**HAMPTON CASE STUDY**

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**Summary of Loan Terms**

Hampton Machine Tool Company had requested the renewal of an existing $1 million loan originally due to be repaid on September 30. Also, the company was asking for an additional loan of $350,000 for planned equipment purchases in October. Both loans’ principal, totaling $1.35 million, would be repaid at the end of 1979 and the interest was paid monthly with an interest rate of 1.5% per month (about 18% annually).

The initial loan of $1 million is to facilitate purchasing the stock of several dissident shareholders and it was to be taken down at the end of December 1978. Specifically, the proceeds of the loan, plus $2 million in excess cash were used immediately to repurchase 75,000 shares of Hampton’s $10 par value stock from several dissident shareholders at an aggregate cost of $3 million.

Besides, the additional loan of $350,000 is used to purchase the equipment in October to maintain production efficiency. This equipment has an estimated life of eight years and an estimated net salvage value of zero, and the $350,000 purchase price will be depreciated on a straight-line basis.

1. **Company Analysis**

Using the “5 C’s of credit” to evaluate Hampton Machine Tool Company:

* Capacity:

Although Hampton suffered a setback as 1978 sales were far below capacity, its ROA in 1978 was about 13.33% and ROE was about 30%, indicating that the company still had a strong operational ability.

Hampton’s selling terms were 30 days net, indicating that the client needs to pay up to 30 calendar days (not business days) after they have been billed. Also, based on the analysis of the company’s historical turnover rate, its account receivables turnover ratio in 1978 was about 4.2 times and the account receivables turnover period was about to 86 days, which was about three times of the 30 days. This indicates that Hampton had a slow collection, long aging, and time mismatch issues, which were not conducive to the company’s future production and operation activities and may even impact its ability to repay the loan on time.

On August 31, 1979, Hampton’s backlog of unfilled orders amounted to about $16,500,000, about 90% of annual capacity, showing that the company was competitive in this industry with a lot of sales orders. Besides, the company finally received the delayed components and just finished the $1,320,000 work in progress in early September, and the remainder of work-in-progress inventories will probably remain stable. This is a good sign to see the relief of a substantial backlog of sales orders, which also means the company can receive the remaining cash from customers to finish the deal.

With raw materials and components supply assured and the efficiency provided by the new equipment planned to purchase, the backlog sales order and shipment forecasts are expected to be met for the rest of the year 1979. This means the company will have the ability to repay their loan later this year once they finish the order as scheduled.

* Collateral:

Hampton can use its assets, including real estate, equipment, inventory, and account receivables as collateral.

* Capital:

The Liabilities to Assets (L/A) ratio: 3262/5872 = 56%, which means 56% of funds provided by creditors and 44% provided by shareholders.

* Conditions:

Hampton’s major customers included the aircraft manufacturers and automobile manufacturers in the St.Louis area. During its recovery period, the several years before 1978, military aircraft sales had increased substantially, reflecting both an expanding export market and a more benign domestic market. The segment of Hampton’s market in the automobile manufacturers area had stabilized. Finally, Hampton’s market share increased in the regional capital goods industry because many thinly competitors failed. The expanding export market and increased regional market were good for raising Hampton’s sales, which enhanced its ability to repay the loan.

* Character:

Hampton was established in 1915 with about 64 years of history, successfully weathering the severe cyclical fluctuations of the machine tool manufacturing business. Due to its conservative financial policies, strong working capital positions were maintained traditionally as a buffer against economic uncertainty. Therefore, during the ten years before December 1978, the company had no debt on its balance sheet, indicating that Hampton had a good management history and financial planning.

Hampton had traditionally kept its ample cash balances on deposit at the St. Louis National Bank and the bank’s management knew Mr. Cowins well, which means the bank and the company had other business transactions, and they have always maintained a good relationship.

As the president of Hampton, Mr. Cowins, 58 years old, is widely respected in the business community as an energetic and successful executive. Therefore, Hampton is quite trustworthy with an experienced and respectful executive.

1. **Financial Analysis**

Based on the historical financial statement and the company statement, a projected cash budget, income statement, and balance sheet are created as below:

Projected cash budget from September 1979 to December 1979 (thousands of dollars)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | September | October | November | December |
| Cash from account receivables | 684 | 1323 | 779 | 1604 |
| Cash from bank loan |  | 350 |  |  |
| Total cash inflow | 684 | 1673 | 779 | 1604 |
| Cash for account payable | 948 | 0 | 0 | 0 |
| raw material | 600 | 600 | 600 | 600 |
| other expenses | 400 | 400 | 400 | 400 |
| new equipment | 0 | 350 | 0 | 0 |
| tax payment | 181 | 0 | 0 | 181 |
| Interest payment | 15 | 15 | 20.25 | 20.25 |
| Principal payment | 0 | 0 | 0 | 1350 |
| Total cash outflow | 2144 | 1365 | 1020.25 | 2551.25 |
| Beginning cash balance | 1559 | 99 | 407 | 165.75 |
| net cash | -1460 | 308 | -241.25 | -947.25 |
| Ending cash balance | 99 | 407 | 165.75 | -781.5 |

