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Letter from the Editor

Welcome to the Spring/Summer 2007 issue of the *Journal of Finance Case Research*, the official journal of *The Institute of Finance Case Research* (IFCR). Volume 9, Number 1 is the first of two issues for 2007. I would like to express my thanks to the authors, reviewers and other supporters who have helped us get another issue put together.

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 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 has been consistently 25% or less. The *Journal* is listed in *Cabell's Directory of Publishing Opportunities in Economics and Finance* and other standard references.

In addition to the *Journal*, 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.

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. Historically, cases presented at conferences have had more success in getting published, perhaps because of the scrutiny and comments they receive from other educators.

The *Journal* accepts cases of all types. 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.

As I mentioned in the last issue, the *Institute* is currently planning to create an outlet for shorter problems, classroom exercises, and teaching ideas which will debut in 2008. (This publication is currently unnamed.) Some of our colleagues have been using short exercises in class for many years, and I hope folks will send those in and have them editorially reviewed and published the *Journal's* sister publication.

Finally, I would like to encourage all of our readers to consider volunteering to review manuscripts as schedules permit. 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 interesting and timely cases. I urge you to put all of these to good use in your classes and seminars.

For additional information about the *Journal* and the *Institute*, please go to ***jfcr.org*** on the Web.

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

QUALITY TABLECLOTH MANUFACTURING: A CASE STUDY IN ALTERNATIVE FINANCING

Harry F. Griffin, Troy University, Montgomery Campus

It was a mid-May afternoon when Cathy Benedict crossed the Southeastern Texas University stage to accept her baccalaureate degree. She had graduated near the top of her business school class. Cathy's parents and many of her parents' friends were in the audience that day to support and congratulate Cathy on her accomplishment. Among her parents' friends was Michael Tolbert, who was a model success story. He had founded and nurtured a thriving financial services business until that business was transformed into the Atlantic-Pacific Commercial Bank. One division of the A&P Bank was singularly focused upon well-collateralized commercial loans.

As a college student, Cathy had researched the textiles industry and written a report about it. She was amazed to discover the profitability of commercial textile manufacturing. From that time forward, Cathy knew that someday she would own her own textile business.

Cathy owned Quality Tablecloth Manufacturing Company, incorporated five years after graduating. Employing a new technology, QTMC Inc. manufactures a tablecloth of futuristic quality and distinction: so much so that QTMC sets a new tablecloth standard for the restaurant industry. The tablecloths are manufactured at the Quality textile plant and then with an invoice shipped to Cathy's customers.[1] The tablecloths are not inexpensive, costing $100 each. The majority of QTMC's customers, therefore, immediately pay the invoice in order to take advantage of QTMC's trade credit terms of 2/10 net 30. However, there are a few of QTMC's customers who decline the trade credit discounts, preferring to pay at a later date. These are the customers that have created the balances in the accounts receivable ledger at Quality. Exhibits 1 and 2 are QTMC Inc.'s Common-Sized Balance Sheet and Income Statement.

After a bumpy beginning, QTMC Inc. had been successful for the last two years. Cathy, as both the CEO and the principal sales representative, guided her firm through a period of economic expansion. A robust economy rewarded both Cathy and her firm.

The robust economy also rewarded the hotel industry. Both business and pleasure travel increased. The travel industry trade publications noticed that not only are more people traveling, but also that they are staying longer at their destination hotels and eating more often at their hotel restaurants. Because the hotel trade publications and industry interpreted this action as a positive trend, several of the more economically astute hotel franchises decided to replace their restaurant tablecloths.

Dan Myers is a Western Coast hotel chain principal. Dan attributes his success as an hotelier to carefully attending to the demographics his guests who frequent his hotels, as well as keeping a sharp eye on the trade publications. In an effort to keep an eye on his competition, Dan often dines at his competitors' restaurants. On several occasions Dan observed the taste and elegance that the QTMC tablecloth contributed to an otherwise ordinary dining experience. Not to be outflanked, Dan contacted QTMC with a tablecloth purchase order for $100,000; a quantity sufficient to refurbish all of his hotel restaurants in California and Oregon.

Exhibit 1
Quality Tablecloth Manufacturing Company Common Size Balance Sheet

	Dec 31, 2000		
Assets		**Liabilities**	
Current Assets		**Current Liabilities**	
Cash	1.97%	**Notes Payable**	0.20%
Accounts Receivable	18.16%	**Accounts Payable**	6.37%
Inventory	3.93%	**Total Current Liabilities**	6.57%
Total Current Assets	24.07%		
		Long Term Debt	0.53%
Fixed Assets			
Gross Property, Plant and Equipment	57.97%	**Common Equity**	92.90%
Less accumulated Depreciation	-16.38%		
Net Property, Plant and Equipment	34.35%		
Total Fixed Assets	75.93%		
Total Assets	100.00%	**Total Debt and Equity**	100.00%

Exhibit 2
Quality Tablecloth Manufacturing Company Common Size Income Statement

	January 1 to December 31, 2000
Revenues	100%
Production Costs	60%
EBIT (Operating Income)	40%
Taxes (25%)	10%
Net Income	30%

Exhibit 2 describes production costs of sixty percent for each tablecloth produced. The cost basis for this order is therefore $60,000. QTMC, however, faced a problem: the firm lacked the $60,000 in cash necessary to begin production. Because she is a smart entrepreneur, Cathy rents her building, leases her manufacturing equipment, and warehouses little inventory because she sells everything that Quality manufactures. When Quality Tablecloth Manufacturing landed its largest purchase order, Cathy's success became her adversary.

QTMC could not qualify for traditional bank financing, because QTMC had no assets to offer as collateral. When she and her accountant were looking over her most recent financial statements, she remembered that her accountant had suggested that she lease her equipment. At the time this suggestion was logical because a lease generally appears as an asset on the balance sheet. Leasing also negates the necessity of expending capital for equipment acquisition. Cathy realized that a detailed accounting approach and reasonable tax practices worked to her detriment with respect to traditionally obtained operating capital. Cathy put her business degree to the test, and engineered a relatively modest amount of earnings before taxes. Her efforts were successful, resulting in a minimum tax bill and representative net income. These same efforts thwarted her attempts to secure bank financing. Because of Quality's controlled earnings, the firm could not qualify for bank financing.

Cathy related her problems during a conversation with her parents. Cathy's dad, a retired Air Force colonel, suggested that Cathy contact Mike Tolbert. Because Mike had known Cathy for most of her life, he felt that he might be able to sway his loan officers into authorizing a loan of the necessary capital.

Recognizing a fellow entrepreneur, Mike appreciated her plight. Waiving the rules, he personally approved Cathy's $60,000 loan request. Being a good entrepreneur, Cathy immediately put the money into Quality. Materials were ordered. Tablecloths were manufactured and shipped to Dan's hotel chain. Dan authorized payment on the QTMC invoice. Sixty days later, QTMC received payment for the shipment.[2] To a textile industry observer, it looked as if the QTMC was headed for corporate superstardom. However, growth problems persisted for the young firm.

The $60,000 bank loan had become problematic. While Cathy had kept the loan appropriately serviced, she had become frustrated in her efforts to repay the principal. Quality's growth had effectively been capped by the debt level because all of QTMC's assets are pledged to A&P bank. QTMC was ineligible for another loan, because the firm was carrying all of the debt that it can afford.

Several months later, Cathy attended the textile manufacturer's regional conference in Atlanta. The conference had attracted not only the established manufacturers, but also the new and upcoming entrepreneurs in the industry. The conference theme was: "How to Increase Revenues without Increasing Expenses." Cathy spent a couple of days at the conference participating in several discussions and work groups.

During her final evening in Atlanta, Cathy was working in her hotel room at her computer when the telephone rang. Dan, having been notified of her location, called to inform her that he was very pleased with her firm's work. Moreover, he told Cathy that a FEDEX package was arriving at the QTMC office the next day with a second purchase order for an additional $100,000 of tablecloths. Both grateful and chagrined, Cathy thanked Dan and hung up.

Immediately Cathy recalled the problems in securing the $60,000 required to produce the previous order. She understood that if she could not fill the second order, there was a good chance that she would lose all of Dan's future business as well as any business that Dan may refer to her. She quickly calculated the future value of that business and realized that allowing an order of that size to pass was not an option. Because her market segment was relatively narrow, Cathy also knew that other tablecloth buyers would discover that Dan had moved his business to another textiles firm and might follow suit, believing that QTMC was in financial trouble. Cathy reluctantly admitted to herself that marketplace expectations might actually drive QTMC out of business. She knew to whom she must call.

Cathy called her family to ask for $60,000. She fully understood that she may have to sell some or all of her equity in the firm that she had personally conceived, designed, and created.

She was pleasantly surprised when her parents agree to lend QTMC $60,000 from their savings account, on the condition that it was repaid within thirty days. Even though Cathy wondered if she could pay her parents back within thirty days, she gratefully accepted the funds. In one week, QTMC purchased the necessary materials, manufactured the tablecloths, and with an invoice shipped the order. Because she knew that it would take from forty-five to sixty days before the invoice was paid, Cathy turned her attention to repaying her parents. She had three weeks left.

Cathy was exhausted both logically and emotionally. She knew that she could not default on a loan from her parents. Further, she knew that QTMC was ineligible for another bank loan. That evening at the gym, Cathy encountered Maggie Maye. Maggie was at the gym to attend an aerobics class. Maggie was a personal friend of Cathy's, as well as the Chamber of Commerce representative to the local business community.

As an entrepreneur, Cathy knew to listen to others in the business community when a finance-related problem persists. Cathy sketched her problem to Maggie. Maggie suggested that Cathy consider factoring her accounts receivable: that is, selling her accounts receivable to a specialty financial services company whose specific market niche is buying accounts receivable (a factor).

Maggie referred Cathy to Joe Merriwether; an independent factoring broker who had a working relationship with several factoring firms nationally. The next morning, Cathy contacted Joe and, since his calendar is clear, suggested an appointment for later that afternoon at her office. Joe had an open afternoon calendar and agreed to the meeting.

Joe and Cathy met in the QTMC office. Cathy explained the magnitude of her problem, and asked if Joe could help. Joe told her that he believed he could help. One of the factoring firms that he represented was ABC Funding. Through ABC Funding, he could provide monies to QTMC with no consideration given to either QTMC's current financial position or to the fact that she could not qualify for bank financing. Joe agreed to work with Cathy in order to establish a factoring account for QTMC with ABC Funding. Once the account was established, ABC could wire-transfer funds overnight directly into QTMC's bank account for any invoices purchased. Cathy asked if she must commit to a minimum time in order to secure an account. Smiling, Joe explained that the contract that ABC Funding offers had neither minimum nor maximum time requirements. QTMC could cancel the contract whenever Cathy deemed necessary. Joe explained further that the funding contract carried no stipulations concerning either a minimum dollar amount of accounts receivable factored or a minimum number of required transactions during the life of the contract.

Joe also explained that it was the responsibility of ABC Funding to ascertain the legitimacy and accuracy of the invoice that Quality had submitted. However, there was a catch. Until the invoice was confirmed as true and accurate, and QTMC's customer (the counterparty) had agreed to pay the invoiced amount to ABC Funding rather than Quality, no monies would be transferred into the QTMC bank account. For example, in order to confirm the validity of QTMC's most recent tablecloth shipment, ABC Funding would transmit to Dan a query in order to ascertain the legitimacy of the invoice. As soon as Dan acknowledged that the invoice was true and accurate, and that he agreed to pay ABC Funding rather than Quality, ABC would release funds to QTMC.

Quietly, Cathy wondered aloud why Dan would be willing to pay ABC Funding for goods and services received from QTMC. Joe explained to Cathy that typically the customers agree to the new arrangement because they like the terms. Dan was still responsible to pay the invoice in the same forty-five to sixty days; choosing to do so because he could earn some risk free interest during the float period.

Cathy pondered another potential scenario. What if ABC transferred money to QTMC and then Dan decided not to pay the invoiced amount to ABC? Joe was ready for that question also. Once monies are transferred from ABC to QTMC, and then Dan refuses to recognize ABC as the legitimate owner of the account receivable and does not pay ABC Funding, ABC has several recourse options available. ABC Funding can authorize an account receivable exchange with Cathy. That is, she could exchange a current account receivable that is equal in value with ABC for the receivable in question. Another strategy was to allow her to exchange several smaller current receivables that sum to the same value as the receivable in question. Finally, she could return the funding advance and have QTMC collect the receivable.

Cathy was both intrigued and interested by the concept of generating funds through the use of accounts receivable factoring. She decided to open the account and proceeded with the necessary documentation. She immediately submitted Dan's outstanding invoice for $100,000 to ABC Funding.

Generally accepted accounting principles (GAAP) not only allow QTMC to record the credit sale to Dan as revenue, but also to record the credit sale in the account receivable ledger. Although GAAP allows this sale to be recorded as an asset, it is a cashless asset. ABC Funding purchased this asset from QTMC at a discount, thereby providing liquidity to an otherwise cashless asset. Even though the amount paid for the asset may be less than the invoiced amount, the payment is made to QTMC the next day following counterparty acknowledging receipt. QTMC then has the operating funds required to begin work on its next order. All that is necessary for ABC Funding to continue providing QTMC cash advances in exchange for future accounts receivable invoices is that QTMC sell to financially stable customers.

Following are the terms of the ABC Funding and QTMC factoring contract. The contract states that ABC Funding will pay immediately an advance to QTMC the amount of 75% of the invoice amount. Sixty days later, Dan paid $100,000 to ABC Funding to satisfy the short term debt. ABC Funding owed QTMC the balance of $25,000 less a discount fee. The discount fee is stated as a four percent fee for the first thirty calendar days, and a two percent for every 15 calendar days thereafter.

QTMC offers Dan trade credit terms of 2/10, net 30 (a 2% discount is authorized if the invoice price is paid in ten days, otherwise the total invoice price is due in thirty days). However, Dan always paid his bills in sixty days, ignoring the credit terms. The QTMC and ABC Funding factoring contract is finally in place. QTMC has sold to ABC Funding the accounts receivable representing Dan's second $100,000 purchase order.

NOTES

1. The invoice is a legal document, stating what was purchased, how many of the tablecloths were purchased, and the agreed-upon price for the total purchase on a per unit basis. Further, the invoice states Quality Manufacturing's trade credit terms.

2. The American Society of Tablecloth Manufacturers, the tablecloth manufacturer's trade association, reports that on average, customers take approximately seventy days to pay their invoices for the tablecloths that they have received. However, there is a caveat. The caveat is

that the major consumers of tablecloths, such as the United States government and major retailers such as Wallace Markets, Stears, etc. often dictate the trade credit terms that they require if manufacturers want to do business with them. For example, Wallace Markets might require ninety day terms. Then, if the accounts receivable ages to one hundred days, Wallace Markets is only ten days late, thereby allowing the retailer to maintain their current credit ratings. A smaller retailer with thirty day trade credit terms would be seventy days late, and the smaller retailer's credit rating would reflect that fact. However, manufacturers cannot afford to not deal with the major retailers because they do spend a lot of money; especially with Quality Manufacturing.

CUT THE DIVIDEND OR BORROW TO PAY IT? THE CASE OF PARKWAY PROPERTIES

Jonathan Breazeale, Sam Houston State University
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ABSTRACT

Parkway Properties (NYSE: PKY) is a Real Estate Investment Trust (REIT) focused on the ownership, management and leasing of commercial office properties. REITs have the advantage of being organized as corporations while not being required to pay corporate income taxes. To qualify as a REIT, firms must meet certain criteria, the largest of which is to distribute at least 90% of its otherwise taxable earnings via cash dividends to its shareholders on an annual basis. This requirement results in a capital constraint in the form of low retained earnings. With a lack of cash being retained from net income, Parkway and its competitors are forced to access the capital markets frequently to fund growth and acquire properties. However, in 2005 the office market was continuing a period of decreasing occupancy and lower rental rates that affected office REITs in a very dramatic way. Operating loss carry-forwards were diminishing as well. Several peers, including the nation's largest office REIT, had cut their dividend to reflect lower anticipated earnings in 2006 and beyond. Parkway was not exempt from these tough market conditions. In both 2004 and 2005, the $2.60 per share dividend it paid to its shareholders was greater than the amount of cash it had available to pay them. Parkway's stock price reflected this bad situation, and the 2005 president's letter to the shareholders informed them that the company did not anticipate covering the dividend until 2007. Should Parkway follow suit and reduce its dividend, or should they borrow through the tough times in anticipation of improving market conditions?

REAL ESTATE INVESTMENT TRUSTS (REITs)

Real Estate Investment Trusts (REITs) were created by Congress in 1960 to allow small investors access to capital intensive, large-scale real estate. Small investors were allowed to pool their equity in REITs just as they would in any other corporation, enabling them to participate in an industry that was formerly inaccessible for the purpose of diversifying their personal portfolios. REITs own and, in many cases, operate income-producing real estate of a specific type or types. For instance, there are REITs that own office buildings, industrial properties, apartments, hotels, shopping centers, timber, or a combination of these and other types of real estate. REITs may also own financial assets such as mortgages and other real estate financing. The most important aspect of a REIT is that it does not pay corporate income taxes as long as it meets certain requirements - the largest of which is that it distributes 90% of its otherwise taxable income to its shareholders each year in the form of dividends. It is a great advantage for equity investors to receive distributions that have not been taxed, but the REIT is faced with the difficulty of having to access capital markets frequently for external funding since it cannot use much of its net income to fund investment in new assets. In other words, REITs have very small amounts of retained earnings on their balance sheets.

Due to the large amount of depreciation arising from investment in long-term fixed assets and the large gains/losses that can result from the sale of large assets, REITs utilize measures of financial performance that deviate somewhat from GAAP measures reported by other public corporations. The National Association of Real Estate Investment Trusts® (NAREIT) is an industry organization that provides services to REITs and acts on behalf of its member firms in lobbying and other political efforts. NAREIT defines the measure Funds from Operations (FFO) as net income (on a GAAP basis) excluding gains or losses from sales of most property as well as depreciation of real estate (National Association of Real Estate Investment Trusts, Inc., 2002). This provides a measure of operating performance more consistent with the recurring nature of the REIT's operations rather than net income that is influenced by large one-time transactions such as asset sales or large changes in depreciation brought about by either sales or acquisitions. Therefore, FFO provides a measure that is more consistent with the types of assets held by REITs and allows for better comparison of the operating performance of multiple REITs as well as trend analysis of individual REITs year after year.

While FFO provides a more consistent measure of operating performance for the real estate industry, it is not well suited to provide a measure of how much cash is available for a REIT to pay its all-important dividends. As a result, some REITs also disclose Funds Available for Distribution (FAD) which might also be reported as Cash Available for Distribution (CAD) or Adjusted FFO. While FFO is "standardized" across the industry, the calculation of FAD is not. However, FAD is essentially FFO less capital expenditures (tenant improvement allowances, leasing commissions, non-revenue enhancements, capital improvements to new acquisitions, etc.) that reduce the actual amount of cash that is available to distribute to shareholders.

As of December 31, 2005, there were approximately 200 publicly traded REITs on U.S. stock exchanges with assets valued at more than $475 billion. Office properties comprise approximately 19% of the total value of assets owned by REITs - making them the largest property type in which REITs are invested (Invest In REITs, 2006).

PARKWAY PROPERTIES

Parkway Properties ("Parkway") is a REIT focused on the ownership, management and leasing of commercial office properties in the Southeastern United States, Chicago and Phoenix. They are headquartered in Jackson, Mississippi, and have been in business since 1971. Prior to 1995, Parkway included what is now Eastgroup Properties (NYSE: EGP) which was spun-off to focus on the firm's industrial properties and allow Parkway to pursue a focus solely on investment in office properties. In its present form, Parkway has been traded on the New York Stock Exchange since 1996; however, its senior management team has been working together for more than 15 years.

In 1998, Parkway decided to employ its own management teams to operate its assets on a day-to-day basis. Property Managers, Building Engineers and Administrators were hired to work in management offices located strategically throughout the portfolio. This decision led to better control over the investment performance of its assets and more streamlined operations from a single operations team rather than a collection of multiple third-party management companies – with their different reporting structures and operating strategies. It also allowed Parkway to start branding itself as an *owner-operator* of real estate and not simply an *owner*.

Since its decision to invest solely in office properties, Parkway has been a company focused on strategic planning. Their first plan – "24 in 24" – was a list of tasks geared toward achieving a $24 stock price in the first 24 months of being listed on the NYSE. Rocketing through this goal, "24 in 24" was extended twelve months to include further tasks that were intended to take the company stock price to $36 a share. The "36 in 36" program was also achieved and followed up in November 1998 with the "5 in 50" plan – a plan to attain $5.00 in FFO per basic share in 50 months. This goal was achieved on December 31, 2002, and quickly followed by the "VALUE^2" plan in which Parkway set as its goal to exceed the weighted average cumulative FFO growth of its REIT peer group by 10% or greater. As Parkway announced success of this program in early 2006, it announced its next 36 month plan – "GEAR UP" – in which it set as its goal $7.18 in cumulative FAD per share over the next 36 months. Needless to say, Parkway has a long history of setting challenging goals for itself and attaining those goals. Details regarding Parkway's portfolio of office properties is provided in Exhibit 1.

While Parkway has successfully accomplished all of its four strategic plans to date, GEAR UP represents a shift in its focus on FFO and stock price. Its new FAD metric is a clear indication that the company is serious about attending to the strength of its cash dividend. As of December 31, 2005, Parkway had paid seventy-seven (77) consecutive quarterly dividends; however, earnings since 2002 had not resulted in an increase in its cash dividend payment. In fact, a downturn in the office market had resulted in Parkway paying a dividend that *exceeded* its FAD. Parkway's senior management team had been hoping for an improving office market for almost three years, but they were still waiting for occupancy and rental rates to rebound.

