Financial Statement Analysis

For

Construction Supply, Inc.

For Period

December 31, Year 1 -3

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Per your request, we have completed an analysis of the financial statements for Construction Supply Inc. The objective of the analysis was to provide an independent assessment of the Company's overall financial condition.

This report summarizes key measures used by; outsiders like bankers evaluating credit worthiness or potential investors evaluating potential investment opportunities, in addition to internal management evaluating financial performance. The report contains the results of numerous financial calculations, along with our observations about the financial performance and trends over the period analyzed.

We did not complete any independent audit activities to verify the accuracy of your company's financial statements. The observations/conclusions derived are based on the accuracy of the financial performance information you provided.

This analysis examines your company's:

- **Solvency/Liquidity – Bill Paying Capacity**
- **Safety – Funding Structure Risk**
- **Profitability – Economic Performance**
- **Productivity – Asset Mix/Asset Productivity/Asset Quality**
- **Cash Flow – Internal and External Sources of Cash Flow**

As part of the analysis, we compared your company's operating performance against benchmark statistics for comparably sized businesses; engaged in the same industry sector. The industry financial performance statistics used were created by Risk Management Associates (RMA), the National Association of bank credit officers.

RMA produces financial performance information based on business financial statements provided by their affiliate banks throughout the country on an industry sector basis. The names of the businesses are redacted from the financial statements before they are submitted to RMA to protect confidentiality.

The RMA Annual Statement Study is used by commercial lenders throughout the country in their business loan underwriting process to help determine business credit worthiness.

As part of this comparison exercise, we calculated specific performance deviations between your company's performance and the RMA industry benchmark standards.

The report concludes with a summary of our overall financial performance observations and structural recommendations.

Financial Ratio Interpretations

We calculated a series of fourteen (14) Financial Ratios as a primary analytical tool for this report. Eight (8) of the Ratios measure specific financial structure issues and six (6) of the Ratios measure specific utilization rates. To help describe the results of the Ratio calculations, we have utilized our unique language of dollars and cents.

Ratios contain two numbers. The top number is called the Object Number and the bottom number is called the Subject Number. The intent of the analysis is to measure the size of the Object Number in comparison to the Subject Number.

To describe each of the Eight (8) Financial Ratios, we place dollar ($) signs in front of the numbers. The bottom number is the subject of the analysis. We begin the description of the Ratio using the Subject Number and we set this number equal to $1.00.

Scheduled below is an example of a Financial Ratio along with a description of the Ratio calculation utilizing the language of dollars and cents:

Ratio format:	Object Number / Subject Number
Sample ratio:	Net Profits / Sales
Calculation:	$125,000 / $2,500,000
Interpretation:	$0.05 / $1.00

The example above represents an analysis of Net Profits generated on Total Sales for the year.

Sales volume for the period measured is $2,500,000.00 and the Net Profits generated for the same period measured is $125,000.00. The Subject of the analysis is Total Sales generated and the Object of the analysis is the Net Profits generated.

Utilizing the language of dollars and cents, the results of the Ratio analysis is described by saying, "For every dollar of Sales generated, the business produced five cents in Net Profits." This represented a 5.0% return on Sales.

The six (6) Financial Utilization Rate Ratios measure the average length of time it takes; to collect Accounts Receivable, sell Inventory, and pay Accounts Payable. The pace of these activities dictates the dollar size of these Assets and Liabilities on the Balance Sheet and has a direct impact on the level of operating cash flow produced internally by the business.

Scheduled below is an example of a Financial Utilization Rate Ratio along with a description of the Ratio calculation:

Ratio format:	Object Number / Subject Number
Sample ratio:	Sales / Accounts Receivable
Calculation:	$2,500,000 / $250,000
Interpretation:	10 times

The Rate of Accounts Receivable Collections is ten (10) times per year. This rate translates into an average Collection Period of:

$$\frac{\text{365 Days}}{\text{10.0 Times}}$$

Average Accounts Receivable Collection Period is 36.5 Days.

Accounts Receivable and Inventory are listed as Current Assets because Accounts Receivable are expected to be collected within a year of making the sale and Inventory is expected to be sold within a year of purchase. Accounts Payable are listed as Current Liabilities because they are expected to be paid within a year of receiving the invoice.

The term Turnover speaks to the average length of time it takes to; collect Accounts Receivable, sell Inventory, and pay Accounts Payable. The longer the timeline, the larger dollar size these items will be on the Balance Sheet. The shorter the timeline, the smaller the Balance Sheet dollar size will be on the Balance Sheet.

When you evaluate a Balance Sheet it is important to understand its construction logic. Assets listed on the left-side of the document are listed in descending order of their life/usage expectancy. Current Assets have a life/usage expectancy of less than one-year, Fixed Assets are greater than one year, and Other/Intangible have a life/usage expectancy for even longer periods.

The Balance Sheet's funding structure on the right-hand side follows similar logic. Debt which must be repaid, is listed first. Current Liabilities are to be paid within then next twelve months while Long-term Debt has a longer repayment structure. The other source of funding, Equity, does not have a repayment requirement and it is listed last.

Construction Supply Inc.'s Financial Performance

Solvency/Liquidity – Business Bill Paying Capacity

The first performance measure we examined was your company's Solvency/Liquidity position. This analysis evaluates the Company's ability to pay its outstanding short-term obligations, listed as Current Liabilities on the Balance Sheet.

The cash flow capacity to pay Current Liabilities will be generated primarily from the management of the Current Assets listed on the Balance Sheet. Operating cash inflow is generated from; Sales made on a cash basis, Accounts Receivable collected, and the consideration of non-cash expenses like depreciation and amortization incurred in the period. A company's Solvency/Liquidity is measured by the Current and Quick ratios.

Current Ratio

The Current Ratio compares the dollar size of the Current Liabilities against the dollar size of the Current Assets. It is calculated by:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Current Liabilities by accounting definition are debts/bills due to be paid within 12 months of the date the Balance Sheet. Current Assets are assets that will be utilized within the next 12 months to produce operating cash flow.

This Ratio is described by starting from the bottom of the Ratio. For every dollar of Current Liabilities due to be paid in the next 12 months, how many dollars of Current Assets are available to pay these obligations? As a rule of thumb, financial analysts like to see a minimum relationship of $2.00 of Current Assets available to pay every $1.00 of Current Liabilities.

The Table below reflects the results of the Current Ratio analysis for your company over the last 3 fiscal year ends:

	Year 1	Year 2	Year 3	Industry Benchmark
Liquidity/Solvency				
Current	1.70	1.48	1.32	1.70

In Year 1, for every $1.00 of Current Liabilities, your company had $1.70 in Current Assets available to pay these obligations. In Year 2, bill paying capacity declined to $1.48 for each $1.00 of Current Liabilities and continued to decrease to $1.32 in Year 3.

The Benchmark standard listed in the Table reflects the RMA Median for comparably sized businesses engaged in the whole distribution of building materials/supplies. The RMA data was compiled from a group of 272 comparably sized businesses.

The analysis of the Current Ratio reflects a declining trend in bill paying capacity over the 3-year period. The most recent year end level of $1.32 is below the RMA median industry standard of $1.70.

