Murdoch UNIVERSITY

BUS308 CREDIT AND LENDING DECISIONS

GROUP PROJECT: AN ANALYSIS OF GLOBAL MACHINERY AND METALS COMPANY (GMMC) AND CAUDILLO, HOUBEN AND NOOR)

[Sources: Hempel, Simonson and Coleman 1994:772 – 775 and Caudillo, Houben and Noor "Growing beyond the core business" McKinsey & Company]

GENERAL REQUIREMENTS:

Working in groups of 3 to 4, develop logical and coherent responses to the questions raised below. The opinions or decisions that are presented should be supported by references to appropriate texts, articles, websites and current banking practice.

Although all students are expected to play an important role in the development of the paper, the final submission should be presented as a comprehensive group project.

The following lists of deadline and requirements should be adhered to. Failure to do so will result in a lower grade on the project.

SUBMISSION DATE: 5 November 2017

FORMAT REQUIREMENTS:

The group paper should

- be typed and double spaced;
- flow as a well documented coherent, committee paper;
- cite all sources;
- have correct formats for the bibliography, footnotes and references;
- have on the first page of the paper, the title of the paper, the authors' names and respective tutorial groups; and
- have an executive summary.

Quality is the most appropriate determinant of the grade awarded but it is suggested that approximately **3,000 words** be a suitable length.

Part A: Global Machinery and Metals Company [35 marks]

SPECIFIC REQUIREMENTS / QUESTIONS:

1. Outline the mechanics of a letter of credit arrangement. Examine the bank's exposure to risk should it accept time drafts. In GMMC's case what additional collateral should Motor City National Bank then obtain?

2. Examine GMMC's financial statements and then conduct a financial ratio analysis. Does the firm have adequate collateral in receivables and inventory?

3. GMMC is requesting increases in its lines of credit to meet its sales growth. Should Motor City National Bank approve it increases in both the line of credit and the letter of credit? What special risks do you see in this situation:
   - To the bank?
   - To the company?

Part B: Caudillo, Houben and Noor (2015) "Growing beyond the core business" McKinsey & Company [15 marks]

Quality is the most appropriate determinant of the grade awarded but it is suggested that approximately **1,500 words** be a suitable length.

The group paper should have an abstract.

GMMC is seeking an increase in credit line to meet its sales growth. How do the views and analyses presented by Caudillo *et al.* (2015) be incorporated by GMMC's management to improve their profitability and reduce their risk?

Dr Dominic Gasbarro
25 September 2017

GLOBAL MACHINERY AND METALS COMPANY, INC.

Mr. David Farmer, assistant vice-president at Motor City National Bank, Detroit, Michigan, was considering in early 1988 an expanded loan request from one of the bank's established customers—Global Machinery and Metals Company, Inc. (GMMC). David Farmer had only recently joined the Motor City Bank after two years of credit analysis and lending experience at a nearby competing institution. The GMMC account, which was established at the Motor City Bank about four years ago, had been brought to the bank by the officer whom Farmer had recently replaced; hence he had no prior contact or experience with the managers at GMMC, beyond his understanding that the account had been a satisfactory and profitable one for the bank since the relationship began in 1984.

David Farmer was approached by Wayne Newton, one of the principals of GMMC, with a request for a material expansion in the company's credit facilities. Newton was asking for an increased line of credit to $1 million and an increase in the letter of credit (L/C) line to $1 million.

The GMMC credits currently approved were as follows:

1. Line of credit: $500,000 at prime plus 2 percent.
2. L/C: $750,000 at prime plus 2 percent, with a fee of 1 percent per annum at issue plus 1 percent at funding.

The preceding authorized credit lines, which had been increased in 1985, were secured by all accounts receivable and inventory. Advances against those lines were based on 50 percent of eligible accounts receivable and 40 percent of inventory in amounts not to exceed the total credit approved.

The L/C line had been in constant use since its establishment in 1984 at or near the authorized limit. The line of credit was zeroed out in 1985 for about 60 days, for about 30 days in 1986, and was paid down to a low of $265,000 in 1987. Average usage in 1987 totaled $470,000. Mr. Newton told David Farmer that his current request for increased credit facilities resulted from the continued rapid expansion of GMMC sales. Newton indicated that he would appreciate prompt consideration and approval by the bank of his request for increased credit. (See Exhibits 1 and 2).