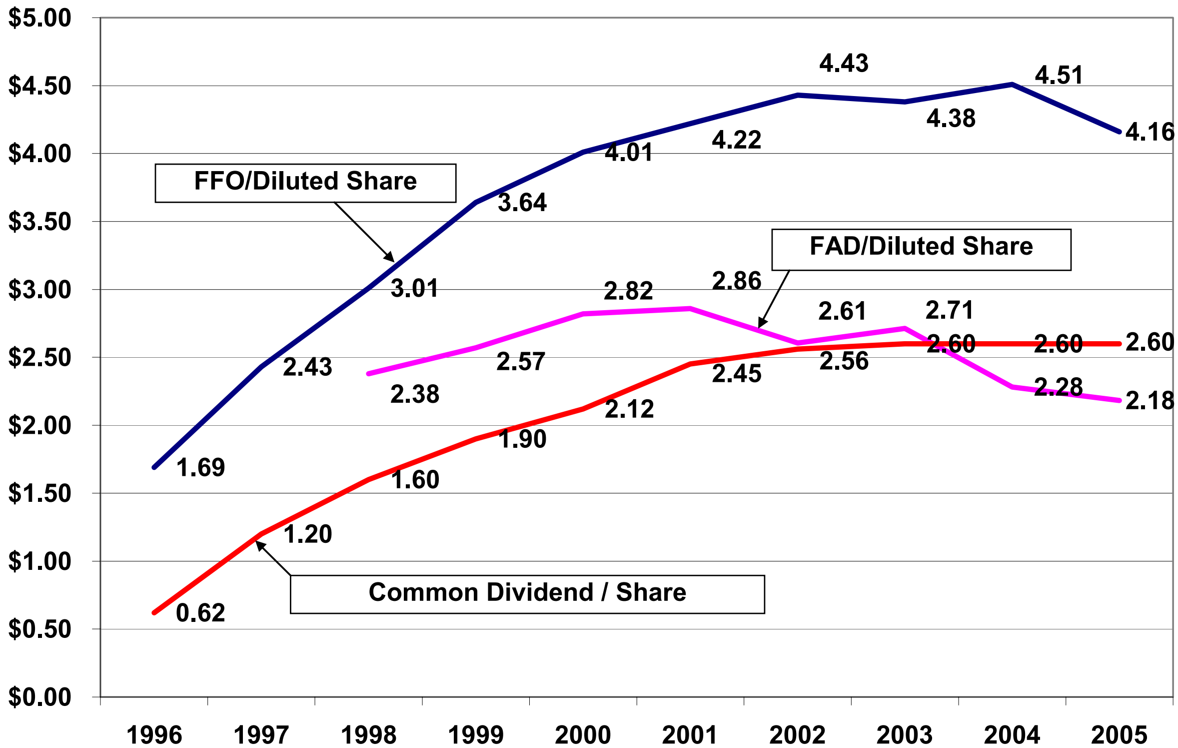
Exhibit 1. Parkway's Portfolio of Assets as of January 1, 2006[1]

Location	Number of Office Properties	Total Net Rentable Square Feet (in thousands)	% of Total Net Rentable Feet	Average Gross Rent per Square Foot	Estimated Average Market Rent per Square Foot	% of Leases Expiring in 2006	% Leased As of 1/1/2006
Houston, TX	15	2,246	18.3%	$ 18.02	$ 16.42	14.4%	94.2%
Atlanta, GA	9	1,382	11.2%	$ 20.51	$ 19.93	6.9%	89.8%
Chicago, IL	1	1,070	8.7%	$ 33.20	$ 31.57	5.7%	90.8%
Memphis, TN	5	1,009	8.3%	$ 19.86	$ 18.43	11.8%	85.3%
Phoenix, AZ	3	872	7.1%	$ 23.41	$ 22.09	20.5%	92.4%
Columbia, SC	3	868	7.1%	$ 15.27	$ 16.09	10.6%	86.1%
Jackson, MS	5	841	6.9%	$ 17.66	$ 17.18	11.8%	89.0%
Orlando, FL	4	691	5.7%	$ 22.18	$ 20.45	7.2%	81.5%
Knoxville, TN	2	547	4.5%	$ 14.73	$ 16.00	12.5%	88.7%
Charlotte, NC	2	511	4.2%	$ 16.94	$ 15.75	7.4%	84.7%
Richmond, VA	6	498	4.1%	$ 17.24	$ 16.37	12.7%	80.9%
Nashville, TN	1	434	3.6%	$ 13.68	$ 16.75	3.7%	72.2%
Hampton Roads, VA	3	384	3.1%	$ 17.33	$ 16.79	8.1%	92.7%
St. Petersburg, FL	2	322	2.6%	$ 18.60	$ 18.31	5.3%	90.3%
Jacksonville, FL	2	302	2.5%	$ 17.44	$ 17.64	10.6%	96.4%
Ft. Lauderdale, FL	2	215	1.8%	$ 21.99	$ 23.07	19.8%	98.0%
All Others	1	32	0.3%	$ 8.00	$ 8.00	0.0%	100.0%
Total/Weighted Ave.	66	12,224	100.0%	$ 19.89	$ 19.15	10.8%	88.9%

[1] Parkway Properties - 2005 Annual Report

Still hopeful of a strengthening market, Parkway's President, Steve Rogers, stated in his 2005 letter to the shareholders, "In 2005, our dividends paid to common shareholders exceeded FAD by approximately $5 million, reflecting primarily the drop in average occupancy during the year and the continued roll down in rental rates. Our projections show that FAD should cover the dividend by 2007, therefore we do not anticipate a change in our dividend policy at this time." Parkway's historical FFO, FAD and Dividend are presented graphically in Figure 1.

Figure 1. Parkway's Historical FFO, FAD and Cash Dividend[2]



[2]Parkway Properties - Earnings Press Releases

MARKET CONDITIONS

Revenues

Two factors largely determine the revenues of an office REIT – percentage occupancy and market rental rates. These two factors are very closely related, and the largest economic indicator that an office REIT relies upon to predict both occupancy and rental rates is *job growth*. Quite simply, as more and more workers are hired during an economic expansion, the more office space firms must lease in order to provide those workers with a desk or cubicle – as well as the additional space needed to support a larger work force (conference rooms, break areas, rest rooms, etc.). Assuming a relatively fixed supply of office space (because it's not easy to produce an office building very quickly), job growth is the key determinant of the amount of office space demanded by firms in the economy. Annual U.S. unemployment data since 2000 is summarized in Exhibit 2.

Exhibit 2. Annual U.S. Unemployment Data[3]

Year	Unemployment Percentage	Number of Unmeployed Workers
2000	4.0%	5,692,000
2001	4.7%	6,801,000
2002	5.8%	8,378,000
2003	6.0%	8,774,000
2004	5.5%	8,149,000
2005	5.1%	7,591,000

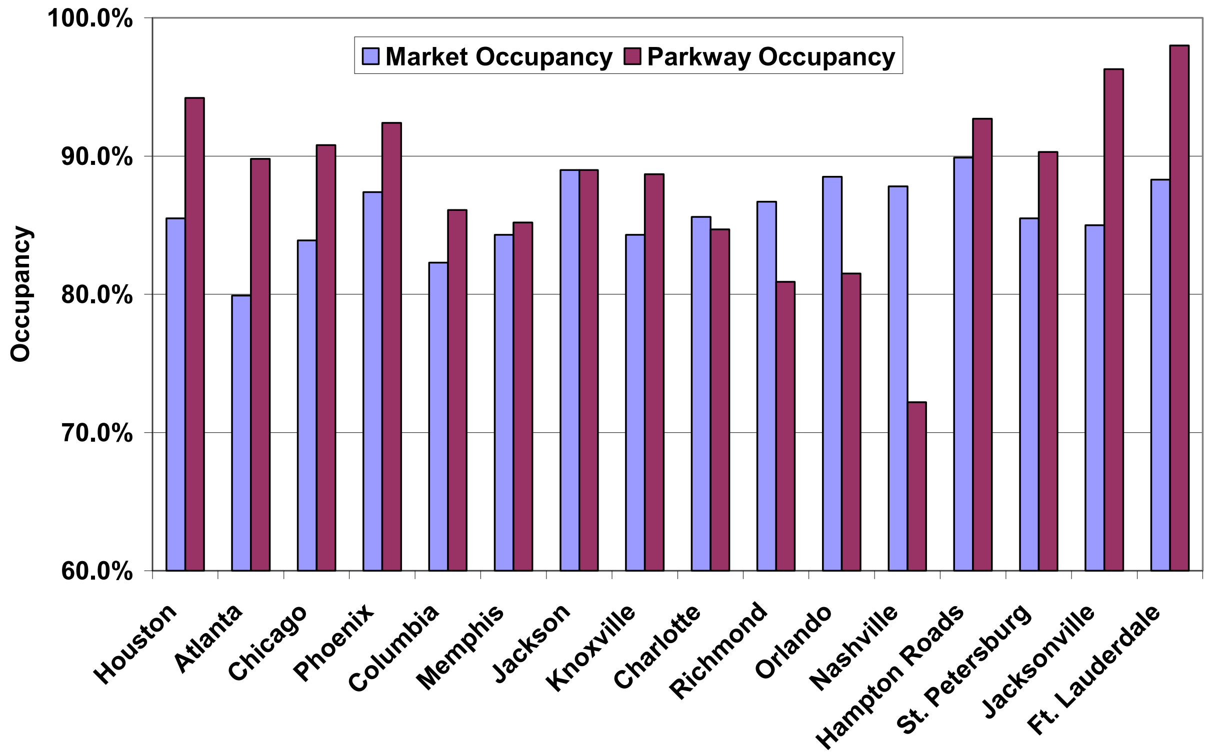
[3]Bureau of Labor Statistics

From an unemployment low of 4.0% in 2000, the economy slowed rapidly, and the effects of the unemployment were felt quickly by office landlords. By 2003, the boards of directors of two public office REITs had already decided to reduce dividend payments. On April 24, 2003, the Board of Directors of Highwoods Properties (NYSE: HIW) announced a reduction in its annual dividend due to decreased earnings. This 8.6% reduction in dividend comes from a REIT which is closely aligned to Parkway with regard to its geographical focus and investment markets. Two of its large tenants, WorldCom and US Airways, had declared bankruptcy – and Parkway also incurred the difficulties associated with leasing space to WorldCom in its home market of Jackson, Mississippi. Glenborough Realty (NYSE: GLB) announced a reduction in its $0.43 quarterly cash dividend to $0.35 per quarter on June 30, 2003. In its release of second quarter results, President and CEO, Andrew Batinovich, was quoted as saying, "the combination of lower occupancy and a slower absorption of vacant space and development land has resulted in an increase in the Company's payout ratios. At this point in the real estate cycle, it appears that significant increases in office occupancy may not occur until late 2004, therefore, we believe it is prudent to maintain our solid balance sheet and reduce the dividend at this time."

Unemployment peaked at a rate of 6.0% in 2003, and REITs were eagerly anticipating an increase in hiring that would lead to greater occupancy rates across the country. But, contrary to Mr. Batinovich's prediction, absorption did not increase materially by the end of 2004, and office REITs were still waiting for occupancy to improve over a year later. Many industry insiders were quick to note that a lag between job growth and occupancy should be expected because many firms were already carrying excess office space on their existing leases. Enough jobs would have to be created to fill this "shadow space" before tenants would look to landlords for more space than they currently leased. The situation was so dire for Amerivest Properties (NYSE: AMV), that on March 9, 2005 its board voted to suspend all dividend payments on its common stock until it could determine how best to proceed strategically. For Amerivest, all options were on the table – sale or merger of the company, locating a joint venture partner, liquidating assets, etc. By the end of 2005, Amerivest had successfully begun selling underperforming assets to improve its financial position. The continued difficulty of the office market contributed to several rumors of consolidation and corporate control activity within the industry by the end of 2005.

Regarding occupancy and leasing success, Parkway seemed to be faring better than most. Parkway's occupancy compared to that of each of its investment markets as of January 1, 2006, is shown in Figure 2. As you can see, Parkway's leasing efforts resulted in a higher than average occupancy in 12 of its 16 markets. Better yet, Parkway was handily outperforming the market occupancy in Houston, Atlanta and Chicago – its three largest investment cities.

Figure 2. Parkway vs. Market Occupancy as of January 1, 2006[4]



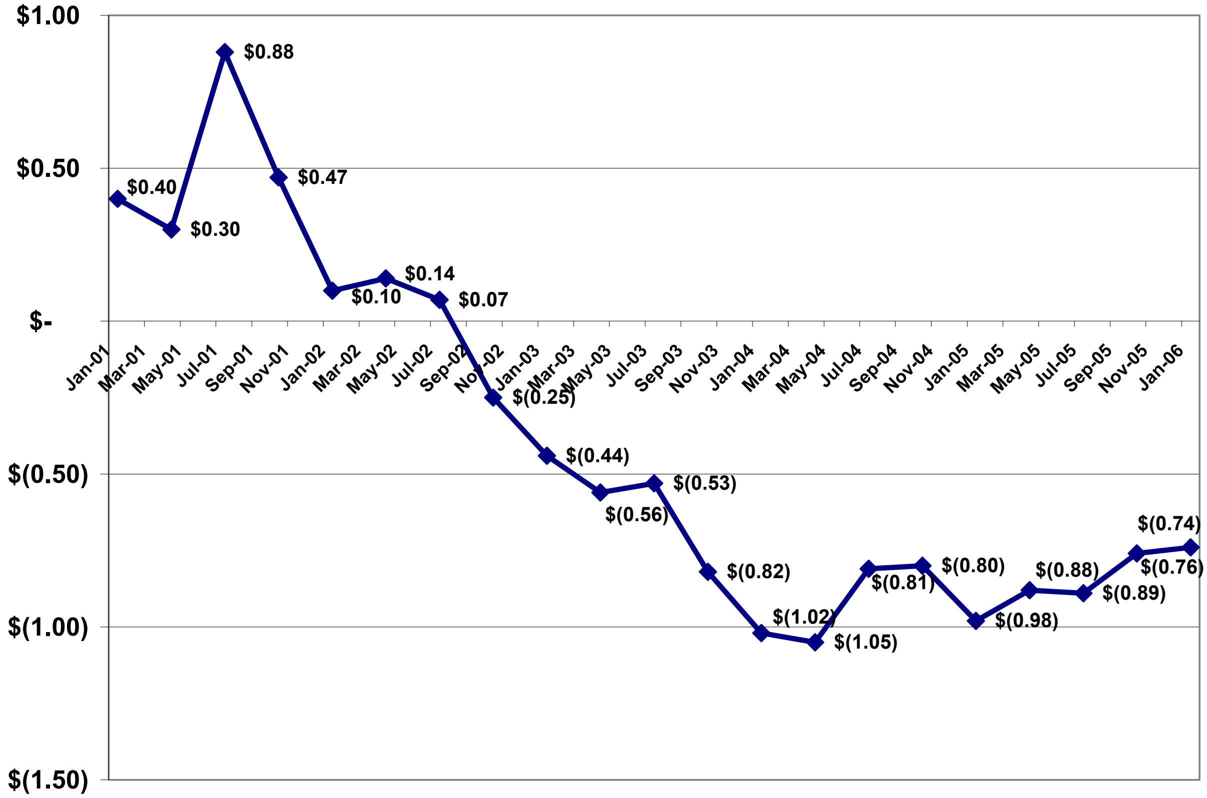
[4]Parkway Properties – 4th Quarter Earnings Webcast, February 7, 2006 (www.pky.com)

While Parkway enjoyed successful leasing in terms of occupancy, it was filling up space in its properties at comparatively low rental rates. The way in which Parkway tracks its existing rental rates in comparison to market rates is referred to as *embedded growth*. Embedded growth allows Parkway to determine what will happen as leases expire and customers renew their lease. Since the second quarter of 2002, Parkway's expiring customers have, on average, been able to renew their leases at rental rates *below* what they were previously paying. At January 1, 2006, Parkway had observed fourteen consecutive quarters of existing customers renewing leases at lower rates.

Figure 3 provides Parkway's historical embedded growth. In July 2001, a Parkway customer whose lease was expiring could expect to pay (on average) $0.88 more per square foot per year in rent during the term of its lease renewal. An average size customer of approximately 5,000 square feet would therefore anticipate paying an additional $22,000 to Parkway over the next five years for its office space ($4,400 per year). On January 1, 2006, a customer could expect a reduction of $0.74 per square foot per year in its rental rate when it renewed it lease at market terms. At an average rental rate of $19.89 on that same date, that is approximately an anticipated 4.0% decrease in revenues to Parkway (assuming all expiring customers renewed).

In it's quarterly earnings press release for the 4th quarter of 2005, Parkway disclosed that approximately 1,326,000 SF of office space was expiring in 2006. Assuming an average rate of $19.89 for those leases, Parkway could expect a $981,240 reduction in revenues (again assuming a consistent level of occupancy). Remember, too, that Parkway had been observing this negative embedded growth for fourteen consecutive quarters.

Figure 3. Parkway's Historical Embedded Growth in Rental Rates[5]



[5]Parkway Properties – 3rd Quarter Earnings Webcast, October 30, 2006 (www.pky.com)

Expenses

Expenses for owners of office buildings have been historically dominated by two areas: taxes and utilities. Not only was the office market experiencing a drop in rental rates and occupancy, it was experiencing an increase in expenses across the board – not just taxes and utility costs. After September 11, 2001, owners of office properties saw sharp increases in their property insurance. Owning office buildings was seen as a riskier endeavor in a post-9/11 economy. Also, as a result of the unprecedented hurricane season of 2005 in Florida and the southeastern U.S., insurance costs were expected to soar once again in 2006, and this was evident in the new insurance policies being issued to other landlords.

Taxes were rising at rates not seen in years. Taxes are based on assessed market values each year as determined by the county appraisal district in which the properties are located. After the collapse of Enron, WorldCom and others, REITs observed a large amount of new funds flowing into real estate in search of "safer" investments. Increased demand caused market prices of commercial office properties to skyrocket, and taxes skyrocketed with them.

Utility costs were rising rapidly as well. 2005 was a very hot year, and forecasts for 2006 were for similar weather. Parkway's focus on the southern United States meant that they would incur a pretty significant cost for using more electricity if they could not manage their air conditioning systems effectively. Recent deregulation of the utilities market had also attracted speculators looking for higher returns than the equity market had provided since 2000. At December 31, 2005, prices for retail electricity had more than doubled since 2003.

Capital Costs

Capital costs for office REITs effectively fall into one of three categories, (1) leasing commissions that REITs pay real estate brokers to represent both the landlord and the tenant in the leasing transaction, (2) tenant improvement dollars that landlords provide tenants as an allowance to alter the existing space to meet their operational needs, and (3) non-revenue enhancing building improvements to update the property.

Leasing commissions are driven by market conditions but do not usually fluctuate much from six percent of the total revenue generated by the signed lease. However, low occupancy and demand for office space made customers a rare commodity. Landlords began offering incentives to brokers for signing leases with them rather than the competition. An example of this type of incentive for a five year 5,000 square foot lease would be their regular commission plus a 42" flat panel television (about $3,000 in value). Now in the grand scheme of things, this $3,000 is not a lot of money for a five year lease deal, but with low rates, high expenses, and high capital costs, this only contributed to the rising costs associated with generating revenue.

Not only did the hurricanes create a much higher cost of insurance – supply and demand for construction materials in the areas devastated by Hurricanes Katrina and Rita made it much more expensive to customize office space for new and expanding customers. The price of drywall (sheet rock) soared. The price of steel and other raw materials were going up on account of demand from the improving economy in China as well as increased demand in the areas affected by the hurricanes. Landlords would have loved nothing more than to have tenants pay for this increased costs out of their own pocket, but the scarcity of potential new tenants dictated that landlords absorb most, if not all, of these costs.

Non-revenue capital enhancements (NRE) include items such as expenditures to meet the requirements of the Americans with Disabilities Act (ADA) to provide greater access to citizens with mobility challenges. They also include costs associated with meeting certain building or fire code requirements and another other aesthetic aspect of the building such as lobby or restroom upgrades. The largest component of NRE, however, is the replacement of old or failing building systems such as the roof or portions of air conditioners. With an aging portfolio, Parkway saw these costs increasing as well. A summary of Parkway's capital costs is provided in Exhibit 3.

Exhibit 3. Parkway Properties - Historical Capital Costs[6]

	Leasing Costs (Tenant Improvements & Leasing Commissions)		
Year	New Leases ($ per square foot per year)	Renewal & Exapansion Leases ($ per square foot per year)	Non-Revenue Enhancing Building Improvements ($ per square foot)
2000	$2.10	$1.02	na
2001	$3.04	$1.18	na
2002	$3.11	$1.36	$0.31
2003	$3.33	$1.52	$0.55
2004	$3.09	$1.78	$0.42
2005	$3.58	$1.99	$0.71

[6]Parkway Properties – Earnings Press Release Supplemental Information Packages

Office REIT Peer Group

The effect of the difficult leasing market on Parkway's peer group was not uniform. As previously mentioned, many REITs had already been forced to reduce dividend payments at some point in the past several years. REITs had been hoping for improving market conditions as soon as it was evident that the market for office space was on the decline. As with all real estate cycles associated with the market for office space, neither the slow down nor the recovery was uniform.