Quick Ratio

The Quick Ratio represents a more stringent test of the business's ability to pay its short-term obligations. This calculation considers only those Current Assets which are most easily or quickly convertible into cash. This analysis eliminates Inventory and any other Current Assets identified as less liquid. The Quick Ratio is calculated by:

$$\frac{\text{Liquid Assets (Cash, ARs, Marketable Securities, etc.)}}{\text{Current Liabilities}}$$

This analysis measures the size of the liquid Current Asset pool against the total Current Liabilities. While the Current Ratio assumes you have time to convert Current Assets into cash to pay obligations coming due; the Quick Ratio measures your immediate ability to generate the cash needed to pay the Current Liabilities. As a rule, business financial analysts like to see a minimum relationship of $1.00 of liquid Current Assets for every $1.00 of Current Liabilities.

Any time the Quick Ratio is less than $1.00/$1.00, the business on paper is technically insolvent. If there was an immediate demand to pay the Current Liabilities, the business would not be able to make the payments. This could lead to business bankruptcy or outright business operating failure.

The Table below reflects your company's Quick Ratio:

	Year 1	Year 2	Year 3	Industry Benchmark
Liquidity/Solvency				
Quick	0.70	0.59	0.47	0.90

In Year 1, for every $1.00 of Current Liabilities, your company had 70¢ in Liquid Assets available to pay. In Year 2 it declined to 59¢ and continued to decrease to 47¢ in Year 3. The RMA median standard for the industry is 90¢. The Company's Quick Ratio results are declining over time and are below the industry standard.

The RMA benchmark indicates businesses engaged in this industry are challenged to generate timely bill paying capacity given the mix of Assets they have on their Balance Sheet. As a result of this liquidity challenge, businesses in this industry sector typically cannot afford to carry significant amounts of debt they must repay.

Leverage – Funding Structure Risk

The next financial measure evaluates your company's funding structure. Capital used to acquire the Assets listed on the Balance Sheet comes from owners of the business or from creditors of the business.

Owner contributions to the funding effort is reflected as Equity on the Balance Sheet. Capital that is provided by creditors is listed as Liabilities on the Balance Sheet.

Equity capital represents the owners' investment in the business. Equity holders have ownership rights that enable the ability to control the management decision making processes for the business. Capital provided by creditors is acquired based on an agreement between the business owner(s) and the various providers. The agreement will specifically define the cost for the usage of the capital provided and the requirements for repayment.

All capital has a cost for usage. Business owners put capital in their business that could potentially be invested in other ways. By choosing to put their capital in their business, they intentionally forgo alternative investment options, and the potential returns that could be generated. To justify the risks associated with making an investment in their business, owners need to generate a reasonable rate of return.

Capital provided by creditors typically carries a specific interest rate charge for usage and both the interest and the principal must be repaid in a defined timeline.

Ultimately, every business must be capitalized in a safe manner. A reasonable return on investment must be produced to incent the business owner(s) to continue to operate the business, and the capacity to repay the interest and principal to the creditors in compliance with the terms defining repayment requirements must be generated by the business.

Debt to Equity Ratio

Leverage is measured by calculating the Debt to Equity Ratio. This Ratio measures the dollar size of the Equity against the dollar size of the Total Liabilities. For every dollar of capital provided by the owners, how much capital is being provided by the creditors?

The funding structure of a business is considered safe when the business can operationally generate the cash flow capacity to repay the Liabilities in the normal course of business. A business is considered highly leveraged if a substantial portion of the total capital used to fund the business is being provided by creditors.

The higher the Debt to Equity Ratio, the greater the funding structure risk. Ultimately, every business will reach a position where it is not operationally able to repay all the Liabilities.

Access to capital provided by creditors is dependent on the borrower's ability to repay. The more leveraged a business becomes, the less likely it will be able to secure additional loans from a financial institution.

Funding structure risk is a part of being in business. To sustain the business, the funding structure must be manageable and cash flow affordable.

This Ratio reflects the owner's willingness to take on and manage the risks associated with capital provided by creditors. A high ratio suggests a high degree of funding structure risk, while a low ratio may indicate a conservative funding structure risk position. The ratio is calculated by:

$$\frac{\text{Total Liabilities}}{\text{Equity}}$$

This Ratio states for every dollar of Equity Capital (money the owners have invested and retained) the business has "X" dollars in Capital provided by creditors. In today's business marketplace, the Debt to Equity Ratio should typically be $3.00/$1.00 or lower.

Your company's Leverage Ratio has been/is:

	Year 1	Year 2	Year 3	Industry Benchmark
Leverage				
Debt to Equity	1.44	2.07	3.50	1.30

In Year 1, for every $1.00 of Equity, your company had $1.44 in Total Liabilities. Leverage increased in Year 2 to $2.07 and continued to increase to $3.50 in Year 3. The RMA Median Debt to Equity Ratio indicated for every $1.00 of Equity, creditors collectively were providing $1.30.

Your Company's Balance Sheet reflects an increasing level of funding structure risk during the 3-year period. The most recent year end Debt to Equity Ratio is substantially above the RMA industry standard of $1.30. To compound the concern for funding structure risk, most of the Liabilities listed on your Balance Sheet are Current Liabilities that are due to be repaid in the next 12 months.

Net Working Capital

Another measure used to evaluate funding structure risk is an analysis of the business's Net Working Capital. This analysis measures the amount of Current Assets that are not already encumbered by an existing Current Liability. The business will have access to the cash generated from the use of the net Current Assets to address cash flow needs faced by the business.

This analysis will also help to evaluate whether the repayment terms for the Liabilities on the Balance Sheet are properly structured. The key funding structure rule for a business is *"Match the repayment term for the borrowed funding used to acquire an Asset to the Asset's useful life and its ability to generate operating cash flow."*

Assets with a short-term useful life should typically be funded with short term sources of capital and Assets with long term useful life should be funded with long term sources of capital.

Net Working Capital is calculated by subtracting Current Liabilities from Current Assets. If short term debt capital is utilized to acquire long term Assets, the amount of Net Working Capital available to address cash flow needs will erode.

Your company's Net Working Capital position indicates the following:

	Year 1	Year 2	Year 3	Industry Benchmark
Leverage				
Working Capital	$296	$351	$426	N/A

In Year 1 your company had $296,000 of Net Working Capital. It increased in Year 2 to $361,000 and further increased in Year 3 to $426,000. The increase in the dollar amount of Net Working Capital suggests the Balance Sheet is properly funded and does not reflect an improper term structure for the funding used by the Company to acquire long term Assets.

RMA does not produce a calculation of Net Working Capital, so no benchmark standard was available to include in this analysis.

Profitability

The next financial measure is Profitability. Profitability Ratios evaluate the economic viability of the business. The first two Ratios measure reported Profitability in relation to Sales Volume.

The number one goal of every business owner should be to make as much money as possible; that justifies being in business. The most valuable small businesses consistently generate measurable operating profits with positive internal cash flow.

Profitability on the business Income Statement is measured by computing the Gross Profit Margin, and the Pretax Margin.

Gross Profit Margin

Gross Profit represents the portion of Total Sales dollars left after the Cost of Goods Sold expenses have been considered. There is an old saying in business, "If you don't make it at Gross Profit, you don't make it, period."

The Gross Profit Margin is calculated by dividing Gross Profits by Sales:

$$\frac{\text{Gross Profit}}{\text{Sales}}$$

This ratio states for every dollar of Sales generated by the business, in the period being measured, "X" cents were generated in Gross Profit.