GMMC was organized in 1965 as a sole proprietorship, owned and operated by Wayne Newton, who was 54 years of age. GMMC operated as a dealer for new and used machine tools. In 1980 Newton converted the firm to a corporation. At about the same time, he concluded that some diversification of product and activity would serve to reduce the firm's risk as well as increase its profitability. Accordingly, GMMC began importing finished steel products such as stainless steel rounds, angles, pipes, sheets, and plates, principally from Japan and, to a lesser extent, from Spain and Korea.

METALS DIVISION

The metals division, whose sales had shown rapid growth in recent years, sold stainless steel products to about 450 customers in the South and Southwest. One client accounted for about 10 percent of total division sales; nearly all other buyers were significantly smaller, with no other customer accounting for as much as 3 percent of volume. Sales were managed through five salesmen, primarily to small and medium-sized distributors and fabricators. Mr. William Hardin, 46, directed the metals division and its sales staff. He operated in GMMC with a great deal of autonomy.

The GMMC metals division worked with three Japanese suppliers and one each in Spain and South Korea. The company could sell to its customers at prices approximately 20 percent less than competitors who offered equivalent U.S.-made products. This price advantage had allowed GMMC to expand its metals division sales volume quite rapidly.

Recently the company had begun building its inventory of stainless steel products in anticipation of voluntary industry import restrictions on supplies from Japan and Korea. Although GMMC enjoyed a significant price advantage on its imported stainless steel products, there were some important disadvantages to imported sources of supply. GMMC customers had to place their orders at least 60 days in advance of needed delivery. This put GMMC at some competitive disadvantage with domestic (U.S.) suppliers, who could respond to orders in four to six weeks. This situation led to apparent risks for GMMC related to any interruption of supply sources. For example, dock strikes, either in the country of origin or in the United States, could quickly affect supplies. Domestic sources of similar-quality stainless steel products would be available to replace imports, but at a substantially higher cost to GMMC. Almost all of the recent inventory growth had resulted from the growth of stainless steel sales plus recent purchases to hedge against possible import restrictions.

MACHINE TOOL DIVISION

Mr. Wayne Newton closely supervised the activities of the machine tool division. Three salesmen serviced approximately 400 accounts, which were primarily machine shops and small manufacturers. GMMC frequently purchased surplus used machinery, and from time to time the company even bought entire small manufacturing plants, using in these cases various joint-venture partners. Sales by GMMC, when a large-scale purchase was made, would either be at auction or to existing customers within about 30 days.

When used machinery was purchased, it would be shipped to the company's facility for repair or refurbishing if that proved necessary. GMMC had maintained an excellent reputation for selling quality used machinery, and profit margins on this business were excellent.

PRODUCT MIX

The product mixes for year-end 1985, 1986, and 1987 were as follows:

	1987		*1986*		*1985*	
	Sales	**Earnings**	**Sales**	**Earnings**	**Sales**	**Earnings**
Metals division	79%	73%	73%	66%	45%	(14%)
Machine tool division	21%	27%	27%	34%	55%	114%

The company's records indicated that about 66% of the machine tool division's sales in 1986 resulted from used machinery, which accounted for 75 percent of the division's profitability.

FACILITIES

The company owned office and warehouse space containing approximately 36,000 square feet. In addition, other warehouse and yard area was leased with annual payments of $25,000. The majority of GMMC's facilities had been constructed from materials acquired through purchase of closed manufacturing plants. Through use of company labor the cost of facilities had been held to a minimum without sacrificing function.

STAFFING

The company employed a total of 18 people, none of whom were union members. Messrs. Newton and Hardin drew annual salaries of $50,000 each. They also participated in a bonus program based upon performance. Each of the two men earned a bonus of $50,000 in 1987. Common stock ownership was divided, with Mr. Newton owning 60 percent and Mr. Hardin holding 40 percent.

