taxes		(1,307)	(1,282)	(988)
Net Income		$1,850	$1,772	$1,274
Net Income Excluding Non-recurring Items[1]		$1,850	$1,772	$1,457
Earnings Per Share-Diluted		$0.89	$0.86	$0.62
Earnings Per Share-Basic		$0.91	$0.88	$0.63
Earnings Per Share-Diluted Excluding Non-recurring Items[1]		$0.89	$0.86	$0.62
Earnings Per Share-Basic Excluding Non-recurring Items[1]		$0.91	$0.88	$0.72
Average Common Shares Outstanding-Diluted[2]		2,079	2,060	2,067
Average Common Shares Outstanding-Basic[2]		2,037	2,021	2,037

[1] Non-recurring items refer to the gain on the sale of KCAL in fiscal 1997 and accounting change for SFAS 121 and acquisition-related costs in fiscal 1996.
[2] The difference between basic shares outstanding and diluted shares outstanding is attributable to stock options.
[3] Pro forma adjustments reflect the acquisition of ABC, sale of KCAL, and the disposal of certain publishing operations acquired in the ABC acquisition as if those events occurred at the beginning of the years presented.

Source: *Annual Report*, The Walt Disney Company, 1998

Exhibit 4. The Walt Disney Company Consolidated Statement of Cash Flows (in millions)

Year Ended September 30

		1998	1997	1996
	Net Income	$1,850	$1,966	$1,214
Items Not Requiring Cash Outlays	Amortization of Film and Television Costs	2,514	1,995	1,786
	Depreciation	809	738	672
	Amortization of Intangible Assets	431	749	301
	Gain on Sale of KCAL	0	(135)	0
	Accounting Change	0	0	300
	Other	(75)	(15)	22
Changes In	Receivables	(664)	(177)	(297)
	Inventories	(46)	8	(13)
	Other Assets	179	(441)	(399)
	Accounts and Taxes Payable and Accrued Liabilities	218	608	56
	Film and Television Costs – Television Broadcast Rights	(447)	(179)	58
	Deferred Income Taxes	346	292	(78)
	Investments in Trading Securities	0	0	85
		3,265	3,133	2,493
	Cash Provided by Operations	5,115	5,099	3,707
Investing Activities	Film and Television Costs	(3,335)	(3,089)	(2,760)
	Investments in Theme Parks, Resorts, and Other Property	(2,314)	(1,922)	(1,745)
	Acquisitions	(213)	(180)	0
	Proceeds from Sales of Marketable Securities and Other Investments	238	31	409
	Purchases of Marketable Securities	(13)	(56)	(18)
	Investments in and Loan to E! Entertainment	(28)	(321)	0
	Proceeds from Disposal of Publishing Operations	0	1,214	0
	Proceeds from Disposal of KCAL	0	387	0
	Acquisition of ABC, Net of Cash Acquired	0	0	(8,432)
		(5,665)	(3,936)	(12,546)
Financing Activities	Borrowings	1,830	2,437	13,560
	Reduction of Borrowings	(1,212)	(4,078)	(4,872)
	Repurchases of Common Stock	(30)	(633)	(462)
	Dividends	(412)	(342)	(271)
	Exercise of Stock Options and Other	184	180	85
	Proceeds from Formation of REITs	0	1,312	0
		360	(1,124)	8,040
	(Decrease)/Increase in Cash and Cash Equivalents	(190)	39	(799)
	Cash and Cash Equivalents, Beginning of Year	317	278	1,077
	Cash and Cash Equivalents, End of Year	$127	$317	$278