Exhibit 4 summarizes information on Parkway's peer group as of December 31, 2005. Panel A provides information about the peer group's market capitalization, its total annual stock return for 2005 and historical information on cash dividend payments. Panel B provides detail about the respective investment markets of each firm in the peer group. Evidenced by their continued dividend growth over the past several years, several firms seemed somewhat insulated from the decreasing occupancy and rental rates that plagued Parkway. Most notable among the firms that remained insulated were Boston Properties and SL Green Realty which continued to raise their dividends due to stronger market conditions in the major cities of Boston and New York. Trizec Properties, Highwoods Properties (who had already reduced their dividend), and others who were more heavily invested in secondary markets were struggling to meet their existing dividend payments – as were Brandywine and Arden who were largely invested in individual markets (Philadelphia and Los Angeles respectively).

Exhibit 4. Summary Information on Office REITs

Panel A. Market Capitalization, Return and Cash Dividend Information[7]

Office REIT	Equity Market Value as of 12/31/2005 (in 1000s)	2005 Total Annual Stock Return	Cash Dividends			
			2002	2003	2004	2005
Equity Office Properties	12,319,136	11.02%	2.00	2.00	2.00	2.00
Boston Properties	8,340,292	18.79%	2.41	2.50	2.58	2.69
Brookfield Properties	6,815,496	-19.47%	0.40	0.50	0.62	0.70
Trizec Properties	3,580,012	25.37%	0.26	0.80	0.80	0.80
SL Green Realty	3,218,540	29.83%	1.79	1.90	2.04	2.22
Arden Realty	3,017,776	24.20%	2.02	2.02	2.02	2.02
Mack Cali Realty	2,673,734	-0.67%	2.50	2.52	2.52	2.52
HRPT Properties	2,172,061	-12.78%	0.80	0.80	0.82	0.84
CarrAmerica Realty	2,024,955	11.00%	2.00	2.00	2.00	2.00
Prentiss Properties	1,884,908	12.41%	2.22	2.24	2.24	2.26
Alexandria Real Estate	1,810,365	11.82%	2.00	2.20	2.52	2.72
Kilroy Realty	1,790,334	49.57%	1.98	1.98	1.98	2.04
Brandywine Realty	1,567,956	1.02%	1.76	1.76	1.76	1.78
Highwoods Properties	1,537,154	8.84%	2.34	1.86	1.70	1.70
Corporate Office Properties	1,407,029	24.74%	0.86	0.91	0.98	1.07
Maguire Properties	1,364,729	18.35%		0.82	1.60	1.60
Glenborough Realty	629,464	-8.36%	1.72	1.56	1.40	1.40
Parkway Properties	567,981	-15.78%	2.56	2.60	2.60	2.60
Government Properties	193,131	0.71%			0.60	0.60
Amerivest Properties	100,543	-34.84%	0.51	0.52	0.52	-

[7]Center for Research in Security Prices (CRSP)

Panel B. Areas of Geographical Focus[8]

Office REIT	Geographical Focus
Equity Office Properties	Nationwide in major metropolitan markets
Boston Properties	Boston, New York, Washington D.C., San Francisco & Princeton
Brookfield Properties	New York, Toronto, Calgary, Houston, Washington D.C., Los Angeles, etc.
Trizec Properties	Houston, New York, Dallas, Los Angeles, Washington D.C.
SL Green Realty	Midtown Manhattan
Arden Realty	Southern California
Mack Cali Realty	Primarily Northeastern US - New Jersey, New York and Pennsylvania
HRPT Properties	Nationwide
CarrAmerica Realty	Washington D.C., Northern California, San Diego, Seattle,
Prentiss Properties	Washington D.C., California, Austin and Dallas
Alexandria Real Estate	Washington D.C., Boston, San Francisco, San Diego, Seattle, etc.
Kilroy Realty	California and the western U.S.
Brandywine Realty	Pennsylvania, New Jersey and Virginia
Highwoods Properties	Southeastern U.S. and Kansas City
Corporate Office Properties	Maryland, Virginia, Colorado, New Jersey, Pennsylvania
Maguire Properties	California
Glenborough Realty	Washington D.C., Southern California, New Jersey, Boston and San Fran
Parkway Properties	Houston, Southeastern U.S., Chicago, Phoenix
Government Properties	Various - Leases only to US Government Agencies
Amerivest Properties	Denver, Phoenix, Dallas and Indianapolis - In process of selling assets.

[8]Company 10-K filings

On December 14, 2005, Equity Office Properties publicly announced a reduction in its cash dividend beginning with the first quarterly dividend of 2006. It anticipated its total 2006 dividend to be $1.32 per share compared with the $2.00 per share annual dividend that the company had paid in the several years prior to 2006. This announcement of a 34% reduction in cash dividends by the largest company within the industry was accompanied by the statement "…the 2006 dividend will more accurately reflect the taxable income the company expects to generate in 2006." Interestingly, this news had very little noticeable impact on Parkway's stock price. Had the market already priced Parkway as a "dividend cut waiting to happen?"

Looking Forward

At the heart of Parkway's oncoming strategic plan is the decision to convert from an *owner-operator* of real estate to an *operator-owner* of real estate. Since 1998, Parkway had been developing its skills as managers and leasing agents and the strategy of converting from an *owner-operator* to an *operator-owner* served several purposes. First, Parkway could use this newly developed strategic advantage to increase its profitability. Since its decision in 1998 to self-manage and lease, Parkway had been offering these services through its wholly owned subsidiary Parkway Realty Services, and it had become quite good at both management and leasing. The GEAR UP plan is focused on taking advantage of these developed skills.

More importantly, Parkway is now able to generate capital internally without having to access the external debt and equity markets during a period of a depressed stock price. Parkway's intent is to sell a majority interest in most of its properties while retaining management and leasing services for the joint venture or partnership. Such a divestiture of ownership provides Parkway with large amounts of new capital for growth through acquisition of new properties that would not otherwise be available from external sources (or at the very least would be much more expensive via external sources). It also substantially increases its return on its minority interest. Selling older assets that no longer "fit" the portfolio would also reduce the increasing burden of non-revenue enhancing capital expenditures that has reduced Parkway's FAD. From a financial perspective, the recycling of assets in GEAR UP would enable Parkway to invest in real estate such that the rates of return on their minority interest would far exceed their cost of capital.

On an operating basis, Parkway's fiduciary responsibilities – not only to their own shareholders but now to the shareholders and owners of their venture partners – would increase substantially. The reporting requirements and required duties would place new burdens on its management and administrative teams – especially its accounting team. If they could pull off the transition, the financial gain would certainly be worth the burden. Could Parkway extend its winning streak by surpassing the goals of another three year operating plan? Could it do so quickly enough to not require a reduction in its dividend? Much of the answer depends on how long it will take for the office market to rebound. Parkway and its peers had been expecting the turn-around for quite some time, but it had yet to come. It was in this environment that Parkway's management team began discussion on whether to maintain or cut the dividend.

REFERENCES

Invest in REITs, 2006. www.investinreits.com

National Association of Real Estate Investment Trusts, Inc., 2002, *White Paper on Funds From Operations*

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ANGLERS INC.: VALUE-BASED MANAGEMENT

Bert Stine, Stephen F. Austin State University

Anglers' management has asked for an analysis of an expected increase in sales. A free cash flow forecast reveals that the sales growth will decrease the value of the firm. The analysis is expanded to include value-based management concepts. Factors that influence the value of the firm are considered and a strategy that will increase the value of Anglers is established.

BACKGROUND

Anglers Inc. manufactures a successful line of fishing lures. The company entered the market five years ago with a competitively priced spinning lure featuring a large vibration spinner and a high quality cable body. The initial success of the lure allowed the company to expand their offering to a variety of fishing lure styles and sizes. Their latest fishing lure, the "Mad Minnow," has been very successful. Based on this success, the company is now planning an increase in marketing expenditures to further grow sales and create value for the company. Currently, the anticipated sales growth is 5%, but management expects the marketing campaign to increase sales growth to 7%. Carl Jameson, the newest member of the strategic management team, has been asked to analyze the impact of the proposed marketing expenditure on the value of Anglers. Carl has worked in production since the start-up of the company. In the last few years he has taken night classes in accounting and finance at the local state university. The president of Anglers sought to move Carl to the management side of the business by placing him on the strategic management team. The president asked the chief financial officer of the team, Mark Thompson, to mentor Carl's progress. At the strategic planning meeting the president asked Mark and Carl to determine the impact of sales on the value of the firm at growth rates of 5% and 7%.

Mark and Carl talked as they returned to their office. "I am leaving for my vacation tomorrow Carl," commented Mark. "I am going fishing for a few days at the company lake. You will have to work on the analysis while I am away. You might calculate a few ratios and then perform a free cash flow analysis. You have worked with free cash flows in your finance class so you can refer to your text book for the specifics. The cabin has an Internet connection, so e-mail if you have any problems. I should be available each evening, but remember I am on vacation so please keep the e-mails to a minimum."

Carl thought for a moment and decided that for a quick ratio analysis he would compute ROE using the extended Du Pont equation. For the free cash flow analysis, he would need to forecast the income statement and balance sheet accounts necessary to generate free cash flows. He would then discount the free cash flows, including a horizon value, at the weighted average cost of capital to get an estimate of the value gained as a result of the sales growth. "I can handle it," responded Carl. "I will only e-mail you if I run into some problems."

Basic Relationships

The next day, after Mark left for his fishing trip, Carl began to organize the data necessary to determine the impact of the projected increase in sales. He began by recalling a few basic relationships.

1) Free Cash Flow (FCF) is the amount of cash available for distribution to the company's investors after the company has invested in the working capital and fixed assets necessary to continue operations. The FCF calculation distinguishes between investor supplied capital and capital supplied from operating current liabilities. The value of a company is largely determined by its expected future free cash flows.

2) Market Value Added from the increase in sales can be estimated by finding the value of operations based on future free cash flows and comparing that value to the beginning value of operations.

To select the income statement and balance sheet accounts necessary to compute free cash flows, Carl recalled the basic free cash flow definition.

FCF = EBIT(1-T) - Net investment in operating capital

Carl would first divide total assets into operating assets (necessary to run the business) and non operating assets (marketable securities). He would then list the accounts necessary to forecast EBIT, net operating working capital, and operating long term assets recalling that:

Net operating working capital = operating current assets - operating current liabilities

Operating long term assets = net plant and equipment

Total net operating capital = net operating working capital + operating long term assets

Analysis

The income statement and balance sheet are shown in Exhibit 1. The DuPont ratio analysis at the bottom of the exhibit shows a return on equity of 13.5%. The accounts needed to forecast the free cash flows are shown as a percent of sales in the input portion of Exhibit 2. The partial income statement generates EBIT and the partial balance sheet generates total net operating working capital. The FCF section combines the total net operating capital, EBIT after tax, a horizon value, and the MVA (market value added = present value of operations - total net operating capital for the current year). Since it was important for the strategic management team members to understand the concept of investor supplied capital as opposed to capital supplied by operating current liabilities, Carl would reconcile the investor supplied capital generated by the FCF analysis with the liabilities side of the balance sheet in his report.

Carl began his analysis using a 5% growth rate in sales. He forecast the necessary accounts using the percent-of-sales method. For the years beyond 2010, Carl computed a horizon value assuming a constant rate of growth of 5% to infinity and a cost of capital of 10%. Carl made a mental note that his report to the team should include an explanation of the horizon value. Comparing the present value of the free cash flows discounted at 10% (including the horizon value) to the 2005 Total Net Operating Capital of $1,760,000, Carl found that the 5% rate of growth in sales actually results in a negative market value added of $244,000. In other words, an investment in total net operating capital of $1,760,000 produces future free cash flows that have a present value that is smaller than the initial investment. The growth in sales actually takes away value. Confused, Carl felt that maybe a higher projected sales growth would result in a positive MVA. Carl used the scenario tool in his spread sheet to change the growth in sales from 5% to 7%. At a growth rate of 7% he found an even greater loss in value. It was time to e-mail Mark Thompson.

Correspondence

Mark Thompson, relaxed after a productive day of fishing, turned on his computer at 7:00PM and heard the familiar prompt, "you've got mail." Mark clicked on the following message from Carl.

> From: Carl Jameson <C_Jameson@boohoo.con>
> To: Mark Thompson <M_Thompson@coolmail.nat>
> Subject: Help
>
> Mark,
>
> The DuPont Analysis looks fine in the areas of profit margin on sales, total asset turnover and use of debt. The ROE of 13.5% is very competitive in the industry. However, the free cash flow analysis shows that the projected 5% increase in sales actually reduces the value of the company. I don't understand it. For our industry 5% is a fairly high growth rate, yet it does not add any value to our company. I tried 7% growth and the result is even worse. How can a high positive growth rate take value away from the firm?
> Carl

Mark read the message, sipped his drink and replied.

> From: Mark Thompson <M_Thompson@coolmail.nat>
> To: Carl Jameson <C_Jameson@boohoo.con>
> Subject: Help is on the way
>
> Hey Carl, the fishing has been great here. Sounds like you have run into a bit of trouble. Let's start with the basics. Accounting ratios only tell part of the story. Let's focus on the free cash flow analysis. What is your weighted average cost of capital (WACC) and what is your Expected Return On Invested Capital (EROIC). I will be in all evening so let me know your WACC and EROIC and we will go from there.
>
> Mark

Carl thought for a few minutes after reading Mark's e-mail. He had used a WACC of 10%, but he had not calculated the EROIC. He referred to his finance book in the Value-Based Management section and found the following formula for the EROIC (Brigham and Daves 2004).

$$EROIC_N = \frac{EBIT(1-T)_{N+1}}{Operating\ capital_N} \qquad \textbf{Equation 1}$$

He acquired the necessary data and computed an EROIC of 9.31%. Carl sent the WACC and EROIC to Mark.

> From: Carl Jameson <C_Jameson@boohoo.con>
> To: Mark Thompson <M_Thompson@coolmail.nat>
> Subject: EROIC/WACC
>
> Mark,
>
> Glad the fishing is going well. The WACC is 10% and the EROIC is 9.31%.

Mark replied with three words.

> From: Mark Thompson <M_Thompson@coolmail.nat>
> To: Carl Jameson <C_Jameson@boohoo.con>
> Subject: EROIC/WACC
>
> Think about it.

Carl looked at the e-mail and thought for a moment. "Of course!" he exclaimed to himself and replied.

> From: Carl Jameson <C_Jameson@boohoo.con>
> To: Mark Thompson <M_Thompson@coolmail.nat>
> Subject: EROIC < WACC
>
> Mark, I see what you mean. The expected return on invested capital is less than the weighted average cost of capital. No wonder there is a loss in value.

Mark followed with an e-mail offering some additional guidance.

> From: Mark Thompson <M_Thompson@coolmail.nat>
> To: Carl Jameson <C_Jameson@boohoo.con>
> Subject: Now you are on the right track.
>
> Remember Carl, growth is only one aspect of value creation. Refer back to your finance book where there is a description of four fundamental wealth drivers. You are going to need to understand the relationships when you explain to the strategic planning team why a positive growth rate in sales will result in a loss in value. More importantly, you will need to suggest an alternative to the proposed expenditure for sales promotion. I think when you examine the relationship between the value drivers you can suggest a strategy that will increase the value of the firm.
>
> By the way, our prototype lure, the "Shimmy Shad," is working like a charm.

Value Creation

Carl responded with a "thanks for the help" and then referred to his finance book where he found the following equations. Assuming a constant rate of growth for sales the value of the firm's operating assets (value of operations) is found by:

$$V_{op\ (at\ time\ N)} = Capital_N + \frac{Capital_N(EROIC_N - WACC)}{WACC - g}$$ **Equation 2**

Where EROIC = Expected return on invested capital
WACC = weighted average cost of capital
g = growth in sales

Alternatively:

$$V_{op\ (at\ time\ N)} = Capital_N + \left[\frac{Sales_N(1+g)}{WACC - g}\right]\left[OP - WACC\left(\frac{CR}{1+g}\right)\right]$$ **Equation 3**

Where g = growth in sales

OP = Operating profitability = $\dfrac{EBIT(1-T)}{Sales}$

CR = Capital requirement = $\dfrac{OperatingCapital}{Sales}$

WACC = Weighted average cost of capital

Carl noticed that Equation 2 could be used to clearly illustrate the problem with the proposed sales promotion plan. If the EROIC is less than the WACC, then the second term of the equation indicates that the increment in value will be negative. Since Carl's analysis assumed a constant rate of growth he could use the equation to summarize his spread sheet analysis. He decided that it would be helpful to illustrate the relation ship between EROIC and the WACC by creating the following table assuming a fixed EROIC of 9.31%.

Table 1. WACC, EROIC, and Market Value Added (MVA)

WACC	Value of Operations (Using Equation 2)	MVA (Value of Operations - $Capital_N$)
.08		
.09		
.0931 (= EROIC)		
.10		
.11		

By computing the MVA added at each level of WACC, he could show the strategic planning team that MVA is positive only where the WACC is less than EROIC. When WACC equals EROIC, the MVA is $0. There is a negative MVA where WACC is greater than EROIC. No matter how high the rate of growth, there will not be an increase in value unless the EROIC is greater than the WACC.

Carl could then use Equation 3 to show the interaction of the four value drivers. Visually inspecting the equation reveals that the capital requirement (CR) is inversely related to value and the operating profit (OP) is positively related to value. Assuming that the firm's WACC cannot be changed at this point, the EROIC must be increased before an increase in sales will result in additional value. Carl felt that if the capital requirement could be reduced or the operating profit increased, the EROIC could be increased to a rate that exceeded the weighted average cost of capital. A growth rate of 5% should then add value to the company.

Carl e-mailed Mark one more time.

From: Carl Jameson <C_Jameson@boohoo.con>
To: Mark Thompson <M_Thompson@coolmail.nat>
Subject: operating profit/capital requirement

Mark, are we in a position to increase our operating profit or reduce our capital requirement?

Pleased that Carl now understood the important relationships in value-based management, Mark offered the following advice.

From: Mark Thompson <M_Thompson@coolmail.nat>
To: Carl Jameson <C_Jameson@boohoo.con>
Subject: It is a possibility

It would be difficult to reduce our capital requirement in the near term, but I have often thought that if we could update and streamline the production process we could reduce our operating costs from 81% of sales to about 78% of sales. Why don't you add a scenario where operating costs are 78% of sales starting in 2006 and growth in sales is a constant 5%? I think you will find an improvement in the EROIC and should see some value creation.

Mark

Carl thanked Mark again and began preparing the data. Carl used the scenario function of his spread sheet to add an additional scenario. Cost as a percent of sales would be change from 81% to 78% next year (2006). Carl would use a 5% rate of growth in sales each year. He would compute the EROIC and compare it to the WACC. He would also compute the market value added and the impact on the firm's total value. Carl would also show the market value added in terms of the firm's equity.

Carl felt like he could make significant contributions at the next strategic planning team meeting with his analysis. He also felt that he now had a better understanding value management.

REFERENCES

Brigham, Eugene and Phillip Daves (2004). Corporate Value and Value Based Management. *Intermediate Financial Management, 8th Edition*, 332-369.

Exhibit 1. Anglers Inc., Income Statement and Balance Sheet

Income Statement ($Thousands)	YEAR			
	2005			
Net Sales	2,000.00			
Costs (except depreciation)	1,620.00			
Depreciation	120.00			
Total operating costs	1,740.00			
Earnings before interest and taxes	260.00			
Less Interest	32.00			
Earnings before taxes	228.00			
Taxes (40%)	91.20			
Net Income before preferred dividends	136.80			
Preferred dividends	1.80			
Net available for common dividends	135.00			
Common dividends	20.00			
Addition to retained earnings	115.00			
Number of shares	20.00			
Dividends per share	1.00			
Balance Sheet ($Thousands)	YEAR			
	2005			
Assets			Liabilities and equity	
Cash	20.00		Accounts payable	100.00
Marketable securities	40.00		Notes payable	80.00
Accounts receivable	160.00		Accruals	120.00
Inventories	600.00		Total current liabilities	300.00
Total current assets	820.00		Long-term bonds	500.00
Net plant and equipment	1,200.00		Preferred stock	220.00
			Common stock	600.00
			Retained earnings	400.00
			Common equity	1,000.00
Total assets	2,020.00		Total liabilities and equity	2,020.00

Carl's ROE calculation:

ROE = (Profit margin)(Total asset turnover)(Equity multiplier)
= (135/2,000)(2,000/2,020)(2,020/1,000) = .135 = 13.5%

Exhibit 2. Inputs as a % of Sales, Partial Income Statement and Balance Sheet, FCF Analysis

INPUTS						
YEAR	2005	2006	2007	2008	2009	2010
Growth in Sales		5%	5%	5%	5%	5%
Cost as % of Sales	81%	81%	81%	81%	81%	81%
Depreciation as % of Net Plant	10%	10%	10%	10%	10%	10%
Cash as % of Sales	1%	1%	1%	1%	1%	1%
Accounts Receivable as % of Sales	8%	8%	8%	8%	8%	8%
Inventory as % of Sales	30%	30%	30%	30%	30%	30%
Net Plant as % of Sales	60%	60%	60%	60%	60%	60%
Accounts Payable as % of Sales	5%	5%	5%	5%	5%	5%
Accruals as % of Sales	6%	6%	6%	6%	6%	6%
Tax Rate	40%	40%	40%	40%	40%	40%
WACC	10%	10%	10%	10%	10%	10%
PARTIAL INCOME STATEMENT						
Net Sales	2,000.00					
Costs	1,620.00					
Depreciation	120.00					
Operating Costs	1,740.00					
EBIT	260.00					
PARTIAL BALANCE SHEET						
Cash	20.00					
Accounts Receivable	160.00					
Inventories	600.00					
Operating Current Assets	780.00					
Net Plant & Equipment	1,200.00					
Accounts Payable	100.00					
Accruals	120.00					
Operating Current Liabilities	220.00					
FCF						
Net Operating Working Capital	560.00					
Net Plant	1,200.00					
Total Net Operating Capital	1,760.00					
Investment in Operating Capital						
EBIT after TAX	156.00					
FCF						
Horizon Value						
Value of Operations						
MVA						

WHISTLING BIRD WINERY

Armand Gilinsky, Jr., Sonoma State University
Raymond H. Lopez, Pace University

> "The supply of grapes crushed in the 2002 harvest was an all time record and it followed a very good 2001 harvest. Quality is excellent – yet thousands of acres of vines are being pulled up across California with replanting of fruit trees. Mondavi recently announced a reduction of 10 percent of their workforce due to a reduced demand for wines selling above $25.00 per bottle at retail and a projected quarterly operating loss for the first time since they became a public company (1993). How are things going for you on the East Coast?" [1]

Laurie Johnson had trouble responding to the information she had just heard from her cousin Wayne Rodgers during a telephone conversation in May, 2003. She had recently prepared a business plan for expansion of her Whistling Bird Winery located in Cutchogue on the North Fork of Long Island. Her plans included the purchase of grape growing acreage as well as expansion of the winery and construction of a retail store, new tasting room and renovation of a special events facility. The cost of these initiatives was estimated at $2.4 million and would take approximately a year to complete. His information created a surge of uncertainty concerning not only these plans but also the outlook for her current wine producing activities.

