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Chapter 10

Evaluating Commercial Loan Requests

Fundamental credit issues

- Regardless of the type of loan, all credit requests mandate a systematic analysis of the borrower's ability to repay.
- When evaluating loan requests, bankers can make two types of errors in judgment.
  - Extending credit to a customer who ultimately defaults.
  - Denying a loan to a customer who ultimately would repay the debt.
- In both cases, the bank loses a customer and its profits are less.

Five fundamental issues

- Five fundamental issues
  - Character and data quality
  - Use of loan proceeds
  - Loan amount
  - Source and timing of repayment
  - Collateral
- In addition to these issues, credit analysis should examine risks that are unique to each loan.
  - Quality of mgt; the soundness of the business; sensitivity to economic conditions; the firm’s relationship with other creditors; etc.

Character and quality of data

- The foremost issue in assessing credit risk is determining a borrower's commitment and ability to repay debts.
- An individual's honesty, integrity, and work ethic typically evidence commitment. For a business, commitment is evidenced by the owners and senior management.
- Whenever there is deception or a lack of credibility, a bank should not do business with the borrower.
- It is often difficult to identify dishonest borrowers.
- The best indicators are the borrower's financial history and personal references.

Use of loan proceeds

- Loan proceeds should be used for legitimate business operating purposes
- Speculative asset purchases and debt substitutions should be avoided.
- The true need and use of the loan proceeds determines the loan maturity, the anticipated source and timing of repayment, and the appropriate collateral.
- One common pitfall is to focus too much on collateral and end up financing a firm's long-term needs with short-term notes.

Loan Amount

- The amount of credit required depends on the use of the proceeds and the availability of internal sources of funds.
- Borrowers often ask for too little in requesting a loan and return later for more funds.

Primary source and timing of repayment

- Loans are repaid from cash flows.
- Four basic sources of cash flows:
  - Liquidation of assets
  - Cash flow from normal operations
  - New debt issues
  - New equity issues

Collateral

- Collateral is the security a bank has in assets owned and pledged by the borrower against a debt in the event of default.
- Liquidating collateral is clearly a second best source of repayment for three reasons:
  - There are significant transactions costs associated with foreclosure. (Time, money.)
  - Bankruptcy laws allow borrowers to retain possession of the collateral long after they have defaulted.

What can be collateral?

- Virtually any assets, or the general capacity to generate cash flow, can be used as collateral.
- Collateral must exhibit three features:
  - Its value should always exceed the outstanding principal on a loan.
  - A lender should be able to easily take possession of collateral and have a ready market for sale.

Evaluation: A four-part process

- The purpose of credit analysis is to identify and define the lender's risk in making a loan.
- Four-part process:
  - Overview of management, operations, and the firm's industry
  - Common size and financial ratio analysis
  - Analysis of cash flow
  - Projections and analysis of the borrower's financial condition

Step 1: Overview of management, operations and industry

- Background information on the firm's operations
  - Organizational and business structure
  - Products or services provided
  - Competitive position in the marketplace
  - Business and industry outlook report
  - Management character and quality
  - The nature of the borrower's loan request and the quality of the financial data provided.

Step 2: Common size and financial ratio analysis

- Common size ratio:
  - divide by total assets (balance sheet) or net sales (income statement).
  - It is adjusted for size and thus enables comparisons across firms in the same industry or line of business.
  - The figures can be distorted, if a firm has one balance sheet or income statement item that differs sharply from industry standards.

Financial ratio analysis

- Four categories
  - Liquidity ratios: indicate its ability to meet its short-term obligations and continue operations.
  - Activity ratios: signal how efficiently a firm uses assets to generate sales.
  - Leverage ratios: indicate the mix of the firm's financing between debt and equity and potential earnings volatility.
  - Profitability ratios: indicate the firm's sales and earnings performance (ROE, ROA).