Source: *Annual Report*, The Walt Disney Company, 1998

Exhibit 5. The Walt Disney Company Key Financial Ratios

Year Ended September 30		1998	1997	1996
				Pro Forma[1]
Operating Performance	Operating Income/Total Revenues	17.5%	19.0%	17.5%
	Income Before Income Taxes/Total Revenues	13.7%	14.1%	12.8%
	Net Income/Total Revenues	8.1%	8.2%	7.3%
Return On Investment	Net Income/Average Stockholder's Equity	10.1%	10.6%	9.2%
	Net Income/Average Total Assets	4.6%	4.7%	4.0%
Capital Structure	Borrowings/Average Stockholders' Equity	63.7%	66.3%	78.2%
	Borrowings/Average Total Book Capitalization	29.3%	29.2%	33.5%
	Borrowings/Total Market Capitalization	22.5%	20.5%	29.0
Debt Service Coverage	Income Before Net Interest and Taxes/Total Interest Cost	6.1x	5.4x	4.7x
	Income Before Net Interest, Depreciation, and Amortization/Total Interest Cost	8.1x	7.1x	6.1x
Cash Flows	Cash Provided by Operations Per Share	$2.46	$2.48	$1.79
	Cash Provided by Operations Per Share/Total Revenue	22.3%	23.6%	18.5%
	Cash Provided by Operations Per Share/Average Total Assets	12.8%	13.4%	14.2%

[1] Pro Forma adjustments reflect the acquisition of ABC, sale of KCAL, and the disposal of certain publishing operations acquired in the ABC acquisition as if those events occurred at the beginning of the years presented.

Source: *Annual Report*, The Walt Disney Company, 1998

Exhibit 6. The Walt Disney Company Business Segments

Business Segments	1998	1997	1996
Revenues			
Creative Content	$10,302	$10,937	$10,159
Broadcasting	7,142	6,522	4,078
Theme Parks and Resorts	5,532	5,014	4,502
	$22,976	$22,473	$18,739
Operating Income			
Creative Content	$1,403	$1,882	$1,561
Broadcasting	1,325	1,294	782
Theme Parks and Resorts	1,287	1,136	990
KCAL Gain	--	135	--
Accounting Change	--	--	(300)
	$4,015	$4,447	$3,033
Capital Expenditures			
Creative Content	$221	$301	$359
Broadcasting	245	152	113
Theme Parks and Resorts	1,693	1,266	1,196
Corporate	155	203	77
	$2,314	$1,922	$1,745
Depreciation Expense			
Creative Content	$209	$187	$163
Broadcasting	122	104	104
Theme Parks and Resorts	444	408	358
Corporate	34	39	47
	$809	$738	$672
Identifiable Assets			
Creative Content	$9,509	$8,832	$8,837
Broadcasting	20,099	19,036	19,576
Theme Parks and Resorts	9,214	8,051	7,066
Corporate	2,556	2,578	1,862
	$41,378	$38,497	$37,341
Supplemental Revenue Data			
Creative Content			
Theatrical Product	$5,085	$5,595	$5,472
Consumer Product	3,452	3,076	2,518
Broadcasting			
Advertising	5,287	4,937	3,092
Theme Parks and Resorts			
Merchandise, Food, and Beverage	1,780	1,754	1,555
Admissions	1,739	1,603	1,493

Source: *Annual Report*, The Walt Disney Company, 1998

Exhibit 7. Background – Shanghai

Shanghai is the largest city in the world. It covers an area of approximately 2500 square miles and has a population of over 16 million. About 14 miles north of the city the Whangpoor and Yangtze rivers meet and empty into the East China Sea. Hangzhau Bay is south of the city. Shanghai's location near these important waterways has contributed significantly to its position as the leading Chinese port and industrial city. It occupies a central location along China's coastline. Except for a few hills lying to the southwest, most parts of the Shanghai region are flat and belong to the alluvial plain of the Yangtze River Delta. Average sea level elevation is about 13 feet.

With a northern subtropical maritime monsoon climate, Shanghai enjoys four distinct seasons, generous sunshine, and abundant rainfall. Its spring and autumn are relatively short compared with summer and winter. The average rainfall is 1200 millimeters, with nearly 60 percent of the precipitation coming during the May through September rainy season.

Shanghai has the most developed transportation system in China. Three railway lines come into the area from the South, West, and North. The longest high-speed railroad in Asia, which will connect the city with Beijing, is under construction and scheduled to be operational in 2008.