Company History

Laurie Johnson and her brother Fred grew up on a 35-acre potato farm on the North Fork of Long Island. Owned by her parents, the farm barely provided for family living expenses. While her father John plowed the fields, her mother Patti Anne taught 4th grade at a nearby public school.

The experience of growing up on a farm had a very different impact on the adult lifestyles of the children. Laurie loved the land. She enjoyed walking the fields with her Dad and seeing the animals that lived on the land, especially the birds nesting in the tall oaks on the periphery of the family property.

For her brother Fred the experience was quite different. An avid reader and athlete, he could not wait to leave the farm for college. With a full athletic scholarship to Yale, Fred thrived in what he thought was a "big city" (New Haven, Connecticut) and then went on to Columbia University for an MBA with a strong emphasis on finance.

Laurie attended the agricultural school at Cornell University. She worked during the summer at small wineries in the Finger Lakes region of New York State. Upon graduation in 1985, she was offered an assistant winemaker position at the Glenora Winery in Hammondsport, NY. For three years she experienced all aspects of the wine making process and saw a chance to combine her love for the land with a career path in this industry.

A few years later her parents announced to their children that they were ready to retire and move to Sedona, Arizona. They "sold" their farm to Laurie and Fred in 1988 and headed west.

In January of 1989, Laurie and Fred each unexpectedly inherited $3 million upon the death of an uncle. They had very different uses for these funds. Laurie paid off her student loans and immediately embarked upon a long held plan to convert the potato fields to the growing of wine grapes. Fred paid off his loans and started a financial consulting firm for private equity investors in Manhattan. Although they spoke often on the phone, Fred had not been out to the farm for more than 3 years. Laurie would occasionally meet him in Manhattan for dinner.

During the spring of l989, Laurie implemented the planting of 20 acres of grape vines on the property and named her new business Whistling Bird Vineyards. By the fall of 1994, her first harvest was completed with the grapes crushed at a local winery.

Production was 60 tons of grapes which resulted in 5,000 cases of bottled wine. Within six months, they were all sold locally to restaurants, catering firms and local businesses for gifts and promotions. Her revenue was just over $250,000 and her business was on its way.

Whistling Bird wines (merlot and chardonnay) were well received in the local marketplace. As demand grew for her products, Laurie decided to operate her own winery. There was a small winery on six acres of land just east of her vineyards. She had been speaking with the owner and sensed that he was ready to retire and move south. After only three meetings, they agreed upon terms of a sale and in the fall of 1996 Laurie was the proud owner of a winery. With an investment of $2.2 million financed with a mortgage from a local Long Island bank, she was ready to oversee her first wine production in the fall of 1997. With expanded acres producing quality grapes and grape purchases from other vineyards, the renamed Whistling Bird Winery generated just over $1.5 million in revenue.

Over the next five years through 2002, the Whistling Bird Winery expanded in the local wine markets. Product acceptance was translated into growing net revenues (Exhibit 1). Although operating expenses grew rapidly, Laurie felt that this spending was needed to meet competition and solidify her products with wholesalers, retailers and the final consumer. The building blocks for sustained growth, with commensurate operating efficiencies, were achieved by 2002.

The firm's balance sheets (Exhibit 2) and statement of cash flows (Exhibit 3) reflected the efforts made by Laurie and her management team as well as the challenges of this business. Most significant was the rapid and continuing expansion of inventories as premium red wines required longer lives in the oak barrels. These growing inventories were financed with a rapidly expanding line of credit from a local bank. However, that bank was nearing its lending limit to any one borrower. Either a larger bank would be needed within the year or another perhaps more permanent financing source would be needed. Page Hopkins, Laurie's accountant and financial manager, had recently been exploring a number of options with North Fork Bancorp.

The Wine Industry on Long Island

From humble beginnings in 1973, the Long Island Wine Industry had developed steadily with growing numbers of vineyards, wineries, acreage and production of quality wine products. It currently (2003) produced a broad variety of varietals from cabernet sauvignon and merlot to chardonnay, cabernet franc and shiraz. All actions of current winery owners pointed to continued growth and expansion into the 21st century.

Grape growing and wine production were located primarily on the eastern end of Long Island which juts more than 100 miles into the Atlantic Ocean, parallel to the coast lines of Connecticut and Rhode Island. It is a maritime region with a unique combination of climate, soil characteristics and growing conditions ideal for quality wine production. Bays bordering the North and South Forks insulate the vineyards and trap moist warm air. Along with rich sandy glacial soil, this combination creates the perfect environment for growing grapes. Growing seasons are quite long (an average of approximately 200 days) and relatively mild winters have encouraged the planting of Europe's noble vinifera grapes on almost all acres planted. The growing region encompasses both Nassau and Suffolk Counties with the majority of wineries and vineyards located at the East End on the North and South Forks.

Long Island wines were sold primarily in the New York Metropolitan Region. Products were found at most vineyards and in local wine retail stores, as well as in a broad variety of restaurants and catering establishments. As quality had been enhanced with higher ratings by wine magazines and in national taste testings, the market broadened up and down the East Coast. It was not surprising that large regional distributors had in recent years shown a growing interest in carrying these wines, and it was expected that these patterns of geographic growth would continue. A few wineries already distributed in Florida, California and elsewhere and it was expected that this trend would accelerate as knowledge spread of the rising quality of Long Island wines.

Long Island Wine country was becoming increasingly respected as an important premium wine-producing region. There were currently three appellations (American Viticulture Areas) approved by the Bureau of Alcohol, Tobacco and Firearms (BATF) – the North Fork of Long Island, The Hamptons and, as of April 2001, Long Island AVA. This latest designation allowed for further expansion beyond the two Forks of Long Island's East End, while at the same time protecting the overall integrity of the regions wines. [2]

Long Island Wine Country – The Early Years

How did it all begin? A small band of hesitant artisans and amateurs started the industry in converted barns and potato fields some 30 years ago seeking a simpler agrarian lifestyle, or so they thought. In less than a third of a century, the profile of Long Island Wine Country had morphed to that of self-assured professionals backed by deep-pocketed investors who were also seeking a different lifestyle as owners of Napa Valley-like showcase wineries making prize winning and sought-after wines. While world class wines might be some years away, the money, the talent and the will to make them were all in place. It seemed just a matter of time according to winery owners and operators.

The land of the North Fork, where most of the wineries were located, was flat to slightly rolling, planted not only with grapes but also with potatoes, sod and fruit trees. Craggy oaks shaded the villages of Greenport, Southold and Cutchogue, small and quaint with 200 year-old houses and 100-year-old churches and plaques to show where the old Pilgrim stocks used to stand on the village green. The water is never more than a few miles away with Long Island Sound to the North and Peconic Bay and The Atlantic Ocean to the South.[3]

The Last Five Years – A Maturing Wine Producing Region

In 1999, Long Island had 20 wineries, 26 wine producers and 25 vineyards that did not have their own wine-making ability. They either sold their grapes to other wineries or contracted with other wineries to produce their wine. [4]

A sure sign of the maturing of the industry on Long Island came with the announcement of a custom-crush facility to be constructed in Mattituck. It would cater to independent vineyard owners and grape buyers that lack their own wine-making facilities.[5]

Russell Hearn, the winemaker at Pellegrini Vineyards, planned this venture along with investors Mark Lieb, a Connecticut money manager and owner of the 50-acre Lieb Vineyard, and Bernard Sussman, also a money manager and an associate of Lieb. The partners expected to fund 40 to 50 percent of the new winery with equity and borrow the remainder from a Long Island bank.

"The primary purpose of this venture is to make wines for a number of small and large producers which choose not to, or are unable to, build their own wineries", Hearn has said. "Our service would allow someone to have small amounts of wine made and bring in their own consultant (winemaker) to set the style. A number of wineries that offered custom services in the past are approaching their maximum." Moreover, grape land under commercial production may double in the next two decades, further expanding the customer base. [6]

Beverage Consumption in the United States

The volume of alcoholic and non-alcoholic beverages consumed by Americans had been growing modestly over the last seven years. By far, the largest category was soft drinks which in 2002 was almost double the next largest category – coffee. The consumption of wine, produced domestically as well as imports, had grown steadily over the same period, but its volume was significantly smaller, less than 4 percent of soft drink volume in 2002 (see Exhibit 4).

In terms of growth in consumption, the wine industry performed better than most other beverage categories. It had expanded by 2.8 percent per year since 1996, trailing only bottled water at 10.8 percent per year and cider (beverage alcohol) at 8.8 percent per year. Overall beverage consumption had been growing at only 1.8 percent per year.

On a per capita basis, wine consumption also performed quite well in recent years (Exhibit 5). It had risen steadily from 1.8 gallons per person per year in 1996 to just over 2.0 gallons in 2002. Once again the bottled water category had experienced the greatest growth in recent years, while soft drinks were still, by far, the largest beverage market segment (over 31 percent of total industry consumption).

Wine tends to be a relatively more expensive beverage as it places quite a bit higher in performance when retail sales are measured. In Exhibit 6, it may be observed that the expenditures for wine placed it as the fourth largest market segment trailing only soft drinks, beer and distilled spirits. Bottled water sales were again the fastest growing segment at 12 percent per year, while wine sales were in second place at 8.2 percent per year. Overall industry growth in retail sales was 4.3 percent over the same seven year period.

Wine Industry Characteristics

Total wine consumption in the United States reached an all time high in 2002. At 595 million gallons, it exceeded the record consumption of 587 million gallons reached in 1986 (see Exhibit 7). From those peak years in the mid-1980s, total consumption as well as per capita consumption trended down for more than a decade. Since the early 1990's growth had resumed and record consumption and sales were being observed, especially in the major market segment, table wine. Table wine in the 1980s represented between 82 and 84 percent of consumption. In response to changing tastes and preferences of the consumer, it exceeded 89 percent in 2002.

Wine sales in the United States over the last decade showed clearly that table wine was winning over consumer's choice. Dessert wines declined from 1991 through 1997 (Exhibit 8) and have since experienced renewed growth. Sparkling wine (champagne) sales also declined in the early 1990s and stayed at lower levels except for a spike in 1999 [students: can you explain it?].

Also reflecting the changing tastes and preferences of the American consumer were the growth performances of table wine sales by color. In the 1980's white wines accounted for more than one half of all wines consumed in the United States with a peak market share of 62 percent reached in 1985 (Exhibit 9). Since the early 1990's, the red wine segment has been the growth driver of the industry, more than tripling its consumption by 2002 to a market share of 39 percent. The white wine segment grew much more slowly throughout the 1990's. More recently, consumption growth has accelerated, yet has not reached the levels of 1985. Finally, the rosé/blush category peaked in the early 1990's, then generally trended downward at a slow pace since those years.

It should be remembered that the red wine category includes wines that are more expensive to produce, due to aging requirements. Therefore, they generally sell for higher prices at both wholesale and retail levels. The result has been that revenues from red wine sales at wineries as well as distributors and retailers have grown faster and are now substantially higher than those of either the white or rosé/blush market segments.

Competitive Characteristics of the Wine Industry

Since the 1960's there has been a substantial increase in the number of firms producing wine products in the United States. From hundreds of companies in the 1960's and 1970's, the number exceeded 1,800 wineries in the late 1990's.[7] Most were relatively small and located primarily in California. In the last few years, the twenty largest firms produced approximately 90 percent of all American wines by volume and 85 percent by value at wholesale.

The competitive structure of the industry could be classified into three groups – standalone wineries both public and private and conglomerate or multi industry firms primarily public. The largest publicly traded winery was Robert Mondavi along with Chalone, a much smaller firm. The privately held firms were led by E&J Gallo, the industry giant, along with Kendall Jackson, The Wine Group and more than one thousand small to medium size wineries. The largest concentration was in California although in early 2003 every one of the fifty states had at least one winery!

The final group of competitors was composed of large multi-industry firms. They included Allied Domecq, Brown Forman (Wine Estates Division), Foster's (Beringer Blass), Constellation Brands (Canandaigua Division), Diageo (Chateau and Estates Division), Fortune Brands, Louis Vuitton Moet Hennesey (LVMH) and UST (formally know as U.S. Tobacco).

In addition to domestic competition, a growing percentage of the wine consuming marketplace had been gained by imports. In addition to the traditional "Old World" supplies from France, Italy, Germany, Spain and Portugal, a new group of countries had experienced growing acceptance of their wine production. Australia, Chile and Argentina (the "New World" suppliers) increased their market share in the last decade with quality wines at very competitive prices.

Consolidation among wineries began to accelerate in the early 1990's as larger producers decided to purchase smaller ones in order to achieve greater economies of scale in marketing and economies of scope in gaining access to more varied channels of distribution. These larger wineries could then become more effective in negotiating favorable selling terms with the small number of large regional distributors. The "consolidators" were generally public firms that were able to offer predominantly family-run wine businesses, a means to greater liquidity of their investment in larger more diversified firms. Concurrently, the attractiveness of wine production across the United States resulted in a growing number of entrepreneurs purchasing or starting new small operations.

The wine industry was capital intensive. In addition to land and vineyards, a fully integrated firm needed investments in crushing facilities, fermentation tanks, barrels for aging their product and warehouses to store the bottled and cased wine. Ownership was not essential for any of these activities. However, in order to control quality and quantity of production, these investments became essential as a firm developed its brands and expanded its markets.

Business risks were also substantial. Weather conditions could affect the quality and quantity of grape production. Insect damage and disease could affect the grape vines. Replanting of new vines required 4-5 years before commercial quantities of grapes could be expected and another 2-3 years for maximum sustained output.

In the fall of the year, usually late September to early November, depending on the weather, grapes were picked and carefully brought from the fields to the crushing facility. There is only one crop per year and crushing takes from one to two months. Consequently, the investment in this facility stands idle at least ten months of the year. Since all the grapes in a region mature at approximately the same time, there is no way to rent out crushing capacity to other wineries at other times of the year.

After crushing, the juice is pumped into the fermentation tanks. These stainless steel vessels are temperature controlled to balance the heat generated by the natural fermentation process. Fermentation takes only a few weeks after the crush, so this investment is also idle more than 85 percent of the time.

From the fermentation tanks, the wine is pumped into oak barrels for aging. These barrels are quite expensive, currently costing $600 to $700 each. Due to quality concerns, they are used for only 4 or 5 years at which time their value is negligible (some are cut in half and sold as planters). A barrel aging facility is a large open space that also must be climate controlled. During the aging process, some wine is lost due to evaporation through the porous oak barrel. Every two weeks each barrel is refilled up to 3 inches from its top. For premium red wines that are in barrels for two years or longer, about 5 percent of the original wine will be lost.

Wine Production in the United States

The internal structure of the wine industry in America has been undergoing fundamental changes over the last quarter century. In terms of product, the most significant developments were observed in the table wine category. This is the largest segment of production and value of shipments amounting to more than 85 percent in the last decade. These products have been responding to changes in the tastes and preferences of consumers for higher quality premium wines.

Grapes used in the production of table wines are of varying quality. Varietals are delicate thin-skinned grapes whose vines usually take approximately four years to begin bearing fruit. As defined by the Bureau of Alcohol, Tobacco, and Firearms truth in labeling standards, one variety – the name of a single grape – must be used if not less than 75 percent of the wine was derived from grapes of that variety, the entire 75 percent of which was grown in the labeled appellation of origin. Appellation denoted that "at least 75 percent of a wine's volume was derived from fruit or agricultural products and grown in place or region indicated".[8] To develop the typical varietal characteristics that result in enhanced flavor, taste and finish could take another 2 to 3 years after the four years it takes newly planted vines to bear fruit. These additional growing periods, in the pursuit of enhanced quality and value, increase both investment levels and operating expenses.

Table wines are defined as those with 7 to 14 percent alcohol content by volume and are traditionally consumed with food. In contrast, other wine products such as sparkling wine (champagnes), wine coolers, pop wines and fortified wines are typically consumed as stand-alone beverages. Table wines that retail for less than $3.00 per 750 ml. bottle are generally considered to be generic or "jug" wines, while those selling for more than $3.00 per bottle are considered premium wines.

Premium wines generally have a vintage date on their labels. This designation signifies that the product was made with at least 95 percent of grapes harvested, crushed and fermented in the calendar year shown on the label and used grapes from an appellation of origin (i.e. Napa Valley, Sonoma Valley, etc. in California; North Fork, the Hamptons and Long Island AVA on Long Island). Within the premium wine category, a number of market segments have emerged based on retail price points. Popular premium wines generally sell for $3.00 to $7.00 per bottle, while super premium wines retail for $7.00 to $14.00. The ultra premium category sells for $14.00 to $20.00 per bottle while any retail price above $20.00 per bottle is considered to be luxury premium.

Laurie's Decision

After her conversation with cousin Wayne, Laurie set up a meeting with her operations Manager Dan Henning and her accountant Page Hopkins. She also invited the director of the Long Island Wine Council, Nanette Hansen, to get a broader perspective of local conditions. More than a few hours were spent on the website of the Wine Institute headquartered in San Francisco.

The meeting began with Laurie presenting her ideas for expansion: "There is an opportunity to purchase additional grape producing acreage across the road from the vineyard, 28 acres for $900,000. We have been farming over one-half of that land and purchasing its grapes for more than six years in order to supplement and/or complement our own production. Grape quality has been uniformly excellent and we have approached Mr. O'Reilly on more than one occasion about a possible sale. This is an opportunity that we cannot afford to pass up. It will provide us with increasing supplies of premium grapes for our merlot brands and also open a new market, petite Shiraz. With expanded winery capacity in place for the 2004 harvest, we should easily meet our newly revised sales goals. We will be able to have ownership and control of our grape supplies for the foreseeable future.

Our winery also needs expansion and I have estimates of between $800,000 and $900,000 for that work. It will require two fermentation tanks as well as some barrel aging space. The tasting room at the far end of that building also needs expansion since we have observed consistent overcrowding even on week days in the fall. That would cost another $250,000.

Finally, many of the other wineries on the North Fork have facilities for special events (weddings, birthday parties, anniversaries, business meetings, etc.). By constructing a building for these activities, we could generate another source of revenues and cash flows. For the design I have in mind, the cost would be $450,000."

Dan supported Laurie's plans. "The winery is operating at 100 percent capacity and I still had to ship some grapes from last year's harvest over to the custom crush facility in Mattituck [9]. I'd like to bring all our production back here under our complete control."

Page had a number of questions concerning the cost estimates of each expenditure category, but was also interested in the perspective of Nanette representing a broader industry analysis.

Nanette was prepared for those questions: "At the Long Island Wine Institute, our prime focus is the local producers and their markets. I can't tell you much about conditions in California such as how long the "glut" of grapes will last, but we have studied the markets extensively in the east.

On the supply side, acreage planted in grapes and production of premium wines have grown steadily over the past six years, through the harvest of 2002. A long, hot growing season last year was ideal for grape growing, resulting in small flavor-packed grapes. It was the third great vintage in a row for the North Fork.

Only six inches of rain fell from mid-April to the beginning of September, 10 inches below normal. Stretches of relatively intense heat caused vines to temporarily "shut down" growth, limiting progress of the growing cycle and reducing the size of the fruit. The resultant small berries caused by this "stressing", if able to ripen correctly made for a more concentrated and flavorful wine. More color was produced from the increased skin-to-juice ratio. Previous premium vintages of 1993, 1995 and 1997 came from very similar hot, dry summer growing seasons.

In 2001 an almost perfect balance between rainfall and temperatures produced a spectacular harvest. Low rainfall, warm temperatures and an extended growing season combined to produce fully ripe, healthy grapes and one of the East End's best vintages ever. This followed a 2,000 vintage that produced a number of award-winning whites and reds in local and national competitions. These wines from the 2000 vintage were a turning point for recognition of the region.

A final point to be made on the supply side is related to the changing composition of vineyard and winery ownership, especially on the North Fork. Over the last few years, a number of new owners have come into the area. They have brought a new respect for the land and the grape growing process. In addition, they have contributed strong financial support to both vineyards and wineries. (Exhibits 10 and 11). [10]

On the demand side of the market for Long Island wines, a major segment is event driven – celebrations of either a personal or business nature. For many local wineries, this represents 40 percent or more of their revenues and any weakness in pricing or volume will be felt quickly on cash inflows."

There has been a weakening in the last two years in business spending for events. While volume has held up reasonably well , the price points have deteriorated – medium priced product ($10-15/bottle) has been substituted for premium wines ($25/bottle and up). Corporate and business budgets have been tightened and it is unlikely that this trend will be reversed in the next few years.