Step 3: Cash flow analysis

- Cash flow estimates are compared to principal and interest payments and discretionary cash expenditures to assess a firm's borrowing capacity and financial strength.
- Cash flows:
  - Operating activities
  - Investing activities
  - Financing activities

Step 4: Financial projections

- The previous 3 stages: historical performance
- The final step addresses the future conditions.
- In order to understand the range of potential outcomes, an analyst should make forecasts that incorporate different assumptions about the future.
- Sensitivity analysis:three alternative scenarios

Risk-classification scheme

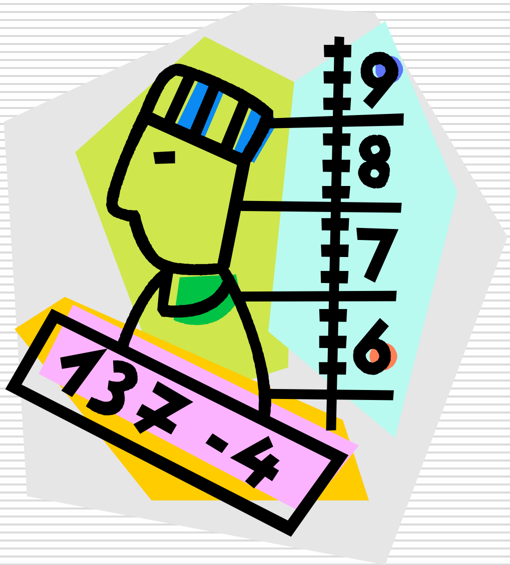
- After evaluating the borrower's risk profile along all dimensions, a loan is placed in a rating category ranked according to the degree of risk.
- Such a system is used for credit granting and pricing decisions.

Two types of errors in judgment:

- Type I Error
  - Making a loan to a customer who will ultimately default
- Type II Error
  - Deny a loan to a customer who would ultimately repay the debt.

Ratio analysis

- Liquidity and activity ratios
- Leverage ratios
- Profitability ratios



Liquidity and activity ratios

- Net Working Capital = CA - CL
- Current Ratio = CA / CL
- Quick Ratio = (Cash + A/R) / CL
- Days Cash = Cash / Avg. daily sales
- Inventory Turnover = COGS / Avg. Inv.
- AR Collection (Days A/R) = (A/R) / Avg. daily sales
- Days Cash to Cash
  = Days Cash + Days A/R + Days inventory
- Days Payable Outstanding =AP / Avg. daily pur.
  = AP / [(COGS + ΔInventory) / 365]
- Sales to net fixed assets = Sales / Net fixed assets

Wades Office Furniture:
Liquidity Ratios

Wades Office Furniture	*[- H I S T O R I C A L -]*		*[- H I S T O R I C A L -]*		*[- H I S T O R I C A L -]*	
Unaudited: , SIC #2522	1999		2000		2001	
FINANCIAL RATIOS	$ 1,000		$ 1,000		$ 1,000	
Liquidity Ratios						
Current Ratio	1.45		1.48		1.40	
Quick Ratio	0.78		0.81		0.74	
	Days	Times	Days	Times	Days	Times
Days Cash	6.80	53.70 x	5.93	61.53 x	2.11	172.64 x
Accounts Receivable Turnover	60.46	6.04 x	62.39	5.85 x	55.67	6.56 x
Inventory Turnover	83.20	4.39 x	81.09	4.50 x	78.00	4.68 x
Days AP Outstanding	48.83	7.47 x	60.60	6.02 x	53.09	6.88 x
Days Cash to Cash Cycle	101.62	3.59 x	88.81	4.11 x	82.70	4.41 x
Est. W.C. financing Needs	$1,417		$1,320		$1,870	
Memo: COGS / Accounts payable	6.09 x		5.97 x		6.44 x	

Leverage ratios

- Debt Ratio = Debt / Total assets
- Debt to tangible net worth = Debt / Tang. NW
- Times interest earned = EBIT / Int. exp.
  where,
  EBIT = Earns before tax plus int. exp.
- Fixed Charge Coverage
  = (EBIT+lease pay) / (Int. exp.+ lease pay)
- Net Fixed Assets to Tangible NW
- Dividend Payout %
  = Dividends paid / Net profit