Shanghai is the largest and busiest seaport on the West Coast of the Pacific Ocean. In 2000, it's second international airport will be opened, located in the Pudong New Area. With modernization of the old airport, Shanghai can now handle 25 million air travelers per year. In addition to the rail lines, a large number of highways lead from Shanghai to other cities in the Yangtze Delta area. Within 200 miles of the city live 250 million people, the most populous region in China.

Shanghai is also the focal point of China's national development policies and is designated as the engine to drive economic development in the Yangtze River region. It has a well established, diversified manufacturing base of heavy and light industries. In the last decade, the economy has shifted towards service-oriented industries. The Shanghai region, with 1 percent of China's population, is responsible for producing 10 percent of the country's Gross Domestic Product! It is projected that Shanghai will be a Far Eastern international financial, business, and trading center within the next 10 years.

Exhibit 8. Background Report – Hong Kong

Hong Kong is a bustling center of economic activity, with one of the world's highest population densities. It is located near the mouth of the Pearl River, about 90 miles southeast of Canton, China. It ranks among the major ports in Asia, and as a center of trade, commerce, manufacturing, and tourism. Hong Kong covers a total area of 1,126 square miles, but only 404 square miles of the total is land. It had a population of almost 7 million inhabitants in late 1998.

Hong Kong consists of a peninsula attached to the mainland of China and more than 235 islands. The main land area is divided into two sections – the New Territories in the north and the Kowloon Peninsula in the south. The main island, Hong Kong Island, lies just south of the Kowloon Peninsula.

Most of Hong Kong's economic activity takes place in the urban areas of Victoria and Kowloon, where a majority of the people live. Victoria is the capital of Hong Kong, and Kowloon is the largest urban settlement. Victoria is the seat of government and the financial center of Hong Kong. It is located on the north shore of Hong Kong Island, opposite Kowloon on the Kowloon Peninsula. Victoria Harbor separates these two communities.

Hong Kong has a semi-tropical climate, tending towards the temperate, for nearly one-half the year. The summer months of May to August are hot and humid with temperatures reaching 90ºF. Occasional showers and thunderstorms may be expected, particularly during morning hours. September and October are likely to experience tropical cyclones of varying strengths. During November and December, there are pleasant breezes, plenty of sunshine, and comfortable temperatures. January and February are cloudier, with occasional cold fronts bringing in cold, northerly winds with temperatures dropping below 50ºF. March and April are generally milder and pleasant, with occasional spells of high humidity. Rainfall averages 88 inches per year, with more than 75 percent of that rain falling in the summer months.

Hong Kong's transportation system revolves around the airplane. A new, world class, international airport, recently completed on landfill from Lantau Island, can handle in excess of 30 million passengers per year and connects Hong Kong to every major city and population center in the world. Although the area is relatively small it boasts one of the world's most efficient, safe, affordable, and frequent public transportation systems. The Mass Transit Railway (MTR) is an underground network with five lines and 44 stations. On Hong Kong Island several franchised bus companies operate approximately 300 bus routes. The Kowloon-Canton Railway connects Hong Kong Island to the mainland, while the Kowloon-Shenzheng Highway, connecting Hong Kong to Canton providence, is one of the busiest highways in Asia.

Exhibit 9. Comparative Data Shanghai and Hong Kong

Characteristics	*Shanghai*	*Hong Kong*
Weather	Seasonal	Warm
Land Area for Proposed Theme Park	1,000 acres	430 acres
Indigenous Population (Metropolitan Area)	16 million	7 million
Regional Population	105 million	45 million
Tourist Population (Area)	40 million	10.4 million
Hotel Rooms Within Two Hours of the Park	25,000	35,000

Exhibit 10. Climate Conditions – International Comparisons

	Mean Temperature (Fahrenheit)				*Days of Rain or Snow*			
Month	*Tokyo*	*Paris*	*Shanghai*	*Hong Kong*	*Tokyo*	*Paris*	*Shanghai*	*Hong Kong*
January	38	37	41	62	8	15	12	4
February	39	39	46	63	8	13	8	8
March	45	44	50	66	13	15	14	6
April	55	51	64	77	14	14	10	10
May	62	57	72	80	14	13	11	10
June	69	63	77	83	16	11	19	16
July	76	66	86	84	14	12	16	14
August	79	65	87	85	13	12	14	12
September	73	60	79	82	17	11	11	10
October	61	52	73	79	14	14	10	6
November	52	44	60	74	10	15	5	5
December	43	38	48	66	7	17	7	4