In his discussion at the bank, Mr. Newton summarized his credit requests to the bank officer, David Farmer, as follows:

GMMC wishes to increase its line of credit to $1,000,000 to strengthen our ability to buy closed manufacturing plants and/or surplus machinery on short notice and to enable the company to enter larger joint venture deals. We anticipate an average use for 1988 of $700,000, with a minimum of $300,000. We also want to use a portion of the credit line to finance increased stainless steel inventory from time to time in anticipation of supply interruptions. Finally, the increase we ask in the letter of credit line, to

$1,000,000 from the present $750,000, will help us finance additional stainless steel inventory to meet our steadily growing demand.

Mr. Farmer promised to review these requests and to respond to Mr. Newton within the next few days.

EXHIBIT 1 Global Machinery and Metals, Inc.—Balance Sheets

	12/31/85 (Unaudited)	12/31/86 (Unaudited)	12/31/87 (Audited)
Assets			
Current assets:			
Cash	$ 54,500	$ 76,420	$ 62,370
Receivables net of allowance for doubtful accounts (Note 1)	457,676	787,442	972,154
Inventories (Note 2)	644,794	1,527,925	2,480,115
Prepaid expenses	6,608	7,677	10,802
Total current assets	1,163,578	2,399,464	3,525,441
Property, plant, and equipment (at cost)			
Building	54,800	54,800	54,800
Equipment, furniture, and fixtures	87,281	103,943	113,635
Leasehold improvements	18,760	23,434	23,434
Land	23,000	23,000	23,000
Less: accumulated depreciation	(55,195)	(66,846)	(81,695)
Net property, plant, and equipment	128,646	138,331	133,174
Other assets	632	704	423
Total assets	$1,292,856	$2,538,499	$3,659,038
Liabilities			
Current liabilities:			
Notes payable	$ 50,000	$ 320,000	$ 500,000
Liability on L/Cs	150,000	580,000	750,000
Trade accounts payable	388,730	746,572	1,093,557
Accrued interest and taxes	48,081	66,522	88,364
Federal income taxes payable	147,000	142,600	250,048
Total current liabilities	783,811	1,855,694	2,681,969
Equity			
Common stock, 2,000 shares authorized and issued	100,000	100,000	100,000
Retained earnings	409,045	582,805	877,069
Total equity	509,045	682,805	977,069
Total liabilities and equity	$1,292,856	$2,538,499	$3,659,038

EXHIBIT 2 Global Machinery and Metals, Inc.—Statement of Income

	1985 (Unaudited)	1986 (Unaudited)	1987 (Audited)
Net revenues	$2,654,526	$4,330,934	$5,229,695
Costs and expenses			
Cost of goods sold	1,688,268	3,111,927	3,759,491
Selling, general & administrative expenses	582,804	849,151	873,670
Total cost and expenses	2,271,072	3,961,078	4,633,161
Revenue after costs and expenses	383,454	369,856	596,534
Other income (expense)			
Miscellaneous income	1,120	(11,286)	3,898
Interest income	(26,037)	(45,810)	(56,668)
Total other income	(24,917)	(57,096)	(52,770)
Income before federal taxes	358,537	312,760	543,764
Provision for federal income taxes	160,500	139,000	249,500
Net income	$ 198,037	$ 173,760	$ 294,264
Statement of Retained Income			
Retained earnings—beginning of period	$ 211,008	$ 409,045	$ 582,805
Net income	198,037	173,760	294,264
Retained earnings—end of period	409,045	582,805	877,069

Note 1: Bad debt expense:

1987	$16,863
1986	117
1985	1,053

The reserve for doubtful accounts totaled $12,114 as of 12/31/87.