Wades Office Furniture: *Leverage Ratios*

Wades Office Furniture	*[- H I S T O R I C A L -]*	*[- H I S T O R I C A L -]*	*[- H I S T O R I C A L -]*
Unaudited: , SIC #2522	1999	2000	2001
FINANCIAL RATIOS	$ 1,000	$ 1,000	$ 1,000
Leverage Ratios			
Debt to Tangible Net Worth	2.31 x	2.01 x	2.05 x
Times Interest Earned	3.01 x	3.08 x	4.36 x
Fixed Charge Coverage	1.96 x	1.79 x	2.09 x
Net Fixed Assets to Tangible Net W	63.82%	53.20%	46.97%
Dividend Payout	0.00%	0.00%	0.00%

Profitability ratios

- Return on Equity (ROE)
  = Net income / Total equity
  - Profit before taxes to net worth
    = Profit before taxes / Tangible net worth
- Return on Assets (ROA) = Net income / Total assets
  - Profit before taxes to total assets
    = Profit before taxes / Total assets
- Asset utilization (AU) = Sales / Total assets
  sometimes referred to as asset turnover
- Profit margin (PM) = Net income / Sales
- Sales growth = ΔSales / Last period's sales
- Income taxes to profit before taxes
  = Reported income tax / Profit before taxes

Wades Office Furniture: *Profitability Ratios*

Wades Office Furniture Unaudited: , SIC #2522 *FINANCIAL RATIOS*	*[- H I S T O R I C A L -]* 1999 $ 1,000	*[- H I S T O R I C A L -]* 2000 $ 1,000	*[- H I S T O R I C A L -]* 2001 $ 1,000
Profitability Ratios			
Return on Net Worth (ROE)	18.07%	13.05%	22.54%
Profit Before Taxes to Net Worth	29.09%	21.94%	36.24%
Return on Assets (ROA)	5.61%	4.44%	7.57%
Profit Before Taxes to TA	8.67%	7.21%	11.76%
Equity mult (leverage = TA / TE)	3.22 x	2.94 x	2.98 x
Income			
Tot. asset turnover (sales / TA)	2.32 x	2.39 x	2.77 x
All other income / total assets	0.00%	0.00%	0.00%
Expenses			
Net profit margin (NI / net sales)	2.42%	1.86%	2.73%
COGS / net sales	67.22%	66.28%	66.41%
Operating expenses / net sales	26.35%	28.20%	27.27%
Income Taxes to Earnings Before	35.34%	38.46%	35.67%
Sales / Net Fixed Assets	12.19 x	13.66 x	18.20 x

Cash flow analysis:
Cash pays a loan not net income

- Cash Assets

$$\sum_{i=1}^{n} \Delta A_i = \sum_{j=1}^{m} \Delta L_j + \Delta NW$$

- Let A1 = Cash, then:

$$\Delta A_1 = \sum_{j=1}^{m} \Delta L_j - \sum_{i=2}^{n} \Delta A_i + \Delta NW$$

- Let ΔNW = Δstock + Δsurplus + NI - DIV

$$\Delta A_1 = \sum_{j=1}^{m} \Delta L_j - \sum_{i=2}^{n} \Delta A_i + \Delta \text{stock} + \Delta \text{surplus} + \text{NI} - \text{DIV}$$

- Let NI = Revenues - Expenses - Taxes

$$\Delta A_1 = \sum_{j=1}^{m} \Delta L_j - \sum_{i=2}^{n} \Delta A_i + \Delta \text{stock} + \Delta \text{surplus} + \text{Revenues} - \text{Expenses} - \text{Taxes} - \text{DIV}$$

Sources and uses of cash

$$\Delta A_1 = \sum_{j=1}^{m} \Delta L_j - \sum_{i=2}^{n} \Delta A_i + \Delta stock + \Delta surplus$$

$$+ \text{Revenues} - \text{Expenses} - \text{Taxes} - \text{DIV}$$

- Sources of cash are:
  - Increase in any liability
  - Decrease in any non-cash asset
  - New issues of stock
  - Additions to surplus
  - Revenues
- Uses of cash are:
  - Decrease in any liability
  - Increases in any non-cash assets
  - Repayment / refunding of stock
  - Deductions from surplus
  - Cash expenses, taxes, dividends

Understanding sources and uses

- Assets are a use of cash:
  - $-(A_t - A_{t-1})$
- Liabilities are a source of cash:
  - $+(L_t - L_{t-1})$
- Revenues are a source of cash:
  - +Revenues
- Expenses are a use of cash:
  - -Expenses
- Just sum up each part

There are two types of cash flow statements

1. Direct
   - Converts the income statement into a "cash based income statement."
   - Begins with net sales and adjust for changes in balance sheet items.
2. Indirect
   - Adjusts net income for non-cash charges and changes in balance sheet items.