Will the Long Island wine industry be adversely affected by these national trends in cost containment? Will the regional extent of our markets shelter us from these slowdowns in demand?

The market for Long Island wine has expanded from the New York metropolitan region, north to Boston and south to Philadelphia, Baltimore and Washington, D.C. Especially in New York City, the financial services industry has experienced some of the largest declines in employment as well as reductions in salaries and bonuses.

Special events volume has slowed with cost containment at parties of all kinds, as well as restaurants. The reason overall volume and revenues have been rising is expansion of the geographic market for Long Island wines on the east coast and growth westward through New York, Pennsylvania, Maryland and Virginia. This geographic expansion may be able to counter the local trend toward lower prices. From conversations with our members, the next few years are likely to be quite challenging for the industry on the East End.

One final statistic I picked up in reading a *Business Week* article last year concerns the consumption profile of wine drinkers in the United States. Whereas in many European countries such as France, Germany, Italy and Spain, wine is almost a necessity with meals – this is not the case here in the United States. Just over 10 percent of American adults account for 86 percent of wine consumed annually! We have not yet been successful at stimulating wine consumption to broader segments of the population. Until this occurs, your market strategy should be directed towards those consumers already drinking wine on a regular basis." [11]

Laurie thanked everyone for sharing their ideas and expertise with her. Her plans totaled $2.4 million. She would have to prioritize each item and defend these expenditures when making a formal proposal for financing. In preliminary negotiations with a Long Island Bank, they had a lending limit for a business her size of $3 million for fixed assets. They were also financing a small percentage of her inventory through a revolving line of credit. Anything above those levels would have to be sourced by some form of equity, meaning that Laurie would no longer own all of the Whistling Bird Winery!

Laurie decided it was time to make another phone call, this time to her brother Fred. Although he hadn't visited the North Fork in years, he had been to the Hamptons each summer driving his BMW to his family's summer home on the beach.

"Fred, how has your business and career been going this last year? I heard about all the reductions in financial services employment – have you been affected?"

"My firm has maintained its competitiveness in these uncertain times," replied Fred. "We are also diversifying our clients' portfolios from real estate and annuities into private and public equity positions. If you know of any interesting investment opportunities, we would gladly examine the financial data."

Somewhat surprised, Laurie responded, "Fred, right here at Whistling Bird Winery, we have a financial proposal. We need an equity investment of approximately $2 million. Although the equity in the business is low, I will not be willing to give up control."

"Send me your financial statements," replied Fred, "and I'll contact you in two weeks with a proposal. The amount you are looking for is well within the range of my clients."

"Thanks Fred", said Laurie. "I'll fax you the data tomorrow."

Two Weeks Later

"Laurie, this is your brother. I received your materials and have a proposal for an investment of $2 million. Can we meet for lunch this Wednesday and I'll present the details. I also would like my wife to be at our meeting. Liz Anne has been an equity strategist for a large investment banking firm in Manhattan and I think she can provide some insight into the workings of the private equity market. She would also like to visit the winery."

Laurie agreed and the three met for a long lunch at the Old Mill House in Peconic. After the salad, Fred presented details of his $2 million proposal to Laurie.

"Although investment returns are low these days for fixed income instruments, venture capital is still expensive. I could offer you a ten-year note with interest at 6 percent, with warrants attached. They would provide the investor with potential capital gains up to their required return of between 20 and 25 percent per year. These warrants would be exercisable for the next five years into company stock at $1 per share. The note would also be amortized from year 6 through year 10."

"Those seem to be expensive terms, Fred, especially since the book value of my common stock is almost $4 per share as of year-end 2002. I will have to speak with my accountant concerning these warrants, especially the number needed to be attached to this note so that the required rate of return will be realized by your investor. By the way, who is this investor and when can I meet him?"

"Laurie, you have known him all your life!"

One More Meeting

After receiving her brother's proposal which included a fixed income instrument and warrants to purchase shares in the firm, Laurie met again with Dan and Page.

"I can't believe how expensive this funding could be even under the lowest cost presentation", said Laurie. "With my most optimistic forecast of earnings growth for Whistling Bird Winery and his 'cheapest' financing alternative, I could lose more than one half ownership in the company. I surely do not want that to happen!"

Dan reiterated his desire for purchasing the vineyards across the road and expanding winery capacity. "This property has been owned by the O'Reilly family for 55 years. We may never get an opportunity to purchase it again if it is bought by another winery. We have managed it for the last six years and know the quality of grape production."

Page listened attentively to the two operating managers and had clearly planned her ideas for this meeting. An integral component of her presentation was a summary of an appraisal report that had been prepared for Laurie by a local firm specializing in wine industry asset valuations on Long Island (Appendix A). It showed quite clearly that the current value of the firm's two largest asset categories was considerably higher than their book values ($8.698 million vs. book values of $6,037 million). Adding the difference of $2.661 million to the firm's equity value would surely enhance Laurie's bargaining position in negotiating for new funds.

Page also summarized and prioritized the three components of the Whistling Bird expansion plans. "It seems to me that the highest priority at this time is the land purchase", said Page. "We can produce larger volumes of wine, if the market so demands, at the new custom crush facility. By postponing the other projects, Laurie, you would reduce the volume of funds needed from your brother and, consequently, the dilution in your ownership position. If you really want to spend the entire $2.4 million in the next year, remember the Class B common stock on the balance sheet."

After the meeting ended, Laurie walked slowly back to her office. Almost there, she turned, walked out of the building and proceeded towards the vineyard. Past the old oak trees with the birds in the branches, she walked all the way down to the shore of Peconic Bay. Sitting on a large rock near the shore, she spent the next hour considering her alternatives. She knew that when she got back to the office, Dan and Page would be waiting for her decision.

Notes

1. Murphy, Dean E., "California Grape Rush of 90's Withers as Prices Collapse," *New York Times*, May 25, 2003.

2. To put this information in perspective, the California wine industry has been in business for more than 200 years and currently has 86 AVA's. (www.wineinstitute.org).

3. "On the North Fork, Dreams of Napa" , *New York Times*, July 26, 2000 Section F, pg. 1.

4. Hamm, Steve and Sandra, Dallas, "A Wine Region That's Aging Beautifully, *Business Week*, Nov. 23, 1999.

5. There are nine of these facilities in the wine country in California.

6. Walzer, Robert, "Hearn pressing for $2M winery", *Long Island Business News*, October 1, 1999, pg. 5A.

7. The Wine Institute, www.wineinstitute.org.

8. Title 27, Part 4 of the Code of Federal Regulations, Bureau of Alcohol,Tobacco and Firearms, Regulatory Agency, United States Department of the Treasury.

9. A custom crush facility provides winemaking services for vineyards that do not have a winery and wineries that do not have sufficient capacity or expertise to make certain wines. A custom crush facility can take in harvested grapes and return wine that has been bottled, labeled and packaged for sale. It also offers laboratory and technical services. Premium Wine Group, located in Mattituck and serving numerous North Fork vineyards and wineries is such a facility.

10. Lynn, Jane Bryant, "2002 Harvest Report, *The Wine Press*, October, 2002.

11. Himelstein, Linda, "This Merlot's For You", *Business Week*, September 30, 2002, pp. 65-68.

EXHIBIT 1
Whistling Bird Winery
Income Statements
(dollars in thousands)

	2002	2001	2000	1999	1998
Net Sales	$4,924	$4,477	$3,906	$3,315	$2,764
Cost of Goods Sold	3,242	2,866	2,495	2,108	1,626
Gross Profit	$1,682	$1,611	$1,411	$1,207	$1,138
Operating Expenses					
Marketing & Advertising	132	119	106	92	81
Selling & Administration	850	738	647	520	326
Total Operating Expenses	982	857	753	612	407
Operating Income (EBIT)	$700	$754	$658	$595	$731
Interest Expense	342	297	269	257	236
Net Income Before Taxes	$358	$457	$389	$338	$495
Provision for Income Taxes	143	183	256	135	198
Net Income (Loss)	$215	$274	$233	$203	$297
EPS	.30	.39	.33	.29	.42
Number of Cases Sold	55,000	53,146	49,531	44,527	38,777
Price per case received by company	$87.52	$84.24	$78.86	$74.45	$71.28

Notes: Prime + 2 ½% on average balance for line of credit.
Long term debt (mortgage) at 7 ½%.
Federal and State income tax rate of 40%.

EXHIBIT 2
Whistling Bird Winery
Balance Sheets
(dollars in thousands)

	2002	2001	2000	1999	1998
Assets					
Current Assets					
Cash	$222	$199	$210	$197	$191
Accounts Receivable	244	252	268	245	214
Inventories	2981	2581	2335	1985	1750
Prepaid and Other Expenses	44	40	42	38	37
Total Current Assets	$3,491	$3,072	$2,855	$2,465	$2,192
Property, Plant and Equipment	3253	128	2992	2921	2801
Less: Accumulated Depreciation and Amortization	197	174	167	174	197
Net Property, Plant and Equipment	3,056	2,954	2,825	2,785	2,687
Other Assets (net)	15	14	15	14	12
Total Assets	$6,562	$6,040	$5,695	$5,264	$4,891
Liabilities and Capital					
Current Liabilities					
Accounts Payable	$271	$233	$198	$177	$155
Accrued Expenses	244	202	176	154	137
Line of Credit (bank)	1166	909	869	689	514
LTD (current portion)	30	30	30	30	30
Total Current Liabilities	$1711	$1374	$1273	$1050	$836
Long Term Debt					
Mortgage	2,080	2,110	2,140	2,165	2,209
Equity					
Class A Common	1510	1510	1510	1510	1510
Class B Common	0	0	0	0	0
Retained Earnings (Loss)	1261	1046	772	539	336
Total Equity	$2,771	$2,556	$2,282	$2,049	$1,846
Total Liabilities and Equity	$6,562	$6,040	$5,695	$5,264	$4,891

Notes: Class A Common Stock—10 votes; Class B Common Stock—1 vote.
Currently outstanding: 710,000 Class A shares; 0 Class B Shares
Effective Corporate Taxes (Federal and State) at 40%.

EXHIBIT 3
Whistling Bird Winery
Statement of Cash Flows
(dollars in thousands)

	2002	2001	2000	1999
Cash Flows From Operating Activities				
Net Income	$215	$274	$233	$203
Depreciation	23	7	31	22
Increase in Receivables (net)	8	16	(23)	(31)
Increase in Inventories	(400)	(246)	(350)	(235)
Increase in Prepaid and Other Expenses	(4)	2	(4)	(1)
Increase in Accounts Payable	38	35	21	22
Increase in Accrued Expenses	42	26	22	17
Net Cash Provided (used) by Operating Activities	$(78)	$114	$(70)	$(3)
Cash Flows From Investing Activities				
Purchase of Property,Plant&Equipment	$(125)	$(136)	$(71)	$(120)
Other Assets (net)	(1)	1	(1)	(2)
Net Cash Used for Investing Activities	$(126)	$(135)	$(72)	$(122)
Cash Flows From Financing Activities				
Increase (decrease) from Bank Line of Credit	$257	$40	$180	$175
Increase (decrease) in Long Term Debt (Current Portion)	0	0	0	0
Increase (decrease) in Mortgage	(30)	(30)	(25)	(44)
Net Cash Provided (used) in Financing Activities	$227	$10	$155	$131
Net Income in Cash	23	(11)	13	6
Cash at the Beginning of the Year	199	210	197	191
Cash at the End of the Year	222	199	210	197

EXHIBIT 4
United States Beverage Consumption
(millions of gallons)

Beverage Category	2002P	2001	2000	1999	1998	1997	1996
Soft Drinks	15,153	15,023	14,925	14,895	14,820	14,385	13,940
Coffee	7,700	7,710	7,700	7,750	7,800	7,854	7,901
Milk	6,950	6,910	6,885	6,918	6,880	6,890	6,924
Beer	6,353	6,241	6,202	6,136	6,002	5,922	5,898
Bottled Water	6,000	5,400	4,950	4,570	4,070	3,730	3,100
Tea	1,940	1,910	1,870	1,850	1,825	1,788	1,744
Juices	1,830	1,790	1,750	1,720	1,710	1,702	1,692
Powdered Drinks	1,320	1,340	1,350	1,370	1,360	1,365	1,358
Wine	**586**	**557**	**552**	**538**	**519**	**512**	**497**
Distilled Spirits	365	357	354	343	334	320	329
Cider (Beverage Alcohol)	10	11	10	10	9	7	6
Totals	48,277	47,249	46,548	46,101	45,329	44,485	43,389

Notes: P = Preliminary
Totals may not add up due to rounding

Source: *Adams Wine Handbook* 1999, 2003

EXHIBIT 5
United States Beverage Consumption
(gallons per person)

Beverage Category	2002P	2001	2000	1999	1998	1997	1996
Soft Drinks	52.5	52.7	52.9	53.4	53.7	52.8	51.7
Coffee	26.9	27.0	27.3	27.8	28.3	28.8	29.3
Milk	24.1	24.2	24.4	24.8	24.9	25.7	25.7
Beer	22.0	21.9	22.0	22.0	21.8	21.7	21.9
Bottled Water	20.8	18.9	17.5	16.4	14.8	13.7	11.5
Tea	6.7	6.7	6.6	6.6	6.6	6.6	6.5
Juices	6.3	6.3	6.2	6.2	6.2	6.2	6.3
Powdered Drinks	4.6	4.7	4.8	4.9	4.9	5.0	5.0
Wine	**2.0**	**2.0**	**2.0**	**1.9**	**1.9**	**1.9**	**1.8**
Distilled Spirits	1.3	1.3	1.3	1.2	1.2	1.2	1.2
Cider (Beverage Alcohol)	.03	.04	.04	.04	.03	.03	.02
Totals	**167.4**	**165.6**	**164.9**	**165.2**	**164.3**	**163.2**	**161.1**

Notes: P = Preliminary
Totals may not add up due to rounding

Sources: *Adams Wine Handbook*, 1999, 2003
Statistical Abstract of the United States

EXHIBIT 6
Retail Sales and Share of Retail Dollar by Beverage
(dollars in millions)
1996-2002

Beverage Category	2002	2001	2000	1999	1998	1997	1996
Soft Drinks	$75,915	$74,700	$73,100	$70,980	$68,913	$66,171	$63,455
Beer	74,400	69,940	67,400	63,850	59,811	56,398	53,010
Distilled Spirits	42,150	39,502	37,317	35,770	34,014	33,600	33,328
Milk	18,765	18,400	17,700	17,495	17,153	17,166	17,181
Juices	14,360	14,000	13,400	13,140	13,066	13,002	12,920
Wine	**20,530**	**19,020**	**18,120**	**16,600**	**14,535**	**13,718**	**12,848**
Coffee	8,150	8,040	8,050	8,165	8,112	8,050	7,972
Bottled Water	7,100	6,210	5,545	5,120	4,480	4,070	3,600
Tea	1,340	1,300	1,280	1,265	1,252	1,225	1,195
Powdered Drinks	860	870	880	888	885	887	885
Totals	$263,570	$251,982	$242,792	$233,273	$222,221	$214,287	$206,394

Source: *Adams Wine Yearbook*, 1999, 2003

EXHIBIT 7
Wine Consumption in the United States
1980 – 2002

Years	Total Wine (millions of gallons) [1]	Total Wine (per capita) [3]	Total Table Wine (millions of gallons) [2]	Total Table Wine (per capita) [3]
2002	595	2.06	532	1.84
2001	561	1.96	503	1.76
2000	558	1.97	498	1.76
1999	551	2.02	482	1.76
1998	526	1.95	466	1.72
1997	520	1.94	461	1.72
1996	505	1.90	443	1.67
1995	469	1.79	408	1.56
1994	459	1.77	395	1.52
1993	449	1.74	381	1.48
1992	476	1.87	405	1.59
1991	466	1.85	394	1.56
1990	509	2.05	423	1.70
1989	524	2.11	432	1.74
1988	551	2.24	457	1.86
1987	581	2.39	481	1.98
1986	587	2.43	487	2.02
1985	580	2.43	378	1.58
1984	555	2.34	401	1.69
1983	528	2.25	402	1.71
1982	514	2.22	397	1.71
1981	506	2.20	387	1.68
1980	480	2.11	360	1.58

Notes: [1] All wine types including sparkling wine, dessert wine, vermouth, other special natural and table wines.
[2] Table wines include all still wines not over 14 percent alcohol content.
[3] Per capita consumption based on the resident population of the U.S.

Source: The Wine Institute, http://www.wineinstitute.org,, Gomberg, Fredrikson & Associates.

EXHIBIT 8
Wine Sales in the United States
Domestic Shipments and Foreign Producers
Entering U.S. Distribution Channels
1991 – 2002
(millions of gallons)

Year	Table Wine (1)	Dessert Wine (2)	Champagne Sparkling Wine	Total Wine	Total Retail Value (in Billions)
2002	532	37	27	595	$21.1
2001	503	34	25	561	19.8
2000	499	32	28	558	19.0
1999	475	31	37	543	18.1
1998	466	31	29	526	17.0
1997	461	29	29	519	16.1
1996	439	31	29	500	14.3
1995	404	30	30	464	12.2
1994	394	33	31	458	11.5
1993	381	35	33	449	11.0
1992	405	37	33	476	11.4
1991	394	39	33	466	10.9

Notes: (1) Includes all still wines not over 14 percent alcohol; excludes Canadian coolers (made from malt).
(2) Includes all still wines over 14 percent alcohol.

Source: The Wine Institute, http://www.wineinstitute.org.

EXHIBIT 9
U.S. Table Wine Market [1]
Color Mix Profile
(millions of nine-liter case shipments)

Year	Red	White [(2)]	Rosé/Blush [(3)]	Totals [4]
2002	88	91	33	212
2001	81	84	33	198
2000	79	81	34	194
1999	74	74	38	185
1998	66	74	38	178
1997	61	76	39	176
1996	55	74	38	167
1995	46	71	39	156
1994	41	71	39	150
1993	36	68	38	143
1992	36	69	42	147
1991	26	67	40	133
1990	25	68	44	136
1985	33	99	27	159
1980	41	80	30	151
1975	36	27	21	83
1970	28	14	14	56

Notes: [(1)] Consumption of Domestic and Imported Wine.
[(2)] Includes white wine produced from white grapes only.
[(3)] Includes all wines labeled "rose" or "blush" and all wines labeled "white" produced from red grapes.
[(4)] Addition of columns may not agree due to rounding.

Source: "The U.S. Wine Market", Impact Databank, Review and Forecast", 1998, 2001, 2003

EXHIBIT 10
Long Island Wine Industry Statistics
(Select Years)

Year	Number of Vineyards	Number of Wineries	Planted Acres	Total Acres Owned	Value Per Acre	Wine Production (Cases)
2002	52	29	3000	4000		500,000
2000		21	2200	2800	25,000	400,000
1999		21	2100			
1998		21				200,000
1996	40			1800		
1995		23	1,055			200,000
1989		14				
1987		12				
1985	16	7	600			
1984	12	4	700			
1975		1				
1973	1		17		4000	

Source: Various Issues of the following publications:
The Wine Press, *Underground Wine Journal*, *Wine East*, *Long Island Business News*, and *Newsday*.

EXHIBIT 11
Selected Values of Vineyards and Wineries on Long Island
(Select Years)

Year	Name	Location	Winery Capacity (cases)	Total Acres	Estimated Value
2001	Gristina	Cutchogue		82.5	$5,200,000
2001	Raphael	Peconic	10,000	70	6,000.000
2000	Bedell Cellars	Cutchogue	8,000	50	5,000,000
	Pindar Vineyards		80,000	42.5	
	LeClos Thirese (Theresa's Field)			40	400,000
1999	Hargrave	Cutchogue	6-8,000	84	4,000,000
1999	Laurel Lake Vineyards	Laurel	5,500	23	2,000,000
1999	Corey Creek	Southold	4,000	30	2,500,000
1999	Peconic Bay Vineyards	Cutchogue		35	2,200,000
1999	Bidwell Vineyards	Cutchogue	15,000	34	2,900,000
1997	Laurel Lake Vineyards	Laurel		23	3,000,000
1997	Manor Hill Vineyards	Cutchogue		65	1,800,000
1993	Dzugas-Smith Vineyards	Cutchogue		29	245,000

Sources: Various issues of the following pulications:
The Wine Press, *Underground Wine Journal*,
Wine East, *Long Island Business News*, and *Newsday*

Appendix A

Report of the Appraisal of Assets
of Whistling Bird Winery

In response to the request of Ms. Laurie Johnson, sole owner of the Whistling Bird Winery, we hereby enclose our estimates of current market values for the firm's wine inventory as well as its fixed asset position. Our personnel have carefully examined your inventories, land, winery building and equipment and compared it with current market values that we have observed over the last six months. We are pleased to report to you that the quality of your inventory is excellent and your assets are in top operating condition.

With your firm's growing emphasis on the production of premium red wines (Merlot and Cabernet Sauvignon), our appraisal estimates that 30 percent of wine in barrels by volume has been stored for more than two years, resulting in a doubling of its book value at the time fermentation was completed in early 2001. Another 40 percent, also red wine, has been in barrels for 14 months mostly from the 2002 harvest. Remaining wine volumes are a mixture of younger reds and white chardonney. We conclude that as of November, 2003 the value of inventory, if sold in the local wholesale market, would result in receipts of $4.65 million.

In a separate analysis of property, plant and equipment, our real estate expert on current market conditions estimates the value of company owned land at $1,088,000 or $32,000 per acre on the 34 acres under cultivation by Whistling Bird. This is in contrast to $720,000 which is the current book value of this land on an historical cost basis.

