K. J. Somaiya Institute of Management Studies and Research

Financial Modeling

PGDM – FS 2016 – 18 - Trimester IV

Duration: 3 hours **50 Marks** **Date : 11/09/2017**

Note : All Questions are compulsory and carry equal marks.

The Indian Factory case involves an industrial company that requests a short-term loan from a commercial bank to cover short-term operating needs. It is a new loan request that must be analyzed by you as an analyst.

Compute the vertical analysis and financial ratios included in the spreadsheet. When the numbers have been laid out and the ratios computed, you would interpret the figures to formulate financial conclusions and answer certain questions.

BACKGROUND

On January 20, 2009, the financial analyst of the HSK Bank received the financial statements of the Indian Factory for the fiscal years ending September 30, 2006, 2007, and 2008. The numbers submitted by the client are attached. The manager of the bank has asked his trusted analyst to immediately perform the financial analysis, since the credit request is to be considered in today's evening session of the credit committee.

The company, which is not yet a client of the bank, requested a loan for Rs. 3 crores for 180 days. The analyst has heard of the company, but has never been directly involved with them in business transactions. The reason for the expedited treatment of this credit is that the factory's owners are friendly with one of the bank's directors. The company has been established in the market for many years. It manufactures general clothing (men's, women's, and children's) for the domestic market (growth rate of about 5% annually), aimed at the middle and upper middle classes. The Indian Factory principally has dealt with the Asian PSU Bank and with a specialized public sector bank for long-term financing. A respected and socially prominent local family that has a reputation for being very conservative and traditional in its business dealings owns it.

CONVERSATION WITH THE CFO

Upon examining the financial statements, the analyst noted that the external auditor, the firm of Chaturvedi & Sons Co., was unfamiliar to him. The analyst had questions about some of the numbers and called the CFO of Indian Factory for some clarifications. The CFO has been with the company for fourteen years and was promoted to his present position three years ago. Concerning the purpose of the loan, he said it was "for working capital purposes."

With respect to sales, he indicated that “Sales are growing — following the same trends as last year” and that “Our policy is to raise prices along with inflation,” now estimated at 15% per year by the analyst. “We've never had problems with raising our prices due to the high quality of our brand names and our entrenched market position,” said the CFO. “We sell 85% of our production at 90 day terms to strong distributors. The other 15% is sold on a cash basis through our own store, which is well located in the main shopping district. The July - August - September quarter constitutes about 25% of annual sales and production.”

The analyst also asked why inventories were higher and payables lower in the past year. The CFO said that, in the case of inventories, “We wish to increase our stocks as a hedge on inflation.” Regarding payables, he said, “Our policy is to buy some raw materials on a cash basis to take advantage of discounts offered by some suppliers.”

ADDITIONAL INFORMATION (FROM MANAGEMENT DISCUSSION IN ANNUAL REPORT)

- Inventories are valued on a LIFO basis and the LIFO Reserves is Rs. 5 crores.

- The management does not believe that it will ever have to pay its remaining Deferred Tax Liability.

- Indian Factory has various Operating Leases. The present value of these leases was Rs.145 lacs at the beginning of 2008 and Rs.130 lacs at the end of 2008. At the beginning of 2008, the lease had an average implied interest rate of 12%. The annual payments are Rs.20 lacs, which is recorded as a part of cost of goods sold on the income statement. Using the annual payment, we can project the present value of current portion of lease payment of Rs.17 lacs and non-current portion of lease payments to be approximately Rs.113 lacs at the end of 2008. In addition, the equipment being leased had a 10-year remaining life at the beginning of the year and no estimated salvage value. Straight-line depreciation is used.

- The “loss on destruction of facility” is a non-recurring charge for costs related to an accidental explosion at one of the Indian Factory facilities. This is the first such loss that the company had experienced but these type of events are not considered unusual in the industry.

- Pension Liability

Year	Fair Market Value of Assets (Rs lacs)	Fair Market Value of Liabilities (Rs lacs)
2006	500	1,000
2007	600	1,050
2008	600	1,150

Before writing up his analysis, the analyst called an acquaintance at the Asian PSU Bank— a friend since university years. The Asian PSU banker indicated that the Indian Factory had been a client of Asian PSU for eight years. The present owners were the second generation of the family to direct the company; they took over three years ago and installed the present CFO.

The banker mentioned that, when the company was taken over with long-term notes by the present generation of owners, a certain amount of goodwill was put on the company's books. Also, about two months ago, the Indian Factory sold an old warehouse for Rs.2.1 crores. Terms of the sale were three years, including 20 months grace and are included in the other current assets in 2008.

The Asian PSU Bank, because of traditional relationships, mainly dealt with the owners rather than the management; obligations were paid in a satisfactory manner, although rollovers (renewals) were frequent on the short-term loan. Six months ago, Asian PSU Bank approved a new credit facility, with full recourse to Indian Factory, of Rs. 4 crores for the discount of receivables.

A “discount facility” is one where the banks “buy” certain of the customer’s trade receivables at a specified price, for example, at a 10% discount. This means that the customer receives Rs.90 for every Rs100 of receivables. The bank collects the receivables when they are due for payment of the amount advanced to the customer, plus interest.

Structuring with “full recourse” to Indian Factory means that Indian Factory guarantees payment of the transaction in case the trade receivables are not paid when they are due.) The credit facility was fully taken down almost immediately, and outstanding’s have not changed since then. The Asian PSU Bank also has financed equipment purchases for Indian over the years, generally with good results. Asian PSU is now near its legal lending limit with Indian Factory.

Question 1: How do sales increases compare to inflation? What does this mean?

Question 2: What do the numbers reveal about Indian's operational efficiency?

Question 3: What effect are interest expenses having on profits?

Question 4: What is the situation with receivables? What does it mean?

Question 5: What is the inventory situation? What does it mean? Contrast these numbers to the information provided by Indian's CFO.

Question 6: What is the situation with fixed assets? What does it mean?