Four sections in either cash flow statement.

1. *Operations*
   - Includes income statement items and all current assets and current liabilities.
2. *Investing*
   - Includes all long term assets
3. *Financing*
   - Includes all long term liabilities and equity (except retained earnings) plus dividends paid.
4. *Cash*
   - Total of the above, but must equal the actual change in cash and marketable securities.

Converting the income statement into a cash based income statement

1. *Operating:*

- Cash sales:
  - + Net Sales
  - - Δ Accounts receivables
  - = Cash sales
- Cash purchases (negative value):
  - - COGS
  - - ΔInventory
  - + ΔAccounts payable
  - = Cash purchases
  - = Cash gross margin

Converting the income statement into a cash based income statement

Operating (continued):

- Cash operating expenses (negative value):
  - - Operating expenses
  - + Non-cash charges (dep. and amortization.)
  - - Δ Prepaid expenses
  - + Δ Accruals
  - = Cash operating expenses
- Other expenses and taxes:
  - - Other expenses + Other income
  - - Reported taxes
  - + Δ Income tax payables and deferred inc. tax
  - = Other expenses and taxes
- = Cash flow from operations (CFO)

Cash based income statement (cont.)

2. *Investing:*

- \- Capital Exps. = ΔNet fixed assets + depreciation
- \- ΔOther long term assets
- = Cash used for Investing.

3. *Financing:*

- \- Payments for last periods current maturity debt
- \- Payments for dividends
- = Payments for financing
- \+ ΔDebt + EOP CM debt
- \+ New stock issues
- = External Financing

4. *= Change in cash and marketable securities*

Projections of financial condition

- *Pro Forma* projections of the borrowers condition reveal:
  - How much financing is required.
  - When the loan will be repaid.
  - Use of the loan.
- *Pro Forma* Projections
  - Determine critical and non critical assumptions.
  - Use industry projections, internal projections and judgment to determine sales projections.

Pro Forma: Income Statement

- $Sales_{2002}$ = $Sales_{2001}$ x (1 + *g_{sales}*)
  = \$12,430 x (1 + *0.20*) = \$14,916
- $COGS_{2002}$ = $Sales_{2002}$ x *COGS % of Sales*
  = \$14,916 x *0.68* = \$10,143
- Sell. Exp_{2002} = $Sales_{2002}$ x *Selling Exp. % of Sales*
  = \$14,916 x *0.13* = \$1,939
- G&A Exp_{2002} = $Sales_{2002}$ x *G&A Exp. % of Sales*
  = \$14,916 x *0.122* = \$1,820
- Int. Exp_{2002} = (Bank $debt_{2002}$ x *rate on bank debt*)
  + (L.T. $debt_{2002}$ x *rate on L.T. debt*)
  = \$697 x *0.145*
  + [(\$75 + \$50 + \$350 + \$225) x *0.09*]
  = \$186

Pro Forma: Balance Sheet (Assets)

Associate balance sheet items with sales.

- AR_{2002} = *Days A/R* x Average Daily $Sales_{2002}$
  = *50* x ($14,916 / 365) = $2,043
- $Inventory_{2002}$ = $COGS_{2002}$ / *Inventory turnover*
  = $10,143 / *4.9* = $2,070

Capital expenditures from the capital budget:

- Gross fixed $(GFA)_{2002}$ = GFA_{2001} + *Cap. Exp.$_{2002}$*
  = $791 + *$400* = $1,191
- Accumulated $depreciation_{2002}$
  =Acc. $Dep._{2001}$ + depreciation $exp._{2002}$
  = $346 + *$110* = $973