The Gross Profit Margin (GPM) evaluates three (3) operational issues. It evaluates your business':

- Pricing policies
- Inventory Control policies
- Operational Efficiency

Declining Gross Profit Margins may be caused by Pricing issues. As an inducement to generating Sales, prices can be intentionally lowered. If the prices are lowered, the GPM will go down.

It may also be possible that the process utilized by management to set prices on products and services is flawed. The result can be lower Gross Profit Margins.

Several Inventory management decisions can impact the Gross Profit Margin. If the purchasing process is not well managed, the prices paid to acquire inventory could be high, resulting in a lower GPM.

Inventory choice/mix decisions my result in the acquisition of items that prove not to be in demand. The only effective ways to remove them from the Inventory mix is to either send them back to the supplier and likely pay a restocking charge, or intentionally reduce the price. Either scenario will reduce the GPM.

Managing Inventory is a complex process. It must first be effectively sourced and then purchased. Discounts may be offered by suppliers that must be analyzed. Once purchased, it must be efficiently received, accounted for, and cared for while it is in possession.

Inventory is subject to several challenges that impact its viable shelf-life and ultimate salability. They include issues like effective merchandising skills, seasonality, style, competition, obsolescence, sales rights exclusivity, expiration of patent rights, shrinkage, and perishability.

The Cost of Goods Sold expense on the Income Statement may include elements of cost other than the cost of Inventory. Examples of other expenses would be Direct Labor and Freight-in charges. If these costs are not well managed, the result could be a higher total Cost of Goods Sold and a resulting lower Gross Profit Margin.

Your company's Gross Profit Margin has been/is:

	Year 1	Year 2	Year 3	Industry Benchmark
Profitability				
Gross Profit %	24.8%	24.0%	23.5%	24.7%
Gross Profit Dollars	24.8¢	24.0¢	23.5¢	24.7¢

In Year 1, for every average $1.00 of Sales, the company made 24.8% or 24.8¢ in Gross Profit. Gross Profits decreased to 24.0% or 24.0¢ in Year 2 and continued to decrease to 23.5% or 23.5¢ In Year 3. The RMA industry standard for the Gross Profit Margin was 24.7% or 24.7¢ for every dollar of Sales.

Over the 3-year period reported, the Gross Profit Margin declined by 1.3¢ for every dollar of Sales produced. It was 1.2¢ below the RMA industry benchmark standard in Year 3.

Pretax Margin

The Pretax Margin evaluates the operational bottom line for the business. It compares Pretax Profits against Total Sales. The Pretax Margin is calculated by dividing Pretax Profit by Total Sales:

$$\frac{\text{Pretax Profit}}{\text{Sales}}$$

For every dollar of Sales produced in the period being measured, what level of Pretax Profits were generated? Pretax Profits represent the operational pool of dollars that can be reinvested in the business to fund the purchase of additional Assets. Retained Earnings enable businesses to qualify for access to additional Liabilities to help fund the business going forward.

The Pretax Margin evaluates two operational issues:

- Operating Expense Control
- Adequate Sales Volume for the level of Operating Expenses

Operating Expenses represent overhead costs incurred to manage the business. Most Operating Expenses are not costs caused directly by selling activities.

They include expenses like Rent, Utilities, Administrative Salaries and Benefits, Marketing, Property and Casualty Insurance, Professional Services, and Travel and Entertainment. Most are budgeted expense items business owners/managers choose to be in place.

If discretionary choices made by management set Operating Expenses at arbitrarily high levels, Pretax Profits will be lower. If Operating Expenses are being closely controlled and kept to a minimum required level. and the business is still not reporting meaningful Pretax Profits the business may not be producing enough Sales Volume to adequately cover the base level of Operating Expenses necessary to run the business.

Your company's Pretax Profit Margin has been/is:

	Year 1	Year 2	Year 3	Industry Benchmark
Profitability				
Pretax Profit Margin %	2.4%	2.2%	2.0%	3.2%

In Year 1, for every $1.00 of Sales, your company made 2.4¢ in Pretax Profit. They decreased to 2.2¢ in Year 2 and continued to decline to 2.0¢ in Year 3. Throughout the 3-year period, the Pretax Profit Margin has been declining and is below the industry standard of 3.2¢.

Return on Assets Ratio/Return on Equity Ratio

The Return on Assets and Return on Equity Ratios are other performance measures that use Pretax Profit dollars. The Return on Assets evaluates the level of Pretax Profits generated from the use of the Assets owned and deployed by the business.

Return on Assets is calculated by:

$$\frac{\text{Pretax Profit}}{\text{Total Assets}}$$

For every dollar of Assets deployed, what is the level of Pretax Profits?

Your company's Return on Assets Ratio (ROA) has been/is:

	Year 1	Year 2	Year 3	Industry Benchmark
Profitability				
Return on Assets	6.7%	6.0%	4.7%	6.5%

In Year 1, for every $1.00 of Assets on the Balance Sheet, your company made 6.7% or 6.7¢ in Pretax Profit. It decreased to 6.0% or 6.0¢ in Year 2 and continued to decline to 4.7% or 4.7¢ in Year 3. Your ROA is below the RMA median standard of 6.5% or 6.5¢ for every dollar of Assets deployed.

Return on Equity evaluates the business owner(s) return on their investment in the business. Given the significant amount of risk associated with owning/operating a small business, the business owner(s) should expect to receive a reasonable rate of return. As a rule, at HBRC we believe that should be somewhere between 15.0% -25.0%.

Return on Equity is calculated by:

$$\frac{\text{Pretax Profit}}{\text{Equity}}$$

For every dollar of Equity capital invested in the business by the owner(s), what is the level of Pretax Profits?

Your company's Return on Equity (ROE) has been/is:

	Year 1	Year 2	Year 3	Industry Benchmark
Profitability				
Return on Equity	18.4%	20.3%	20.9%	15.7%

In Year 1, for every $1.00 of Equity, your company made 18.4¢ in Pretax Profit. It increased to 20.3¢ in Year 2 and continued to increase to 20.9¢ in Year 3. It is above the RMA median industry standard of 15.7¢.

The ultimate evaluation of the adequacy of ROE must consider the level of funding structure risk. ROE is above the RMA industry standard but Total Liabilities on your Balance Sheet are nearly two and a half times larger than the industry standard for comparably sized businesses.

Does the ROE generated justify the considerably higher level of funding structure risk? Do not be fooled by the number. The risk taken should be justified by the return generated.

Productivity

The next major area of the business financial analysis process is the measure of Productivity. Most small businesses have limited access to capital. They cannot afford to deploy capital in a non-productive or inefficient manner. Owners must create a mix of Assets that will efficiently produce Sales. The primary purpose for having Assets on the Balance Sheet should be based on their ability to generate Sales.

Sales to Assets Ratio

The Sales to Assets Ratio measures the productivity level of the Assets. The Sales to Assets ratio is calculated by:

$$\frac{\text{Sales}}{\text{Total Assets}}$$

For every dollar of Assets on the Balance Sheet, what level of Sales volume is being generated?

Your company's Sales to Assets ratio has been/is:

	Year 1	Year 2	Year 3	Industry Benchmark
Operating Efficiency - Productivity				
Sales to Assets	2.85	2.74	2.33	2.70

In Year 1, for every $1.00 of Assets, your company generated $2.85 in Sales. In Year 2 it declined to $2.74 and continued to decline to $2.33 in Year 3. It is below the RMA median industry standard of $2.70.

To expand the analysis of Asset productivity, we included an analysis of both Accounts Receivable and Inventory.

