

Tejas Steel Supply, Inc.

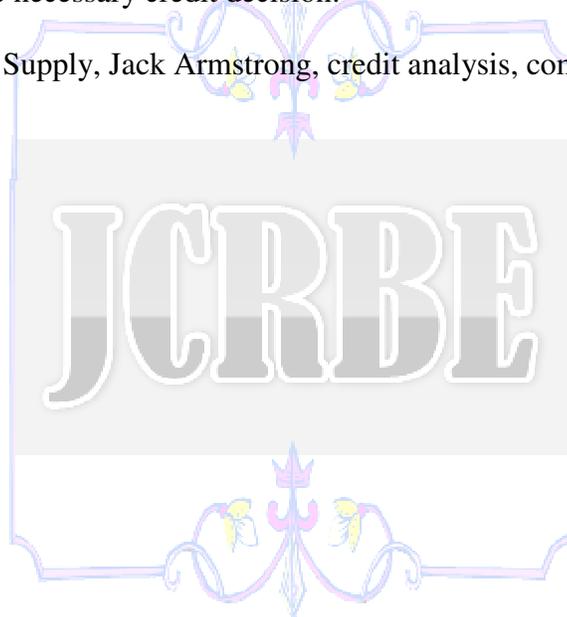
James B. Bexley
Sam Houston State University

Joe F. James
Sam Houston State University

Abstract

This case study is designed to explore the credit needs and worthiness of Tejas Steel Supply, Inc. Within the case process it will require identifying the elements necessary to evaluate a prospect for a commercial loan, to analyze financial data, to perform credit analysis, and to make a commercial loan decision. The supporting data will provide information to make the necessary credit decision.

Keywords: Tejas Steel Supply, Jack Armstrong, credit analysis, commercial loan



Introduction

In June of 2009, Mr. Jack Armstrong, President and CEO of Tejas Steel Supply, Inc. (hereinafter referred to in the case as Tejas) decided that he was not satisfied with his current bank's ability to meet his financial needs. A business associate referred him to Mr. Frank Lawrence a loan officer for Enterprise Bank.

Mr. Armstrong called the bank for an appointment with Mr. Lawrence. He received a quick response, and was told by Mr. Lawrence that he was available the following morning and that Mr. Armstrong should bring his current personal financial statement along with corporate financial statements for the past three years and the most recent quarter ended March 31st.

The next morning the two exchanged greetings, and Mr. Lawrence asked his first question, "Why do you want to leave your current bank?" Mr. Armstrong noted that they were nice people, but dealt with his banking relationship as if it were not important. Additionally, the loan officers changed frequently, causing him to have to basically start over with the relationship. Perhaps, the "last straw" came when his line of credit came up for renewal, and Mr. Armstrong requested an increase in the amount of the line of credit but could not get a response. Mr. Lawrence then asked, "What was your request?" Mr. Armstrong noted that he had told his existing bank, Community National Bank, that he needed loans totaling \$950,000 made up of a term loan currently totaling \$550,000 and a line of credit totaling \$400,000 which represents an increase of \$150,000 over his existing line. The reason for the line increase was to purchase additional inventory in response to increases in sales. Mr. Armstrong noted that he would move all of his deposits to the bank, if they made the loan. Mr. Lawrence told him that he would work-up the credit and do his investigations, and if he had any questions he would get back to him promptly.

Credit Process

Mr. Lawrence obtained a personal credit report, a National Association of Credit Managers' Report, a Dunn & Bradstreet Report, and performed credit inquiries at his existing bank and other creditors. There were no problems reported by suppliers or credit agencies, but the suppliers reported that the company never took advantage of the trade discounts.

His previous bank, First State Bank, reported that his high line of credit for the company was \$800,000 and his personal debt did not exceed the existing loan amount of \$150,000. When asked if there were problems with the credit, the officer at First State Bank said no, but sometimes Mr. Armstrong did not get statements and aging data to the bank in a timely manner.

The mortgage company reported that his \$500,000 home mortgage had paid down to \$350,000, and that Mr. Armstrong had handled the loan as agreed. Local Savings Bank has a mortgage loan on Tejas land and building with an outstanding debt of \$285,000 on a building and land currently valued at approximately \$700,000.