Pro Forma: Balance Sheet (Liabilities)

Trade credit may be tied to inventory growth, thus accounts payable tied to inventory growth:

- AP_{2002} = *Days AP* x Avg. Daily purchases$_{2002}$
  = *Days AP* x $((COGS_{2002} + \Delta Inv._{2002}) / 365)$
  = *53* x ($10,143 + ($2,070 – $1,764) / 365)
  = $1,517

Principal payments on debt can be obtained from the capital budget:

- LTD_{2002} = LTD_{2001} + New LTD_{2002} – CM LTD_{2002}
  = $300 + *$0* – *$75*
  = $225
- Term notes $(TN)_{2002}$ = TN_{2001} + *New* TN_{2002} – *CM* TN_{2002}
  = $0 + *$400* – *$50*
  = $350

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Pro Forma: Balance Sheet (Equity)

Balance sheet definitions:

- Retained earnings $(RE)_{2002}$

  $= RE_{2001} + (NI_{2002} – Div._{2002}) + \text{Acct Adjust.}$

  $= \$804 + (\$339 – \$0) + 0$

  $= \$1,893$

- $Stock_{2002} = Stock_{2001} + \text{New stock issues}$

Pro Forma: Determining the "Plug Figure"

- Sales growth will determine growth in receivables, inventory and profit.
- Net Income varies directly with sales in a stable environment.

The difference in projected asset base and total funding without new debt determines additional credit needed or the Plug figure.

- When Assets_{2002} > ($\text{Liabilities}_{2002}$ + Net worth_{2002})

  →Additional financing is required (notes payable plug):

  $\text{Notes payable}_{2002} = A_{2002} – (L_{2002} + NW_{2002})$
- When Assets_{2002} < ($\text{Liabilities}_{2002}$ + Net worth_{2002})

  → Surplus cash, invest (marketable securities (plug):

  $\text{Mkt. securities}_{2002} = – (A_{2002} – (L_{2002} + NW_{2002}))$

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Wades financial projections assumptions:
Most likely circumstances, income statement

- Sales increase by 20 percent annually.
- Cost of goods sold equals 68 percent of sales.
- Selling expenses average 13 percent of sales,
- G&A expenses average 12.2 percent of sales
- Depreciation equals $110,000 annually.
- Noninterest expense equals $110,000 in 2002 and $135,000 in 2000.
- Interest expense equals 14.5 percent of bank debt and 9 percent of other long-term debt.
- Income taxes equal 36 percent of earnings before taxes
- Income tax payable increases annually by the rate of change in 2001.

Wades financial projections assumptions:
Most likely circumstances, balance sheet

- A/R collection improves to:
  50 in 2002 and 46 in 2000.
- Inventory turnover increases to:
  4.9 in 2002 and 5.1 times in 2000.
- Days AP outstanding remains constant at 53.
- Prepaid expenses increase by $5,000
- Accruals increase by $20,000 annually.
- $400,000 is loaned to purchase new equipment, with the principal repaid in 8 equal annual installments.
  - depreciation on the new equip. $40,000, while depreciation on old will be $70,000 per year.
- The minimum cash required is $120,000.
- Other assets remain constant at $50,000.