Accounts Receivable Turnover

The analysis of Accounts Receivable looks at the efficiency of the collection process for all Sales made on a credit basis. It contrasts actual collection experience against collection policies and comparable industry standards for the collection of Accounts Receivable.

Accounts Receivable Turnover is calculated by:

$$\frac{\text{Sales}}{\text{Accounts Receivable}}$$

Accounts Receivable Turnover measures the rate of the collection process. To understand the rate of collections more clearly, a second calculation is completed that converts the rate of collections into an average number of days it takes to collect.

The Average Accounts Receivable Collection Period is calculated by:

$$\frac{\text{365 Days}}{\text{Accounts Receivable Turnover}}$$

This Ratio calculates the average number of days the business takes to collect Accounts Receivable.

Your company's Accounts Receivable Turnover and Collection Days have been/are:

Operating Efficiency - Productivity				
AR Turnover (times/year)	8.4	8.1	7.4	8.4
AR Collection Days	43.4	45.1	49.6	43

In Year 1, your company collected its Receivables 8.4 times a year or every 43.4 days. The collection rate declined to 8.1 times or every 45.1 days in Year 2 and continued to decline to 7.4 times or every 49.6 days in Year 3. The rate of collections is declining over time and is slower than the RMA median industry standard of 8.4 times or every 43 days.

Inventory Turnover

Another key Asset to analyze when measuring productivity is Inventory. The objective of the Inventory Turnover analysis is to determine how long the Inventory is in possession before it is sold.

Inventory Turnover is calculated by:

$$\frac{\text{Cost of Goods Sold}}{\text{Inventory}}$$

The Inventory Turnover Ratio measures the pace associated with the sale of Inventory. The second part of this calculation translates the turnover pace into the average number of days the Inventory is in possession before it is sold.

The Average Number of Days the Inventory is in possession before it is sold is calculated by:

$$\frac{\text{365 Days}}{\text{Inventory Turnover}}$$

Your company's Inventory Turnover and Average Inventory Days have been/are:

	Year 1	Year 2	Year 3	Industry Benchmark
Operating Efficiency - Productivity				
Inventory Turnover (times/year)	4.2	3.9	3.1	6.8
Days in Inventory	87	93	119	54

In Year 1, your company sold its Inventory at a rate of 4.2 times a year or on average every 87 days. The rate of inventory declined in Year 2 to 3.9 times or on average every 93 days. It continued to decline in Year 3 to 3.1 times or every 119 days.

The average time the Inventory was in possession got longer each year and was higher than the RMA median industry standard of 6.8 times or every 54 days. In the most recent year, your company had Inventory in possession an average of 65 days longer than the industry standard period.

Accounts Payable Turnover

As an extension of the analysis of Inventory, the rate that payments are made to the inventory suppliers is calculated. Developing good working relationships with suppliers is a key to creating a successful business.

Accounts Payable represent the amount owed to trade suppliers. These obligations are key funding components of the Balance Sheet because they are Liabilities that do not have any immediate cost for usage. They represent a relatively free and renewable source of capital if the relationships with the suppliers are properly managed.

Suppliers want to get paid on a timely and regular basis. Many will incent their customers to pay sooner by offering them discounts off listed prices. Taking advantage of discounted pricing from trade suppliers reduces the cost of Inventory which can generate an increase in the Gross Profit Margin.

Suppliers can react to slow payments from their customers by raising their prices, restricting access to their products to customers that pay quicker, or by placing slow paying customers on a collect in full on delivery (COD) basis. If these supplier reactions to slow payment take place, they will reduce the Gross Profit Margin.

The management challenge is to create balance between the use of free sources of capital created by Accounts Payable and the ability to take advantage of discounts offered by the suppliers if they are paid sooner.

Accounts Payable Turnover is calculated by:

$$\frac{\text{Cost of Goods Sold}}{\text{Accounts Payable}}$$

This Ratio measures the pace trade suppliers are paid. The second part of this calculation converts the turnover rate into the average number of days Accounts Payable are outstanding before they get paid. The average payable days is calculated by:

$$\frac{\text{365 Days}}{\text{Accounts Payable Turnover}}$$

Your company's Accounts Payable Turnover and Average Days to Pay have been/are:

	Year 1	Year 2	Year 3	Industry Benchmark
Operating Efficiency - Productivity				
AP Turnover (times/year)	9.5	7.2	5.7	9.6
Accounts Payable Days	38	51	64	38

In Year 1, your company paid its trade suppliers 9.5 times a year or on average every 38 days. In Year 2, the rate of payment declined to 7.2 times or every 51 days and in Year 3 it continued to decline to 5.7 times or every 64 days.

The RMA median industry standard is 9.6 times a year or every 38 days. Your company is paying suppliers at a much slower rate than the RMA standards.

Cash Flow

Cash Flow represents the life blood of every business. To stay in going concern operational condition, a business must be able to pay all its bills within reasonable time requirements. Cash flow must be produced in adequate amounts in time to pay these obligations when they are due.

The proper measurement of operating cash flow requires the analysis of both Income Statement and Balance Sheet information.

Income Statement information critical to the accurate measure of operating cash flow includes identifying Sales made on a cash basis minus all operating expenses and financing costs paid with cash during the period being measured.

Changes to the Balance Sheet that impact cash flow include the increase or decrease in the dollar size of the Assets, the increase or decrease in the dollar size of the Liabilities, and Equity over the period being measured.

Asset increases house cash and Asset decreases release the cash being housed. Liability increases generate cash and Liability decreases consume cash. Equity increases create cash and Equity decreases consume cash.

To enable an accurate accounting of all the Income Statement and Balance Sheet changes that impact cash, the American Institute of Certified Public Accountants (AICPA) created a formal financial statement called the Statement of Cash Flow. The Statement of Cash Flow was created in 1987 and contains three (3) component parts:

Operating Cash Flow

The first section of the Statement of Cash Flow summarizes the cash flow generated from everyday business activities. The calculation of Operating Cash Flow begins by combining Profits generated for the period with non-cash expenses like depreciation and amortization that were incurred. This information is available on the business Income Statement.

Also given consideration are the changes in the dollar size of the Current Assets and the noninterest bearing Current Liabilities on the Balance Sheet over the same period. Collectively, these items are added together on a net basis to measure the net amount of Operating Cash Flow generated for the period.

Investing Cash Flow

The second section of the Statement of Cash Flow summarizes the cash flow generated from investing activities. This section considers the change in the dollar size of any cash held in liquid investment accounts and changes in the dollar size of any long-term Assets on the Balance Sheet.

Most small businesses have little if any invested cash Assets on their Balance Sheet. The primary focus of this section of the Statement of Cash Flow is measuring the impact on cash caused by the changes in the long-term Assets.

Cash Flow Before Financing

Cash Flow Before Financing is calculated by combining the total for Operating Cash Flow with the total for Investing Cash Flow. Collectively, this represents the Total Internal Cash Flow generated by the business for the period measured. Business debt service coverage capability is produced primarily from cash flow internally generated by the business.

Financing Cash Flow

Financing Cash Flow is calculated by measuring the changes in the dollar size of the interest-bearing Liabilities and changes to the dollar size of Equity on the Balance Sheet during the period. Changes in Equity are caused by Profit distributions made from the business to the owner(s) or by additional investments made in the business by owners during the period.

