CASES

11-1. THE HOME DEPOT VS. LOWE'S

Assume you are the chief financial officer (CFO) of The Home Depot and you are in the process of preparing for the annual meeting with shareholders. In this regard, you want to analyze the financial condition of Lowe's Companies, Inc. since you know that shareholders and financial analysts are likely to compare your company's financial performance to Lowe's.

Required:

Obtain the financial statements of Lowe's for fiscal 2000 and fiscal 1999 (years ended February 2, 2001 and January 28, 2000). These statements can be obtained at Lowe's corporate Web site (Go to www.lowes.com. Click on About Lowe's and then click on Investor Information). Alternatively, your instructor can provide information on obtaining these financial statements formatted in an Excel spreadsheet (this will facilitate horizontal and vertical analysis).

1. Once you have the financial statements, perform horizontal and vertical analyses of the income statements and balance sheets and horizontal analyses of the statements of cash flow. For each analysis, comment on major differences and similarities in comparison to The Home Depot.

2. Calculate (a) the profitability ratios, (b) the turnover ratios, and (c) the debt related ratios summarized in Illustration 11-12. Compare the ratios to the values for The Home Depot in the chapter and briefly summarize the comparisons (i.e., briefly summarize how The Home Depot stacks up against Lowe's in terms of profitability (profitability ratios), its efficient use of assets (turnover ratios), and its ability to meet its obligations to creditors (debt related ratios).

3. Go to Yahoo! Finance (http://finance.yahoo.com) and search current news stories for both The Home Depot (ticker symbol is HD) and Lowe's (ticker symbol is LOW). Do any of the current news items suggest problems at The Home Depot or Lowe's that are germane to the shareholders' meeting for The Home Depot?

Additional Information

In performing your analyses, you will need the following additional information for Lowe’s:

a.	The stock price per share for Lowe's:	
	February 2, 2001 (end of fiscal year 2000)	$53.80
	January 28, 2000 (end of fiscal year 1999)	$44.41
b.	Common shares outstanding (in thousands)	
	January 29, 1999 (end of fiscal year 1998)	374,388
c.	Total assets (in thousands)	
	January 29, 1999 (end of fiscal year 1998)	$7,086,882
d.	Common stockholders’ equity (in thousands)	
	January 29, 1999 (end of fiscal year 1998)	$3,619,767
e.	Accounts receivable (in thousands)	
	January 29, 1999 (end of fiscal year 1998)	$143,928
f.	Inventory (in thousands)	
	January 29, 1999 (end of fiscal year 1998)	$2,384,700

11-2. JORDAN-WILLIAMS, INCORPORATED

Jordan-Williams, Incorporated (JWI) is a major publisher of college textbooks focused on business education. At the company's quarterly strategy meeting, senior management decided to expand into business education materials aimed at corporations that require entry-level and mid-level managers to complete training courses to improve their business skills. In this space, content (in the opinion of JWI's senior management) is best delivered via the Internet since it has cost advantages and allows for flexibility in scheduling employee training.

JWI has existing content in almost all business areas including accounting, finance, marketing, management, and information systems as well as connections to authors who can develop new materials. However, the firm does not have experience delivering content over the Internet and does not have a sales force with experience selling to the corporate training market. Given JWI wants a rapid entry into this market, it plans on developing a strategic alliance with a company with experience in selling to the corporate market and delivery of content via the Internet.

One of the companies JWI is considering as a partner is NetKnowledge, Inc. NetKnowledge is an infrastructure and services company that supports corporate communication and training. The company has approximately 65 satellite-linked communication centers that corporations can use for live video conferencing or training. NetKnowledge has also developed a platform to deliver pre-recorded training to personal computers via the Internet. For clients that need help developing training materials, NetKnowledge has three production studios for designing and recording client content.

A due diligence team from JWI has met with executives from NetKnowledge, viewed demonstrations of content delivered over the Internet using the NetKnowledge platform, and visited a NetKnowledge production facility. The team is quite impress with NetKnowledge and believes an alliance with the company would be a great fit since NetKnowledge, does not specialize in developing content (it only assists companies with designing and recording content) while JWI is a content expert.

