

**2004 National Community Development Lending School
Small Business Lending Case Study
Carl Ballton**

Small Business Lending Course

AGENDA

- | | |
|------------|--|
| 8:30 a.m. | Introductions |
| 8:45 a.m. | Course Outline and Objectives |
| 9:00 a.m. | Business Fundamentals and Cash Flow Analysis |
| 10:30 a.m. | Break |
| 10:45 a.m. | Credit Analysis vs. Risk Analysis |
| 12:00 p.m. | Lunch |
| 1:00 p.m. | Case Study – Northeast Electronics Company |
| 3:30 p.m. | Summary and Conclusions |
| 5:00 p.m. | End of Class |

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**NORTHEAST
ELECTRONICS
COMPANY**

Union Bank of California

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Northeast Electronics Company

General Overview

Northeast Electronics Company (“NEC” or “the Company”) is a wholesaler and retailer of consumer electronics, cameras, auto alarms and nightclub sound and lighting systems. A majority of its customers are small or medium-sized specialty electronic retailers, small consumer electronic distributors or custom audio/visual system installers who are located in and around the Los Angeles, CA area.

Credit Situation

It is late May 2003 and Chuck Youngblood recently met with John Ramirez, President of NEC, to discuss his business and pursue potential credit and deposit opportunities. Mr. Ramirez has regularly cashed checks from customers that are drawn on Union Bank of California, but does not have a relationship with the Bank. He has expressed dissatisfaction with his primary bank, Key Bank, due to constant operational problems.

The following information was obtained from the recent meeting with Mr. Ramirez and additional information supplied by the Company.

Company Background

John and Maria Ramirez started Northeast Electronics Company in 1981 after John was laid off from his electronics technician job at The Boeing Company. John always enjoyed high quality stereo systems and considered himself quite an audiophile. While at Boeing, he earned extra money moonlighting as an installer of sound and lighting systems for restaurants and night clubs in the Seattle area. Upon being laid off, John decided to pursue his interests in the consumer electronics field. Although he initially began as an installer of sophisticated sound systems, he quickly realized it was more profitable to buy consumer electronics inventory from retailers who were in or near bankruptcy and then resell that inventory through normal wholesale distribution channels. NEC recently opened a retail store around the corner from NBC Studios in Burbank to sell discontinued merchandise purchased from distressed retailers or manufacturers attempting to eliminate discontinued inventory.

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Northeast Electronics Company

Business Description

NEC sells a variety of consumer electronics and audiovisual equipment to retail stores and other wholesalers in Southern California and Mexico. The product represents the full range of consumer electronics including televisions, VCR's, stereo components (tuners, amplifiers, CD players, speakers, etc.), cameras, auto alarms and high quality light and sound systems. The products are typically sold to an upscale end user or a professional sound and lighting specialist.

The Company buys products from the local warehouse of foreign manufacturers or directly from domestic manufacturers. Foreign manufacturers include Mitsubishi, Sony, Yamaha, Canon and Minolta while the domestic suppliers include Bose (speaker systems) and Harmon Kardon (high end stereos). NEC does not import any merchandise. Warehouses for the foreign manufacturers are mostly located on the west coast which allows the Company to be responsive to customers needs, particularly during the peak Christmas selling season. Suppliers typically provide 3%/30 days, net 45 terms. Since the industry is known for thin margins, NEC takes advantage of all possible trade discounts. A number of suppliers, including RCA and Panasonic, factor their receivables through Heller Commercial Finance who collects those suppliers' receivables at 33% a month over a three-month period.

NEC was recently awarded the exclusive distribution rights for the high-end line of Mitsubishi televisions and VCRs. This contract will complement the exclusive arrangement NEC has with other high-end component manufacturers, such as Bose and Harmon Kardon. Maintaining strong supplier relationships is critical to Ramirez. Continued access to supplier discounts and sales of higher margin merchandise has enabled NEC to avoid aggressive price discounting which is so common in the industry. The high level of trade support in the industry results in most distributors having leverage (total liabilities to net worth) of 6x during low sales months and up to 12x just prior to the peak selling season.

Products are received and stored at NEC's warehouse facility in Pacoima (located in the northeast San Fernando Valley) and then shipped to customers via contract truckers. Although a majority of NEC's customers are located throughout greater Los Angeles, the company does sell some of the high-end Mitsubishi, Harmon Kardon and Bose merchandise to Mexican retailers. This business is usually done on pre-paid basis. Occasionally, 30-day U.S. dollar terms are offered to those Mexican customers who have a long, favorable relationship with NEC.

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Northeast Electronics Company

The consumer electronic distribution business is driven principally by favorable reputations with both customers and suppliers. Although NEC has certain exclusive distributorships, Ramirez realizes the direct impact customer satisfaction has on those exclusive relationships. If customers are unsatisfied, the exclusive relationships can be withdrawn at any time with only a 15 day notice. He regularly meets with his major customers to inquire about NEC's responsiveness, service, quality and price competitiveness. Therefore, Ramirez is very concerned about the high turnover of employees experienced by NEC at its warehouse location and, to a lesser extent, at the retail store. He has always made a point to hire workers from the local community, but complains that they often lack the skills required by his operation.

Industry Analysis

Competition in the industry is fierce. The industry is estimated to grow 5% on a real basis in 2003 and 2004, with the large electronic super stores and warehouse stores continuing to gain market share at the expense of the smaller to medium-sized retailer. The successful smaller to medium-sized retailers have carved a niche in the market which focuses on the upscale customer who requires a more knowledgeable sales staff and higher quality merchandise. The super or warehouse stores typically do not have the high quality merchandise or the knowledgeable sales staff required by these upscale customers. Although NEC distributes products in a wide range of categories, its exclusive arrangements with high-end producers minimizes the competitive impact from the super stores.