The Analysis and The Loan Committee

Earlier, Mr. Lawrence requested one of the bank's credit analysts to review the following documents:

1. Balance Sheets of Tejas (Exhibit 1)
2. Income Statements of Tejas (Exhibit 2)
3. Accounts Receivable Aging of Tejas (Exhibit 3)
4. Personal Financial Statement of Mr. and Mrs. Armstrong (Exhibit 4)

The analyst performed the review and provided the loan officer with the following information:

1. A ratio analysis (Exhibit 5) that examined the key ratios that would provide the loan officer with information on Tejas for the last three years and the current quarter compared with industry averages for his peers.
2. An evaluation of the accounts receivable (Exhibit 3) reflecting total receivables of \$1,009,960, with \$108,000 over 90 days. The analyst pointed out that the bank's policy was to value accounts receivable less than 90 days at 70% of the actual receivables less than 90 days.
3. A review of the inventory of Tejas indicating that the total was \$1,780,000 made up of 40% raw materials, 15% goods in process, and 45% finished goods. In providing an estimate of value of the inventory used in calculating loan value, it was the policy of the bank to value raw materials at 40%, goods in process 0%, and finished goods at 50%.
4. In response to a request by Mr. Lawrence, the analyst evaluated the current rates charged on term loans and lines of credit and found that in the past when rates were not as low as the current prime of 3½%, the bank charged prime to prime plus two percent floating for such loans. Currently, the bank's average cost of funds are 1.45% and the bank cannot make its 4% spread without putting "floors" or minimums on the rate charged on the loans.

Loan Presentation

Mr. Lawrence was ready to gather the data and prepare to present the loan to the loan committee of the bank. In preparing the loan request, you are to assume the role of Mr. Lawrence by answering the following questions and prepare the loan presentation to the loan committee:

1. What additional questions would you ask Mr. Armstrong at Tejas to help determine the favorability of making the loan or rejecting the loan request?
2. Evaluate the primary source of repayment.
3. Determine the value of the inventory for use as collateral.
4. Evaluate the accounts receivable and determine what value should be assigned for collateral purposes.
5. If you make a recommendation to make the loan, what rate would you recommend and why?
6. How would you structure this loan?
7. What would be your recommendation to the loan committee concerning this loan request?

Exhibit 1: Balance Sheet: Tejas Steel Supply, Inc.

	31-Mar 2009	31-Dec 2008	31-Dec 2007	31-Dec 2006
Cash	\$67,800	\$113,000	\$139,320	\$130,600
Accounts receivable	\$1,009,960	\$914,284	\$859,200	\$782,600
Inventory	\$1,780,000	\$1,357,600	\$1,315,200	\$1,111,800
Current assets	\$2,857,760	\$2,384,884	\$2,313,720	\$2,025,000
Land	\$100,000	\$100,000	\$100,000	\$100,000
Plant & Equipment	\$614,000	\$610,000	\$602,700	\$598,000
Depreciation	\$(280,000)	\$(270,000)	\$(230,000)	\$(190,000)
Net plant and Equipment	\$334,000	\$340,000	\$372,700	\$408,000
Total assets	\$3,291,760	\$2,824,884	\$2,786,420	\$2,533,000
Notes payable	\$800,000	\$800,000	\$650,000	\$650,000
Accounts payable	\$640,834	\$190,228	\$467,364	\$370,460
Accrued expenses	\$70,000	\$80,000	\$64,000	\$50,000
Current liabilities	\$1,510,834	\$1,070,228	\$1,181,364	\$1,070,460
Long-term debt	\$275,000	\$300,000	\$400,000	\$500,000
Total liabilities	\$1,785,834	\$1,370,228	\$1,581,364	\$1,570,460
Capital	\$100,000	\$100,000	\$100,000	\$100,000
Retained earnings	\$1,405,926	\$1,354,656	\$1,105,056	\$862,540
Total stockholders' equity	\$1,505,926	\$1,454,656	\$1,205,056	\$962,540
Total liabilities and equity	\$3,291,760	\$2,824,884	\$2,786,420	\$2,533,000

Exhibit 2: Income and Expenses: Tejas Steel Supply, Inc.