Note 2: Inventories are stated at the lower of cost, first-in, first-out method, or market. Amounts of inventories used in computing cost of sales for periods covered by the financial statements are as follows:

12/31/87	$2,480,115
12/31/86	1,527,925
12/31/85	671,402

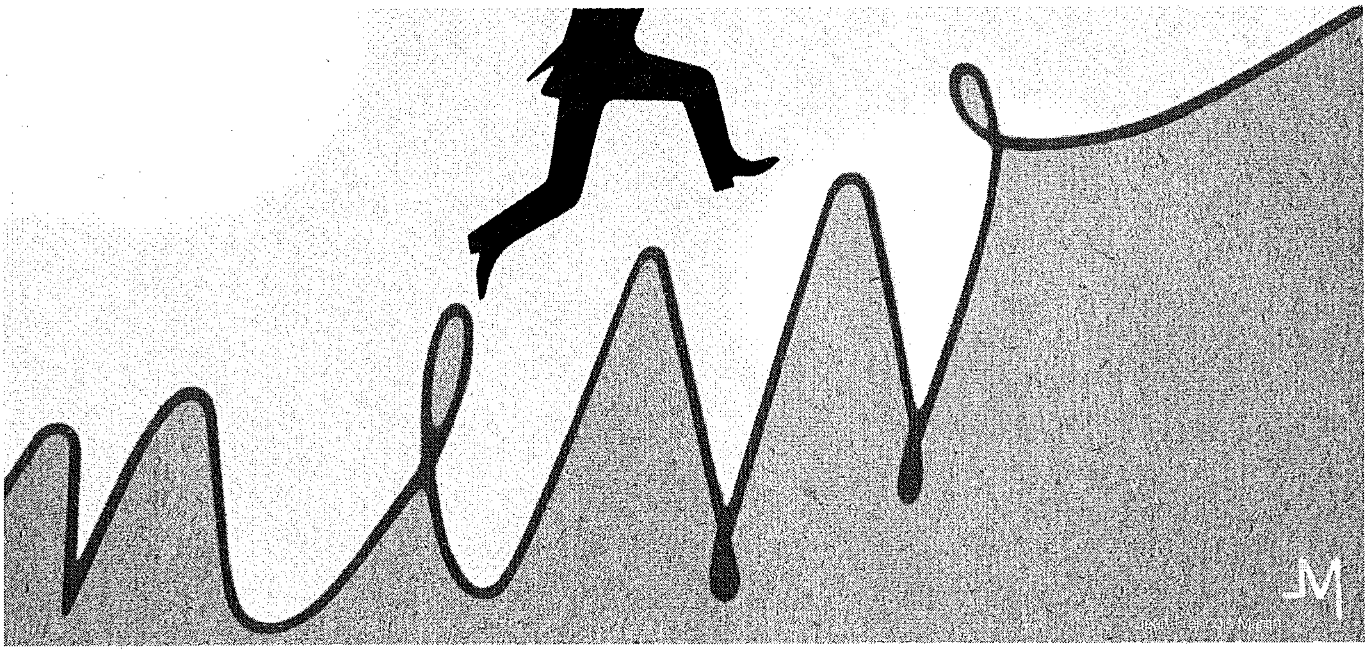
McKinsey&Company

Growing beyond the core business

Most companies are seeking growth outside their core business, according to a new survey. But few have made revenue gains as a result—or have the right capabilities to support it.

A clear majority of executives say their companies are pursuing growth in categories outside their core business—and report a strong belief that doing so has created company value. But a McKinsey Global Survey suggests that over time, companies' aspirations to grow through these activities have produced only modest results and that few companies have the right practices in place to support such growth.[1]

These are the key findings from a survey on how companies expand into product or service categories beyond their core business. Nearly nine in ten respondents say that in the past five years, their companies have either pursued at least one activity in a new category, have considered it, or plan to do so in the next five years. Companies are most likely to pursue new activities through investments in organic growth and with long-term interests in mind. Executives at emerging-economy companies report greater paybacks than their peers at developed-economy firms—but few respondents overall say that over time, the activities have added much to company revenues. This could be because, according to the results, there's much room for improvement in the ways that many companies identify and evaluate new opportunities.