Financing Cash Flow is also referred to as the Total External Cash Flow generated by sources from outside the business.

Your company's Operating Cash Flow reveals the following:

Account	Year 2	Year 3
OPERATING CASH FLOW (OCF)	($104)	($285)

In Year 2, your company operationally consumed $104,000 more cash than it generated. In Year 3, the Company consumed $285,000 more cash than it generated. Throughout the period analyzed, Total Operating Cash Flow for the Company was negative.

Your company's Investing Cash Flow reveals the following:

Account	Year 2	Year 3
INVESTING CASH FLOW (ICF)	($36)	($69)

In Year 2 your company invested an additional $36,000 in long term Fixed Assets. In Year 3, the Company made an additional investment of $69,000 in long term Fixed Assets.

Your company's Cash Flow Before Financing reveals the following:

Cash Flow Before Financing (line 11 + 17)	($140)	($354)

Combining Operating and Investing Cash to compute Cash Flow Before Financing shows the Company produced negative Internal Cash Flow over the period analyzed. In Year 2, Construction Supply internally consumed $140,000 more cash than it generated. In Year 3, the Company consumed $354,000 more cash than it generated.

Businesses that consume more cash than they operationally produce are not sustainable unless they have access to external sources of cash, i.e. either from loans made to the business by a financial institution or from additional Equity investments made by the existing owners or additional owners.

Having negative internal cash flow makes access to these external sources of capital very unlikely.

Z-Score

One last indicator of overall financial strength is a business's Z-Score. The Z-Score is generated from a financial model designed to predict the probability of business bankruptcy.

This financial analysis tool was created by Dr. Edward Altman, a Professor of Finance at New York University. The key structural elements in Dr. Altman's model measure the levels of business liquidity and leverage as well as asset utilization and business profitability.

A Z-Score of 1.22 or less reflects a business that is in distress. A score between 1.23 and 2.90 represents a caution zone. A score of over 2.90 represents a business with a relatively safe Balance Sheet.

Your company's Z-score for Year 3 is 2.90 which suggests bankruptcy is not likely in the immediate future.

Performance Deviations

The next step in our analytical process, we calculated a series of performance deviations between Construction Supply and the RMA industry standards. The objective is to determine the dollar size of the deviation and discuss the related performance issues and concerns.

This exercise sets industry financial ratio standards as a target performance objective. It measures the dollar change in the Company's financial ratios that would be required to align the company's performance with the benchmark.

Total Debt Deviation:

$430,000		*1.3*		*$559,000*
Company's Equity	X	Industry D/E Ratio	=	Desired Debt Level
Company's Total Liabilities	-	Desired Liabilities	=	**Performance Deviation**
$1,504,000		*$559,000*		***$945,000 too much***

Gross Profit Dollar Deviation:

$4,504,000		*24.7%*		*$1,112,488*
Company's Sales	X	Industry GP%	=	Desired Gross Profit $
Desired Gross Profit $	-	Company's Gross Profit $	=	**Performance Deviation**
$1,112,488		$1,058,000		**$54,488 short**

Pretax Profit Dollar Deviation

$4,504,000		*3.2%*		*$144,128*
Company's Sales	X	Industry PT%	=	Desired Pretax Profit $
Desired Pretax Profit $	-	Company's Pretax Profit $	=	**Performance Deviation**
$144.128		*$90,000*		***$54,128 short***

Sales Dollar Deviation – proactive approach

$1,934,000		*2.70*		*$5,221,800*
Company's Total Assets	X	Industry Sales to Asset Ratio	=	Desired Sales $
Desired Sales $	-	Company's Sales $	=	**Performance Deviation**
$5,221,800		*$4,504,000*		***$717,800 short***

Asset Dollar Deviation – reactive approach

$4,504,000		*2.70*		*$1,668,148*
Company's Sales	÷	Industry Sales to Asset Ratio	=	Desired Total Asset $
Company's Total Asset $	-	Desired Total Asset $	=	**Performance Deviation**
$1,934,000		*$1,668,148*		***$265,852 too much***

Accounts Receivable Dollar Deviation

$4,504,000		*8.4x*		*$536,190*
Company's Sales	÷	Industry A/R Turnover	=	Desired A/R $
Company's Total A/R $	-	Desired A/R $	=	**Performance Deviation**
$612,000		*$536,190*		***$78,810 too much***

Inventory Dollar Deviation

$3,446,000		*6.8x*		*$506,765*
Company's COGS	÷	Industry Inventory Turnover	=	Desired Inventory $
Company's Inventory $	-	Desired Inventory $	=	**Performance Deviation**
$1,121,000		*$506,765*		***$614,235 too much***

Accounts Payable Dollar Deviation

$3,446,000		*9.6x*		*$358,958*
Company's COGS	÷	Industry A/P Turnover	=	Desired A/P $
Company's A/P $	-	Desired A/P $	=	**Performance Deviation**
$602,000		*$358,958*		***$243,042***

Overall Financial Performance

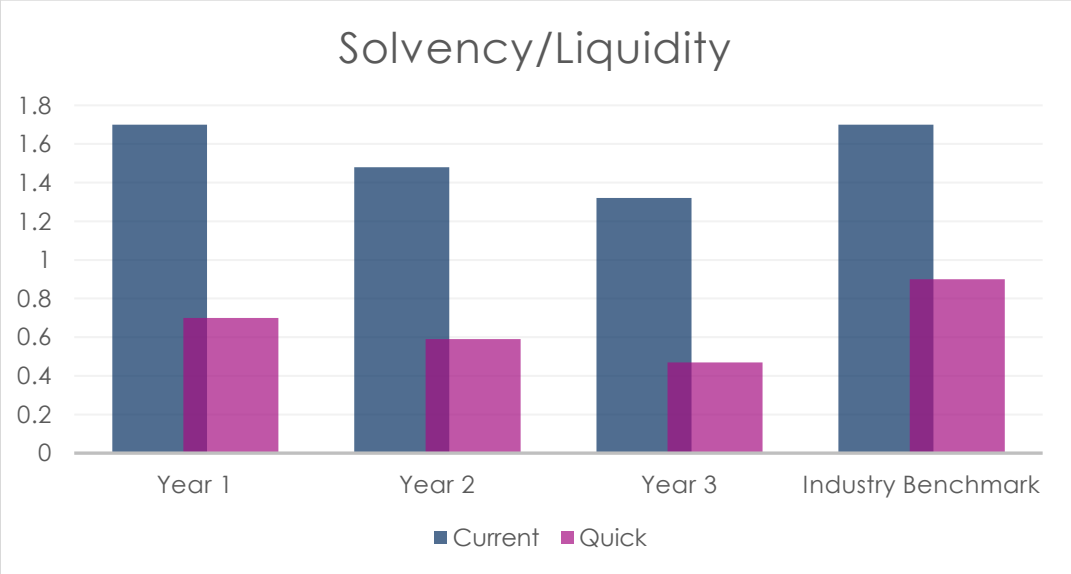
Examining your company's overall financial performance reveals the following grades:

Overall Financial Performance				
	Excellent	Good	Fair	Needs Attention
Liquidity/Solvency				
Current Ratio			X	
Quick Ratio				X
Safety				
Debt to Equity Ratio				X
Profitability				
Gross Profit Margin				X
Pretax Profit Margin				X
Productivity				
Sales to Assets Ratio				X
Return on Assets			X	
Return on Equity			X	
AR Collection Period				X
Inventory Days				X
AP Days			?	
Cash Flow				
Operating Cash Flow				X
Internal Cash Flow				X

Overall Performance Observations

Solvency/Liquidity

Your company's bill paying capacity illustrated by the Current and Quick Ratios has been on a steady decline over the last three years and is presently below industry standards.