	Interim 2009	2008	2007	2006
Sales revenue	\$1,878,000	\$6,400,000	\$6,101,000	\$5,400,000
COGS	\$1,333,380	\$4,480,000	\$4,209,000	\$3,780,000
Gross profit	\$544,620	\$1,920,000	\$1,892,000	\$1,620,000
Operating expense	\$438,869	\$1,428,500	\$1,408,900	\$1,176,000
NI before taxes and interest	\$105,751	\$491,500	\$483,100	\$444,000
Interest expense	\$26,875	\$107,500	\$110,000	\$120,000
Income taxes	\$27,606	\$134,400	\$130,584	\$113,400
Profit after taxes	\$51,270	\$249,600	\$242,516	\$210,600

Exhibit 3: Accounts Receivable Aging March 31, 2009: Tejas, Inc.

Customer	Credit	Credit Days Outstndng			Before Dec. 2008
	Extended Since Feb. 28, 2009	30 days	60 days	90 days	
Frank Smith	\$33,000	\$66,000			
TIMCO	\$44,000				
Star Supply			\$20,000		
Dallas Iron Steel	\$15,000				
Thompson Supply			\$15,000	\$6,000	
Frank & Sons	\$45,000				
Houston Steel					\$25,000
Dallas Supply	\$6,000	\$5,000		\$10,000	
Huntsville Supply Co.	\$104,000				
Jacksonville Co.	\$52,000	\$3,600			
Walker Inc.	\$54,000	\$30,000	\$60,000	\$6,000	\$2,000
Liberty Co.	\$10,000				
Ramirez Brothers	\$35,600				
Larry Orr & Co.		\$15,000	\$30,000		\$34,000
Prestige Steel	\$12,000				
Great Star Inc.	\$84,000				
Ford & Sons		\$4,000	\$10,000	\$10,000	\$10,000
Austin Smith & Sons	\$45,000	\$8,000			
Dry Supply Inc.	\$26,000	\$30,000		\$5,000	
CARCO Inc.	\$(240)				
Other	\$40,000				
Total	\$605,360	\$161,600	\$135,000	\$37,000	\$71,000
Total: all receivables	\$1,009,960				

**Exhibit 4: Personal Financial Statement for Jack & Mary Armstrong
April 1, 2009**

Assets		Liabilities and Equity	
Cash	\$24,000	Notes Payable: Banks	\$150,000
Marketable securities	108,000	Notes Payable: Steel, Inc.	65,000
Loan receivables	80,000	Mortgage on home	335,000
Residence	550,000	Total liabilities	550,000
Automobiles	44,000	Equity	1,821,926
Personal Property	60,000		
Tejas Inc. Stock	1,505,926		
Total assets	\$2,371,926	Total Liabilities and equity	\$2,371,926

Salary (1998)	\$150,000
Bonus (estimated)	30,000
Other	2,000
Total Income	\$182,000

Exhibit 5: Financial Ratios: Tejas, Inc.

	Annualized 2009	2008	2007	2006	Industry Ave. 2008
Liquidity Ratios					
Current Ratio	1.892	2.228	1.959	1.892	2.100
Quick Ratio	0.713	0.960	0.845	0.853	1.000
Activity Ratios					
Average collection period	49.07 days	52.14 days	51.40 days	52.90 days	49.00 days
Inventory turnover	3.40X	3.35X	3.47X		3.60X
Financial Leverage Ratios					
Debt to equity	1.19	0.94	1.31	1.63	1.50
Coverage of interest expenses	8.99	10.15	10.15	8.57	3.5
Profitability Ratios					
Gross profit margin	29.00%	30.00%	31.01%	30.00%	30.70%
Net profit margin	2.73%	3.90%	3.98%	3.90%	3.60%
Return on total assets	6.23%	8.84%	8.70%	8.31%	5.07%
ROE	13.62%	17.16%	20.12%	21.88%	17.00%

Tejas Steel Supply, Inc. Case Solutions

- What additional questions would you ask Mr. Armstrong at Tejas to help determine the favorability of making the loan or rejecting the loan request?**

