HIGH PERFORMANCE TIRE

High Performance Tire (HPT) Ltd. is a retail tire chain with a network of company-owned stores in the B.C. Interior. It was formed by Harry and Edna Wallace in 1952 and was passed on to their daughter Jane Wallace in the late 1960s. Jane Wallace maintained control of this family-owned business until 2001, at which time she transferred the responsibility for day-to-day management to her son William.

By early 2004, HPT was having difficulties and Jane Wallace decided to become actively involved again in the company to turn things around. Her first action was to hire Jenny Chen, CA, CFA, CMC from the accounting firm of Dexter, Mathews & Jones to review current operations and make recommendations.

WILLIAM'S TENURE

William Wallace had led a privileged and carefree life, and his mother did not feel that he would be able to operate the business successfully, but she had little choice if she wanted to keep the business under family control. Despite his MBA with double concentrations in marketing and finance from a major university, Jane Wallace did not feel that her son had the patience and general business acumen to operate such a sizeable business at this time. She was also fearful that he would recklessly try to expand the business and lose interest once things did not go exactly as planned.

Upon taking over operations in late 2001, William Wallace immediately began to put a major expansion plan into effect that he had worked on as the graduating project in his MBA. This plan had two major focal points. One was to expand the number of retail tire outlets in smaller communities and the other was to diversify the products provided at each of the outlets to include higher margin automotive maintenance services including fluid changes, tune-ups, alignments, batteries and brakes. A number of tire chains in Canada had followed a similar strategy of diversification and were successful.

In 2001, all the outlets were expanded to include bays for maintenance work as well as tire installation. Sales of these new services were poor over the next two years. To have their fluids changed, customers had to leave the vehicle and wait for a considerable period of time in the customer reception area. An appointment was also required. This was not as convenient as other lube stores where patrons did not need either an appointment or to get out of their vehicles and generally could have the work done in less than 20 minutes. For more complicated maintenance work, like tune-ups and alignments, HPT's mechanics had a reputation in the community of not being highly qualified. There had been a number of cases that received extensive coverage in the local press, where HPT mechanics had made mistakes that caused major damage to the vehicles they were working on. Instead of admitting they were at fault and keeping public relations damage to a minimum, HPT was taken to court a number of times and forced to pay the repair costs.

In addition to its sales outlets in Kamloops, Kelowna, Penticton, Prince George and Vernon, in 2002/2003 additional stores were added in Revelstoke, Golden, Chase, Williams Lake and Salmon Arm. By early 2004, all outlets were underutilized. Canadian Tire, as well as local service stations with strong ties to the community, lowered their prices and improved their customer service and proved to be formidable competitors.

Prior to 2001, HPT Ltd.'s workforce was composed of a number of experienced tire professionals who had been with the company for years. When William Wallace took over operations, he decided to try to increase profitability by cutting wages and benefits. The result was that most of these professionals left and were replaced by younger, less experienced staff with much poorer customer service skills. The tire sales staff was taken off salary and put on straight commission as a means of increasing sales. The sales staff did become "hungrier," but the more aggressive practices alienated many customers.

In order to increase gross profits, HPT began buying more no-name tires from overseas suppliers. These sales generated a higher gross profit margin for the retailer initially and the customer did receive a lower price, but quality concerns due to shorter tread life and blowouts soon caused sales and margins to fall.

A new accounting system was purchased in 2002 in order to better automate the general accounting, billing, inventory and payroll functions of the company. The low-cost vendor was selected to save cash to help fund the expansion. This vendor provided very poor software installation and training and then went bankrupt. HPT's clerical staff struggled with the new system and matters were made worse by high employee turnover due to low wages and William Wallace's disorganized management style and "short fuse." A lot of overtime had been used to clear the backlog of clerical work, while customers, staff and suppliers were becoming alienated over delays and errors.

In the first quarter of 2003, Jane Wallace suspended all dividend payments. William Wallace had been drawing too much from the company to fund the construction of a new home and to purchase a new luxury car.

