Braeside Farm: Financial Analysis of a Startup Service Business

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Abstract

The case illustrates financial analysis in the start-up and first year operations of a service-oriented business. The decision of the value of continuing the business versus liquidation is discussed from the lender's perspective at the time the case was written.

Braeside Farm: Financial Analysis of a Startup Service Business

Introduction

Braeside Farm, founded in October 2008, provides the West Michigan area with a premiere hunter/jumper, dressage training and horse boarding facility designed to meet the needs of beginner through advanced riders. Its mission is to provide a full-service riding and boarding facility, focusing on excellent care of the horse and enjoyment for the rider in a competitive arena. In addition, Braeside hopes to offer horse training and sales programs that help match horses to riders within and beyond its stables. Group adventures for all ages, including organized trail rides and overnight experiences accommodating both horse and rider, are under consideration. The farm's current and prospective services are shown in Table 1.

The West Michigan equine facility market currently caters to two classes of riders: 1) the highly competitive, upper socio-economic class and 2) the casually competitive, lower socio-economic class. Braeside Farm markets toward the middle to upper middle class riders who have the desire and financial means to compete at all levels, but who would largely focus on regional events. Its services are more comprehensive than the majority of barns in the area, but Braeside Farm sacrifices some of the personalization available at the more elite barns in the area. Braeside is extremely proud of its trainers, who are as qualified as those at the elite barns and far better known than the trainers at the smaller barns are. It has had the ability to attract top-level junior trainers and the youth who aspire to be serious riders. Simply put, Braeside Farm is the only B level barn in a field of few A and many C level barns.

While other barns tend to focus on one aspect of the horse world, such as showing and competing, Braeside Farm also concentrates on clients who wish to support their primary riders. For example, a child who is interested in competing in weekly horse shows, an adult who would like to learn to ride and/or those who are interested in simply furthering their relationship with their horse.

Braeside Farm's goal is to maintain its current clientele, while capturing the equestrian market that is without a premiere barn in the area. The facility is located directly off a major highway in the Grand Rapids, Michigan metropolitan area with close access to the areas of Rockford, Ada and Muskegon. This area was chosen not only because of its easy-to-access location, but also because it was offering a very healthy value per acre of land and a comparatively low property tax rate.

Company Background

The enterprise consists of two limited liability corporations (LLC): Braeside Property LLC and Braeside Farm LLC. The first entity owns the fourteen-acre property, which consists of a twenty-four stall boarding facility, a covered indoor riding facility, five outdoor paddocks, two outdoor riding arenas, a hay barn and a residence. The residence provides an additional benefit to the business of providing a means for around the clock onsite security for the property. Additionally, since living on the grounds is a requirement of the barn manager position, the market value of the monthly rent is deducted from the manager's salary.

Braeside Farm LLC is the operating side of the business, which pays a monthly rental expense to Braeside Property LLC. Braeside Farm LLC collects the monthly boarding fees, pays operating expenses and maintains the assets. Table 2 presents the original organizational structure for the business. For the first year of operations, two married couples owned the enterprise, but as the first year ended, a lack of financial responsibility in meeting partnership obligations led to a legal dissolution of the two LLCs on January 31, 2010. A concern of the partnership breakup decision was that the remaining owners could face immediate repayment on existing loans, according to the business attorney. The lender's justification, due to the fact the original business plan and structure were not in place, would support the right to call the mortgage and line of credit.

Pro Forma and Actual Financial Statements

Table 3 contains the forecasted profit and loss for the first year of operations. Based on these projections, along with the business plan, a local lender approved a $140,000 mortgage secured by an interest in the property and a $25,000 commercial line of credit to the Property LLC. One of the two couples (Owner 1) provided the remaining financing of $215,000. Actual results for the first year of operations are contained in Tables 4, 5 and 6.