The remaining $2,336,000 of depreciated book value of the winery plant and equipment has also increased in value since its original purchase. Its current value is $2.96 million according to our appraiser.

In summary, upon a sale of these two major asset categories, it is estimated that they would bring into the firm a total of $8,698,000, or $2,661,000 more than their current book value of $6,037,000. This additional value could be added to the firm's equity account of $2,771,000 at year end 2002, bringing its total up to $5,432,000

Summary Data

Asset	Book Value December 31, 2002	Adjusted Market Values November 30, 2003
Land – 34 planted acres	$720,000	$1,088,000
Plant & Equipment	2,336,000	2,960,000
Inventory	2,981,000	4,650,000
Totals	$6,037,000	$8,698,000
Less: Liabilities	3,266,000	3,266,000
Equity Value	$2,771,000	$5,432,000
Equity Value Per Share (710,000 shares outstanding)	$3.90	$7.65

It was a pleasure to provide you with the above data. If there is any additional information or clarification you may require, do not hesitate to contact us.

Respectfully submitted,

Sharon Brown, President
East End Associates
November 24, 2003.

Appendix B

Laurie Johnson's Position with Projections

Laurie has projected capital expenditures of $2.4 million for expansion of Whistling Bird Winery operations. She had taken them to her local bank along with her business plans for the next five years. Those projections included two scenarios, revenue growth rates of 15 and 20 percent expected over the forecast period with enhanced operating efficiencies and expanded profit margins.

The bank officer was skeptical of her optimistic expectations, especially after speaking with a number of other wine operators in the area. Their final proposal was for only a $400,000 term loan with a small increase in the revolving line of credit to $3 million. Their implications and position were clear – the firm needed larger equity capital to sustain its growth plans. While the longer term outlook for the industry was quite favorable, they were quite cautious about business over the next two years (2004 and 2005).

Laurie realized that permanent capital was needed to support her growth initiatives. However, she was not able to add to her personal investment in the business. Her husband David, a professor of history at Stony Brook University also believed that too large a percentage of the family's assets were already in the business.

Appendix C

Liz Anne Johnson's Private Equity Guidelines

Fred's wife Liz Anne had worked with Fred on guidelines his firm would use for their new venture into private equity and she shared this information with Laurie.

Stage One (start ups, "seed deals")
Outside capital flows into the firm for the first time with funds being spent on organizing operations. The first products and/or services show evidence of interest on the part of potential customers. The firm is in operation for less than a year and risks are quite high.

Expected Rate of Return 45-55%

Stage Two
The firm is producing products or supplying services, thus generating revenues. Accounts receivable and inventories are growing, customer relations are being established and strengthened.

Expected Rate of Return 35-40%

Stage Three
Company revenues are growing and the firm is profitable on a cash flow and net income basis. Funds are needed to expand capacity, expand market segments or facilitate an acquisition.

Expected Rate of Return 20-30%

Bridge Financing
The firm expects to go public with an IPO in 6 to 12 months. A deal is structured so that funds from the IPO would repay the supplier of the bridge financing in whole or in part along with their required return.

Expected Rate of Return 15-25%

Buyout or Acquisition Financing
Current or a new management team buys another firm. Depending on the expertise of management and the characteristics of the business, a deal of one to three years is usually structured.

Expected Rate of Return 25-35%

The following check list is generally required to be completed for any of the above proposals:

- General Business Plan with Goals
- Growth Prospects
- Plan for Achieving Goals
- Amount of Financing Desired and How It Will be Used
- Description and Background of Key Managers
- Pro Forma Statements: Balance Sheets, Income Statements, Statements of Cash Flows
- Detailed Financial Projections of Revenues, Cash Flows, Gross Margins, Inventory Turnover and Management
- Capital Expenditure Budgets
- Expected Rates of Return on Assets, Investments and Equity

Appendix D

Fred Johnson's Position with Projections

Fred had some questions concerning the timing of the expenditures outlined in Laurie's proposal. He was also concerned about the "grape glut" and its impact on product pricing. In addition, the economic outlook in the near term did not seem to be either clearly defined or strong. Therefore, his expectations were for average annual growth rates in revenues of between 5 and 10 percent in contrast to Laurie's 15 to 20 percent. He did, however, agree that enhanced efficiencies could generate faster growth in net income than the growth in revenues.

With respect to Laurie's overriding concerns over control, Fred quite understood. Perhaps the last thing on his mind was to have to take over the operations of Whistling Bird Winery. He approached this deal from strictly a financial point of view. Fred was looking for a viable and profitable investment of $2 million that would fit nicely into his portfolio. A current return of 6 percent, with a total expected annual return of 20 percent over at least a five-year holding period, was quite acceptable to him. While he might have expected a 25 percent total annual return on an investment with this risk a few years ago, equity risk premiums had been trending downward. Thus a 20 percent annual return would meet his current portfolio needs.

Fred had received a copy of the report from East End Associates and understood their higher estimate of Whistling Bird's asset position. Yet he was still quite concerned about the lack of liquidity of this investment and its impact on the cost of capital. Although he was confident of being repaid his $2 million at the end of five years, as well as receiving his interest payments each year, the capital gain component of his total return was quite uncertain.

This investment would definitely have a buy-and-hold profile. Selling a private equity investment is traditionally accomplished through an initial public offering or an acquisition by another firm years after the venture has developed into a viable, competitive and profitable business. In evaluating his potential position in Whistling Bird, he did not realistically see either of these scenarios occurring in the foreseeable future. His only hope for monetizing his investment would be to sell his shares back to Laurie at a reasonable value or try to sell them to another private investor.

Acknowledgements

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The case was also tested for its academic integrity and usefulness as a learning tool through the format of a colloquium held under the auspices of the Center for Applied Research within the Lubin School of Business of Pace University. The authors thank Dr. Michael Szenberg, Director of the center, Dr. Surendra K. Kaushik, Associate Director and Diana Ward, Assistant Director, for their efforts on our behalf.

HAVEIT MORTGAGE: APPLYING THE FINANCIAL-COMPONENTS APPROACH IN ACCOUNTING FOR FINANCIAL ASSETS

William Brent, Howard University
Kang Cheng, Howard University

CASE DESCRIPTION

This case addresses the considerations and risks involved in accounting for financial assets and liabilities under the financial-components approach that is established and still gaining ground in recently issued Statements of Financial Accounting Standard (SFAS) such as No. 156, "*Accounting for Servicing of Financial Assets – an amendment of FASB Statement No. 140"*. The financial-components approach allows the finance/servicing institutes the flexibility in creating and transferring their financial products. However, when intertwined with the fair value measurement issues, the financial-components approach also introduces additional accounting risks that can lead to operating risks. This case employs a real business model but a fictitious company to demonstrate the application of the financial-components approach and the lethal consequence when the accounting practice is not applied properly. The purpose of this case is to highlight the estimated elements inevitably factored into the financial statements and the importance of accounting conservatism. This case is appropriate for higher-level undergraduate accounting students or first year MBA students with accounting or finance concentration. Given the more complicated fair value measurement issues addressed in recently issued SFAS No. 157, *"Fair Value Measurement"*, students will benefit even more by contrasting different accounting measurement bases such as the amortized cost measurement and the fair value measurement.

CASE SYNOPSIS

In early December 2006, Haveit Mortgage Solution Inc., the eleventh largest subprime mortgage lender in America suddenly halted operations with a letter from the CEO to the employees and other stakeholders. During the last week of 2006, Haveit Mortgage filed for Chapter 11 bankruptcy. The company's sudden decline was a surprise to both the internal and the external stakeholders considering the company was still aggressively originating mortgage loans by November 2006. Did Haveit suffer from increased mortgage defaults? Were Haveit's backers scared off by the mere possibility of losses? Who were their backers and why were they scared off? Did anything unethical take place? Most importantly, could this sudden decline be foreseen and be avoided? The answer lies in the analysis of the general business model and recently issued financial accounting statements. A business model based on "stretched" accounting practice without considering the risk elements is bound to fail in due course. Haveit Mortgage is a fictitious company; all data and statements were developed from publicly available financial information. The business model, however, is modeled after a real firm that filed bankruptcy in December 2006.

INTRODUCTION

Banking Economics

The residential mortgage markets had been growing during the last few years. Baby boomers were "trading up" and had the resources to purchase more expensive homes. Credit performance was good and exposures created by overly aggressive financial engineers were in decline as the risk implicit in them were on the rise. Private conduits were growing to meet the shelter needs of all sectors of the housing market which is home equity, second mortgage, one-to-four family houses, and various commercial property loans. Securitization and the attendant changes in capital markets for mortgage-backed and collateral mortgage obligations and the economy overall were in a growth stage. Banking regulators were implementing the supervisory aspects of the derivatives markets as accounting and regulatory changes were increasing to manage this blooming market and the asset flow throughout the system. Thus, regulators were very aware of asset valuation, distribution and recognition of mortgage valuation of the mortgage assets were the target of audits nationwide.

Haveit Mortgage and the Mortgage Banking Industry

In 2003, B. D. Will, an experienced mortgage banker, and a group of investors from Chicago purchased Haveit Mortgage Solutions, head-quartered in California. In 2005, with more than 400 employees, the company originated $8 billion in mortgage loans, covering most of the Western states in the US. According to an online news service report, Haveit's business was up 44 percent at one point in 2006. Before the sudden demise, Haveit had more than 800 employees and was ranked as the eleventh largest subprime mortgage lender in the US in terms of loan origination.

Subprime lenders are a sub-group of the mortgage banking industry that originates mortgage loans from borrowers with less-than-perfect credit records or lower income. Due to the nature of the clientele, subprime mortgage loans lack the quality of conventional confirming mortgage loans. To compensate for the risk to the loan originator/investor, usually a higher interest rate is charged to the borrower or special provisions are built into the loan agreement to protect the investors. Similar to conventional mortgage bankers, subprime mortgage lenders' operations fall into four main areas:

1. Loan Origination/Marketing: Origination activities include targeting borrower markets, identifying borrowers, reaching loan agreements, processing the paperwork and eventually funding the loans.
2. Warehousing: This is the period when the lenders actually hold the loans and collect interest revenues directly from the borrowers.
3. Loan Sale/Securitization: This refers to the activities to bundle-up and to sell loan receivables as asset-backed securities or other financial instruments. It is at this stage

that the financial-components approach is applied to identify and to repackage different financial assets and liabilities.

4. Servicing the loans: Servicing of the loans may or may not be sold together with the loan. If the loans are sold with servicing retained, the originator, now the servicer, collects the payments and channels them through the asset-backed securities holders by charging a servicing fee.

The industry's financial statistics reveals that mortgage bankers make money, first and foremost, in servicing, with warehousing and origination following in that order. Until the change of accounting standards that introduced the financial-components approach, mortgage companies typically lost money in loan sale/securitization. For fiscal years 1990 and 1991, average net income/loss for mid-size mortgage companies were as follows:

Servicing Income: $2,921,000
Warehousing Income: $1,518,000
Origination Income: $857,000
Loan sale/securitization Loss: $(3,708,000)

The Financial-Components Approach---A More Flexible Accounting Method

In a sense, the accounting losses recognized upon loan sale/securitization disguise the true nature of a mortgage company's source of profits. On the one hand, the mortgage loan receivables are transferred to security investors and are taken off the balance sheet. Considering that loans are usually transferred at less than the face value, an accounting loss has to be recognized upfront. On the other hand, however, servicing of the loans, the most profitable area of the operation, is usually retained. From the mortgage company's viewpoint, loan sale/securitization represents investments in the mortgage servicing rights that the company expects to benefit for the life of the loans; it is not an economic loss at all. Nevertheless, the values of the servicing rights are not faithfully reflected on the financial statements.

In 1995, the Financial Accounting Standard Board (FASB) issued Financial Accounting Standard (FAS) No. 122 *"Accounting for Mortgage Servicing Rights"* to change this misleading reporting practice. The next decade witnessed several amendments and replacements of FAS No. 122. (No. 125 in 1996; No. 140 in 2000; and No. 156 in 2006) However, the financial-components approach first established in FAS No. 122 carried through.

Following the financial-components approach, upon the transfer of financial assets or financial liabilities, the transferor is required to decompose the underlying financial assets or financial liabilities into different components based on control; some components are transferred to the transferee while others are retained on the transferor's books. In other words, the financial- components approach mandates the creation and the carrying of financial assets or liabilities that otherwise would be a part of an integral financial asset. In a way, the financial-components approach is the FASB's answer for bringing every valuable financial asset or liability on the balance sheet. Each right and obligation will be recognized and accounted for separately. The following example, adopted from FSA No. 140, highlights the financial-components approach:

Company D originates $1,000 of prepayable loans that yield 10% interest income for their 9-year expected lives. Company D sells nine-tenths of the principal plus interest of 8% to another entity for $880. Company D will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the 2 percent of the interest income not sold. Company D obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourses obligation to repurchase delinquent loans.

In this case, at the transaction, the integral financial asset: $1,000 of original loan is decomposed into:

1). Loans sold (nine-tenths of the original loans), valued at $900.
2). Call Option, estimated fair value $70.
3). Loan Servicing Asset, estimated fair value $90.
4). Recourse Obligation, estimated fair value $60.
5). One-tenth Interest Retained, valued at $100

Before the financial-components approach,

Cash proceeds	$880	
Loss on Loan sales	20	
Loan sold		$900

After the financial-components approach,

Cash proceeds	$880	
Call option	70	
Servicing assets	90	
Loan sold		$900
Recourse obligation		60
Gain on loan sales		80

Haveit Mortgage Business Model Applied to the Financial-Components Accounting

As one of the leaders in the subprime lending industry, Haveit Mortgage built its business on two of the four main operation areas: loan origination and loan sale/securitization. The main focus was really on loan origination. Loan sale/securitization was necessary to gain access to funding to support new loan originations, but the company's strength was on its marketing ability to identify and to reach lesser qualified borrowers, often, a first-time borrower seeking financing for their first house.

Haveit Mortgage was not one of the really aggressive "predatory" lenders, those that were seemingly in business to end up with defaulted properties. Even in the letter to stakeholders to inform the sudden cease of operations, the management reiterated their mission statement as "to influence the mortgage industry toward increased affordability options for a changing market of home buyers." News covering Haveit's sudden demise reported that evidence suggested that Haveit management wasn't filled with "Enron-style" bad guys. Under Chapter 11, Haveit's web site featured more than a dozen contacts for potential employment and information on how employees could convert life insurance and get COBRA benefits.

As an independent profit-driven enterprise, however, Haveit Mortgage had to have been concerned about its accounting earnings. With the clear focus on loan originations, the business model can be summarized as the following:

1. To aggressively reach out for marketing and loan origination;
2. To minimize the time and amount warehousing originated loans;
3. To sell loans or to securitize mortgage-backed assets through business partners in the finance industry.
4. To minimize servicing by selling the mortgage servicing rights when possible.

In their 2005 annual report, the following footnote to the financial statements describes their loan sale/securitization transactions:

> "The Company recognizes net gains or losses on whole loan sales and securitizations of its residential real estate loans at the date of settlement and when the Company has transferred control over the loans to either a securitization transaction or to third party purchaser.
>
> For whole loan sales, the amount of gain or loss is calculated as the difference between the net cash received for the loans and the allocated carrying value of the loans. The Company primarily sells its loans on a servicing released basis and the net cash received includes a premium for the mortgage servicing rights.
>
> For securitization transactions, the Company retains the mortgage servicing rights and a gain is recognized to the extent that the net selling price exceeds the carrying value of the loans sold. The Company structures each securitization transaction to meet the sale requirements of Statement of Financial Accounting Standards No. 140, "*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*" and, as a result, at the closing of each securitization, the Company removes from its balance sheet the carrying value of the loans held for sale and adds to its balance sheet the estimated fair value of the assets obtained through the securitization transaction which generally include the cash received (net of transaction expenses), retained junior class interests (residual interests in securitized loans) and mortgage servicing rights.
>
> For both whole loan sales and securitizations, while the Company does not retain credit risk on the residential real estate loans it securitizes, it does have a potential liability under standard industry warranties it makes to purchasers and insurers of the mortgage-backed securities to purchase back the loans in cases of default on the borrower."

Under the financial-components approach, accounting gains and losses recognized in loan sale/securitization transactions depend largely on the identification of financial components and the estimated fair value of each and every financial component.

This business model seemed to be working well from 2003 to 2006. As a matter of fact, before the sudden demise, major financial institutions showed strong confidence and support for Haveit. By 2006, Merrill Lynch, who underwrote Haveit's mortgage-backed securities, owned 20% of Haveit. For a relatively young mortgage company, this kind of strong support was everybody's envy.

DISCUSSION ISSUES

Assessing the Operation Areas

Haveit's business model seemed to be working fine until the current crisis. Unlike most other mortgage companies that operate on all four areas, Haveit seemed to have the competitive edge by focusing on marketing and loan originations. Even though industry statistics indicate that servicing is the most profitable area of practice with warehousing tailing in a distance, origination is still a profitable area. Aside from the assets identification and profit recognition issues on the accounting books, operationally, what are the benefits and risks in separating the areas? Were there fundamental issues that contribute to Haveit's troubles?

Identifying Components

The key in applying the financial-components approach is certainly the identification of financial components. As was pointed out by SFAS No. 140, to properly identify financial components, the focus is on control. It is important that the identifications are comprehensive and exhaustive, including all the assets as well as liabilities. Only when all assets and liabilities are properly accounted for can the profits or losses be properly reflected.

From Haveit's footnote to financial statements, it seems that the financial-components approach is more relevant for securitization transactions. Is that the case? What are the financial components created in a whole loan sale transaction, as well as in a securitization transaction? To apply the financial-components approach, it is important to identify which value-added components are created and which component(s) is (are) retained or transferred.

Immediately before the sudden demise, Haveit was obligated to purchase back \$93 million from Merrill Lynch and \$12.7 million from Credit Suisse Boston due to bad loans, according to one newspaper report. Haveit's stakeholders, internal as well as external, were surprised by those numbers that were never reported on the financial statements. How should those obligations be properly reflected on the balance sheet as well as on the income statement?

Fair Value Measurement of Components

The numerical example adopted from FAS No. 140 illustrates the accounting mechanism only with all the fair values given. The question is: are there readily available fair values for all identified components? If not, then how do we estimate the fair value? Or, are there alternative accounting measurement basis?

From a mortgage company's viewpoint, servicing is most profitable in that there are fees and other charges to be collected. Mortgage loans are backed by real properties with real values; in that sense, principals of the loans are protected. Borrowers' default on payments or even foreclosures on real property does that increase or decrease the value of service? Compared with prepayment of loans where anticipated interest revenues and fee revenues stop abruptly, does default risk increase or decrease the fair value of servicing? How do we estimate the fair value of the servicing assets as well as other components identified in the transaction? It takes a thorough understanding of the economic benefits of the identified assets to reach a reasonable estimate.

Under the financial-components approach, estimates of fair value directly impact the reported gains or losses on the transactions. This is only the initial gains/losses recognition. Following the initial recognition, however, the subsequent measurement is also an issue. Fair values do fluctuate. When fair values of assets increase (decrease), what changes on the financial statements?

CONCLUSION

The Board of Directors at Haveit Mortgage is seeking your advice. What would you consider a proper valuation method for the interim and long-term disposition of these mortgage assets? How will your choice of valuation methods affect the market value of the Corporation? Also, determine what level of value would be expected for the firm to continue its operations in a legitimate manner. Finally, and most importantly, determine any real or derived benefits to the firm created by the selection of either of the two alternatives.

ELMO BANK, INC.: ALTERNATIVES FOR ACHIEVING CAPITAL ADEQUACY

Sid Howard Credle, Hampton University
P. Michael McLain, Hampton University
Travell T. Travis, Hampton University

This case explores the acquisition of Elmo Bank Inc. ("Elmo" or "the Bank") which has suffered significant financial losses in recent years. Its capital position has eroded to the extent that heightened bank regulatory action may be warranted. As a result, the Board of Directors of Elmo (the "Board") is forced to raise capital and seek offers which include but are not limited to: (1) the sale of Elmo through a merger, tender offer or sale of substantially all of its assets along with an infusion of resources to adequately capitalize the Bank or (2) an infusion of capital into Elmo through a private placement of a single or a few accredited or sophisticated investor(s). A number of different offers have been received and a determination must be made regarding which offer should be accepted.

The Board has received numerous offers regarding Elmo's circumstances. Student teams performing the function of the Board along with the management of Elmo have to review each of the proposals to determine which offer is in the best interest of the existing shareholders of Elmo. In addition to determining the fair value of Elmo and preparing comparative analyses, the student teams must present their own offer to Elmo.

BACKGROUND DATA

For the past five (5) years, Elmo's financial condition declined as measured by industry averages of asset and liability composition, asset quality, liquidity and capital adequacy. Since December 2000, Elmo's management and operations have been subject to a regulatory agreement with the Federal and State banking regulators (the "Regulators"). As a result of the agreement, Elmo is restricted in paying dividends and must raise new capital and hire new management. Elmo's projected financial statements for the 2004 year are presented in Exhibits 3 and 4.

Elmo is one of the nation's oldest minority owned banks located in Tulsa, Oklahoma. Elmo has been losing more than $100,000.00 a month for the past five (5) years. To save Elmo, the Bank decided to cut costs by reducing general overhead and the number of employees from seventy-eight (78) to thirty-eight (38). As a result of this decision, a bank facility located in another city in Oklahoma was closed. Amidst this extreme turmoil, on December 20, 2003, both the President and the Chief Financial Officer resigned from their positions. On December 22, 2003, the Bank's external CPA firm auditors resigned. As a result, the Bank lost its directors and officers ("D&O") insurance and bond insurance. The D&O insurance protects the directors and officers from liability stemming from any shareholder or regulatory litigation. The bond insurance protects the Bank from loses due to theft, fraud, and embezzlement. In addition, two (2) of three (3) newly appointed members of the Board resigned from the Bank as a result of the various problems noted above.