Pro forma Projections: Wades Office Furniture, Income Statement

Wades Office Furniture Unaudited: , SIC #2522 *INCOME STATEMENT*	[- H I S T O R I C A L -] % Cha	2001 $ 1,000	% of Total	[-- P R O F O R M A --] % Cha	2002 $ 1,000	% of Total	[-- P R O F O R M A --] % Cha	2003 $ 1,000	% of Total
Net sales	51.88%	12,430	100.0%	20.00%	14,916	100.0%	20.00%	17,899	100.0%
Cost of goods sold	52.19%	8,255	66.4%	22.87%	10,143	68.0%	20.00%	12,171	68.0%
Gross profit	51.27%	4,175	33.6%	14.33%	4,773	32.0%	20.00%	5,728	32.0%
Selling expenses	58.67%	1,628	13.1%	19.11%	1,939	13.0%	20.00%	2,327	13.0%
Management salaries	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
General & administrative expenses	39.47%	1,689	13.6%	7.74%	1,820	12.2%	20.00%	2,184	12.2%
Research and development expen	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Depreciation & amortization	2.82%	73	0.6%	50.68%	110	0.7%	0.00%	110	0.6%
Other operating expenses	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Total operating expenses	46.88%	3,390	27.3%	14.12%	3,869	25.9%	19.43%	4,621	25.8%
Operating profit	73.67%	785	*6.3%*	15.20%	904	*6.1%*	22.43%	1,107	*6.2%*
Interest on marketable securities	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Income on long term investments	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Interest expense - Bank Notes	31.93%	157	1.3%	-35.62%	101	0.7%	-48.49%	52	0.3%
Interest expense - Term notes + LT	0.00%	0	0.0%	#N/A	85	0.6%	-16.47%	71	0.4%
All other expenses	17.44%	101	0.8%	8.91%	110	0.7%	22.73%	135	0.8%
All other income	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Total All Other Income (Expenses	25.85%	(258)	-2.1%	14.76%	(296)	-2.0%	-12.84%	(258)	-1.4%
Profit before taxes	113.36%	527	*4.2%*	15.41%	608	*4.1%*	39.60%	849	*4.7%*
Income taxes	97.89%	188	1.5%	16.46%	219	1.5%	39.60%	306	1.7%
Extraordinary and other income (e	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Net income	123.0%	339	2.7%	14.8%	389	2.6%	39.6%	543	3.0%
Dividends	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Retained earnings	123.03%	339	2.7%	14.82%	389	2.6%	39.60%	543	3.0%

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Pro forma Projections: Wades Office Furniture Balance Sheet (Assets)

Wades Office Furniture	[- H I S T O R I C A L -]			[-- P R O F O R M A --]			[-- P R O F O R M A --]		
Unaudited: , SIC #2522		2001	% of		2002	% of		2003	% of
BALANCE SHEET	% Cha	$ 1,000	Total	% Cha	$ 1,000	Total	% Cha	$ 1,000	Total
ASSETS									
Cash	-45.86%	72	1.6%	66.67%	120	2.3%	0.00%	120	2.1%
Marketable securities	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Accounts receivable	35.53%	1,896	42.3%	7.77%	2,043	38.7%	10.40%	2,256	39.6%
Inventory	46.39%	1,764	39.4%	17.35%	2,070	39.2%	15.29%	2,387	41.9%
Prepaid expenses	-70.00%	15	0.3%	33.33%	20	0.4%	25.00%	25	0.4%
Deferred tax asset	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Other current assets	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Current assets	34.45%	3,747	83.6%	13.51%	4,253	80.6%	12.56%	4,787	84.0%
Gross fixed assets	17.36%	791	17.7%	50.57%	1,191	22.6%	0.00%	1,191	20.9%
Leasehold improvements	17.82%	238	5.3%	0.00%	238	4.5%	0.00%	238	4.2%
Less accumulated dep.	24.91%	346	7.7%	31.79%	456	8.6%	24.12%	566	9.9%
Net fixed assets	14.02%	683	15.2%	42.46%	973	18.4%	-11.31%	863	15.1%
Notes & contracts receivable	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Long-term investments	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Intangible assets	28.21%	50	1.1%	0.00%	50	0.9%	0.00%	50	0.9%
Other noncurrent assets	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Total Assets	30.80%	4,480	100.0%	17.77%	5,276	100.0%	8.04%	5,700	100.0%

Pro forma Projections: Wades Balance Sheet (Liabilities and Equities)

