UB School of Management

University at Buffalo The State University of New York

Case Study on Credit Analysis – MGF 661

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Business

S. M. Hauling Company is a Buffalo based trucking corporation engaged in the transport of gravel, dry concrete mix, salt, and road construction waste material. The company is operating since last 20 years. The company owns a fleet of 22 trucks and charges its customer by the hour or by the ton of materials. S. M. Hauling Company is affiliated with Sheridan, Inc and Sam Transportation Lines.

Nature of Operations

1. The company operates as a subcontractor for the delivery of road salt to the counties of Niagara and Orleans in the State of New York. This relationship has been in effect for six years generating an average of $500,000 in revenue each year.
2. The company transports gravel and raw concrete components to a concrete manufacturer. This work has averaged $400,000 in revenue per year. An additional contract was signed in the latest fiscal year which increased the total revenue to $600,000 per year. This relationship goes back to over 20 years.
3. The company works as a subcontractor for a major road paving company that does a substantial amount of work for the New York State Department of Transport. This work requires transporting old concrete and road waste materials from the job site to a certified disposal area and transporting new gravel base and blacktop material to the job site. Although work was down during the latest fiscal year, the company has at present a confirmed contract that will generate a minimum of $1.3 million in revenue this year. This work is generally less predictable depending upon how much road work is being done. The relationship goes back to over 10 years.

In addition to the above, the company has a good chance to pick up a $1 million contract with a construction company for the transportation work on the site of a new supermarket. This will involve hauling waste material away from the site and bringing base materials to the job site.

Loan Request

S. M. Hauling is requesting two loans from our Bank.

1. A line of credit of $100,000 secured by accounts receivables.
2. A 4-year term loan of $515,000 to be used to pay-off a loan of $300,000 to another bank and the remaining amount of $215,000 to buy equipment. This loan will be secured by net plant and equipment as shown in the latest fiscal year balance sheet of the company as well as the affiliated companies. The loan will be guaranteed by the Small Business Administration - SBA (a federal government agency) in the event the company defaults on the loan. However, the guarantee will only be for 80% of the remaining balance at the time of default, the rest will be the bank's risk.

Camels Rating

- **Capital Adequacy:** As per the financial statement, the retained earnings of the company have reduced by approximately 11%, Long term borrowings of the company have reduced significantly by 51% which has pulled the liabilities down as compared to the previous years
- **Asset Quality:** The client has requested for a line of credit for $100,000 in order to meet their working capital expenses. As per discussions with the client, this line of credit will be secured with 75% of all AR, which amount to $181,500

  The client has also requested for a 4-year term loan of $515,000 which will be secured through net assets of S.M Hauling, Sheridan Inc, and Sam Transportation lines amounting to $319,000 (Schedule A) which is not sufficient to mitigate the risk of default, however, the loan will be guaranteed by 80% of the loan amount by the Small Business Administration - SBA in the event the company defaults on the loan, the rest will be at the bank's risk.
- **Management Quality:** Sheridan Inc is holding S.M Hauling and Sam Transportation Lines, Inc which are altogether owned by Sam Maggio, This shows that as Sam himself is the CEO and owner of

company and its fellow subsidiaries, there are less chances of taking any expert services in his business, There is concentration of managerial power in one hand which leads to operational mismanagement and low productivity due to lack of specialization. As per the income statement its observed that the revenue has drastically dropped and there are losses, which shows the inefficiency in managing business by him in recent years. But it should be noted that he has built a good relationship with the contractors. All of the 3 ongoing operations are almost running for more than 5 years with the oldest relationship going back to almost 20 years and if improvements are made by the management, company can stabilize in the long run and revive from its losses.

- **Earnings record:** As per the financial statements of the S.M Hauling, the revenues are showing a decreasing trend, the revenues have declined by 20.40% in comparison with previous years. As revenues are declining, the company has reported net loss in the latest financial year. It can be observed that the profits are going down every year.

  For Sam Transportation Inc and Sheridan Inc, the revenues have declined by 20% and 48% respectively, and both the companies have reported losses which shows the operational incompetence.

- **Liquidity Position:** Current ratio and quick ratios of the company state that the liquidity position of the company is deteriorating, for every dollar of current liabilities the company has 67 cents to offer. Further, the company has 59 cents in cash and accounts receivable as per the quick ratio. The working capital of the company is negative which states that the company's operations are inefficient, and funds are inadequate to support its day to day working.

- **Sensitivity to market risk exposure:** S.M. Hauling being a trucking corporation provides services such as Storm Maintenance, Landfill Construction, Liner Development, Sediment Structures, Material Transporting, Equipment Transporting, etc. and such companies are exposed to various market risks; as they are engaged in transportation of raw materials and equipment, they run on very thin margin as transportation cost, loading, unloading cost are involved, a minor increase in the cost would impact its transportation business. It has been observed in the past that Federal Reserve increases the rates in patterns usually to combat inflation. Increase in rates have a major effect on Cost of Capital - the interest rates used in borrowing money to fund new equipment and facilities. Series of lifts in interest rates will topple freight markets and damage fleet finances.