Moreover, Elmo's external audit report for 2003 indicated a "going concern" deficiency. A cited deficiency of this type indicates that in the auditor's opinion it was doubtful that the Bank would continue into the subsequent year. To make matters worst, on January 1, 2004, the Bank was given fifteen (15) days to either put the Bank back "together" financially or the Regulators would issue a finding letter and move to protect the Bank's depositors. In practical terms, this meant that the Bank was on the verge of closing.

As a result of these actions, the Board scrambled. The Board diligently sought the advice of its counsel, called on its resources and industry contacts, ran the operations of the Bank on a daily basis and miraculously managed to hire new external auditors. With these changes, the Board was able to purchase new D&O and bond insurance policies, approve a cost reduction program and begin the search for a new president.

In February 2004, the Board hired Diane D. Sandy as president. Ms. Sandy had a long tenure as a chief lending officer for a bank serving an African-American community. Upon taking office, she immediately implemented the Board's approved overhead and employee reduction initiative. Inefficient Elmo branches were also closed. These actions and other subsequent decisions preserved the Bank's operating status for approximately nine (9) additional months.

Although the Board and its new president were capable of saving the Bank in 2004, additional regulatory pressure was brought to bear in the fourth quarter of 2004. The Regulators told Ms. Sandy and the Board on November 1, 2004, in no uncertain terms that the Bank must raise at least $3,000,000.00 in new capital in order to remain open. If not, the regulators would issue a warning letter and possibly proceed to close the Bank by December 31, 2004. The Bank responded by soliciting offers from other banks, potential investors and venture capitalists. Of the numerous solicitations received, four (4) proposals were deemed acceptable for further consideration. The four (4) proposals were received from:

- Wanna Buy Corporation ("Wanna Buy")
- Dana Douglas Imports, Inc. ("Douglas")
- Flap Jack City Investors, Inc. ("Flap Jack")
- Mainstreet National Bank, Inc. ("Mainstreet")

Both Douglas and Flap Jack are predominately minority owned and operated companies. General information regarding each offer is presented below.

REQUIRED

1. Given the information provided, determine to the best of your ability, the value of Elmo as of December 1, 2004.

2. Prepare an analysis of each of the proposals. Include a computation of the before and after comparison of the value of the combined entity and the aggregate gain or loss to the

existing Elmo shareholders and the shareholders of the acquiring and/or investing corporation.

3. Given all of the information available, please make an equitable offer to the Board to acquire at least fifty-one percent (51%) of the outstanding shares of Elmo. Use a formal "Letter of Intent to Purchase" to fulfill this requirement.

4. Are there any non-financial issues to consider during the proposal discussions?

ADDITIONAL DATA

Elmo has reported net operating losses for the last five (5) years. Those losses may add significant value to any acquiring and/or investing company for tax savings purposes. In addition, there is a difference in the book value of assets and the appreciation of those net assets, which is primarily associated with buildings.

Assume Elmo's accumulated net operating losses are $2,000,000.00 if no change in ownership occurs from the transaction. If there is a change in ownership, the amount has to be allocated over a twenty (20) year period. Assume an interest rate of three and one half percent (3.5%).

Assume Wanna Buy's final proposal offer is $3,500,000.00.

In the due diligence work of the Bank, problems have been encountered in locating the premises and verifying the corporate status of Flap Jack. It has also been difficult to do a background check and verify the references of the principals of Flap Jack. After informal and formal searches for references, it appears no one has ever heard of the principals of Flap Jack. In addition, Flap Jack has not made its "promised" good faith payment into an escrow account as of now.

Assume that the date is now December 15, 2004.

The four (4) proposals are noted below (Proposals 1-4) and additional assumptions and information for all proposals is available in Exhibits 1-4.

Proposal 1

December 1, 2004

Mr. William J. Snow
Chairman of the Board
Elmo Bank, Inc.
1010 Main Street
Tulsa, Oklahoma 22222

Re: Elmo Bank, Inc.

Dear Mr. Snow:

The purpose of this letter is to set forth certain non-binding understandings between Wanna Buy Corporation ("Wanna Buy") and Elmo Bank Inc. ("Elmo") regarding the proposed acquisition by Wanna Buy of a controlling interest in the capital stock of Elmo based on the amount and terms set forth below.

(A) Purchase Price. Wanna Buy will purchase authorized and unissued shares of common stock in exchange for between $3-5MM in cash as specified in a purchase agreement between the parties.

(B) Access. Elmo will afford Wanna Buy's employees, auditors, legal counsel and other authorized representatives all reasonable opportunity and access during normal business hours to inspect, investigate and audit the assets, liabilities, contracts, operations, vendor/customer relationships and business of Elmo before entering into a purchase agreement.

(C) Costs. Wanna Buy and Elmo will each be solely responsible for and bear all of its own respective expenses, including, without limitation, expenses of legal counsel, accountants, and other advisors, incurred at any time in connection with pursuing or consummating a purchase agreement.

If we do not receive a signed copy of this letter on or before December 31, 2004, we will assume you have no further interest in pursuing this matter.

Yours truly,

/s/ Richard Rich

Richard Rich, Senior Vice President
Wanna Buy Corporation
:

Proposal 2

December 1, 2004

Mr. William J. Snow
Chairman of the Board
Elmo Bank, Inc.
1010 Main Street
Tulsa, Oklahoma 22222

Re: Elmo Bank, Inc.

Dear Mr. Snow:

This letter will serve to confirm our offer and, if accepted, our agreement in principle concerning a proposed transaction in which Dana Douglas Imports, Inc. ("Douglas") will purchase shares of common stock of Elmo Bank, Inc. ("Elmo").

The transaction will be structured as a purchase by Douglas of authorized and unissued shares of Elmo's common stock, par value $10.00 per share The purchase price per share shall be the sum of (w) seventy-five percent (75%) of the adjusted tangible book value per share and (x) the post closing adjustments, if any. The number of shares to be purchased shall be the greater of (y) the number which increases Elmo's adjusted tangible book value to eight percent (8%) of total assets or (z) the number which results in the Douglas owning a number of shares equal to 55% of the sum of the total number of outstanding shares of Elmo's common stock and all such shares that could be issued upon the exercise of all outstanding options and warrants to purchase common stock.

For purposes of this letter, "adjusted tangible book value" means the net worth of Elmo in accordance with Generally Accepted Accounting Principles ("GAAP") reflected on its balance sheet at the time of closing minus (y) the sum of all intangible assets and (z) the sum of all permissible accounting adjustments identified by Douglas in its due diligence investigation; except that an amount in excess of $40,000.00 which Elmo may owe to its financial advisor(s) will not be deducted.

"Permissible accounting adjustment" means a reduction in the net worth of Elmo necessary in order for the balance sheet of Elmo to fairly present its financial position in accordance with GAAP. Without limitation, such a reduction may result from correcting net accounting errors or irregularities, liabilities that accrue as a result of this transaction, or any other net accounting entries that in Douglas' reasonable judgment is necessary to properly state Elmo's assets and liabilities.

For purposes of this letter agreement, "post closing adjustments" shall mean the sum of the "earn out" and the "loan loss allowance adjustment", each as hereafter defined. The "earn out" shall be zero if the net income of Elmo in calendar years 2005 and 2006 does not exceed an annualized rate of six percent (6%) of Elmo's average equity in such two (2) year period.

To the extent that net income exceeds an annualized rate of six percent (6%) of average equity in such period, the "earn out" will be seventy-five percent (75%) of such excess until the earn out reaches ten percent (10%) of adjusted tangible book value and fifty percent (50%) of any of such excess remaining thereafter. In no event, however, shall the earn out exceed twenty-five percent (25%) of adjusted tangible book value. The earn out will be computed on the basis of audited financial statements for 2005 and 2006 and, if due, shall be paid by Douglas to the Elmo before April 1, 2007.

The "loan loss allowance adjustment" shall mean the amount, if any, of the increase in the loan loss allowance made that Douglas determines was unnecessary in light of the actual performance of Elmo's loan portfolio in the three (3) calendar years after closing. Any loan loss allowance adjustment shall be paid by Douglas to Elmo within ninety (90) days after the end of the calendar quarter in which the third anniversary of the closing occurs, plus an additional amount equal to a return on the adjustment amount of 3.85% per annum from the closing date until the payment date.

Further, Douglas shall be entitled to immediately appoint four (4) of the members of the Board of Directors for Elmo with the Board having seven (7) members upon the completion of the closing. Consequently, the current Board of Directors is to select three (3) of its members to remain on the Board of Directors until at least the end of the current term. Ms. Diane Sandy shall remain as "transition president" of Elmo until the later of March 31, 2005 or three (3) months after the closing date, with an employment contract which is satisfactory to Ms. Sandy and Douglas. Immediately after the closing of the transaction, the Board of Directors shall elect Bill Bosley as its Chairman.

Please execute and return to Douglas this letter agreement which evidence Elmo's agreement to the terms and conditions herein set forth.

Very truly yours,

/s/ Bill Bosley

Bill Bosley, President
Dana Douglas Imports, Inc.

Proposal 3

December 1, 2004

Mr. William J. Snow
Chairman of the Board
Elmo Bank, Inc.
1010 Main Street
Tulsa, Oklahoma 22222

Re: Elmo Bank, Inc.

Dear Mr. Snow:

Below please find our proposed terms for Flap Jack City Investors, Inc. ("Flap Jack") to consider in purchasing stock from Elmo Bank, Inc. ("Elmo").

Flap Jack will make a tender offer to each of the present shareholders of Elmo to purchase all of the common stock owned by each shareholder at a price of $21.00 per share of the outstanding shares. Flap Jack is making this offer to each shareholder of Elmo's current existing shareholders in an effort to acquire one hundred percent (100%) ownership of Elmo.

In addition to Flap Jack purchasing the common stock owned by the present shareholders of Elmo, it is critical that Elmo raise Tier 1 capital through the issuance of its stock in 2004. We anticipate Flap Jack to purchase one million shares of Elmo's authorized common stock as a part of Elmo's capital campaign for $29,970,000. (Price based upon a perspective single investor purchasing the approximate 1,000,000 available shares of common stock of Elmo at $20.97 per). An appraisal of Elmo was performed as of November 26, 2003 which indicated a fair value per share of Elmo' common stock is in the range of $25.00 per share to $31.00 per share.

It is anticipated that the common shareholder percentage ownership interest that Flap Jack will have with Elmo will be at least seventy-eight percent (78%) common shareholder interest in Elmo. With this common shareholder percentage ownership interest by Flap Jack in Elmo, Flap Jack will be able to exercise control over all aspects of Elmo. All common stock will be considered voting shares.

Flap Jack requests a written response within five (5) business days after presentation of this offer to Elmo's Board of Directors. In the meantime, Flap Jack will deposit a good faith payment of $10,000,000.00, on or before December 10, 2004, into an escrow account established by Elmo whether Elmo agrees to the terms of this letter as an indication of Flap Jack's interest in acquiring Elmo. This deposit will be refunded to Flap Jack immediately if Elmo moves forward with another offer or declines this offer by 3:00 p.m., December 31, 2004.

Sincerely,

/s/ Jack N. Flap, Jr

Jack N. Flap, Jr., President
Flap Jack City Investors, Inc.

Proposal 4

December 1, 2004

Mr. William J. Snow
Chairman of the Board
Elmo Bank, Inc.
1010 Main Street
Tulsa, Oklahoma 22222

Re: Elmo Bank, Inc.

Dear Mr. Snow:

The following terms and conditions represent our proposal for the purchase of Elmo Bank, Inc. ("Elmo") by Mainstreet National Bank, Inc. ("Mainstreet").

Mainstreet shall exchange its shares of common stock for the outstanding shares of common stock of Elmo. The exchange ratio would be determined based on the adjusted book value of Elmo immediately prior to closing. This would provide numerous benefits including substantially higher lending limits and enhanced customer services. In addition, your shareholders would own a common stock that is actively traded. Furthermore, Mainstreet has paid a quarterly dividend for a number of years, and, subject to capital guidelines, expects to continue such quarterly payments. Your shareholders would be eligible for payment the first quarter after consummation of our transaction.

The final structure shall be determined after completion of an analysis to determine the most effective way to maximize the benefit: (1) of continuing to operate under the trade name of Elmo, (2) to your various constituencies such as the regulatory agencies, (3) of Elmo's existing customer base, (4) to your Board of Directors, (5) of Elmo's employee base and (6) to current and future investors/shareholders. We will need additional information in order to analyze the impact any transaction will have on the value of certain tax attributes of Elmo.

This offer shall expire on December 25, 2004 unless specifically extended by Mainstreet.

Sincerely,

/s/ Grey Y. Jones

Grey Y. Jones
Executive Vice President
Mainstreet National Bank, Inc.

Exhibit 1

Capital Section of Balance Sheets of Flap Jack City Investors, Inc. and Wanna Buy Corporation

For the purposes of analysis assume that Flap Jack capital structure is as follows;

Assumptions

Common stock……………………………..	$ 30,374
Capital in excess of par…………………..	17,277,434
Retained Earnings………………………..	6,848,286
Net worth	$ 24,156,094

For purposes of analysis the capital of Wanna Buy has:

Assumptions

Common stock…………………………….	$ 1,345,000
Capital in excess of par……………………	1,092,000
Preferred stock…………………………….	1,047,000
Treasury stock……………………………..	(71,000)
Income loss…………………………………	(991,000)
Retained Earnings………………………….	11,622,000
Net worth	$ 14,044,000

Additional Information

For purposes of analysis of the FMV of Mainstreet common stock, please note that the value of Mainstreet stock at November 30, 2004 was $19.34 per share. The peak value of the common stock of Mainstreet was $22.84 and the lowest value was recorded at $16.52 from January 1, 2004 to November 30, 2004.

Exhibit 2

Elmo Bank, Inc.
Land and Buildings as of November 30, 2004

Location	Book Value		Total	Assessed Value		Total
	Land	Building		Land	Building	
Main – Tulsa Office	$362,800	$ 303,007	$ 665,807	$163,100	$1,073,800	$1,236,900
Lawton Office	37,720	641,351	679,071	70,800	779,900	850,700
Oklahoma City Office	9,430	227,332	236,762	18,900	112,200	131,100
Totals	$409,950	$1,171,690	$1,581,640	$252,800	$1,965,900	$2,218,700

Exhibit 3

Elmo Bank, Inc.
Income Statements (Last 4 months of 2003 and 2004)

								Projected Numbers		
	Aug-03	Sep-03	Oct-03	Nov-03	Dec-03	Aug-04	Sep-04	Oct-04	Nov-04	Dec-04
Interest Income										
Interest and fees - loans	$2,171,032	$2,445,258	$2,754,094	$3,101,936	$3,493,711	$1,953,221	$2,188,872	$2,452,850	$2,748,664	$3,080,153
Interest - securities	$683,959	$758,445	$832,931	$907,417	$981,903	$402,797	$444,792	$486,787	$528,782	$570,777
Interest - federal funds sold	$84,365	$91,701	$99,679	$108,351	$117,778	$60,062	$66,101	$72,744	$80,055	$88,100
Total Interest Income	$2,939,356	$3,295,404	$3,686,704	$4,117,704	$4,593,392	$2,416,080	$2,699,765	$3,012,381	$3,357,501	$3,739,030
Interest Expenses										
Interest - deposit	$751,021	$818,429	$891,924	$972,019	$1,059,306	$382,738	$422,257	$465,876	$514,001	$567,097
Interest - capital leases	$57,103	$70,573	$87,221	$107,797	$133,226	$54,780	$54,779	$54,778	$54,777	$54,776
Interest - other	$0	$0	$<9,509>	$<29,954>	$<63,040>	$0	$0	$<5,287>	$<16,422>	$<34,143>
Total Interest Expense	$808,124	$889,002	$969,636	$1,049,862	$1,129,492	$437,518	$477,036	$515,367	$552,356	$587,730
Net Interest Income	$2,131,232	$2,406,402	$2,717,068	$3,067,842	$3,463,900	$1,978,562	$2,222,729	$2,497,014	$2,805,145	$3,151,300
Provision for loan losses	$1,850	$148,295	$294,740	$441,185	$587,630	$0	$0	$0	$0	$0
Net Interest Income after Provision for Loan Losses	$2,129,382	$2,258,107	$2,422,328	$2,626,657	$2,876,270	$1,978,562	$2,222,729	$2,497,014	$2,805,145	$3,151,300
Non-interest Income:										
Service charges on deposits	$483,762	$539,180	$600,970	$669,841	$746,605	$390,973	$450,665	$520,248	$600,574	$693,303
Securities gains (losses)	$0	$0	$0	$0	$0	$2,890	$2,890	$2,890	$2,890	$2,890
Other non-interest income	$131,148	$144,610	$159,447	$175,806	$193,844	$77,838	$90,741	$105,786	$123,325	$143,772
Total Non-interest income	$614,910	$683,790	$760,417	$845,647	$940,449	$471,701	$544,296	$628,924	$726,789	$839,965
Non-interest Expense:										
Salaries and wages	$1,379,264	$1,539,424	$1,718,151	$1,917,628	$2,140,265	$993,644	$1,114,713	$1,250,485	$1,402,794	$1,573,654
Employee benefits	$518,844	$577,213	$642,149	$714,391	$794,760	$310,042	$321,431	$333,228	$345,457	$358,135
Premises/Equipment expense	$450,678	$528,662	$620,121	$727,401	$853,242	$409,659	$465,609	$529,211	$601,501	$683,667
Other non-interest expense	$1,223,723	$1,372,551	$1,600,095	$1,928,728	$2,387,415	$1,072,586	$1,214,892	$1,377,178	$1,561,495	$1,770,902
Total Non-interest expense	$3,572,509	$4,017,850	$4,580,516	$5,288,148	$6,175,682	$2,785,931	$3,116,645	$3,490,102	$3,911,247	$4,386,358
Income (Loss) Before Income Tax	($828,217)	($1,075,953)	($1,397,771)	($1,815,844)	($2,358,963)	($335,668)	($349,620)	($364,164)	($379,313)	($395,093)
Gain on sale of Branches/Fixed Assets						$78,354	$78,354	$78,354	$78,354	$78,354
Income tax expense (benefit)										
Net Income (Loss)	($828,217)	($1,075,953)	($1,397,771)	($1,815,844)	($2,358,963)	($257,314)	($271,266)	($285,810)	($300,959)	($316,739)

Elmo Bank, Inc.
Net Income Summary (2000-2003)

	Dec-00	Dec-01	Dec-02	Dec-03
Net Income (Loss)	($3,635,957)	($3,147,648)	($2,724,919)	($2,358,963)

Exhibit 4

Elmo Bank, Inc.
Balance Sheet (Last 4 months of 2003 and 2004)
(in thousands)

							Projected Numbers			
	Aug-03	Sep-03	Oct-03	Nov-03	Dec-03	Aug-04	Sep-04	Oct-04	Nov-04	Dec-04
Assets										
Cash and due from banks	$2,994	$3,657	$4,467	$5,456	$6,663	$4,952	$4,079	$3,360	$2,768	$2,280
Federal funds sold	$9,287	$8,588	$7,889	$7,190	$6,491	$4,007	$7,083	$10,159	$13,235	$16,311
Cash and cash equivalents	$12,281	$12,245	$12,356	$12,646	$13,154	$8,959	$11,162	$13,519	$16,003	$18,591
Investment in securities	$40,127	$37,062	$34,271	$31,691	$29,304	$21,529	$21,613	$21,697	$21,782	$21,867
Loans	$40,991	$40,283	$39,586	$38,901	$38,228	$40,629	$41,101	$41,578	$42,060	$42,548
Less: Allowance for loan losses	($1,004)	($1,204)	($1,444)	($1,731)	($2,076)	($1,316)	($1,315)	($1,314)	($1,313)	($1,312)
Net loans	$39,987	$39,079	$38,142	$37,170	$36,152	$39,313	$39,786	$40,264	$40,747	$41,236
Bank premises (net) & other fixed assets	$2,482	$2,480	$2,478	$2,476	$2,474	$1,943	$1,922	$1,901	$1,881	$1,860
Other real estate owned (net)	$0	$0	$0	$0	$0	$147	$147	$147	$147	$147
Accrued interest receivable	$470	$433	$399	$368	$339	$317	$314	$311	$308	$305
Other assets	$528	$576	$628	$685	$748	$642	$673	$706	$740	$775
Total Assets	$95,875	$91,875	$88,274	$85,036	$82,171	$72,850	$75,617	$78,545	$81,608	$84,781
Liabilities										
Deposits										
Demand	$18,918	$17,104	$15,290	$13,476	$11,662	$16,559	$19,579	$22,599	$25,619	$28,639
NOW and MMDA	$21,849	$20,177	$18,242	$16,493	$14,911	$16,602	$16,792	$16,983	$17,177	$17,373
Savings	$18,823	$18,480	$18,144	$17,813	$17,489	$15,591	$15,398	$15,207	$15,018	$14,832
Certificates of deposits	$30,572	$30,575	$30,578	$30,581	$30,584	$19,510	$19,129	$18,756	$18,390	$18,032
Christmas clubs	$341	$383	$430	$483	$543	$310	$339	$371	$405	$443
Total deposits	$90,503	$86,719	$82,684	$78,846	$75,189	$68,572	$71,237	$73,916	$76,609	$79,319
Accrued interest payable	$195	$160	$131	$108	$88	$118	$105	$93	$83	$74
Lease & other borrowed money	$654	$569	$495	$431	$375	$468	$469	$470	$471	$472
Federal funds purchased	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Other liabilities	$240	$395	$650	$1,070	$1,761	$122	$235	$453	$872	$1,679
Total Liabilities	$91,592	$87,843	$83,960	$80,455	$77,413	$69,280	$72,046	$74,932	$78,035	$81,544
Stockholders' Equity										
Common Stock										
Authorized - 2,000,000 shares										
Outstanding - 262,183 shares	$2,358	$2,358	$2,358	$2,358	$2,358	$2,622	$2,622	$2,622	$2,622	$2,622
Surplus	$3,001	$3,001	$3,001	$3,001	$3,001	$3,272	$3,272	$3,272	$3,272	$3,272
Retained Earnings	($1,492)	($1,739)	($2,027)	($2,362)	($2,753)	($2,289)	($2,300)	($2,311)	($2,322)	($2,333)
Capital Infusion	$354	$354	$354	$354	$354	$0	$0	$0	$0	$0
Unrealized gains (losses) on securities	$62	$58	$54	$51	$47	($35)	($23)	($15)	($10)	($7)
Total Stockholders' Equity	$4,283	$4,032	$3,740	$3,402	$3,007	$3,570	$3,571	$3,568	$3,562	$3,554
Total Liabilities and Stockholder's Equity	$95,875	$91,875	$87,700	$83,857	$80,420	$72,850	$75,617	$78,500	$81,597	$85,098

CAPITAL BUDGETING AND RISK ADJUSTMENTS: LIFESTYLE SPA CORPORATION 2007

Robert Stretcher, Sam Houston State University

INTRODUCTION

Lifestyle Spa Corporation (LSC) is considering an expansion of its operations to two additional locations in the Dallas/Fort Worth metroplex. The original facilities are run by the founder, Lisa Porter, who serves as the CEO of this small Nasdaq-listed corporation. The expansions would involve not only the purchase of facilities, furnishings, and equipment, but also would require that Lisa hire two new general managers, and full staff for each facility. The expected cashflows from the new facilities are expected to emulate the cashflows from the original facility, but are dependent on the new management and staff to manage effectively.