JWI is going to be investing heavily to modify its existing content to make it more focused on the corporate training market and to make it compatible with NetKnowledge's delivery platform. Thus, it wants to gain some assurance that NetKnowledge will be around in the foreseeable future to continue selling and delivering the materials to the corporate market. To assess the financial stability of NetKnowledge, the JWI due diligence team performed financial analysis and held discussions with various executives at NetKnowledge. When finished with it's investigation, the due diligence team prepared the following memo supporting a partnership with NetKnowledge.

JWI

JORDAN-WILLIAMS

A Leader in Business Education Since 1923

March 25, 2002

TO: Peter Gandrell (CEO), Christine Sayers (CFO), and Drew Marshall (Director of New Initiatives)

FROM: Ted Chapman, lead manager, due diligence team investigating NetKnowledge

SUBJECT: Report on Financial Condition of NetKnowledge

In fiscal 2001 / fiscal 2000, NetKnowledge (NK) suffered losses of $26,693,086 / $19,909,857. In spite of these losses, the team recommends forming an alliance with NK. NK, like most companies in this space, is an early stage company and losses are not unexpected. The important questions to ask are "does NK have a reasonable plan to become profitable?" and "does NK have the cash to survive until profitability is achieved?" We believe the answer to both questions, is yes.

In 2001, operating expenses increased substantially resulting in an increased loss. However, per our discussions with executives at NK, the increased operating expenses are due in large part to a major advertising campaign and expansion of the sales force. The result is that NK achieved substantial brand recognition, and in 2001 revenue increased by 20%. The company believes that, now that it has achieved its brand recognition goals, it can cut operating expenditures (including advertising and sales force salaries) back to a level of 80% of the amounts in fiscal 2000 or $27,609,269 (80% x 34,511,586). With current revenue at $17,547,648, and assuming an ongoing revenue growth rate of 20%, the company will be profitable in three years (i.e., at the end of fiscal 2004, revenue of $30,322,337 will exceed expenses of $27,609,269)

Calculation of revenue estimate for year 3:

Revenue in Fiscal 2001	$17,547,648
Revenue in fiscal 2002 (fiscal 2001 with 20% increase)	21,057,178
Revenue in fiscal 2003 (fiscal 2002 with 20% increase)	25,268,614
Revenue in fiscal 2004 (fiscal 2003 with 20% increase)	30,322,337

It appears to us that achieving profitability in 3 years is a very feasible goal. The company has expanded its Web hosting options to a 24/7 basis and is now able to service clients with training demands around the world. In the fourth quarter of fiscal 2001, the company signed contracts with three additional Fortune 500 clients to deliver services in 2002. The revenue from this prestigious group of clients is, of course, not reflected in the financial statements for 2001. Also, keep in mind that our partnership with NK will provide incremental revenue to the company.

Of course, achieving profitability will only be possible if the company does not run out of cash. At the end of fiscal 2001, NK had approximately $20,000,000 in cash and cash equivalents. The net decrease in cash and cash equivalents in fiscal 2001 was approximately $10,000,000. Thus, it appears that the company will be able to survive for at least 2 years (through fiscal 2003). At that point, assuming our net initiative is a success, we may want to make an equity investment in NK to provide the company with the cash it will need to survive a third year beyond 2001 (i.e., through fiscal 2004). Assuming an annual decrease in cash of $10,000,000, we would need to make an equity investments of $10,000,000. At the end of year 3, as discussed above, NK will be profitable and likely able to fund itself internally. An investment of $10,000,000 would give us a substantial equity position in a firm that we predict will be successful. Furthermore, it would allow us to have a substantial say in the direction of NK, thus insuring that the company remains focused on our long-run needs in addition to the needs of its other clients. Alternatively, in light of the fact that the company will be only a year away from profitability at the end of fiscal 2003, if we decide not to make an equity investment, NK should be able to obtain additional debt or equity financing from creditors or investors.