Also, risk of maintaining the quality of service is present as truck drivers involved in this business are expected to deliver on time and maintain good business relationship with customers, delay in service can negatively impact the age-old relationship with clients

Further, Sheridan, Inc. which acts as a real estate company will be majorly affected by rise or fall in interest rates. As interest rates go down people tend to invest more in the real estate by taking loans and if interest rates increase people will avoid taking loans due to high rates.

Guarantees:

(a) Personal guarantors provided by owners/management, or any corporate guarantees

- ✓ The loan will be secured by net plant and machinery worth $567000 as per the latest year's balance sheet
- ✓ The loan will be secured through personal guarantee of Sam Maggio, i.e. in case of default, his personal assets can be used to fulfill the loan requirement

(b) Government guarantee such as SBA

- ✓ The loan will be guaranteed by the Small Business Administration - SBA (a federal government agency) for 80% of the term loan amount

Trends on Cash flow from operating activities:

As per the cash flow statement, it is evident that here has been a drop in the cash flow from operating activities by approximately 26%. This is mainly because of decline in the revenues of the company by 21% in comparison with previous year. Further, cash collection from customers have plunged down by 21.32% which has affected the cash inflow

As a result of decrease in revenue, the direct costs have decreased which is favorable however, the gross margin has declined by approximately 11%

Major Cash Inflow:	Amt in $(000)	Major Cash Outflow:	Amt in $(000)
Gross Revenue	1689	Direct Costs	1389
Changes in A/c's & Notes Rec	45	Cash Payment for Expenses	169
Cash Income	217	Interest expense	67
		Changes in A/c's & Notes Pay	41
Total	**1951**	Total	**1666**

Scoring Model: Score of S.M. Hauling Company is 1.83 which is above 1.81 so there are chances of company to succeed in the near future and it's likely that the company would not make a default in the repayment of the loan amount, although it's subsidiary company Sheridan, INC has a poor performance. The other company Sam Transportation Lines is showing good signs. If we look at an average score of all the 3 companies, it is higher than 1.81 which is the standard benchmark

Ratio Analysis for Scoring Model:

- The Working Capital to Total Assets ratio measures a company's ability to cover its short-term financial obligations. This ratio provides insight as to the liquidity of the company and by analyzing the ratio for all the 3 companies it falls below the standard benchmark for all the 3 years. Company needs a line of credit of $100,000 which will be secured against account receivables and also company is expecting to pick up future contract of $1 million which will generate additional revenue along with the ongoing projects, which will help to improve its day to day operations
- Retained Earnings to Total Assets: The ratio of retained earnings to total assets helps measure the extent to which a company relies on debt, or leverage, the lower the ratio, the more a company is funding assets by borrowing instead of through retained earnings which, again, increases the risk of bankruptcy if the firm cannot meet its debt obligations. As working capital is not sufficient, this ratio shows that the company uses borrowings to run its business and is highly leveraged.
- Earnings before taxes to Total Assets: The pretax earnings of the company is negative and thus the ratio is negative as well, its shows that the profitability of the company through its assets is not up to the mark and assets are not utilized effectively.
- Equity to Liabilities: This ratio shows the amount of leverage the company uses to manage its business and the higher leverage indicates higher risk for shareholders, the company's ratio shows that the borrowing of the company is used to finance its operations, its shows that the company currently is not stable to service its long-term debt and its daily operations.
- Total Revenue to Total Assets: This ratio shows the company's efficiency in managing its assets in relation to the revenue generated. The higher this ratio, the smaller the investment required to generate sales revenue and, therefore, the higher the profitability of the company. As of now the ratio

of the company is 1.95 which shows that the company is generating 1.95 dollar of sales for every dollar invested in assets, which is favorable

Loan recommendation

We are accepting the term loan request and the line of credit request of S.M Hauling under the condition that the client will comply to the covenants listed below.