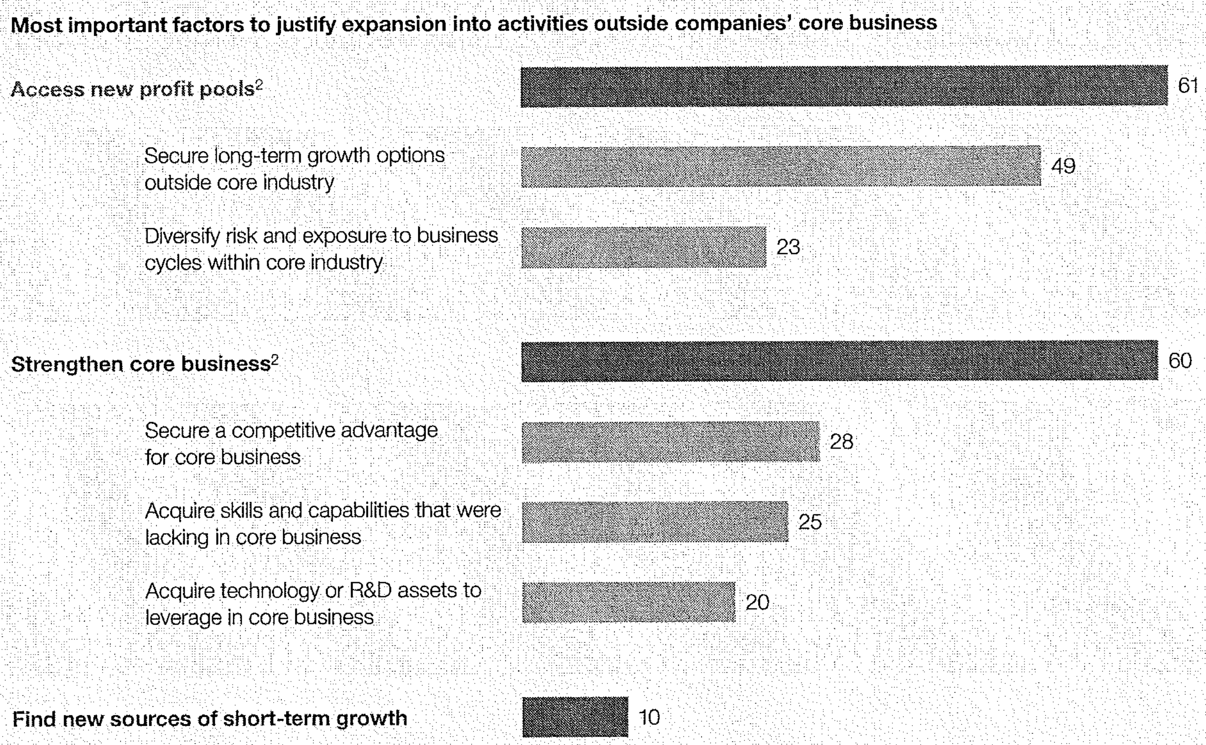
Significant value at stake—and modest results

At most companies, pursuing growth in new product or service categories outside the core is already on the agenda. Three-quarters of respondents say that over the past five years, their companies have pursued at least one business activity in a new category. Another 14 percent say their companies have either considered pursuing this growth or plan to do so in the next five years.

For many of these companies, growth beyond their core business is a long-term play. Among C-suite executives (who respondents most often say are responsible for evaluating these opportunities), only one in ten say their companies consider new activities for short-term returns. C-level respondents also say their companies are equally likely to consider such a move to access new profit pools as to strengthen their core business (Exhibit 1).

Exhibit 1 **Companies pursue new activities both to access new profit pools and to strengthen their core business.**

% of C-level respondents,[1] n = 273



[1]Respondents who answered "other" or "don't know" are not shown.
[2]These figures reflect the aggregation and recalculation of responses on the individual factors that follow.

No matter the reason, though, few executives report significant top-line results over time from diversifying activities. Only one-third of all respondents say their companies' moves beyond the core generate more than 10 percent of their revenues today. The share of revenues increases with the number of activities that companies pursue. But even at firms that are active in more than ten product or service categories, 35 percent of executives say these activities make up more than 10 percent of revenue. What's more, when asked about the biggest revenue-generating activity of the past five years, respondents most often say this move has created just some financial value for their companies.[2]

The emerging-economy advantage

At the same time, executives also report notable differences in the value that developed-economy and emerging-economy companies see from these growth activities beyond the core. At companies based in emerging economies, respondents are about 1.4 times more likely than their developed-economy peers to say their biggest move in a new category has created significant value for their companies—likely due to structural advantages in their home markets (Exhibit 2).