Assume that you are a recent finance graduate and as the newest member of the credit analyst training program you have been assigned the Braeside Property loan. Your task is to evaluate the current financial situation, forecast the firm's expected performance for the upcoming year and advise the lender to extend or end the bank's loan exposure to Braeside Property. Use the following questions to guide your recommendation.

1. Repayment of the mortgage was based on monthly payments with an annual interest rate of 7.25%, a maturity of twenty years (240 months) and maturity date of five years (60 months). Given the terms, what is the monthly principal and interest (PI) payments? What is the mortgage balance at the end of the five-year period?
2. Based on your findings for the first question and what you know about expected income and expenses, what is an appropriate monthly rental payment from Braeside Farm to Braeside Property? Assume annual property taxes are $6,000.
3. Assuming a monthly rental payment of $2,900, evaluate Braeside Farm's performance to budget for the first twelve months of operations.

4. A major monthly outflow for Braeside Farm is the labor required to feed, water, clean and take to pasture the boarded horses. Based on advice from the CPA, the farm meets the three conditions to deduct the monthly housing rent from the barn manager's wages. Comment on this decision relative to other options the business may have with the residence.
5. Develop a Common Size Balance Sheet and complete the Statement of Cash Flows (Table 6). Discuss the strengths and weaknesses for Braeside Farms and results for the operating, investing and financing activities of the firm.
6. As of the end of the first year of operations, the lender could call the loans since the ownership of the LLC had changed. Given this right from a contractual perspective, should the bank terminate the lending relationship with the entity? Assume a Loan-To-Value ratio of 60% and 100% servicing of the loan(s) in answering this question.

Table 1
Braeside Farm's Services Provided

Horse Care:
Regulating each horse's feeding needs, supplements, requirements and daily turnout.
Maintaining a routine schedule for each horse's farrier needs, dental and veterinary care.
Maintaining a bi-monthly dewormer program for each horse.
Administering any medications, bandages, or recovery care for each horse as needed.
Handling horses for veterinary, farrier, chiropractic, dentistry or other care.
Boarder Care:
Setting up regular lesson schedules for each boarder and training rides for boarded horses.
Maintaining a regular exercise regiment for each client's horse.
Aid in the purchase and/or selling of a client's horse.
Schooling Horses Program:
Choosing the appropriate horses for the program and maintaining training on the horses.
Maintaining the equipment required for the program.
Arranging lessons accordingly with each trainer.
Maintain any leasing arrangements with any school horse to a client.
On-site Horse Shows:
Setting dates for monthly schooling shows at the facility.
Preparing a class list for each schooling show.
Organizing the boarders and riding school clients for each show.
Prepare arena for each event at the schooling shows.
Hire an appropriate judge for each schooling show.
Inform other trainers of the show dates and supply them with a show bill.