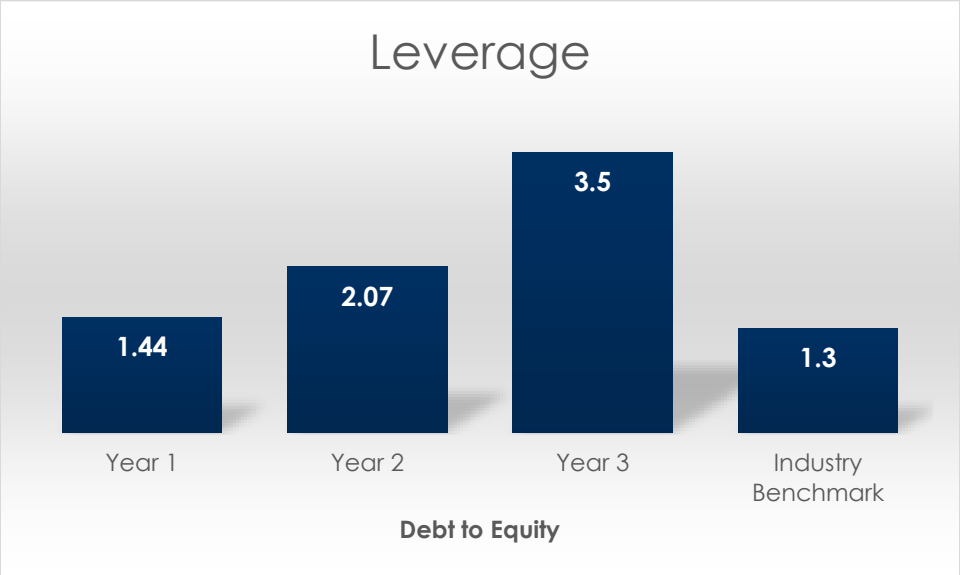


The Current Ratio suggests the Company still has bill paying capacity although it has been deteriorating over the last three years. Management needs to pay attention to this relationship and prevent further deterioration.

The Quick Ratio analysis indicates your company is very illiquid. If the trade suppliers or the lenders call for an immediate payment of their obligations, the Company does not have a sufficient liquid asset base to generate the cash needed to repay the debt.

Leverage

Your company's funding structure risk has steadily increased over the last three years and is significantly above the current industry standard for comparably sized businesses. At the end of the most recent fiscal year, the Company has $2.20 more debt in place for every $1.00 of Equity than its industry counterparts.



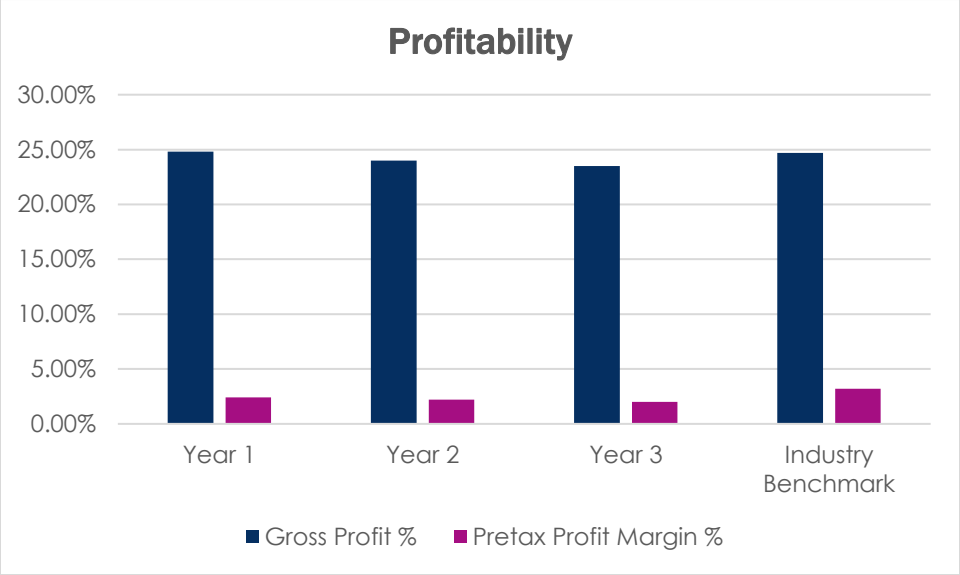
The Company's leverage position is an area of concern that warrants immediate attention. Balance Sheets must balance. If there is a high level of debt on the Balance Sheet it is caused by either the of lack of Equity or by high levels of Assets.

The high level of debt on your Balance Sheet is primarily due to the high level of Assets. Inventory and Accounts Receivable are the largest Assets on the Company's Balance Sheet. In both cases, our analysis indicates the turnover rates for these Assets are much slower than the industry standards.

As a result, the dollar size of these two Assets is significantly larger than it would be if the corresponding turnover rates were more in line with the industry standards.

Profitability

Your company's Gross Profit and Pretax Margins have steadily declined over the last three years. They are both below industry standards.



The Company's Gross Profit % has steadily declined which suggests you have potential problems with the Company's; pricing policies, inventory management processes, the level of any non-inventory costs included in your Cost of Goods Sold expense pool, or a combination of the three. You need to examine each of these operational areas to determine what is causing the GPM decline.

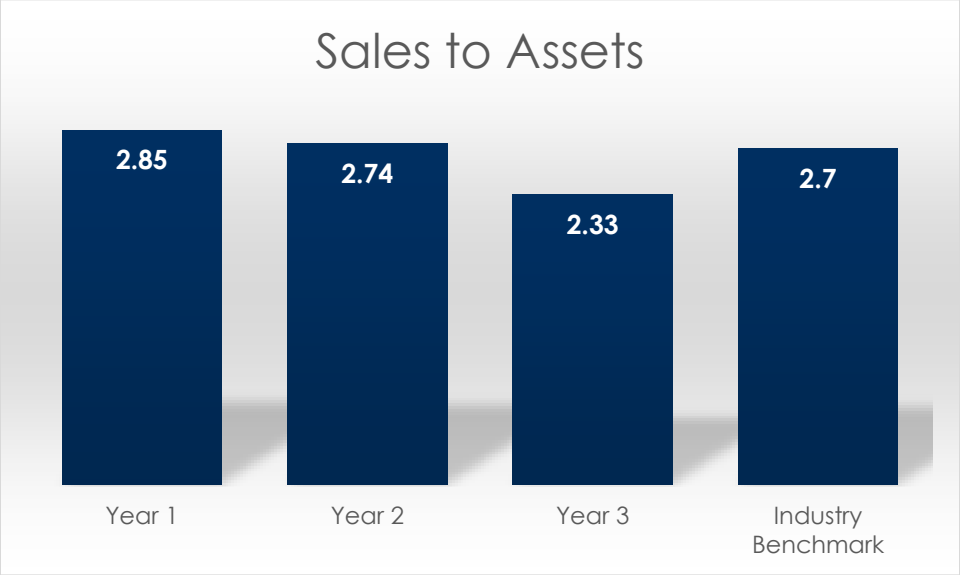
Your company's Pretax % has also steadily declined over the 3-year period. This decline could be caused by issues associated with the company's Operating Expense levels or because the company is not producing enough Sales volume to cover the existing Operating Expenses. The dollar amounts of the Performance Deviations at both the Gross Profit level and their Pretax level are just short of $60,000. An additional $60,000 would increase reported Profits in Year 3 by over 60.0%.