Wades Office Furniture Unaudited: , SIC #2522 ***BALANCE SHEET***	*[- H I S T O R I C A L -]* % Cha	2001 $ 1,000	% of Total	*[-- P R O F O R M A --]* % Cha	2002 $ 1,000	% of Total	*[-- P R O F O R M A --]* % Cha	2003 $ 1,000	% of Total
LIABILITIES & EQUITY									
Notes payable - bank	53.26%	892	19.9%	-21.85%	697	13.2%	-48.49%	359	6.3%
Accounts payable	41.19%	1,282	28.6%	18.35%	1,517	28.8%	19.52%	1,813	31.8%
Accrued expenses	34.88%	348	7.8%	5.75%	368	7.0%	5.43%	388	6.8%
Income tax payable	27.42%	79	1.8%	27.42%	101	1.9%	27.42%	128	2.3%
Current maturity - Term note	0.00%	0	0.0%	#N/A	50	0.9%	0.00%	50	0.9%
Current maturity - LTD	0.00%	75	1.7%	0.00%	75	1.4%	0.00%	75	1.3%
Other current liabilities	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Current liabilities	41.96%	2,676	59.7%	4.93%	2,808	53.2%	0.20%	2,814	49.4%
Deferred tax liability	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Term notes	0.00%	0	0.0%	#N/A	350	6.6%	-14.29%	300	5.3%
Long-term debt (LTD)	-20.00%	300	6.7%	-25.00%	225	4.3%	-33.33%	150	2.6%
Other noncurrent liabilities	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Total liabilities	31.68%	2,976	66.4%	13.68%	3,383	64.1%	-3.53%	3,264	57.3%
Common stock - par	0.00%	600	13.4%	0.00%	600	11.4%	0.00%	600	10.5%
Paid-in surplus	0.00%	100	2.2%	0.00%	100	1.9%	0.00%	100	1.8%
Preferred stock	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Treasury and other equities	0.00%	0	0.0%	0.00%	0	0.0%	0.00%	0	0.0%
Retained earnings	72.90%	804	17.9%	48.41%	1,193	22.6%	45.54%	1,737	30.5%
Stockholder's equity	29.10%	1,504	33.6%	25.88%	1,893	35.9%	28.70%	2,437	42.7%
Total Liab and Equity	30.80%	4,480	100.0%	17.77%	5,276	100.0%	8.04%	5,700	100.0%

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Pro forma Projections:
Wades Office Furniture Liquidity and Leverage Ratios

Wades Office Furniture	[- H I S T O R I C A L -]		[-- P R O F O R M A --]		[-- P R O F O R M A --]	
Unaudited: , SIC #2522	2001		2002		2003	
FINANCIAL RATIOS	$ 1,000		$ 1,000		$ 1,000	
Liquidity Ratios						
Current Ratio	1.40		1.51		1.70	
Quick Ratio	0.74		0.77		0.84	
	Days	Times	Days	Times	Days	Times
Days Cash	2.11	172.64 x	2.94	124.30 x	2.45	149.16 x
Accounts Receivable Turnover	55.67	6.56 x	50.00	7.30 x	46.00	7.93 x
Inventory Turnover	78.00	4.68 x	74.49	4.90 x	71.57	5.10 x
Days AP Outstanding	53.09	6.88 x	53.00	6.89 x	53.00	6.89 x
Days Cash to Cash Cycle	82.70	4.41 x	74.43	4.90 x	67.02	5.45 x
Est. W.C. financing Needs	$1,870		$2,068		$2,235	
Memo: COGS / Accounts payable	6.44 x		6.69 x		6.71 x	
Leverage Ratios						
Debt to Tangible Net Worth	2.05 x		1.84 x		1.37 x	
Times Interest Earned	4.36 x		4.27 x		7.90 x	
Fixed Charge Coverage	2.09 x		2.19 x		2.89 x	
Net Fixed Assets to Tangible Net W	46.97%		52.79%		36.16%	
Dividend Payout	0.00%		0.00%		0.00%	