Table 2: Organization Structure

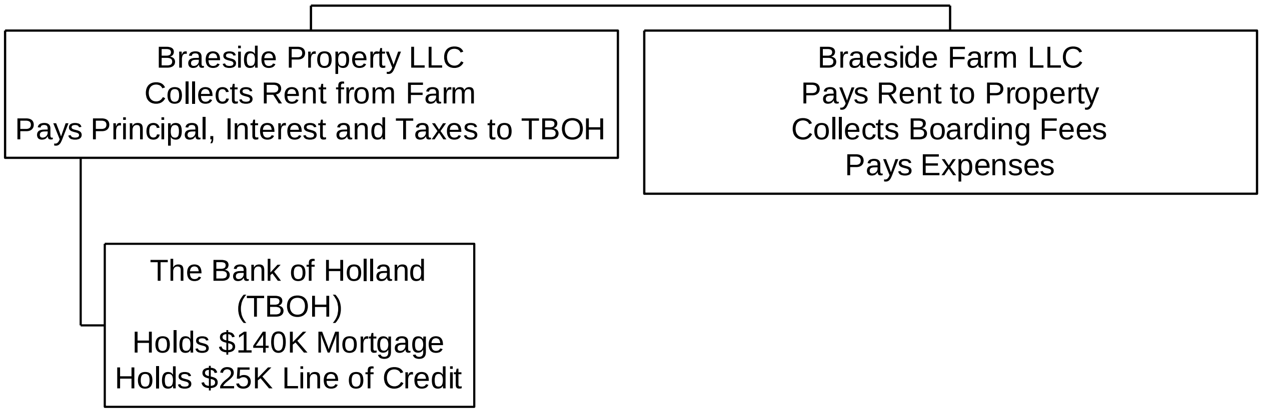

Table 3
Braeside Farm LLC
Budgeted Income v. Expenses
For the Period Ending December 31, 2009

	Q1	*Q2*	*Q3*	*Q4*	*2009*
Income:					
BF Show	0	1,500	1,500	0	3,000
School Horse Lease	2,640	2,640	2,640	2,640	10,560
Boarding Income	10,680	10,680	13,570	17,205	52,135
Trainer Arena Fees Income	90	90	90	90	360
Camp Income	0	650	1,300	0	1,950
Other Income	400	450	450	450	1,750
Total Income	**13,810**	**16,010**	**19,550**	**20,385**	**69,755**
Expense:					
Vehicle Expense	0	0	0	0	0
Advertising and Promotion	0	0	0	0	0
Miscellaneous	0	0	0	0	0
Bank Service Charges	0	0	0	0	0
Contract Labor	1,701	1,701	1,701	1,701	6,804
Farrier	375	375	375	375	1,500
Gasoline, Fuel and Oil	1,050	1,050	1,050	1,050	4,200
Hay & Grain	5,208	5,208	5,968	6,837	23,221
Insurance Expense	750	750	750	750	3,000
Professional Fees	0	0	0	0	0
Rent Expense	8,100	8,100	8,100	8,100	32,400
Repairs and Maintenance	0	0	0	0	0
Shavings	1,500	1,500	1,500	1,500	6,000
Supplies	0	0	0	0	0
Utilities	1,500	1,500	1,500	1,500	6,000
Vet Fees	510	510	510	510	2,040
Total Expense	**20,694**	**20,694**	**21,454**	**22,323**	**85,165**
Income less Expenses	**(6,884)**	**(4,684)**	**(1,904)**	**(1,938)**	**(15,410)**

Table 4
Braeside Farm LLC
Actual Income v. Expenses
For the Period Ending December 31, 2009

	Q1	Q2	Q3	Q4	2009
Income:					
BF Show	0	309	701	0	1,010
School Horse Lease	0	665	30	0	695
Boarding Income	8,912	9,435	10,983	15,683	45,013
Trainer Arena Fees Income	203	160	225	340	928
Camp Income	380	120	0	0	500
Other Income	0	221	0	20	241
Total Income	**9,495**	**10,910**	**11,939**	**16,043**	**48,386**
Expense:					
Vehicle Expense	0	658	367	185	1,210
Advertising and Promotion	638	438	0	0	1,076
Miscellaneous	247	907	109	268	1,531
Bank Service Charges	91	279	502	101	974
Contract Labor	2,619	2,343	3,624	3,212	11,798
Farrier	666	140	650	108	1,564
Gasoline, Fuel and Oil	939	1,371	874	246	3,430
Hay & Grain	3,253	4,792	3,891	5,456	17,392
Insurance Expense	865	1,655	0	1,091	3,611
Professional Fees	3,443	2,374	0	1,124	6,940
Rent Expense	9,165	8,027	8,931	8,708	34,831
Repairs and Maintenance	3,792	2,951	753	506	8,002
Shavings	2,042	2,066	740	810	5,658
Supplies	2,219	1,604	819	549	5,190
Utilities	1,422	1,999	1,323	1,560	6,304
Vet Fees	0	3,248	0	104	3,352
Total Expense	**31,400**	**34,852**	**22,583**	**24,028**	**112,863**
Income less Expenses	**(21,905)**	**(23,942)**	**(10,645)**	**(7,985)**	**(64,477)**