The company's Operating Expenses as a percentage of Sales are lower than the industry benchmark averages. This suggests the lower level of Pretax Margin is not being created by an overhead expense control problem.

The annual Interest Expenses have tripled in dollar size over the 3-year period. The increase in the Interest Expenses is a direct result of the increasing dollar size of the interest-bearing debt on the company's Balance Sheet. The debt level is up because the capital is needed to fund the additional Assets on the Company's Balance Sheet.

Productivity

Your company's asset utilization and productivity measures have been on a steady decline over the last 3 years. They are below industry performance benchmark standards.



The continual decline in productivity suggests your company has been deploying poor Asset utilization practices. It may also indicate the company has been unable to generate sufficient Sales volume to justify its existing Asset base.

All Assets house cash. Having nonperforming Assets means your company is needlessly housing cash in lazy Assets. This has caused a need to borrow more capital to help fund these Assets and meet business operating cash flow needs. The annual interest charges incurred on this debt has tripled, creating a negative impact on the company's profitability.

Your company needs to generate more Sales from the Assets on hand. If additional Sales are not achievable, a plan must be created to reduce or eliminate nonperforming Assets and utilize the cash generated from an orderly sale of these Assets to pay down the debt.

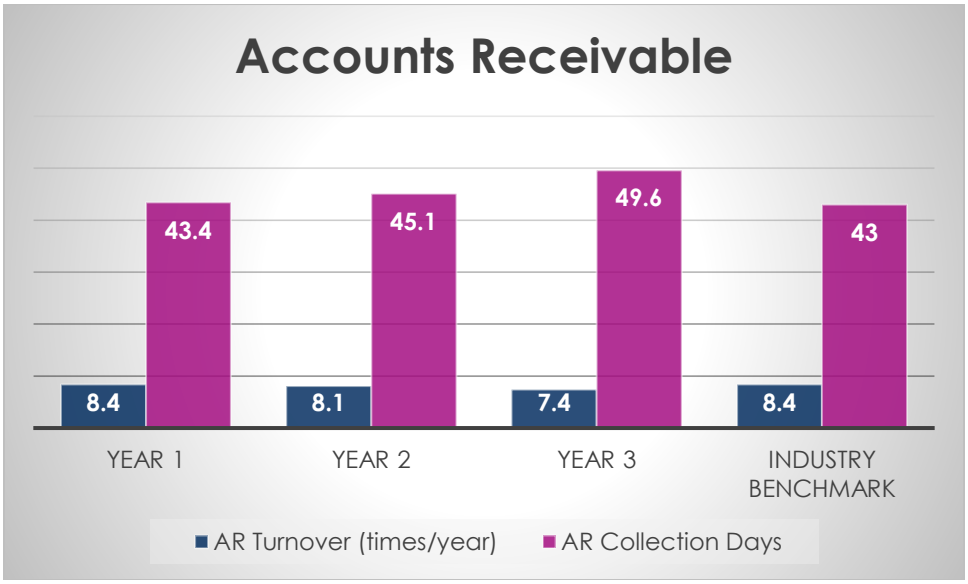
If the company's creditors are demanding immediate repayment of their outstanding debts, you may not have the luxury of time to generate the repayment capability from more Sales or an orderly sale of excess Assets. Your company may have to consider liquidating some Assets to generate the cash.

Questions that needs to be asked include:

1. Are there any excess Assets in the company's Fixed Asset base or in its Working Capital Asset mix?
2. Are there readily available secondary markets for the sale of these excess Assets?

Accounts Receivable

One of the dominant Working Capital Assets in any business is Accounts Receivable. This Asset represents Sales generated from customers on a credit basis.



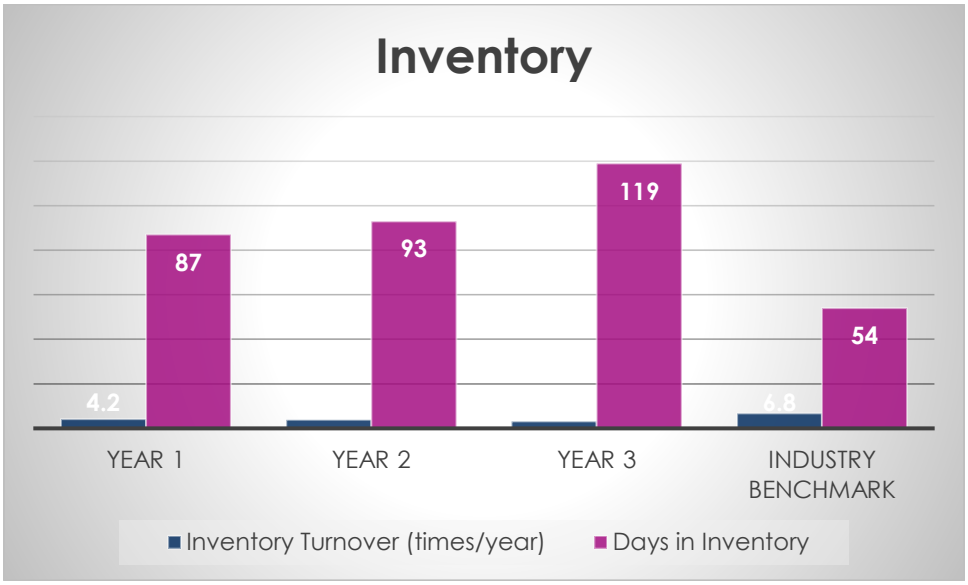
Your company's current average A/R collection rate is 7.4 times a year or every 50 days. The industry benchmark reflects a turnover rate of 8.4 times or every 43 days.

Your Company has its receivables outstanding roughly a week longer than the industry. A week longer does not sound like that much, but it equates to an additional Balance Sheet commitment for A/Rs of $79,000.

This additional A/R commitment must be funded, and the company must incur the related carrying costs. Receivables have numerous carrying costs. They include; financing costs, the costs for processing invoices for sales made on account, all of costs associated with the contact activities required to manage the billing and collection process including staff time, mail charges, settling disputes over billing accuracy, all collection charges incurred, and the possibility of having bad debt write-offs.

Inventory

Your company's Inventory turnover rate has significantly declined over the past three years and is presently much slower than the industry benchmark rate.



Your company is presently selling its inventory 3.1 times a year or on average every 119 days. This compares to an industry standard of 6.8 times or every 54 days.