Some further questions that you may have regarding the credit of Tejas before arriving at an accept/reject decision would be: Would the increase in your line of credit be justified by the proportional increase in sales? Do you have a succession plan for management? Also, could you tell me about your management and sales staff? Who compiles your financial data? Do you have a reserve for bad debts? Tejas has a significant amount of receivables over 90 days, and we would like to know why you continue to extend credit to accounts

over 90 days? When would the bank be able to inspect your inventory and facilities? Do you understand that the loan proceeds will first be used to pay off the loan Tejas has at its present bank-- Community National Bank, and the remaining funds will go towards increasing the line of credit? All the answers to these questions will play a big part on whether or not Tejas' loan is approved. Knowing this extra information about Tejas should make the loan officer's decision a lot easier.

2. Evaluate the primary source of repayment.

When determining the primary source of repayment one must consider if the periodic needs of Tejas are being cleaned up regularly. Also, one has to consider that with the growing capital needs of Tejas leads to an increase for external financing. To meet these needs Tejas must have an adequate primary source of repayment. For most companies accounts receivable and inventory would be their primary source of repayment, but these assets seem to be tied up in other funds. So, instead of Tejas using these short-term assets for repayment, it looks like they will have to use long-term profit as their primary source of repayment. In doing so Tejas will have to depend on their product to provide long-term profitability. This could bring up some questions about Tejas' product, like is it seasonal or not, is the product very marketable, and is the product easy to sell in case of loan default?

3. Determine the value of the inventory for use as collateral.

Tejas' inventory must also be evaluated in order to see if it qualifies for the borrowing base. In order for the bank to assign a value to Tejas' inventory, it must consider its liquidation position. Since, it would be hard for the bank to complete production that is in progress so therefore no value is attached to that part of inventory. From an industry standpoint raw materials are the easiest form of inventory to liquidate. Finished goods are known to be less marketable than most raw materials this is especially evident in the case of large ticket items. Items that would be considered large are houses, machinery, and equipment. These items would have to be sold at a large discount in order to liquidate them within a timely interval. As a manufacture of pipefittings and valves, Tejas' raw materials should be relatively marketable. In turn this should cause there finished products to be relatively marketable. The values that we would assign to each inventory would be Raw materials $\$712,000 \times .40 = \$284,800$, Work-in-process $\$267,000 \times 0 = \0 , and Finished goods $\$890,000 \times .45 = \$400,500$. This gives the company a borrowing base of \$685,300 dollars on their inventory.

4. Evaluate the accounts receivable and determine what value should be assigned for collateral purposes.

Total accounts receivable amount to \$1,009,960 of which \$108,000 are over 90 days, which are not eligible. Therefore, only \$901,960 will be considered at 70% for collateral purposes, which amounts to \$631,372. Of additional concern might be the \$80,000 which is current, however, the companies that have the receivables have receivables over 90 days in addition. Perhaps, it might be wise to deduct the \$80,000 from the collateral amount as an abundance of caution.

5. **If you make a recommendation to make the loan, what rate would you recommend and why?**

The rate recommended for both loans would be prime plus 2 percent with a floor of 5.5 percent, which would allow the bank to make a minimum spread of 4.05 percent. This would also allow for the some degree of pricing for risk.

6. **How would you structure this loan?**

The loan should be structured with the term loan of \$550,000 being put on a five year term with monthly payments. Regarding the receivables line of credit of \$400,000, it should be structured as a one-year note, and reviewed on an annual basis. The accounts receivables, inventory, and raw materials should be cross-pledged on both loans. Additionally, you should have Mr. and Mrs. Armstrong guarantee the total debt. Therefore, if there were a default, you could enforce the debt personally.

7. **What would be your recommendation to the loan committee concerning this loan request?**

Mr. Lawrence would recommend approval of the loan on the basis that it was fully secured as structured in the above paragraph 6. The bank must also require an UCC-1 filing on the collateral because they do not have titles on receivables and inventory. So, therefore the bank will have a first lien filed with the state on that particular collateral. Finally, Mr. Lawrence must require a personal guarantee from Mr. Armstrong. This will give the bank the right to hold him liable if Tejas does not pay their loan.