Source: World Book Encyclopedia
www.Shanghai.gov.cn
Information Services Department, Hong Kong SAG

Exhibit 11. Exchange Rates Shanghai and Hong Kong

Year	*Hong Kong Dollars/ U.S. Dollars*	*China KMB/ U.S. Dollars*
1990	7.8033	
1991	7.7732	
1992	7.7407	
1993	7.7237	5.8199
1994	7.7386	8.5103
1995	7.7341	8.3336
1996	7.7352	8.2995
1997	7.7451	8.2797
1998	7.7458	8.2784

Source: Pacific Exchange Rate Service, Pacific University of British Columbia

Exhibit 12. Development Plans in China

	Shanghai	*Hong Kong*
Phase I Opening	2006	2006
Magic Kingdom Theme Park	220 acres	140 acres
Hotels	50 acres (1800 rooms)	30 acres (1400 rooms)
Retail and Entertainment Center	30 acres	20 acres
Roads and Support Facilities	50 acres	40 acres
Total	350 acres	230 acres

	Shanghai	*Hong Kong*
Phase II Opening	2011	2011
EPCOT Theme Park	200 acres	120 acres
Hotels	40 acres (1500 rooms)	10 acres (1000 rooms)
Convention Center	40 acres	25 acres
Retail and Entertainment Center	30 acres	15 acres
Roads and Support Facilities	40 acres	30 acres
Excess	300 acres	

Total Phase I + II	1000 acres	430 acres

Exhibit 13. Disney in Asia – Financing Costs and Visitor Market Data

	Shanghai	***Hong Kong***
Phase I		
Construction Costs (Total)	$1.2 billion	$1.8 billion
Disney Portion	$150 million	$300 million
Capacity of Magic Kingdom Theme Park – Phase I Plan	50,000 per day 18,250,000 per year	35,000 per day 12,775,000 per year

	Shanghai	***Hong Kong***
Phase II		
Construction Costs (Total)	$.9 billion	$1.5 billion
Disney Portion	$150 million	$250 million
Capacity of EPCOT Theme Park – Phase II Plan	40,000 per day 14,600,000 per year	25,000 per day 9,125,000 per year

	Shanghai	***Hong Kong***
Most Probable Expected Attendance (Phase I) (2006)		
Mainland China	9 million	
Local Hong Kong Area		1.8 million
Visitors to Hong Kong		3.4 million
Total Visitors	***9 million***	***5.2 million***

	Shanghai	***Hong Kong***
Most Probable Expected Attendance (Phase II) (2011)	7 million	5 million
Total Visitors	***7 million***	***5 million***

Disney Royalties and Licensing Fees in each location	
	10% of Entrance Fees 5% of In-Park Expenditures 3% of total revenues (management fee)
Plus:	35% of Profits or losses in Shanghai 40% of profits or losses in Hong Kong

Exhibit 14. Operating Characteristics of Magic Kingdom Theme Parks and Phase I Hotels – First Full Year of Operations (2006)

	Shanghai	***Hong Kong***
Entrance Ticket Prices		
Adult	$20	$35
Child	14	25
Average Ticket Price	$17	$30

	Shanghai	***Hong Kong***
Food Expenditures per person	$6	$15
Souvenirs, Clothing, and Miscellaneous Expenditures per person	$5	$12
Hotel Operations – Average Occupancy Rates	75%	80%
Average Room Rates	$95	$185

	Shanghai	***Hong Kong***
Fixed Costs (in millions)		
Depreciation Expense	$30	$45
Property Taxes (4%)	48	72
Salary Expenses	32	25
Other Fixed Expenses	18	20
Total	$128	$162

	Shanghai	***Hong Kong***
Weighted Average Interest Costs	6%	7%
Variable Cost per Visitor	$10	$17
Variable Costs – Hotel Room per day	$50	$100
Corporate Tax Rate	25%	35%

