

SellHere.com: A case in commercial bank lending

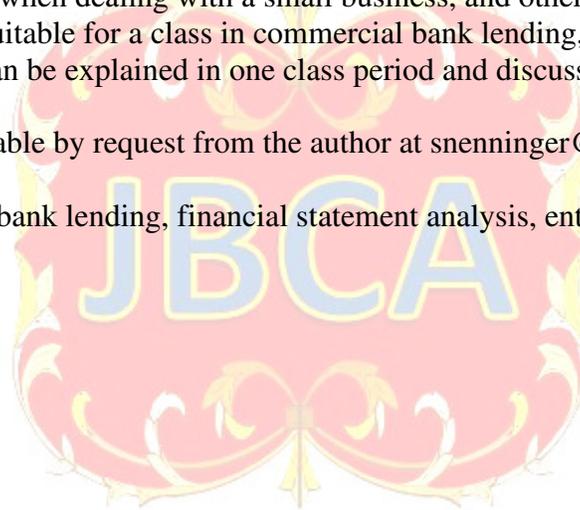
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ABSTRACT

This case describes a scenario to allow students to experience the process of analyzing a small commercial loan request from the point of view of a new loan officer at a community bank. Jay McIntyre is the owner of a small business called SellHere.com. Jay started this as a part time endeavor while working for another company. Over the past several years, the business has grown beyond its current rented office space, and Jay would like to buy his own building to continue the expansion. Through a series of questions, students consider such topics as the factors that impact a credit decision, the construction and analysis of financial statements, economic considerations when dealing with a small business, and other information which may be needed. The case is suitable for a class in commercial bank lending, small business finance, or entrepreneurship. It can be explained in one class period and discussed in the next.

Teaching Notes are available by request from the author at snenninger@shsu.edu.

Keywords: Commercial bank lending, financial statement analysis, entrepreneurship.



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INTRODUCTION

You have just been promoted from credit analyst to loan officer at First National Bank, and you have been prospecting for new clients for the past several months. During this time, you have been an active member of the local Chamber of Commerce and have met several small business owners in town. One such entrepreneur is Jay McIntyre, the owner of a business called SellHere.com. You and Jay have discussed his business in general, and you have explained to him that First National has a strong commitment to helping local small businesses by providing both deposit and loan services. Jay indicated that his operation may be expanding, and he scheduled a meeting with you at the bank.

It is now a Tuesday morning, and you have just completed the meeting with Jay to discuss a loan request. During the appointment, you have learned more about Jay and his background. He earned a degree in computer engineering from a local university and has a minor in business administration as well. While a student, he developed an online listing service for garage sales called SellHere.com. He began by just listing local garage sales in a similar fashion to the listings usually found in newspapers. He further developed the listings to include maps to each sale, the most efficient driving routes to each location, pictures of items for sale, and other features. The business became more and more popular, and Jay continued the site after he graduated in 2014 and began working full time for a different website hosting company.

As his own site became more popular, Jay has expanded his listings to include auctions and small retailers who sell antiques. The business consumed more and more of his time, and Jay decided to quit his full-time job in January of 2018 to work solely on his website and further develop the business. He started by working from home, but as the business continued to grow, he soon realized the need to rent an office for additional space. With that move to a standalone site, he also hired another programmer so he could focus more on marketing to a broader area.

In 2019, Jay began to cultivate business relationships with resale stores ranging from single stores to antique malls. The business has proven to be very lucrative as many of those stores do not have the expertise to develop and manage their own websites and their products tend to be specialty items often searched online. These businesses pay an upfront fee to be included on the SellHere website, then also pay a small percentage of each transaction. That line of business accounted for about 15% of sales in 2019, increased to 25% of sales in 2020, and reached nearly 50% of sales in 2021. This growth in business has led Jay to hire two other programmers for a total of three. He has also hired a local consulting firm to help develop a marketing strategy.

In another effort to boost brand recognition and promote the service, Jay hosted an antiques conference in 2021. He marketed this as a conference to learn current strategies of building an online presence in the antiques industry. All current customers received a discount to attend, and he marketed it to potential customers as well, but the focus was on industry information rather than his service in particular. He secured speakers to address topics including small business development, lending, marketing, and developing an online presence. His service was also prominently displayed, and several sessions included both details of his business as well as testimonials from current clients. It was a success with around 220 attendees and will likely become an annual event. He charged a fee to register, which basically covered all the cost, so he considered the event a great advertising event with no net cost to his business.