Exhibit 2

At diversified companies in emerging markets, executives report that structural advantages help them create value.

% of respondents at emerging-economy companies, n = 149

If your company were to pursue a new activity beyond its core business, in what ways would your home market give you an advantage over companies based in developed markets that are also pursuing new activities?[1]

[1]Respondents who answered "don't know" are not shown. This question was asked only of respondents who work at companies that are headquartered in emerging economies.

When asked what gives their companies a distinctive advantage over those based in developed economies, emerging-economy respondents most often cite greater opportunities to reinvest retained earnings in new businesses—easier to do than in developed economies, where relative growth is much slower—and a greater ability to leverage their local knowledge and relationships.

Best practices for expanding beyond the core business

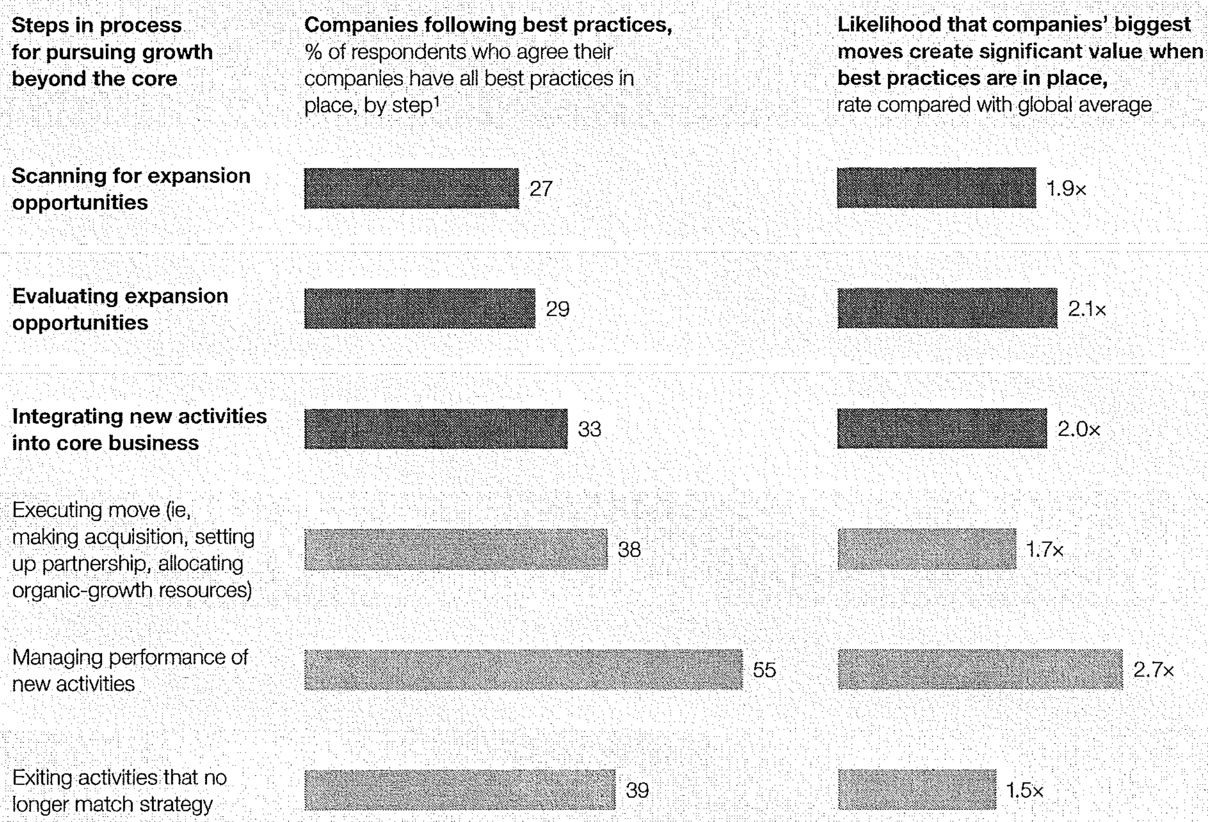
Across regions, respondents at emerging-economy and developed-economy firms agree on the approaches their companies use to grow in new areas: investments in organic growth are cited most often by both groups, followed by mergers and acquisitions.[3] Both groups are likeliest to identify their executive teams and boards as the ones responsible for evaluating opportunities in new categories. There is also consensus among both groups that new activities shouldn't stray too far from the core business. When assessing a move's value potential, nearly two-thirds of all respondents say unique links between the activity and the existing business are the most important criteria their companies consider.