Exhibit 15. Operaing Characteristics of EPCOT Theme Park and Phase II Hotels – First Full Year of Operations (2011)

	Shanghai	*Hong Kong*
Entrance Ticket Prices		
Adult	$30	$60
Child	20	40
Average Ticket Price	$25	$50

	Shanghai	*Hong Kong*
Food Expenditures per person	$9	$30
Souvenirs, Clothing, and Miscellaneous Expenditures per person	$7	$27
Hotel Operations – Average Occupancy Rates	80%	85%
Average Room Rates	$115	$230

	Shanghai	*Hong Kong*
Fixed Costs (in millions)		
Depreciation Expense	$15	$25
Property Taxes (4%)	24	40
Salary Expenses	20	29
Other Fixed Expenses	14	20
Total	$73	$114

	Shanghai	*Hong Kong*
Weighted Average Interest Costs	6%	7%
Variable Cost per Visitor	$12	$21
Variable Costs – Hotel Room per day	$60	$116
Corporate Tax Rate	25%	35%

Exhibit 16. Cost of Capital Assumptions for Phase I and Phase II Operations

	Shanghai	*Hong Kong*
Average Interest Rate on All Borrowings – Net to the Operating Entity	6%	7%
Target Capital Structure		
Debt	65%	60%
Equity	35%	40%
Local Corporate Stock Beta	2.0	1.2
Risk Free Rate	6 ½%	6%
Expected Return on Equities	14%	12%
Country/Political Risk Premium	4%	1 ½%
Expected Growth Rate in Earnings	5%	8%

Exhibit 17. Proposed Financial Structures of the Operating Company in Each Location – Phase I and Phase II (in millions)

	Shanghai		*Hong Kong*	
The Walt Disney Company Investment	***Phase I***	***Phase II***	***Phase I***	***Phase II***
Planning Expenditures	$100	N/A	$75	N/A
Equity in Each Venture	$150	$150	$300	$250
Total	$250	$150	$375	$250
Debt				
Government Loans	$700	$585	$800	$650
Commercial Loans			$300	$400
Total Debt	$700	$585	$1.100	$1.050
Equity				
Country	$350	$165	$400	$200
Disney	$150	$150	$300	$250
Total Equity	$500	$315	$700	$450
Total Capital	$1.2 billion	$.9 billion	$1.8 billion	$1.5 billion

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UPSIDE-DOWN, LEASING AND PACKING: TIME VALUE OF MONEY AND CAR BUYING

Anne Macy, West Texas A&M University

Ever felt like you got a bad deal at the car dealership? Carrie and her two roommates Shawna and Lisa are recent college graduates with new jobs. The three friends go car shopping and encounter various car purchase issues. While two go prepared to the car lot, all encounter common problems. Did the roommates choose the best loan? Did Carrie get a good value on her trade-in? Should Shawna be happy with her payments? Did Lisa choose the right lease terms? These issues are rarely mentioned in finance textbooks but represent common situations. College students are particularly susceptible to these problems because they are likely to need a car loan and do not have much experience with credit. The students are placed in the role of the roommates and must evaluate the offers from the dealership.

GETTING READY TO BUY

"Shawna, are you ready to go car shopping with me?" Carrie asked her roommate.

"Sure. I didn't know you were ready to buy a new car. I thought you were still looking around."

"Well, my car is getting older. I think it still has some trade in value. Plus, the car dealerships are clearing their lots, as they get ready for the new model year cars. I think I can get a last year's model a little cheaper."

"I think you just want a new car," Shawna said teasingly.

"Yes, I suppose so. I am tired of my car. Besides, I finished school and I have a new job. Everyone else at work drives a nice car. I feel like an intern driving into the parking lot in my college car."

"Have you done any research on car prices?" Shawna asked.

"I researched the Internet and know the range of prices for the car I want. I looked at auction sites and in the paper to have a good idea of what my car's trade-in value is. I read over all the potential scams. I have shopped several dealerships and gotten preliminary prices. We are going to Mid-town Dealers because they have given me the most consistent information and prices over the last month. I want $2000 to $3500 for my old car and I am willing to pay around $18,000 to $20,000 for the new car. The trade-in will be my down payment. I really searched the Internet for information. There is a site called Edmond's that has a lot of pricing information. I think I am ready."