Pro forma Projections: Wades Profitability, Cash Flow and Growth Ratios

Wades Office Furniture Unaudited: , SIC #2522 *FINANCIAL RATIOS*	*[- H I S T O R I C A L -]* 2001 $ 1,000	*[-- P R O F O R M A --]* 2002 $ 1,000	*[-- P R O F O R M A --]* 2003 $ 1,000
Profitability Ratios			
Return on Net Worth (ROE)	22.54%	20.56%	22.30%
Profit Before Taxes to Net Worth	36.24%	33.00%	35.58%
Return on Assets (ROA)	7.57%	7.38%	9.53%
Profit Before Taxes to TA	11.76%	11.53%	14.90%
Equity mult (leverage = TA / TE)	2.98 x	2.79 x	2.34 x
<u>Income</u>			
Tot. asset turnover (sales / TA)	2.77 x	2.83 x	3.14 x
All other income / total assets	0.00%	0.00%	0.00%
<u>Expenses</u>			
Net profit margin (NI / net sales)	2.73%	2.61%	3.04%
COGS / net sales	66.41%	68.00%	68.00%
Operating expenses / net sales	27.27%	25.94%	25.81%
Income Taxes to Earnings Before	35.67%	36.00%	36.00%
Sales / Net Fixed Assets	18.20 x	15.33 x	20.74 x
Cash Flow Ratios			
CFO / (DIV + last CMLTD)	-1.71	4.24	6.17
CFO / (DIV + last CMLTD + bnk note	-0.13	0.41	1.07
CFO / (DIV + last CMLTD & CM Term + br	-0.13	0.39	0.96
Growth Rates			
Sales Growth (annualized)	51.88%	20.00%	20.00%
Cost of Goods Sold	52.19%	22.87%	20.00%
Net Income	123.03%	14.82%	39.60%
Total borrowed debt	-20.00%	#N/A	-47.62%
Total Assets	30.80%	17.77%	8.04%

Pro forma projections: Wades Cash Based Income Statement (operations)

Wades Office Furniture Unaudited: , SIC #2522 *CASH BASED INCOME STATEMENT*	*HISTORICAL* 2001 $ 1,000	*PRO FORMA* 2002 $ 1,000	*PRO FORMA* 2003 $ 1,000
Net sales	12,430	14,916	17,899
Change in accounts receivable	-497	-147	-213
Cash receipts from sales	11,933	14,769	17,687
Cost of goods sold	-8,255	-10,143	-12,171
Change in inventory	-559	-306	-317
Change in accounts payable	374	235	296
Cash purchases	-8,440	-10,214	-12,192
Cash margin	3,493	4,555	5,495
Total operating expenses	-3,390	-3,869	-4,621
Depreciation & amortization	73	110	110
Change in prepaid expenses	35	-5	-5
Change in accruals	90	20	20
Change in other current assets & liab.	0	0	0
Cash operating expenses	-3,192	-3,744	-4,496
Cash operating profit	301	811	999
Interest on marketable securities	0	0	0
Income on long term investments	0	0	0
All other expenses & income (net)	-101	-110	-135
Cash before interest & taxes	200	701	864
Interest expense - Bank notes	-157	-101	-52
Interest expense - Term notes and LTD	0	-85	-71
Income taxes reported	-188	-219	-306
Change in income tax payable	17	22	28
Change in deferred income taxes	0	0	0
Cash flow from operations (CFO)	*-128*	*318*	*463*

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Pro forma Projections:
Wades Cash Based Income Statement (investment, financing and cash)

Wades Office Furniture Unaudited: , SIC #2522 CASH BASED INCOME STATEMENT	HISTORICAL 2001 $ 1,000	PRO FORMA 2002 $ 1,000	PRO FORMA 2003 $ 1,000
Cash flow from operations (CFO)	*-128*	*318*	*463*
Capital exp. and leasehold improvements	-157	-400	0
Change in long-term investments	0	0	0
Change in intangible assets	-11	0	0
Change in other noncurrent assets	0	0	0
Cash Used for Investments	*-168*	*-400*	*0*
Payment for last period's CM Term note	0	0	-50
Payment for last period's CMLTD	-75	-75	-75
Dividends paid (DIV)	0	0	0
Payments for financing	*-75*	*-75*	*-125*
Cash before external financing	-371	-157	338
Change in short-term bank debt	310	-195	-338
Change in term notes & EOP CM term note	0	400	0
Change in LT debt + EOP CMLTD	0	0	0
Change in stock & surplus	0	0	0
Change in preferred stock	0	0	0
Change in treasury and other equities	0	0	0
Change in other noncurrent liabilities	0	0	0
External financing	310	205	-338
Extraordinary exp. and cha. In acct. prin.	0	0	0
Current period accounting adjustment	0	0	0

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Thank You Very Much for
Your Kind Attention!