As SellHere continued to grow, it surpassed the current office space capacity. Therefore, Jay has been looking for a building to purchase and develop into a more productive working

space. You have been speaking with Jay about this possibility, and today he approached your bank with a loan request to purchase a two-story office building. The building is located in an historic, retail-focused section of town, and the current owner is leasing the first floor to a used bookstore for \$500 monthly. Jay will use the second floor of the building as his office space and continue to rent out the main floor to the bookstore, at least for now. This is an historic building with generally open space on the second floor that will be remodeled. Plans call for six offices, a kitchenette, a group meeting space, and a customer reception area. Jay believes this is an ideal building for him as it will allow for potential growth. Jay has negotiated a price of \$490,000, and the building was recently appraised at \$520,000. Total cost for renovations is expected to be about \$75,000. First National usually requires a minimum 20% down payment for this type of loan, and Jay has requested a loan for \$450,000. The loan policy states the maximum term is 15 years.

FINANCIAL INFORMATION

When Jay first started his business, it was organized as a simple sole proprietorship. His only administrative document was a DBA (Doing Business As) form that he completed with the local county clerk's office. He established a separate bank account which he used to record all receipts and expenses. With his basic business background, he was able to file tax returns including the business operations on a schedule C. Sales were less than \$20,000 annually through 2016, then grew to about \$43,000 in 2017 which was the year he decided to pursue the business full time.

In early 2018, Jay left his employer and invested \$12,000 of his savings into the business, which he then also transformed into an S-corporation. He bought \$5000 in technology equipment and deposited the other \$6000 into a business checking account. He also hired a CPA firm to prepare tax return, calculate quarterly withholdings, and process payroll. Note that on the tax returns, Jay's salary is the total listed as salary, all other wages paid fall under cost of goods sold. Jay has also prepared an annual balance sheet each year on his own with guidance from his accountant. Finally, he has also prepared a personal statement of wealth.

He feels fairly secure with the financial position of both himself and the company and believes he is generally financially conservative. One of his main concerns, however, is the tax liability generated each year on the company's income for which he is personally financially responsible. He would like to find a way to reduce that personal tax level.

Jay believes he has capacity with the current employees to continue the recent significant growth in the sales for the next two years. He believes sales will then level off a bit as he focusses on improved operations rather than overall growth. He also states that he will raise salaries around 10% each year to maintain a high-quality workforce. He has no other plans for large, fixed asset purchases other than the building, improvements, and the furniture needed

Jay is married and has 2 girls who are 4 and 1. His wife is an elementary school teacher in town, and her salary is reflected in the tax returns.

ASSIGNMENT

1. Using the financial statements given, complete a projected income statement for 2022.
2. Calculate the cash flow available to service debt for 2021 and for projected 2022.
3. Calculate the ratios below for both for 2021 and projected 2022.

	Ratio	Industry Average
Current	$\frac{CA}{CL}$	10
Debt to Assets	$\frac{Debt}{Assets}$	50%
Debt Service Coverage	$\frac{income + depr}{Current\ mat\ of\ LT\ debt}$	12
TIE	$\frac{EBIT}{interest\ exp}$	15
return on sales	$\frac{net\ income}{sales}$	20%
return on assets	$\frac{net\ income}{assets}$	15%
return on equity	$\frac{net\ income}{equity}$	25%

Questions to Discuss

1. What other issues should be addressed when considering this loan request; what questions do you have for Jay?
2. What assumptions did you make in your preparation of the financial statements?
3. What is your confidence level in the projections for next year and for the business in the next 5 to 10 years?
4. Discuss the ratios, noting how they compare to the industry average and how they change with the loan.
5. How does the rent payment compare to the new loan payment?
6. What other information would you need in making this loan decision?
7. What are the strengths and weaknesses of this loan request from the bank's point of view?
8. Does the business have the ability to provide the down payment?

9. What covenants or loan requirements would you require as a part of the loan?
10. What opportunities to cross sell other bank products to Jay might exist?
11. What do you see as potential risks to Jay's business? How could you find out more about this industry?
12. How would you structure this loan? Consider items such as loan term, interest rate, and payment schedule.
13. What economic factors might impact sales of this business - either positively or negatively?
14. Do you have any suggestions on reducing his personal tax liability?
15. Based on the analysis, would you recommend making this loan? Justify your position.