"So you already know what you want?"

"Yes, the car I am looking at has a good safety rating, gas mileage and it doesn't depreciate as fast as some other cars I was considering."

"Hmm. You have done more research than me. I know what new car I want but I haven't really looked into the pricing. As long as the payment is about the same, I should be ok," Shawna replied.

"You just got a new car last year! Are you going to trade it in already?" Carrie asked.

"Yes, I think so. I really don't like having a manual. Besides, I travel so much with work, I would rather have a SUV."

Just then Lisa walks in from getting the mail. "What's up?"

"We are just getting ready to go to the car dealership," Carrie replied.

"Lucky for you I just got the mail. Here is an advertisement from the dealership. They have zero percent financing. They also have a special on leasing," Lisa said.

"Leasing?" Shawna asked.

"Yup, my boss at work leases his car. He is able to drive a better car and pay less each month than if he bought the car. I can't afford the payment on the car I want if I buy it so I think I am going to lease," Lisa answered.

"Leasing sounds too complicated," Shawna added.

"There are a lot of special terms but my boss explained them to me. Basically, the price of the car after any discounts is called the capitalization price. The value of the car at the end of the lease is called the residual value. All you do is take the difference and divide by the number of months to get the monthly payment."

"That doesn't sound right. In finance class, we always had to do time value of money. Where is the interest?" Carrie asked.

"It is called the money factor. It is multiplied by the capitalization price plus the residual value to get a monthly lease fee. My boss told me to make sure my lease is a closed-end lease. That means at the end of the lease, I can walk away from the car no matter what the actual value of the car is at the end. Of course, I have to pay for any damages."

"Sounds too complicated. Plus, the car really isn't yours," Shawna said.

"But I would rather have a better car that I lease than the car I could buy. I want to make a good impression at work and get that promotion," Lisa said matter-of-factly.

"Well, the dealership should be happy to see us!" Carrie exclaimed. The three friends laughed and drove over to the dealership.

CARRIE'S TRADE-IN

Carrie begins looking at the cars. The salesperson Carrie has visited with previously spots her and comes over. Carrie and the salesperson begin to discuss the price of the trade-in and the new car. The used-car manager takes Carrie's college car for a drive and an inspection.

"The list price is $22,000. I don't know if I can go much lower than that," says the salesman.

"I'm not interested in the car at that price," replies Carrie.

The salesperson has to go to the manager and see what price can be offered. Carrie stands her ground and doesn't let the sales techniques get to her. "You are a tough negotiator," the salesman says after two very long hours.

Carrie is pleased. Her trade-in value is $3,000. This is the high end of the range she found in her research. The new car price agreed to is $19,600. Plus, she gets the car in red.

The salesperson takes Carrie to the financing manager.

"Congratulations on your new car. How much are able to pay a month?" asks the financing manager.

Carrie already has calculated this. "I can pay around $400 a month before insurance. Your ad said zero percent financing."

"I will need to run a credit check on you. The zero percent is for those customers with the highest quality credit."

"Oh."

"Don't worry, we have the best rates in town. Would you prefer payments over 48 months, 60 months or 72 months? I can usually get the best deal at 60 months."

"Sixty months is fine." Carrie gets Shawna and Lisa and the three look at Carrie's new car. About fifteen minutes later, the financing manager finds Carrie.

"I was able to find a good deal for you. The loan is at 9% for 60 months with a monthly payment of $407."

Carrie smiles. She just bought her first new car.

UPSIDE-DOWN SHAWNA

Shawna looks around the dealership and finds the salesperson from last year.

"Hi, you sold me this car last year," Shawna says.

"Great. How are you liking it?" he asks.

"It just doesn't meet my needs. I would prefer an automatic and something with more cargo space. I was thinking about a SUV," Shawna answers.

"Ok, we have lots of great SUVs on the lot. Do you see one that you like?"

"Yes, I like the black one with the ski rack."