If you have any questions, please give me a call. I'll be in the rest of this week, and next week Monday. After that, I'll be in Chicago working with the group from Balmer Consulting that is developing our new Authors' Web Site.

Required:

The financial statements for NetKnowledge for fiscal 2001 and fiscal 2000 are provided below. You should analyze them as you deem appropriate . Based on your work, comment on the memo from Ted Chapman. Do you agree or disagree with his analysis and conclusions? Would you recommend pursuing an alliance with NK?

NetKnowledge, Inc. Income Statements	**Year Ended December 31, 2001**	**Year Ended December 31, 2000**
Revenue	**$ 17,547,648**	**$ 14,568,200**
Expenses		
Wages and salaries expense	20,683,471	14,462,540
Depreciation of property and equipment	4,061,739	4,287,653
Other general, selling, and administrative expense	22,274,924	15,761,393
	---------------	---------------
	47,020,134	**34,511,586**
Other income (expense)		
Interest income	1,120,000	1,462,000
(Interest expense)	(1,340,600)	(1,428,471)
	---------------	---------------
	(220,600)	**33,529**
	---------------	---------------
Net loss	**$ (29,693,086)**	**$ (19,909,857)**
	=========	=========

	As of December 31, 2001		As of December 31, 2000	
NetKnowledge, Inc.				
Balance Sheets				
Assets				
Current assets				
Cash and cash equivalents	$	19,951,468	$	30,022,146
Accounts receivable		2,894,587		3,671,664
Prepaid expenses and other assets		256,874		483,651
		---------------		---------------
Total current assets		**23,102,929**		**34,177,461**
Property and equipment		**33,016,763**		**32,334,303**
Less accumulated depreciation		**(12,520,394)**		**(8,458,655)**
		---------------		---------------
Total assets	**$**	**43,599,298**	**$**	**58,053,109**
		=========		=========
Liabilities and stockholders' equity				
Current liabilities				
Accounts payable and accrued expenses	$	5,568,442	$	4,687,852
Current portion of capital lease obligations		5,657,142		3,485,214
		---------------		---------------
Total current liabilities		**11,225,584**		**8,173,066**
Capital lease obligations less current portion		**10,751,610**		**12,965,437**
Bonds payable		**14,400,584**		**-**
		---------------		---------------
Total liabilities		**36,377,778**		**21,138,503**
		---------------		---------------
Stockholders' equity				
Common stock:				
Shares issued and outstanding: 2,543,872				
in 2001 and 2000				
Common stock par value		125,480		125,480
Additional paid-in capital		79,485,662		79,485,662
Accumulated deficit		(72,389,622)		(42,696,536)
		---------------		---------------
Total stockholders' equity		**7,221,520**		**36,914,606**
		---------------		---------------
Total liabilities and stockholders' equity	**$**	**43,599,298**	**$**	**58,053,109**
		=========		=========

NetKnowledge, Inc. **Statements of Cash Flows**		**Year Ended December 31, 2001**		**Year Ended December 31, 2000**
Operating Activities				
Net loss	**$**	**(29,693,086)**	**$**	**(19,909,857)**
Adjustment to reconcile net loss to				
net cash used in operating activities:				
Depreciation and amortization		4,061,739		4,287,653
Changes in operating assets and liabilities				
Decrease in accounts receivable		777,077		(124,587)
Decrease in prepaid expenses and other assets		226,777		(106,440)
Increase in accounts payable and accrued expenses		880,590		(65,804)
		---------------		---------------
Net cash used in operating activities		**(23,746,903)**		**(15,919,035)**
Investing activities				
Purchase of property and equipment		**(682,460)**		**2,696,874**
		---------------		---------------
Financing activities				
Issuance of bonds		14,400,584		-
Payment of capital lease obligations		(41,899)		(18,564)
		---------------		---------------
Net cash provided by financing activities		**14,358,685**		**(18,564)**
		---------------		---------------
Net increase (decrease) in cash				
and cash equivalents		**(10,070,678)**		**(13,240,725)**
Cash and cash equivalents, beginning of period		**30,022,146**		**43,262,871**
		---------------		---------------
Cash and cash equivalents, end of period	**$**	**19,951,468**	**$**	**30,022,146**
		=========		=========