The covenants are as follows:

1) Assignment of $300,000 life insurance policy covering Sam Maggio shared with the line of credit of 100,000 USD
2) Interest at the rate of 3% annual compounded if loan is borrowed by way of line of credit
3) The interest rate of 5% will be applicable plus any administrative fees compounded annually till the repayment of the term loan of 4 years
4) Maintenance of asset quality at existing or better levels
5) Usage of sanctioned term loan amount towards paying the existing loan with other bank and purchase of plant and machinery only
6) Full disclosure of information of loans annually
7) Minimum Current Ratio of 1.0 by the end of first year of operation
8) Improve the working capital by the end of first year operation post loan sanction period
9) Borrower will not borrow money from others without bank's consent
10) Inform the bank immediately if there is a change in ownership of the company

Scoring Model			
S.M. Hauling Company			
	Year 1	Year 2	Year 3
X1 = Working Capital/Total Assets	0.067194	0.012592	-0.16241
X2 = Retained Earnings/Total Assets	0.298419	0.316894	0.310905
X3 = Earnings before Taxes/Total Assets	0.034585	0.022036	-0.01856
X4 = Total Equity/Total Liabilities	0.398943	0.429587	0.41358
X5 = Total Sales or Revenues/Total Assets	2.096838	2.262329	1.959397
Score	1.969063	2.12317	1.836309
Sheridan,INC.			
	Year 1	Year 2	Year 3
X1 = Working Capital/Total Assets	-0.02488	-0.04865	-0.02198
X2 = Retained Earnings/Total Assets	0.482587	0.567568	0.549451
X3 = Earnings before Taxes/Total Assets	0.014925	0.054054	-0.02747
X4 = Total Equity/Total Liabilities	0.932692	1.3125	1.219512
X5 = Total Sales or Revenues/Total Assets	1.189055	1.043243	0.67033
Score	1.124313	0.992453	0.640597

Sam Transportation Lines			
	Year 1	Year 2	Year 3
X1 = Working Capital/Total Assets	0.230769	0.232877	0.072464
X2 = Retained Earnings/Total Assets	0.215385	0.219178	0.057971
X3 = Earnings before Taxes/Total Assets	0.015385	0.328767	-0.10145
X4 = Total Equity/Total Liabilities	0.27451	0.280702	0.061538
X5 = Total Sales or Revenues/Total Assets	6.584615	6.616438	4.942029
Score	6.164555	6.204766	4.6195

Score of S.M. Hauling Company for all the 3 years is above 1.81 which shows company is in a good shape though it's subsidiary company Sheridan, INC has a poor performance. The other company Sam Transportation Lines is showing good signs. If we look at an average score of all the 3 companies, it is higher than 1.81 which is the standard benchmark.

The Working Capital to Total Assets ratio measures a company's ability to cover its short-term financial obligations. This ratio provides insight as to the liquidity of the company and by analyzing the ratio for all the 3 companies it falls below the standard benchmark for all the 3 years. Company needs a line of credit of $100,000 which will be secured against account receivables and also company is expecting to pick up future contract of $1 million which will generate additional revenue along with the ongoing projects.

Gross Margin - It is to be mentioned here that at the time of assessment company had gross Margin of $541,000 for all of the 3 companies in the year 1 which came down to $508,000 and $373,000 in the year 2 and year 3 respectively. This drop is a cause of concern.

Retained Earnings – There is not much of an increase in Retained earnings percentage from year 1 to year 2 and 3 respectively.

Working Capital – Looking at the working capital it seems to be in a bad shape for the company as seen from the ratios.

It is also observed that account receivables of both the companies has dropped from in year 2 and year 3 as compared to year 1 except for the subsidiary SAM Transportation which shows an increase.

Asset Turnover ratio – This ratio shows favorable signs for all the 3 companies including the subsidiary. Such higher ratio is an indicator that hat the company is efficient in generating sales or revenues.

Sensitivity to market risk exposure

S.M. Hauling Company is a Trucking Corporation Company which is engaged in transportation various materials. Trucking corporations are exposed to various market risks as they are engaged in transportation of raw materials and equipment's. They offer various services such as Storm Maintenance, Landfill Construction, Liner Development, Sediment Structures, Material Transporting, Equipment Transporting, etc. A slight increase would have a little impact on trucking business. It has been observed in the past that Federal Reserve increases the rates in patterns usually to combat inflation. Increase in rates have a major effect on Cost of Capital - the interest rates used in borrowing money to fund new equipment and facilities. Series of lifts in interest rates will topple freight markets and damage fleet finances.

Also, Sheridan, Inc. which acts as a real estate company will be majorly affected by rise or fall in interest rates. As interest rates go down people tend to invest more in the housing by taking loans and if interest rates increase people will avoid taking loans due to high rates.

Looking at the company profile, this company was organized 20 years ago by a single owner. Looking at the current reputation of the company, all the ongoing operations look favorable for the company.

Talking about the relationship, Sam Maggio the President and CEO has built a good relationship with the contractors. All of the 3 ongoing operations are almost running for more than 5 years with the oldest relationship going back to almost 20 years. This shows the consistency and the kind of quality work the company is delivering.

Looking at the values and the Business strategy adopted Mr. Sam Maggio the company has been on a good road map for 20 years and the Future projections also shows favorable signs for the company in the coming years.