"Good choice. It is on special this week for $27,500. Its price is $30,000 and I can get you $2,500 in rebates. What do you think?"

Shawna thinks about it for a few minutes. It sounds like a good deal. One of the guys at work just bought an SUV and he paid $28,000. She really didn't know what a good price was. She wishes she had done more research. Maybe she should wait a week and get Carrie to help her get the information on the car.

The salesperson notices Shawna's hesitation. "As a special deal for a returning customer, I will add a six disc CD player to the SUV. No extra charge. Does that help you decide?"

"Yes, sounds good to me," Shawna replies with a smile. She could see herself going skiing in the black SUV over vacation.

"I will give the financing manager the details. Plus, I better get your trade in valued. What is your current car loan?"

Shawna explains that her sports car was purchased last year with a loan for $25,000 at 6% for four years. "My monthly payment is $587.13. I really don't want to be higher than that."

The salesperson returns carrying a sheet of paper with prices. "Your sports car depreciated quite a bit over the year. Plus, you have some dings in the back fender. According to the used car guide, your old car is worth $17,500."

Shawna smiles at the mention of the dings. She never should have let her little sister drive the car. Shawna visits the financing manager's office.

"Congratulations on your new car."

"Thanks. What kind of payment can you get me?"

“Well, because you still owe on your old car, your interest rate is higher. I can get you a loan that keeps your payment basically the same. The payment is $590.60 for five years. What do you think?”

“Super! It’s not that much more.”

Carrie pokes her head into the office. “Are you getting the SUV?” she asks.

“Yup, isn’t it great?”

“Why don’t you two ladies check the cars out while I get the paperwork ready?”

Carrie asks Shawna what type of deal she got away from the finance manager. “Did you get a good interest rate? What about the trade-in?” Carrie asks.

“I don’t really know what the rate is. Apparently, my car depreciated over the last year. But it must be ok, my payment is basically the same.”

Shawna is all smiles.

A LEASE FOR LISA

While Carrie and Shawna were looking at buying, Lisa has been talking with the leasing manager.

“I am interested in leasing a near luxury car. What types of leases do you have?”

“We have lots of different choices. About how many miles do you drive in a year? The average is about 10,000 to 12,000 miles.”

“Yeah, that sounds about right.”

“Do you think you might want to buy the car after the lease?”

“I don’t know. I hadn’t really thought about it.”

“Some people do and some people don’t. At the end of the lease, you can buy the car or you turn it in. How long do you think you want to lease?

“My boss has a three-year lease.”

“Three-years is popular. I can get you a better payment on four-years.”

“Ok. What happens if I want to exchange the car before the lease is up?”

“It’s no problem. You just pay the difference and a service fee. There is also a fee of $0.20 per mile if you go over the allotted miles, which is pretty standard. Which car do you like?”

“The silver car. I want a closed-end lease. What is the money cost?”

“All our leases are closed-end. The money cost is based on the interest rate on purchases. I will have to run a credit check to see what rate we can offer you. Let me look up the silver car.”

The salesman leaves. Lisa checks over the car. She goes over to her old car and looks at the odometer. She drove 14,000 in the last year. Lisa decides that she won’t take her car on her winter vacation to keep the mileage down.

The salesman returns with the prices. “Currently, the capitalization cost on the car is $45,000. The money factor is 0.00333. The residual value of the car after four years is $24,000. Are you going to make a down payment?”

“A down payment? I didn’t think that I needed a down payment.”

“You don’t have to. A down payment will lower your monthly payments. Is that your car?”

“Yes, but I don’t know what it is worth.”

“Let’s have the used car manager price the car.”

The salesman returns after a few minutes. "The trade-in value of the car is $1,200. It makes for a nice down payment."

"Ok, I really won't need a second car. So what is the lease amount?"

"With the down payment and a four-year lease, the monthly payment is $655.77. That's a good deal."

"Sounds good. I am paying just a little more than my friends and I get a better car," Lisa says.

EVERYONE IS HAPPY

Lisa walks over and finds Carrie and Shawna looking at the their cars. Lisa looks at her two friends. They are both smiling. Everyone at the dealership is also smiling. She wonders who got the best deal.

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