11-3. Bobcat Industries[1]

Bobcat Industries produces stainless steel outdoor grills (retail prices from $3,500 - $12,000), as well as stainless steel bars, sinks, and storage cabinets. The company has been profitable in each of the last five years. However, the company has not earned a satisfactory profit given the level of investment by shareholders and creditors. This became very apparent when the company switched to a bonus system based on Economic Value Added (EVA—a system developed by Stern Stewart & Co.) With this system, managers are rewarded when they generate economic income which is basically income from operations less a capital charge. The capital charge is equal to the weighted average cost of capital (15% for Bobcat) times the level of investment (equal to total assets minus non-interest bearing current liabilities (equal to $29,477,535 for Bobcat). In 2001, EVA showed a loss of $1,532,218.

Operating income	**$** 4,445,249
Less taxes at .35	1,555,837
Net operating profit after taxes	$ 2,889,412
Investment	
Total assets	38,929,758
Less non-interest bearing current liabilities (Accounts payable, accrued expenses, and other current liabilities)	9,452,223
Net investment	29,477,535
Times cost of capital	15%
Required return	4,421,630
EVA = Net operating profit after taxes less required return	($1,532,218)

In early 2002, in an effort to increase EVA and generate a bonus, the CEO at Bobcat urged the vice president of operations and the CFO to do a better job controlling the company's investment in two major asset accounts: accounts receivable and inventory. The CEO believes that by reducing the average receivables balance in relation to sales and the average inventory balance in relation to cost of goods sold, EVA will increase.

[1] Note—it would be helpful to review the chapter material on EVA prior to working on this case. See Chapter 10, pages 371-372.

Required:

Part A. Financial statements for Bobcat for 2002 and 2001 are provided below. Calculate accounts receivable turnover and inventory turnover ratios and briefly explain how the CEO can use these ratios to assess whether the vice president of operations and the CFO have been successful in implementing plans to improve the efficient use of company's investment in receivables and inventory. In calculating the ratios, since financial data for fiscal 2000 is not provided, use the ending balances in receivables and inventory rather than the average balances. For example, in calculating the accounts receivable turnover ratio for fiscal 2002, divide sales for 2002 by the balance in receivables at the end of 2002. This approach will also facilitate addressing the question in Part B

Part B. Calculate EVA for 2002. Assume that the cost of capital increased from 15% in 2001 to 16% in 2002 reflecting the greater reliance on equity versus debt financing in 2002.

Part C. Given the sales levels and cost of goods sold levels in 2002, what would be the impact on EVA in 2002 assuming turnover levels did not improve? That is, suppose that accounts receivable turnover and inventory turnover in 2002 did not improve and remained at the levels in 2001 (which you calculated in Part A).

	Year Ended	**Year Ended**
Bobcat Industries	**December 31,**	**December 31**
Income Statements	**2002**	**2001**
Net revenue	**$ 26,453,840**	**$ 22,264,400**
Less cost of goods sold:	14,549,612	13,358,640
	-----------	-----------
Gross margin	**11,904,228**	**8,905,760**
Less selling and administrative expenses	3,608,228	4,460,511
	-----------	-----------
Income from operations	**8,296,000**	**4,445,249**
Less interest expense	538,340	694,250
	-----------	-----------
Income before income taxes	**7,757,660**	**3,750,999**
Less income taxes	544,680	1,312,850
	-----------	-----------
Net income	**$ 7,212,980**	**$ 2,438,149**
	=========	=========