Table 5
Braeside Farm LLC
Balance Sheet
As of December 31, 20XX

	2009	*2008*
Current Assets		
Cash - Bank of Holland (BOH)	(165)	1,764
Accounts Receivable	310	2,500
Total Current Assets	145	4,264
Fixed Assets		
Equipment	31,900	25,868
Furniture & Fixtures	100	100
Horses	4,950	5,300
Leasehold Improvements	73,354	67,054
Accumulated Depreciation	(15,064)	(1,661)
Total Fixed Assets	95,241	96,662
Total Assets	**95,385**	**100,926**
Current Liabilities		
Total Credit Cards	22,696	9,769
Other Current Liabilities		
Vehicle Reimbursement - Owner 1	1,210	0
School Horse Loan - Owner 1	4,200	4,200
Advance - Braeside Properties	99,966	89,921
Advance - Owner 1	14,300	0
Advance - Owner 2	460	0
Bridge Loan - Owner 1	16,400	0
Equipment Loan – BOH	13,949	0
Line of Credit – BOH	24,878	22,500
Total Other Current Liabilities	175,363	116,621
Total Current Liabilities	198,059	126,390
Long-term Liabilities	0	0
Total Liabilities	198,059	126,390
Total Equity	(102,674)	(25,464)
TOTAL LIABILITIES & EQUITY	**95,385**	**100,926**

Table 6
Braeside Farm LLC
Statement of Cash Flows
For the Period Ending December 31, 2009

Cash Flows From Operating Activities	
Net Income	(77,210)
Depreciation	13,403
Adjusted Net Income	(63,806)
Change in Accounts Receivable	X
Vehicle Reimbursement - Owner 1	X
Net cash provided by Operating Activities	**(X)**
Cash Flow From Investing Activities	
Equipment	(6,032)
Horses	350
Leasehold Improvements	(X)
Net cash provided by Investing Activities	**(X)**
Cash Flow From Financing Activities	
Change in Credit Card Balances	X
Change in Advance - Braeside Properties	10,045
Advance - Owner 1	14,300
Advance - Owner 2	X
Bridge Loan - Owner 1	16,400
Equipment Loan – BOH	13,949
Change in Line of Credit – BOH	X
Net cash provided by Financing Activities	**X**
Net cash increase for period	(1,929)
Cash at beginning of period	1,764
Cash at end of period	**(165)**

TEACHING NOTES

Teaching Approaches and Appropriate Courses

An appropriate use of this case would be in the first and/or second course in an undergraduate finance degree. Specifically, when financial ratio analysis and financial forecasting are discussed. The case could be assigned to groups with one group acting as the lending institution and a second group playing the owner's role.

Suggested Answers to Braeside Farm Case Study:

Use the following questions to guide your recommendation.

1. Repayment of the mortgage was based on monthly payments with an annual interest rate of 7.25%, a maturity of twenty years (240 months) and maturity date of five years (60 months). Given the terms, what is the monthly principal and interest (PI) payments? What is the mortgage balance at the end of the five-year period?

   Answer: PV = ($140,000); N = 240; I = 7.25%/12; FV = $0; PMT =? = $1,106.53.

   Amortization: P1 = 1; P2 = 60; Balance =? = $121, 214.96.

2. Based on your findings for the first question and what you know about expected income and expenses, what is an appropriate monthly rental payment from Braeside Farm to Braeside Property? Assume annual property taxes are $6,000.

   Answer: The minimum monthly rental payment should be principal, interest, taxes and insurance (PITI) and utilities and is equal to $2,433. Insurance is $301 ($3,611/12), taxes are $500 ($6,000/12) and utilities are $525 ($6,304/12). The principal and interest is $1,107 (from Question 1).

3. Assuming a monthly rental payment of $2,900, evaluate Braeside Farm's performance to budget for the first twelve months of operations.