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To: Memo to File

From: Chuck Youngblood
Vice President, Commercial Lending

Date: May 15, 2003

Re: Summary of Meeting with John Ramirez, President of Northeast Electronics Company

Recently hosted a lunch for John Ramirez, President of Northeast Electronics Company (“NEC”) to discuss moving his deposit and credit relationship to Union Bank of California.

Ramirez provided NEC’s financial statements for 2000, 2001, and 2002, which are attached. The following is a summary of our discussion concerning the results of the October 31, 2002 fiscal year-end:

- Net revenues fell 14.3% to \$686,300 reflecting continued pressures on NEC’s customer base due to the recession, particularly during the 2001 Christmas season, which is included in 2002 fiscal year. Management continued its strategy of holding pricing firm to maintain margins at the expense of increasing sales. Ramirez believes once you establish a reputation of discounting, your customer base will expect discounts on every transaction.
- Gross profits improved from 7.07% to 8.57% reflecting the sale of higher margin products and the efforts to limit price discounting. As a result, gross profits actually increased 3.7% from \$56,650 to \$58,800. During the 2001 fiscal year, NEC was forced to discount certain slow-moving merchandise which depressed gross margins.
- Operating expenses rose \$2,700 principally due to Ramirez’s increased salary. He increased his salary to help pay for remodeling his private residence.
- Net earnings rose 28% to \$4,500 primarily due to the higher gross margins. Interest expense of \$2,269 fell 42% due to a lower interest rate environment and seasonal debt outstanding for only four months
- Both accounts receivable and inventory rose as a result of the sales slowdown. Receivable turn slowed to 41 days from 32 days in 2001 caused by the recession’s impact on NEC’s customer base. Charge-offs have been stable at 1%. Inventory built up in 2002 as evidenced by a slower inventory turn of 36 days compared to 22 days the previous year.

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Memo to File

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Re: NEC

Although these trends are negative, it is typical for receivable and inventory balances to increase at year-end reflecting the seasonal nature of the business.

- Accounts payable increases reflect the year-end build-up on inventory to support the Christmas season coupled with the extended terms suppliers typically offer during that season.

A credit check has been completed with no recent derogatory credit items found on either the personal credit or business credit. The personal credit report indicates several 30-day delinquencies in the 1997-98 period. The Ramirez' personal financial statement offers little in the way of support for our credit, with a net worth of \$268M centered in his personal residence.

Ramirez has recently learned that his warehouse is located within an "empowerment zone", and he has inquired as to whether the bank has any special financing programs for businesses thusly situated.

I requested additional information concerning results from the first half of the year, plus receivable and supplier information.

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Northeast Electronics Company
 Summary of Operating Performance

<u>Operating Performance</u>	6 Months Ended <u>April 30, 2002</u>	6 Months Ended <u>April 30, 2003</u>
Net Sales	\$326,800	\$422,232
Gross Profits	30,400	38,327
Earnings Before Taxes	2,400	4,899
Net Income	1,800	3,759
 <u>Financial Position</u>		
Cash	\$17,600	\$22,142
Accounts Receivable	70,200	77,664
Inventory	48,300	63,931
Other Current Assets	1,800	2,641
Net Property Plant & Equipment	3,900	2,947
Other Long Term Assets	<u>2,500</u>	<u>2,425</u>
Total Assets	\$144,300	\$171,749
Accounts Payable	\$83,600	\$109,046
Current Portion Long Term Debt	600	5,000
Other Current Liabilities	700	1,572
Long Term Debt	41,700	32,015
Stockholders' Equity	<u>17,700</u>	<u>24,116</u>
Total Liabilities and Equity	\$144,300	\$171,749

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Northeast Electronics Company
 As of April 30, 2001, 2002, and 2003
 Breakdown of Accounts Receivable and Supplier Concentrations

Accounts Receivable

Accounts Receivable Aging:

	2001		2002		2003		%
0 to 30 Days	\$35,613	87.3	\$60,013	86.0	\$74,815	96.3	
31 to 60 Days	4,821	11.8	9,214	13.2	2,143	2.8	
60 to 90 Days	431	0.9	654	0.8	706	0.9	
Total A/R's	\$40,865	100.0	\$69,881	100.0	\$77,664	100.0	

NEC has averaged a 1% bad debt expense every year for the last five years.

Accounts Receivable Concentrations:

	2001		2002		2003		%
Back Bay Sound & Lighting	\$3,562	8.4	\$8,003	12.0	\$12,443	16.0	
Univ. of Wash. Bookstore	1,051	2.4	5,521	8.3	8,031	10.0	
The AudioPhile	3,365	8.2	1,489	2.3	2,376	3.0	
Accounts with <1% of A/R	33,788	81.0	51,462	77.4	54,813	71.0	
Total A/R's	\$41,766	100.0	\$66,475	100.0	\$77,664	100.0	

Supplier Concentrations

	2001		2002		2003		%
Mitsubishi Electronic	\$23,187	23.4	\$22,164	27.7	\$42,810	39.3	
Heller Commercial	34,199	34.5	38,126	47.7	37,822	34.7	
Bose Speaker Company	6,598	6.7	5,012	6.3	13,140	12.0	
Remaining 51 Suppliers	34,790	35.4	14,549	18.3	15,274	14.0	
Total Accounts Payable	\$98,774	100.00	\$79,851	100.00	\$109,046	100.0	