	As of December 31, 2002	As of December 31 2001
Bobcat Industries		
Balance Sheets		
Assets		
Current Assets:		
Cash and cash equivalents	$ 2,407,853	$ 2,350,128
Accounts receivable	1,985,450	1,907,739
Merchandise inventory	8,687,201	8,687,534
Other current assets	568,121	530,954
	-----------	-----------
Total current assets	**13,648,625**	**13,476,355**
	-----------	-----------
Property, plant and equipment (net)	25,001,563	24,774,164
Other assets	698,540	679,239
	-----------	-----------
Total assets	**$ 39,348,728**	**$38,929,758**
	=======	=======
Liabilities and Shareholders' Equity		
Current Liabilities:		
Short-term borrowings	$ 120,357	$ 440,422
Current maturates of long-term debt	290,008	285,318
Accounts payable	6,981,020	6,762,739
Accrued salaries and wages	882,654	781,224
Other current liabilities	1,021,046	1,908,260
	-----------	-----------
Total current liabilities	**9,295,085**	**10,177,963**
	-----------	-----------
Long-term debt	5,446,762	6,948,174
Other long-term liabilities	22,941	21,440
	-----------	-----------
Total liabilities	**14,764,788**	**17,147,577**
	-----------	-----------
Shareholders' Equity		
Common stock at par	796,695	796,695
Capital in excess of par value	6,401,595	6,401,595
Retained earnings	17,385,650	14,583,891
	-----------	-----------
Total shareholders' equity	**24,583,940**	**21,782,181**
	-----------	-----------
Total liabilities and shareholders' equity	**$ 39,348,728**	**$38,929,758**
	=======	=======

PROBLEMS

11-1. Financial News and Analysis For a company recommended by your instructor, read the current financial news (available on Yahoo! Finance) and summarize how the stories relate to the financial condition of the company.

11-2. Reading the MD&A Section of the Annual Report. For a company recommended by your instructor, go to the company's corporate Web site and obtain its annual report (most likely, you will have to click through to investor relations). Briefly summarize how information in the management discussion and analysis (MD&A) section of the annual report helps explain the results in the most recent fiscal year.

11-3. Analyzing Financial Ratios and Cash Flows. Venture Auto Parts is a chain of 35 stores offering a full line of auto parts and supplies to consumers and independent auto repair shops. Danny's Break and Muffler has over 80 stores in the cities serviced by Venture. Recently, Danny Morton, the founder of Danny's Break and Muffler was approached by Venture with an interesting offer. Venture wants to be the sole supplier of mufflers and break parts to Danny's. In exchange, Venture will invest in technology to monitor Danny's inventory levels and make timely deliveries to all locations. Venture asserts that the deal will lead to lower part prices and greater inventory turnover for Danny's.

Required:
Prior to the final phase of negotiation, Danny's daughter, Sarah, has been assigned the task of analyzing the confidential audited financial statements of Venture. As part of her work, Sarah calculated the following ratios and obtained Venture's Statement of Cash Flow for fiscal 2002. Based on this limited information, would you recommend that Danny pursue the deal with Venture?

	Fiscal 2002	Fiscal 2001
Current ratio	1.60	1.50
Quick ratio	0.65	.85
Inventory turnover	3.82	5.25.
Debt to equity	2.76	2.03
Times interest earned	1.02	2.34

	Year Ended
Venture Auto Parts	**December 31**
Statement of Cash Flows	**2002**
Cash provided from operations	
Net earnings	$ 8,567,483
Reconciliation of net earnings to	
net cash provided by operations	
Depreciation and amortization	883,567
Increase in receivables	(3,278,247)
Increase in merchandise inventories	(1,058,430)
Increase in accounts payable	685,740
Increase in income taxes payable	98,351

Net cash provided by operations	**5,898,464**

Cash flows from investing activities	
Purchase of Dundee Stores	(4,558,630)
Purchase of property	(6,875,432)

Net cash used in investing activities	**(11,434,062)**

Cash flows from financing activities	
Proceeds from long-term borrowings	5,785,648

Net cash provided by financing activities	**5,785,648**

Increase in cash and cash equivalents	250,050
Cash and cash equivalents at beginning of year	258,640

Cash and cash equivalents at end of year	**$ 508,690**
	========