When asked about different steps in the process of pursuing growth in new categories,[4] few executives say their companies follow the best practices that make this growth successful. According to executives, firms most often struggle to scan for new opportunities, evaluate those opportunities, and integrate new activities into the core business (Exhibit 3). But respondents at companies that get the practices right are much likelier than others—about twice as likely for each of these three steps—to report that their biggest move in the past five years has created significant company value.

Respondents whose companies follow best practices for scanning, evaluating, or integrating new activities into the core business are twice as likely as others to report significant value creation from diversifying.

Exhibit 3 **Most companies lack best practices to expand beyond their core business, especially when scanning, evaluating, and integrating new opportunities.**

n = 695



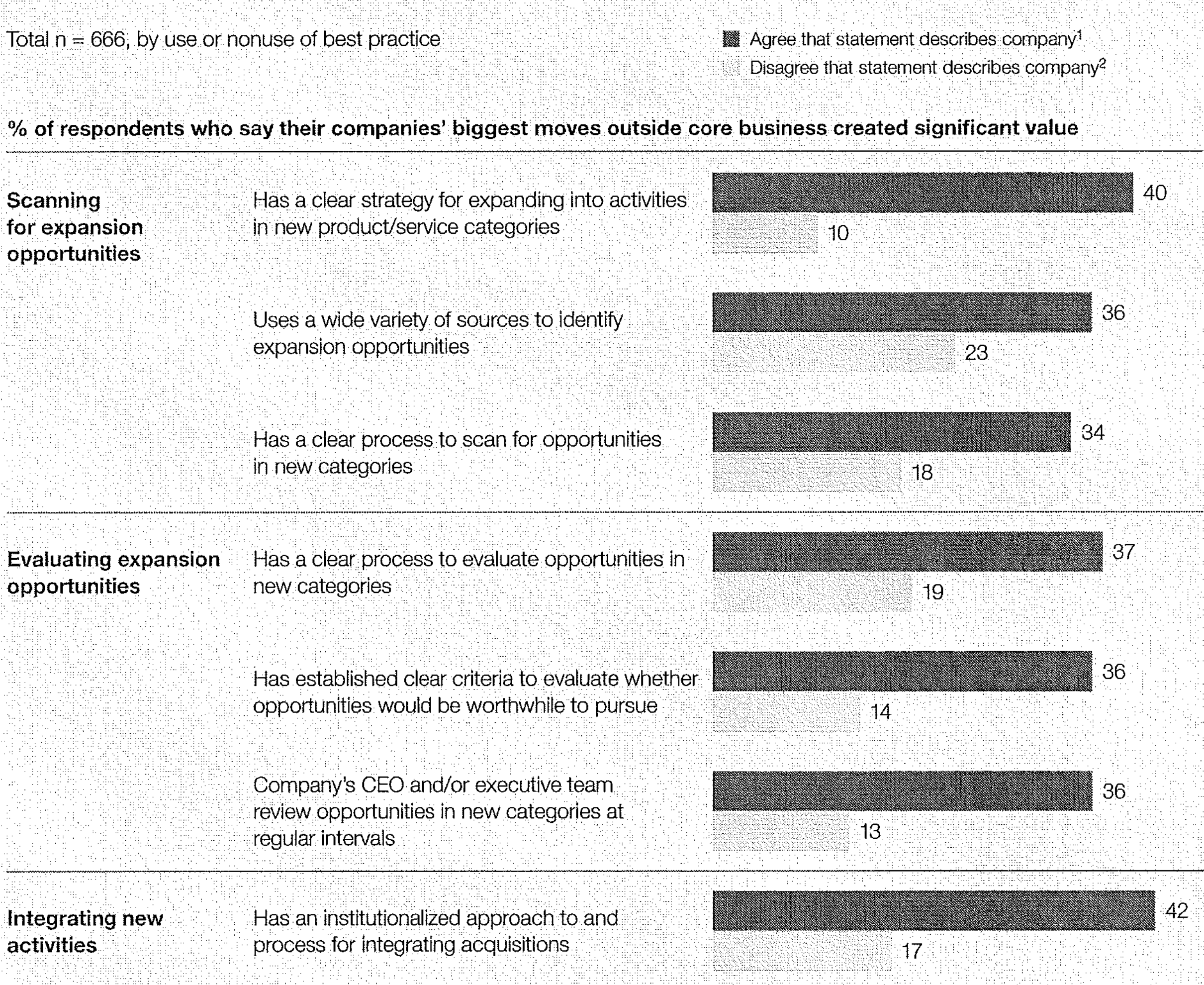
[1]Includes respondents who "agree" or "strongly agree" that the practices describe their companies. Those who answered "somewhat agree," "somewhat disagree," "disagree," "strongly disagree," or "don't know/not applicable" are not included.