FINANCIAL STATEMENTS

Income Statement[1]
For Year Ending December 31

	2003	2002	2001
Sales	6,500,000	5,550,000	4,050,000
Cost of Goods Sold	3,965,000	3,385,500	2,430,000
Gross Profit	2,535,000	2,164,500	1,620,000
Depreciation	485,600	287,200	158,500
Other Operating Expenses	1,690,000	1,387,500	1,012,500
Earnings Before Interest and Taxes	359,400	489,800	449,000
Interest	331,956	160,125	50,645
Earnings Before Taxes	27,444	329,675	398,355
Income Taxes	10,978	131,870	159,342
Net Income	16,467	197,805	239,013

Balance Sheet
For Year Ending December 31

	2003	2002	2001
Cash	57,000	110,000	155,000
Accounts Receivable	95,000	59,000	45,000
Inventories	1,050,000	723,000	540,000
Prepaid Expenses	42,000	36,000	25,000
Total Current Assets	1,244,000	928,000	765,000
Property, Plant and Equipment	7,288,800	4,819,200	3,245,000
Less: Accumulative Depreciation	2,432,800	1,947,200	1,660,000
Net Property, Plant and Equipment	4,856,000	2,872,000	1,585,000
Total Assets	6,100,000	3,800,000	2,350,000
Accounts Payable	440,556	165,000	99,000
Line of Credit	570,638	353,000	267,435
Current Portion of Long-term Debt	325,346	162,000	41,461
Total Current Liabilities	1,336,540	680,000	407,895
Long-term Debt	3,253,460	1,620,000	414,605
Equity	1,510,000	1,500,000	1,527,500
Total Liabilities and Equity	6,100,000	3,800,000	2,350,000

FINANCIAL SITUATION

HPT has a $600,000 line-of-credit with the Toronto Dominion Bank. The limit could be extended, but only if the bank has sufficient loanable funds and the company is in good financial condition. The company must maintain a current ratio of 1.5, a times interest earned ratio of 5.0, and can only borrow up to 50 per cent of the value of its accounts receivable and inventory. The company negotiates separate term

[1] *All funds in Cdn$ unless otherwise noted.*

loans and mortgages to finance its capital purchases. Under Jane Wallace's leadership, HPT had an excellent relationship with its bank, but William's poor management and interpersonal skills had put this relationship in jeopardy.

Retail sales were paid for in cash or by credit card so there were no accounts receivable. Sales to businesses made up about 40 per cent of sales and were on terms 2/10, net 30 with negligible bad debts. HPT bought its tires from the various manufacturers on terms 2/15, net 30, which was the norm in the industry. Interest was charged on overdue accounts at 12 per cent per annum and many retailers who got too far in arrears were put on a cash-and-carry basis.

A slowdown was forecasted in the local economy in 2004 due to the forest fires that took place in the summer of 2003 and the collapse of the Canadian beef industry caused by the discovery of mad cow disease in neighbouring Alberta.

The following industry average ratios (based on year-end figures) were available for companies that sold both tires and automotive maintenance services:

Current Ratio	1.90
Cash Ratio	.51
Inventory Turnover in Days	60 days
Accounts Receivable Turnover in Days	30 days
Accounts Payable Turnover in Days	15 days
Fixed Assets Turnover	3.19
Total Assets Turnover	2.00
Debt Ratio	30.00%
Times Interest Earned	14.63
Cost of Borrowing	6.50%
Gross Profit Margin	42.00%
Operating Profit Margin	12.00%
Net Profit Margin	6.71%
Return on Assets	13.42%
Return on Equity	19.17%

HPT's marginal tax rate was 40 per cent.

TURNAROUND

Jenny Chen had just returned to her downtown office at Dexter, Mathews & Jones from a meeting with Jane Wallace in February, 2004 — Chen was feeling quite sad. Jane Wallace had worked very hard the last 35 years managing the family business as a legacy to her beloved parents who had passed away in a car accident prior to her taking control in the late 1960s. At 64, she was in need of a rest after a long career building HPT, but her son seemed to have mismanaged the business terribly during his short tenure and she now had to take back control before things got even worse.

Jane Wallace asked Chen to prepare a comprehensive review of HPT's operations with a focus on why things had deteriorated so much and what she might do to improve operations. Knowing, quite reasonably, that she could not continue running HPT indefinitely, Jane Wallace also asked Chen to make further recommendations on the future management of the company.

Questions

1. Prepare the Cash Flow Statements for High Performance Tire (HPT) for 2002 and 2003 using the information provided in the Income Statements and the Balance Sheets.

2. Assume the role of Jenny Chen and prepare a memorandum that is divided into sections analyzing the following:

a. Do the financial statements of HPT reflect its business strategy?

b. What are the specific concerns for this particular industry?

c. Short-term liquidity

d. Ability to pay long-term debt

e. Operating efficiency and cash conversion cycle

f. Profitability and sustainable growth model

g. Final recommendations on what Jane Wallace should do to address the problems at HPT and what might be done in the longer term relating to the management of the company.

The maximum word count is 1500 words exclusive of annexes