*PS: Assume account receivable and account payable are net 30 days.*

Projected Income Statement from September 1979 to December 1979 (thousands of dollars)

|  |  |
| --- | --- |
| Sales | 7537 |
| Costs | 5787 |
| Gross profit | 1750 |
| Interest expenses | 70.5 |
| EBT | 1679.5 |
| tax payment | 771.16 |
| NI | 908.34 |
| Dividend | 150 |
| R/E | 758.34 |

Projected Balance Sheet from September 1979 to December 1979 (thousands of dollars)

|  |  |
| --- | --- |
| Cash | -781.5 |
| Accounts receivable, net | 2265 |
| Inventories | 3024 |
| Current assets | 4507.5 |
| Gross fixed assets | 4360 |
| Accumulated depreciation | 3137 |
| Net fixed assets | 1223 |
| Prepaid expenses | 420 |
| Total assets | 6150.5 |
|  |  |
| Accounts payable | 600 |
| Accruals | 552 |
| Taxes payable | 888.16 |
| Current liabilities | 2040.16 |
| Net worth | 4110.34 |
| Total liabilities and net worth | 6150.5 |

**Ratio Analysis of the year 1979 financial statement**

* Profitability analysis:

ROA: (908+914)/ 6150.5 ≈ 29.62%

ROE: (908+914)/4110.34 ≈ 44.33%

* Operating capacity analysis:

Account receivables turnover ratio: (7537+8668)/2265 ≈ 7.15

Account receivables turnover period: 360/7.15 ≈ 50 days

* Solvency analysis:

Earnings/ bank loan: (908+914)/1350 ≈ 1.35

Account Receivable/ bank loan: 2265/1350 ≈ 1.68

The liabilities to assets (L/A) ratio: 2040/6151 ≈ 33.17%

Based on the financial analysis, Hampton does not have the ability to repay the loan at the end of 1979 as Mr. Cowins promised because the company’s ending cash balance is expected to be negative about -$782,000. This can be due to the backlog of the sales order and the 30 days net that the company will collect the account receivables until the next month.

Although the company might perform badly at the end of 1979, the loan is still attractive with a high annual interest rate of about 18% and a short-term period. In terms of profitability analysis, the company has strong profitability with ROA at 29.62% and ROE at 44.33%, showing its products are highly competitive and profitable. Compared with 1978 figures, ROA about 13.33% and ROE about 30%, the company’s profitability increased greatly.

In terms of operating capacity analysis, its projected account receivables (A/R) turnover rate is about 7.15 times and the projected A/R turnover period is about 50 days. Compared with 1978 figures, A/R turnover ratio about 4.2 times and A/R turnover period about 86 days, the company will collect its account receivables more quickly, helping to shorten its A/R aging. Although the average A/R turnover ratio is expected to be higher than before, its turnover period is still longer than 30 days, which still impairs its ability to repay the loan on time.

When it comes to the solvency analysis, Hampton’s earnings and account receivable can cover the bank loan. And the liabilities to assets (L/A) ratio is expected to be lower reaching at about 33.17% compared with that figure at about 56% in 1978. This reflects the company’s conservative financial policy and the company has not reached the level of insolvency and bankruptcy.

1. **Recommendation**

It’s clear that Hampton is unable to repay the loan in December 1979, but can repay that early next year. As a lender, St. Louis National Bank needs to consider the relationship with Hampton, the company’s financial statement in the future, and the return and risk of the loan. From my perspective, the bank can agree to extend the existing Hampton note until the end of the year, plus an additional loan of $350,000 to finance equipment purchases with the following covenants.

* First, since the projected financial statements show that Hampton will default on the loans, the bank can require Hampton not to pay the dividend in December and wait until the total loan is repaid.
* Second, the bank has the right to know the new information of the company and make a covenant that the bank can add the penalty or increase the loan interest rate for the part that is not repaid on maturity.
* Third, the worst case may be that the company goes bankrupt and the loan cannot be repaid. So just in case, the company should provide collateral, such as accounts receivable, real estate, equipment, or inventory. When the loan cannot be repaid, the collateral will be legally owned by the bank to mitigate the loss.

In this way, the bank can make a profit from this loan, maintain a good relationship with Hampton with the opportunity to have more transactions in the future, and also minimize the credit risk.