More specifically, the responses in these three areas (scanning, evaluation, and integration) suggest which individual practices link most closely to value creation. When executives say their companies have a clear strategy for expanding into new activities, for example, they are four times more likely than those whose companies have no such strategy to report significant value creation (Exhibit 4). With respect to managing new activities, respondents are also four times more likely to report value creation when their companies actively and regularly review the performance of these activities.

Exhibit 4

Best practices for scanning, evaluating, and integrating growth opportunities beyond the core can drive significant value.

Total n = 666, by use or nonuse of best practice



[1]Includes respondents who "agree" or "strongly agree." Those who answered "somewhat agree" or "don't know/not applicable" are not included.
[2]Includes respondents who "disagree" or "strongly disagree." Those who answered "somewhat disagree" or "don't know/not applicable" are not included.

Looking ahead

- *Understand the market context.* The results indicate that a company's opportunity to grow successfully beyond its core business differs across regions, with respondents reporting that growth in new categories pays off more in emerging economies than in developed economies. We have also seen that diversifying activities can benefit companies in some industries more than others. For companies looking to expand into new activities, it's important to understand first the extent to which growth beyond the core in their region and industry is either an opportunity or a risk.

- *Find growth close to home.* When asked about the criteria their companies use to assess a new activity's potential value, the largest share of executives say unique links between the activity and the core business are most important. Companies would do well to follow suit and start identifying growth opportunities that are close to home—in other words, ideas or opportunities where they can leverage existing capabilities and skills in their core business.

- *Build the right capabilities.* Most respondents report that their companies lack the capabilities (or even a clear strategy) to grow beyond the core, so it's no wonder that most companies see only modest contributions to revenue as a result of such activities. However, companies with the capabilities to scan, evaluate, and integrate opportunities have a much higher chance to create value with these moves. When planning to pursue new opportunities outside of their core business, leaders should assess their companies' capabilities to make sure the right processes and practices are in place to maximize the value that new activities can add. ■

---

[1] The online survey was in the field from November 4 to November 14, 2014 and garnered responses from 1,143 executives at companies with annual revenues of $500 million or more, representing the full range of regions, industries, functional specialties, and tenures. Of them, 904 executives say their companies have either pursued or considered pursuing growth in a new product or service category, beyond their companies' core business, in the past five years. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

[2] The largest share (49 percent) of respondents say the biggest revenue-generating move has created some financial value; 28 percent say the move has created significant financial value, 9 percent say it had no effect, 8 percent say it destroyed some value, and 2 percent say it destroyed significant value.

[3] We also asked about joint ventures, which 37 percent of respondents cite as an approach their companies have taken to grow beyond their core business.

[4] The steps are: scanning for new opportunities, evaluating opportunities, executing the growth move, integrating new activities into the business, managing the performance of new activities, and exiting activities when they no longer match the strategy.

The contributors to the development and analysis of this survey include **Francisco Caudillo,** a specialist in McKinsey's Miami office; **Skief Houben,** an associate principal in the Amsterdam office; and **JehanZeb Noor,** a principal in the Chicago office.

They would like to acknowledge Yuval Atsmon and Sven Smit for their contributions to this work.