Answer: The two major errors in the revenue side of the business plan versus the actual results were the school horse leases and the boarding income. Not unlike many startup businesses, the forecasts were much too optimistic. Total income was only 69% of the first year forecast. The leasing program only generated seven percent of the expected value and the boarding income fell fourteen percent below expectations. These two components explained eighty percent of the $21, 368 shortfall in revenue ($9,865 + $7,122 = $16,987). On the expense side, four variables were major contributors to the underestimated costs of $27,698 (a 33% error). The firm's legal and organization costs of $6,940 were not included in the original business plan. As mentioned above, entrepreneurs are optimistic by nature and these two couples were no exception. Also, the costs of repairing, modifying and updating the facility did not enter into the original costs estimates. By the end of the first year, the supplies, repairs/maintenance totaled $13,192 (supplies = $5,190 of this total). Finally, the cost of labor was 173% higher than projected. One possible explanation is the four owners were planning to cover the seven days a week operation of the facility and that did not occur. Discussion on the cost of labor issue is continued below in Question Four. Perhaps, the only bright spot in the first year was the cost of feeding the boarded horses was 75% of the expected costs. Exhibit One contains a detailed analysis of the results for this question.

4. A major monthly outflow for Braeside Farm is the labor required to feed, water, clean and take to pasture the boarded horses. Based on advice from the CPA, the farm meets the three conditions to deduct the monthly housing rent from the barn manager's wages. Comment on this decision relative to other options the business may have with the residence.

Answer: The availability of the residence on the property is a definite benefit to the enterprise. Market conditions would vary across different regions, but in West Michigan, the value of comparable rental property with owner paid utilities (electric, gas and cable), washer and dryer was estimated at a minimum of $800 per month. In other words, if the residence was not available onsite, the contract labor costs would have increased by $9,600 annually. This would have lead to a net loss of $74,077 for the first year.

5. Develop a Common Size Balance Sheet and complete the Statement of Cash Flows (Table 6). Discuss the strengths and weaknesses for Braeside Farms and results for the operating, investing and financing activities of the firm.

   Answer: There were two major changes in assets over the period: Investments in operating equipment and improvements in the property. There was a 23% increase in the year over year equipment account and a 9.4% change in improvements to the buildings and facilities. The poor operating results for the period were supported by increasing short-term liabilities of the firm. Borrowing on credit cards increase by 132% over the period, while other short-term sources of funds (advances, equipment loans and a line credit) increased by 50%. The most dramatic change was in the total equity position. The loss of approximately $25K for the first period had jumped to approximately $103K, a change of 303%. Exhibits 2 and 3 contain the Common Size Balance Sheet and the Statement of Cash Flows, respectively.

6. As of the end of the first year of operations, the lender could call the loans since the ownership of the LLC had changed. Given this right from a legal perspective, should the bank terminate the lending relationship with the entity? Assume a Loan-To-Value ratio of 60% and 100% servicing of the loan(s) in answering this question.

Answer: The decision to call the loan from the lender's point of view would depend on the loan-to-value ratio, local real estate conditions for resale, the bank's portfolio of repossessed properties and the status of the loan. Given the time frame of 2008 to 2010 and the severely depressed economic conditions, the lender was essentially was put into a position to determine if the property and business was worth more "alive" or "dead". Since the loan payments were not in arrears and there was a significant amount of equity in the deal, the decision to not call the loan could be supported. Ultimately, if the borrowers did default, the property could be sold or auctioned, since the lender had a reasonable amount of loan exposure.

Epilogue

The two jointly owned LLCs were dissolved at the end of fourteen months (January 2010). Ownership of the two partnerships was transferred back to Owner One. Owner Two signed a personal unsecured note to repay a portion of the financial obligations of the enterprise. The lender decided not to call the loan given the payment history and a personal guarantee from the remaining owners. After making twelve payments, the second couple defaulted on the debt, filed for divorce and filed for Chapter 7 Bankruptcy in September 2011. The first couple continues to own and operate the business as of January 2012.