This has presented an interesting situation for the firm's lenders, two banks that want to fund the purchase of one facility each. Lisa is tasked with assessing the risk and adjusting her capital budgeting criteria accordingly, and has sought the assistance of Bob Fraga, one of her old friends from college, to help.

BACKGROUND

Lifestyle Spa Corporation (LSC) began as a proprietorship in 1992. Lisa Porter, the owner, had just graduated from college with a kinesiology major and a general business minor from a regional university in Texas. Lisa had been a member of the competitive cheerleading squad while in college, and decided to become an entrepreneur. She wanted to do something related to fitness, perhaps even related to cheerleading. She decided to start a fitness and relaxation spa.

Lisa had saved some money from summer work in the months following graduation, and had applied for a bank loan to fund the startup. She located an acceptable facility, and spent about half her money renovating, adding locker room and bath facilities, a common area for a steam room and Spa, and a set of rooms for massage. She spent the other half purchasing equipment for working out, decor, and a nice reception area complete with music, aroma, lighting, and other 'atmosphere' enhancements.

LSC had a very successful grand opening. Lisa had employed college students from a local community college to distribute flyers in parking lots, neighborhoods, at businesses, and to people in vehicles when they stopped at traffic lights. The 11,000 square foot facility could hardly contain the grand opening crowd. Lisa sent helpers to restock the 'healthy munchies' several times during the day, since the initial groceries only lasted the first hour and a half. By 7pm, the grand opening was finished and 118 memberships had been sold! This was about five times the number she had expected on the first day. Interest continued well past the grand opening, and by the end of the first week, over 200 memberships had been sold.

The company was a success in the years following, growing at a rapid rate and reaching the capacity of the facility within four years. In 1998, Lisa incorporated the firm and in 2002 she took the firm public, selling 80 percent to outside investors. Her 'sweat equity' had made her fairly wealthy, and the IPO had allowed her to diversify her investment portfolio for the first time since she started the spa. She retained the executive position and hired a general manager to oversee the spa's functions.

THE SPA

Lisa had created a very peaceful and protected setting for spa members. They could get access to the facilities by becoming a member, and could arrange services for extra fees. These included water relaxation, massages, mud rejuvenation, manicures and pedicures, and even appropriate medical rehab services, performed by qualified personnel from outside the company, who basically rented room space to meet with patients on an appointment basis. This arrangement worked well. Most of the medical rentals occurred during business hours and broke for lunch, whereas most of the spa services occurred over lunch breaks or after normal business hours. Lisa had chosen a strip mall in a relatively safe part of town, and a storefront that was close to parking. Lisa had hired Ted Nigel, formerly a local high school football star, to do cleaning and heavy lifting, and to help close the spa at 9 pm. He informally provided security as well, walking patrons to their cars after dark.

The spa offered patrons a comfortable lounge, as well. The lounge had a bar that served healthy drinks as well as sodas, bottled water and iced tea. The bar also was stocked with healthy snacks such as salads, sandwiches, and energy foods. Members loved this feature of the spa, since many spent a lunch hour in the facility.

Most of the members were women, but a handful of the memberships were held by men. Lisa had anticipated this, and had made limited co-ed space. Most of it was dedicated to feminine tastes and needs, and the design of the facility effectively prevented any male traffic in the female areas. The spa was an immediate success and remained well attended, although membership levels would fluctuate some. By 2001, the spa had relocated to a new facility about a mile from the original location, in a property that the firm had been able to purchase. The firm quickly grew to fill that facility's capacity by 2003. Now, in 2007, the mortgage on the property had been paid down to only a $48,000 balance and the spa seemed to be on a firm financial footing.

FINANCIAL CONDITION AND PERFORMANCE

The spa had been incorporated and stable for several years when Lisa began to consider expansion. In 2004, a huge new planned living subdivision had begun construction about ten miles west of her location. The subdivision was kind of a community in itself. Schools, a post office, and common areas had been planned into the layout, as well as several shopping centers. The community was made up of around 18,000 homes and town homes. Lisa had considered purchasing one of the shopping centers for a new spa location, using around 13,000 square feet and renting out the remainder of the storefront spaces to other occupants.

Another property had also been considered in an upscale community in Fort Worth, about 45 miles away. The community was more established and a large building had been vacated by a pharmacy corporation that had been closing stores of late. The property was for sale and Lisa had considered a purchase if the potential business would warrant the new location.

LSC had accumulated a relatively large amount of liquid assets, and while profitability had kept up nicely, the firm had 'way too much cash for comfort. There were seven larger shareholders who, in combination, could potentially sell over half the shares. The threat of takeover was certainly a possibility if LSC held onto cash for too long. Other than a large distribution to shareholders, the expansion projects seemed to be likely remedies. Lisa had decreased debt to prudent levels in anticipation of potential expansion, adding another item of interest for an acquirer. Lisa didn't know what she would do if the firm were acquired. She felt like her presence in the firm was one element that made it work so well, and her share was about twenty percent. Although this gave her some leverage, she felt that the firm needed to take measures to keep from getting acquired if her position and investment in the firm were to remain stable. Setting up charter barriers to acquisition were distasteful to Lisa; she felt that effective managers shouldn't need to establish these.

THE NEW PROJECTS

The two projects under consideration were named after their locations, Waverly (the strip mall in the subdivision) and Myers Lake (the pharmacy facility). Expanding into one of these was feasible, since the firm had excess debt capacity and cash. Doing both expansions would be a stretch, since a much higher debt level would be required.

Lisa had contacted a good friend from college, Bob Fraga, who had majored in finance and had gone on to get a masters degree in finance, as well. He worked at a securities and investment banking firm in Dallas as a managing director. Lisa knew that Bob had substantial experience with valuing IPO's and he had handled LSC's public offering in 2002. Bob also owned about six percent of the shares in the firm. Bob had offered, at no charge, to develop cashflow estimates per year from the proposed projects to show the creditors. Neither Bob nor Lisa thought that any cannibalism would occur with respect to revenues, regardless of the projects accepted. Bob's estimates appear in Table 1.

Lisa collected market data on the firm, as well (Table 2). The stock price had been stable for several years, hovering around $12 per share. This had emulated the market to some degree, which had not shown large positive or negative swings. LSC stock did not exhibit frequent volume, so the relatively stable price when it did trade indicated that the stock may be properly valued. The company had paid out at least half of earnings in dividends in the past, and the dividend amount had grown at a consistent 4.6% since the IPO. If both project expansions occurred, it would be necessary to retain all of the earnings for several years, or keep the dividends rolling and seek additional equity investment. There were 57 shareholders in total, and the more prominent ones had learned to trust Lisa over the years, so she did not expect any resistance to retention of all earnings if so needed. This would necessitate loans of 80 percent on the expansion assets.

Lisa decided to take a few days off to concentrate on the expansion decisions. She set up an appointment with Bob to analyze the information they had collected. Bob had estimated the effect on the firm's beta if each proposal would be financed 80 percent with debt, as proposed. Lisa had estimates of interest rates the bank would charge under each possible expansion, as well.

Table 1. Bob's Cashflow Estimates Per Expansion.

Myers Lake:

Cost of Facility and Improvements: $9.1 million

Estimated Annual Net Operating Cashflow, 20-year asset base: $1,112,000

Waverly:

Cost of Facility and Improvements: $39.1 million

Estimated Annual Net Operating Cashflow, 20-year asset base: $3,887,500*

*includes expected rental revenues, 97% capacity

Table 2. Market and Other Information

Dividend declared for the year 2007	$2.04
Historic 4-year dividend growth rate	4.6%
Current Stock Price	$31.00
Current Beta	0.91
Current Treasury Rate	2.8%
Current Market Return (adj. avg., Wilshire)	10.9%

Table 3. Beta and Debt Premia Expectations.

Whole-Firm Debt Ratios per Proposed Expansion:	
Current	0.1002
Expansion A (Myers Lake only)	0.3484
Expansion B (Waverly only)	0.5479
Expansion C (both Waverly and Myers Lake)	0.5896
Bob's Estimated Whole-firm Betas per Proposed Expansion:	
Expansion A (Myers Lake only)	0.98
Expansion B (Waverly only)	1.09
Expansion C (both Waverly and Myers Lake)	1.12
Lender Averages for Rates (after tax) under Each Possible Expansion:	
Expansion A (Myers Lake only)	5.4%
Expansion B (Waverly only)	7.8%
Expansion C (both Waverly and Myers Lake)	8.4%

TRI-STATE POWER, INC.

Stephen Henry, Sam Houston State University
Robert Stretcher, Sam Houston State University

ABSTRACT

Tri-State Power Inc. is a regulated utility that provides electrical and natural gas services to a mid-western region of the U.S. In addition, the firm (through its subsidiaries) provides Internet service to businesses and consumers using its network of power lines, and installs and maintains distance learning systems for universities. Although the firm has generated acceptable profit levels in the past, a new proposal calls for the non-regulated portions of the business to be "spun off" into a separate entity, while keeping the regulated monopoly business lines within the existing organization.

The decision about whether or not to pursue this proposal is complicated by the regulatory environment in which the firm operates. The gain from the proposal involves placing the debt burden resulting from prior acquisitions onto the regulated utilities portion of the company, where those costs could be easily passed on to utility consumers in the form of higher rates.

The case places the reader in a position of evaluating the advisability and legality of the proposal, and developing points of justification to bring before the regulatory authorities, who will use this information to either approve or disapprove the proposed reorganization. While the benefit to the firm may be obvious from a financial viewpoint, the downplaying of harm to the consumer would be an obvious challenge for Tri-state's managers.

THE COMPANY

Tri-State Holdings is a publicly traded holding company with two major wholly-owned subsidiaries: Tri-State Power (TSP) and Tri-Star Enterprises (TSE). TSP operates exclusively as a regulated monopoly, providing electric utility services to 1.5 million customers in the mid-western US. TSE, on the other hand, operates two related businesses in the same geographical area. TripWire Internet (TWI) is an ISP that offers high-speed internet service over power lines, and Midwest EduTech (MET) installs and maintains distance learning facilities for colleges and universities within the region. In addition to these two wholly-owned subsidiaries, TSE owns a 40% stake in Midwest Propane (MWP), a regional chain of retail outlets specializing in propane and propane accessories. So far, MWP has been TSE's only consistently profitable investment. All of Tri-Star's businesses are unregulated.

BACKGROUND

Tri-State Holdings has existed in its current organizational form since 1987. Since then, Tri-State has been actively engaged in developing its unregulated businesses within the Tri-Star subsidiary. Unfortunately, though, these efforts have met with limited success. TWI's power-line internet service was popular in the first year after its introduction, but competition from DSL and cable internet providers has tightened profit margins in recent years, and technical support costs have soared. As a result, TWI has generated net losses in each of the past 4 years.

Midwest EduTech has been moderately successful; however, the market for its services is rather small, and universities in the region have been slow to develop distance learning courses. MET's net income is positive, but not large enough to have a material effect on Tri-State's bottom line. Furthermore, its prospects for significant growth are limited.

In terms of return on investment, Tri-Star's crown jewel is its 40% equity stake in Midwest Propane. This chain of some 140 retail propane outlets remains consistently profitable, and paid a dividend to Tri-Star of over $9.5 million last year. No changes in MWP's profitability or dividend policy are expected in the foreseeable future.

Tri-Star's attempts to develop unregulated businesses have been costly; between 1995 and 1999, Tri-state Holdings transferred a total of $550 million in cash to TSE, recording the transactions as inter-company receivables. In January 2000, Tri-State agreed to accept additional equity shares in TSE in exchange for the receivable. That is, Tri-State effectively forgave the debt, since TSE was already a wholly-owned subsidiary.

In March 2000, Tri-State Holdings announced a plan to spin off its unregulated businesses into a separate, publicly-traded entity. The transaction would be conducted as a rights offering; for every four Tri-State shares owned, shareholders would be offered the chance to purchase for $15.00 one newly created share of TSE. With approximately 40,000,000 Tri-State shares outstanding, the plan would result in a cash infusion of almost $150 million if fully subscribed. Under the plan, this new equity capital would be used to reduce the long-term indebtedness of TSE. This would give TSE a debt-to-assets ratio of about 14%, which is in line with the industry average for internet service providers. The new shares, if fully subscribed, would amount to a 95% stake in the newly-public firm. The remaining 5% interest would be withheld, to be used as incentives for the management team taking control of TSE. These shares would eventually be paid out to senior executives in the form of stock options.

The Asset Allocation Agreement calls for TSE to take with it the assets related to its unregulated operations. According to the post-split forecast, this would amount to approximately 20% of the holding company's current assets, and fixed assets (related to the ISP and distance learning divisions) amounting to about 15% of the combined total. In addition, TSE would continue to hold its stake in Midwest Propane.

The liabilities are to be allocated to the entities primarily responsible for incurring them; in total, this amounts to about 26% of current liabilities allocated to TSE, and about 15% of long-term debt. (The bulk of Tri-State Holdings' long-term debt capital consists of $1.4 billion in Equipment Trust Certificates backed by its electric generation facilities. This debt would necessarily remain with TSP.) Detailed pro-forma income statements and balance sheets for the two separate entities are provided in Exhibit 1.

In disclosing the plans for the spinoff, the board of directors announced that Robert Witless, chairman and CEO of Tri-State Holdings had agreed to leave his current post in order to take the reins as chief executive of TSE. Three other senior executives of Tri-State announced their plans to follow suit. Daniel Ocean, Executive Vice President of utility operations would take the helm at TSP.

REACTION TO THE PROPOSAL

The proposal was met with some trepidation by both stockholders and regulators. Stockholders expressed concern that they were being called upon to invest an additional $15 per share. Some worried that this new investment in a high-tech business would involve a level of risk that they (as holders of a utility stock) were not accustomed to. Of course, choosing not to participate in the rights offering was not an attractive option either; stockholders who didn't exercise their right to buy TSE shares would likely suffer a substantial loss of value as a result of dilution.

Chairman Witless addressed these concerns in a press release: "Shareholders will not be harmed by this transaction; rather, they will benefit. Those who are concerned about the risk should take note that no new lines of business are being proposed; whatever risks exist in the unregulated segments already exist for Tri-State Holdings. Shareholders who are uncomfortable with the level of risk inherent in the internet services industry will now have the ability to liquidate their interest in TSE and invest fully in the electric utility business if they so desire. This flexibility will add value for all shareholders by giving them a choice."

"As for the concerns about dilution of ownership for those who choose not to participate: Obviously, we won't know the actual value of TSE until trading begins. However, our investment bankers at Morgenstern & Co. have conservatively estimated a target price of approximately $33 per share, based on the industry-standard P/E multiple of 12. Given that the shares are being offered first to existing Tri-State shareholders at a price of $15, we recommend that all shareholders think carefully before passing up this opportunity."

The Midwest Utility Ratepayers' League (MURL), a non-profit utility industry watchdog group, was more skeptical. "This is just another corporate scheme to benefit executives and shareholders at the expense of utility customers" said Linda Alderson, spokesperson for MURL in a televised interview. "Tri-State Power is a regulated monopoly. The price of electricity is established by the state public utility commission based on the profitability of the utility company. With this transaction, Tri-State is proposing to spin off its most profitable businesses. I'm willing to bet that as soon as it's approved, Tri-State will petition the PUC for a rate increase on the basis that it's no longer earning a 'fair and reasonable' rate of return for its shareholders!"

Despite the objections, Tri-State Holdings submitted its reorganization plan for final approval by the Public Utility Commission of Missouri on June 1, and is currently awaiting a decision.

QUESTIONS

1. What do you make of Tri-State's proposed spinoff of its unregulated businesses? Conduct a ratio analysis of the firm as it currently exists and of the two former subsidiaries after the split (DuPont Analysis may be useful here). What would be the effect of the transaction in terms of liquidity, asset utilization, profitability, and leverage?

2. Consider the effect of the transaction on Tri-State Holdings' stakeholders: employees, customers, creditors, and stockholders. Who stands to benefit from the transaction? Who stands to lose?

3. Do you agree with Witless' claim that the split will create value for shareholders by giving them more flexibility in allocating their investments?

4. What do you think of the January 2000 conversion of Tri-State's receivable into Tri-Star Equity?

5. As a consultant hired to represent Tri-State Holdings, what arguments would you make in order to justify the transaction to the Public Utility Commission, the shareholders, and the customers? How would you counter the claims made by MURL?

6. As a member of the Public Utility Commission, would you be inclined to grant approval to Tri-State's proposal? Why or why not? If not, what modifications would you make to the plan in order to make it acceptable?

Exhibit 1. Tri-State Financial Statements

Consolidated Financial Statements

	12/31/2000 (actual)	12/31/2001 (forecast)	Post-Split Forecast (2001) TSP	TSE
Assets				
Current Assets				
Cash	133,840	139,200	111,360	27,840
Accounts Receivable	117,110	121,800	97,440	24,360
Inventories	50,190	52,200	41,760	10,440
Marketable Securities (MWP Stock)	33,460	34,800		34,800
Total Current Assets	334,600	348,000	250,560	97,440
Fixed Assets (net of depreciation)				
Electric Generation plant / eqpt	2,120,528	2,205,450	2,205,450	
Internet service eqpt	376,425	391,500		391,500
Distance Learning eqpt	12,548	13,050		13,050
Net Fixed Assets	2,509,500	2,610,000	2,205,450	404,550
Intangible Assets (Goodwill)	501,900	522,000	417,600	104,400
Other Assets	836,500	870,000	696,000	174,000
Total Assets	4,182,500	4,350,000	3,569,610	780,390
Liabilities				
Current Liabilities				
Accounts Payable	70,266	73,080	58,464	14,616
Accrued Liabilities	163,954	170,520	119,364	51,156
Short-term debt	175,665	182,700	127,890	54,810
Current portion long-term debt	93,688	97,440	77,952	19,488
Other Current Liabilities	81,977	85,260	68,208	17,052
Total Current Liabilities	585,550	609,000	451,878	157,122
Long Term Debt	1,673,000	1,740,000	1,479,000	111,000
Deferred Liabilities	627,375	652,500	489,375	163,125
Other Liabilities	167,300	174,000	130,500	43,500
Total Liabilities	3,053,225	3,175,500	2,550,753	474,747
Common Stock	169,391	176,175	176,175	10,000
Additional paid-in capital	451,710	469,800	469,800	140,000
Retained Earnings	508,174	528,525	528,525	-
Total Shareholders' Equity	1,129,275	1,174,500	1,174,500	150,000
Total Liabilities and Equity	***4,182,500***	***4,350,000***	***3,725,253***	***624,747***
Revenue				
Electric Power	1,003,800	1,045,800	1,045,800	
Internet Services	157,740	164,340		164,340
Distance Learning	23,900	24,900		24,900
Minority investment in MWP	9,560	9,960		9,960
Total Revenue	1,185,440	1,245,000	1,045,800	199,200
Cost of Sales				
Electric Power	384,083	403,380	403,380	
Internet Services	71,838	75,447		75,447
Distance Learning	4,030	4,233		4,233
Total Cost of Sales	459,951	483,060	403,380	79,680
Selling, General, and Administrative	149,365	156,870	131,771	25,099
Operating & Maintenance Expense	186,707	196,088	164,714	31,374
Depreciation and Amortization	197,376	207,293	174,126	33,167
Total Indirect Expenses	533,448	560,250	470,610	89,640
Interest Expense	130,398	136,950	130,103	6,848
Earnings Before Tax	61,643	64,740	41,707	23,033
Income Tax	15,411	16,185	10,427	5,758
Net Income	***46,232***	***48,555***	***31,281***	***17,274***

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