1040		U.S. Individual Income Tax Return			2021
Filing Status: Married Filing Jointly					
Jay C		McIntyre			
Monica D		McIntyre			
4586 Whispering Pines Drive					
Capital City, TX 54321					
Standard Deductions		Someone can claim: You as dependent Your spouse as dependent			
		Spouse itemizes on a separate return, or you were dual-status alien?			
Dependents:					
	Name	Social Security #	Relationship	Qualified for Child tax Credit	
	Taylor McIntyre	xxx-xx-6789	daughter	x	
	Carson McIntyre	xxx-xx-4321	daughter	x	
1	Wages, salaries, tips, etc. Attached Form(s) W2				202,475
2	Tax-exempt interest	2a	b taxable interest	2b	486
3a	Qualified dividends	3a	b ordinary dividends	3b	78
4a	IRA distributions	4a	b Taxable amount		
5a	Pensions and annuities	5a	b Taxable amount		
6a	Social Security benefits	6a	b Taxable amount		
7	Capital gain or (loss). Attach Schedule D if required.				7 421
8	Other income from Schedule 1, line 10				8 68,454
9	Add lines 1, 2b, 3b, 4b, 5b, 6b, 7 and 8. This is your total income				9 271,914
10	Adjustment to income from Schedule 1, line 26				10
11	Subtract line 10 from line 9, this is your adjusted gross income				11 271,914
12a	Standard deduction or itemized deductions (from Schedule A)				12a 25,736
b	Charitable contributions if you take the standard deduction				12b
c	Add lines 12a and 12b				12c 25,736
13	Qualified business deduction from Form 8995 or 8995-A				13
14	Add lines 12c and 13				14 25,736
15	Taxable Income. Subtract line 14 from line 11. If zero or less, enter 0				15 246,178

Schedule C		Profit or Loss From Business			2021	
(Form 1040)						
Part 1: Income						
1	Gross receipts or sales				588,395	
2	Returns and allowances plus any other adjustments				0	
3	Subtract line 2 from line 1d				588,395	
4	Cost of goods sold				238,000	
5	Gross Profit				350,395	
6	Other income, including federal and state gasoline or fuel tax credit or refund				0	
7	Gross income				350,395	
Part 2: Expenses						
8	Advertising	22,485		20	Rent or lease	7,200
9	Car and truck expenses			a	Vehicles, machinery, and equipment	
10	Commissions and fees			b	Other business property	
11	Contract labor			21	Repairs and maintenance	
12	Depletion			22	Supplies	4,193
13	Depreciation	19,860		23	Taxes and licenses	
14	Employee benefit programs	38,800		24	Travel, meals, and entertainment:	
15	Insurance	5,200		a	Travel	5,562
16	Interest:	0		b	Deductible meals and entertainment	
a	Mortgage			25	Utilities	3,856
b	Other			26	Wages	150,000
17	Legal services	1,400		27a	Other Expenses	
18	Office expense	3,985		b	Reserved for future use	
19	Pension and profit-sharing expense	19,400				
28	Total expenses before expenses for business use of home					281,941
29	Tentative profit or (loss)					68,454
30	Expense for business use of your home					
31	Net profit or (loss)					68,454

SellHere.com

Balance Sheet				
Period Ending	12/21/2018	12/31/2019	12/31/2020	12/31/2021
Current Assets				
Cash and Equivalents	17,567	56,368	37,894	36,785
Short Term Investments	0	40,000	62,000	87,000
Net Receivables	0	16,950	38,740	49,863
Inventory	0	0	0	0
Other Current Assets	0	0	0	0
Total Current Assets	17,567	113,318	138,634	173,648
Gross Fixed Assets				
Gross Fixed Assets	5,000	28,750	43,850	58,950
Less: Depreciation	525	5,005	14,855	34,715
Net Property Plant and Equipment	4,475	23,745	28,995	24,235
Intangible assets	6,000	6,000	6,000	6,000
Other Long-Term Assets	0	0	0	0
Total Long-Term Assets	10,475	29,745	34,995	30,235
Total Assets	28,042	143,063	173,629	203,883
Current Liabilities				
Accounts Payable	0	0	0	0
Current Due of Long-Term Debt	0	0	0	0
Income tax payable	0	0	0	0
Other Current Liabilities	0	0	0	0
Total Current Liabilities	0	0	0	0
Bank Loan	0	0	0	0
Long Term Debt	0	0	0	0
Total Liabilities	0	0	0	0
Equity				
Paid in Capital	16,000	16,000	16,000	16,000
Retained Earnings	12,042	127,063	157,629	187,883
Total Stockholder Equity	28,042	143,063	173,629	203,883
Total Liabilities and Stockholders Equity	28,042	143,063	173,629	203,883

Personal Statement of Wealth Jay and Monica McIntyre As of Dec 31, 2021		
Assets		
	Cash and Equivalents	25,689
	Liquid Investments	22,596
	Cash Value of Life insurance	45,000
	Value of Business Owned	203,883
	Personal Residence	295,000
	Vehicles	35,000
	Household Items	50,000
	Collectables	25,000
	Retirement Investments	96,521
Total Assets		
		798,689
Debt		
	Income taxes due	10,000
	Loans on Vehicles	28,459
	Mortgage on home	226,358
	Student Loans	52,148
Total Liabilities		
		316,965
Net Worth		
		481,724
Total		
		798,689