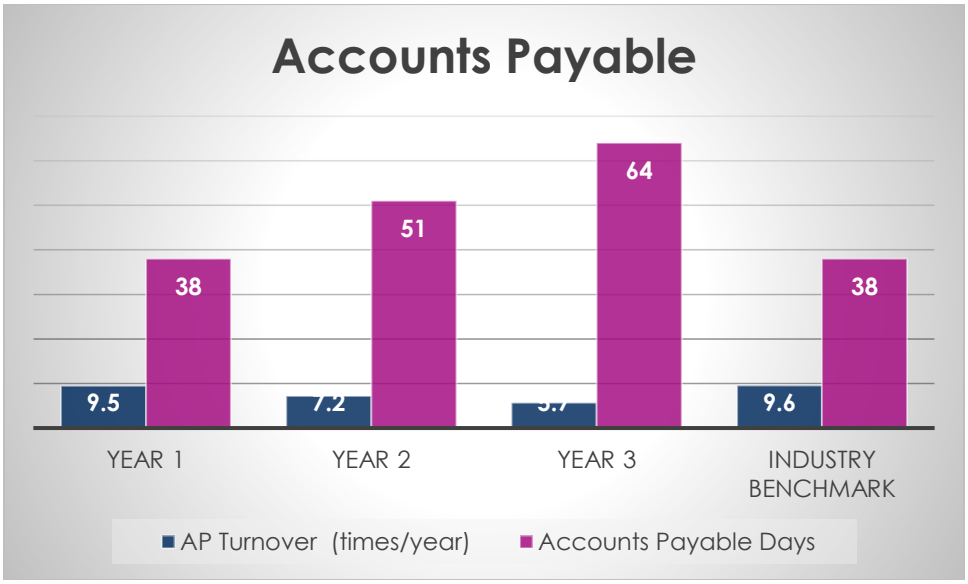
As a result of the slow rate of turnover, the company's Balance Sheet reflects a level of Inventory that is $614,000 higher than what would be in place if the company's turnover rate was in line with the industry median benchmark standard. This excess Inventory is housing cash and requiring an unnecessary funding commitment.

One of the primary reasons why your company has nearly $1.0 Million more debt on the Balance Sheet than its piers is because the additional debt is required to fund this high level of Inventory.

Inventory is an expensive Asset to manage. It has several related carrying costs. There are costs associated with sourcing and financing the purchase as well as costs associated with receiving, storing, retrieving, merchandising, and selling activities. Carrying costs include interest charges, accounting expenses, storage facilities expenses, material handling expenses, seasonality, style changes, technology changes, perishability, shrinkage, dating limitations, and obsolescence.

Accounts Payable

Accounts Payable (A/P) represent an excellent source of free debt funding if it is properly utilized. The dollar size of your company's Accounts Payable has tripled in the last 3 years and the number of days it takes to pay the trade Suppliers has increased dramatically. The company pays A/P at a much slower rate than the rate of payments reflected in the industry benchmark statistics.



Your company is presently paying its Accounts Payable at a rate of 5.7 times a year or on average every 64 days. By comparison, the industry benchmark for A/P payment is a rate of 6.8 times a year or every 38 days.

Managing Accounts Payable is challenging. You want to take advantage of the use of free capital generated from your Supplier's as much as you can, but you do not want to abuse the privilege to the point that slow payments cause your Suppliers to raise their prices or put your account on C.O.D.

You need to closely monitor your company's trade Supplier relationships. Do not let the repayment timelines continue to deteriorate and negatively impact your working relationships.

Recommendations

We recommend an immediate focus on the following:

1. **Retire some outstanding debt**
   Your company needs to reduce its debt load. You can accomplish this objective by reducing the company's Working Capital Asset base (Accounts Receivable & Inventory) and using the cash housed in these Assets to reduce the company's outstanding debt.

2. **Reduce inventory levels**
   You need to review your company's Inventory management practices. Inventory is by far the largest Asset on the company's Balance Sheet. The Industry Performance Deviation calculations suggest the company has over $600,000 more Inventory on hand than the industry median benchmark would suggest is needed.

   Plans need to be developed to review the purchasing practices deployed by the company, and the mix of Inventory items being carried. The Plan should be to review both purchasing and pricing practices and identify items not selling in a reasonable timeframe.

   Inventory items that have very slow turnover rates should be identified and a plan developed to reduce or eliminate them from the Inventory mix. Purchasing opportunities that involve the ability to take discounts should be looked at carefully to assure there is a ready market for the sale of these items.

3. **Collect Outstanding Receivables**
   Your management team needs to focus on ways to speed up the collection of the company's outstanding Accounts Receivable. The billing procedures should be checked for timeliness and accuracy. How does Credit Policy define credit worthiness? How are Credit Policies communicated to the customer base? Do they clearly describe repayment requirements? Are they being uniformly enforced?

   An individual credit account aging exercise should be conducted to identify slow paying customers and any levels of concentration risk in the A/R portfolio. It is our understanding the company's written Credit Policies set payment requirements within 30 days of the invoice date. You need to re-establish your company's Credit Policies with your customer base and enforce the requirement to pay within 30 days of the invoice date. Credit Policy should also address how Accounts Receivable outstanding for longer than 30 days will be managed.

Some consideration should be given to raising prices or restricting additional sales to customers with account balances that are more than 45 days outstanding until they bring their accounts into compliance with the company's Credit Policies.

4. Slow Sales growth rate

Over the last 3 years, your company's Sales volume has doubled, reflecting an average annual growth rate of over 40.0% During this timeframe, the Asset size on the company's Balance Sheet has more than doubled and a significant portion of this increase has been funded with capital provided by creditors.

The company has been profitable during the whole period, but internal cash flow has been negative. Given this scenario, you should consider slowing down your company's Sales volume growth rate. The company needs to grow at a pace that is cash flow affordable.

There is a financial model for estimating the Sales growth rate that would maintain the existing Debt to Equity Ratio in the next year. This sustainable growth rate calculation is based on maintaining 3 key financial structure relationships from the prior year. These relationships include:

1. The Existing Debt to Equity Ratio
2. The Existing Net Profit Margin
3. The Existing Variable Assets to Sales Ratio

Inserting your company's most recent year-end results for these financial relationships into the model indicates the sustainable growth rate for the company for next year is 21.6%. The model does not evaluate the quality of the individual elements, it simply implies given the exiting variables, here is the sustainable growth rate.

Any growth rate achieved that is higher than the sustainable growth rate will cause the level of leverage and the related funding structure risks to increase from current levels unless significant changes are made to business management practices.

Construction Supply, Inc. Balance Sheets, ($000s) December 31, Year 1 - Year 3			
	Year 1	Year 2	Year 3
Cash	$24	$27	$21
Accounts Receivable	$273	$406	$612
Inventory	$413	$638	$1,121
Prepaid Expenses	$8	$14	$15
Total Current Assets	$718	$1,085	$1,769
Gross Fixed Assets	$121	$157	$226
Accumulated Depreciation (-)	($34)	($42)	($61)
Net Fixed Assets	$87	$115	$165
Total Assets	$805	$1,200	$1,934
Notes Payable - Bank	$118	$235	$528
Accounts Payable	$182	$346	$602
Income Tax Payable	$8	$11	$14
Current Portion of LTD	$10	$14	$20
Accrued Expenses	$104	$128	$179
Total Current Liabilities	$422	$734	$1,343
Long Term Debt	$90	$112	$161
Total Liabilities	$512	$846	$1,504
Capital Stock	$50	$50	$50
Retained Earnings	$243	$304	$380
Total Equity	$293	$354	$430
Total Liabilities & Equity	$805	$1,200	$1,934

Construction Supply, Inc. Income Statements ($000s) As of December 31, Year 1 - Year 3			
	Year 1	Year 2	Year 3
Total Sales	$2,297	$3,285	$4,504
Cost of Goods Sold	$1,728	$2,497	$3,446
Gross Profit	$569	$788	$1,058
Accounting & Legal	$5	$6	$12
Auto & Truck	$49	$70	$75
Bad Debts	$2	$9	$22
Depreciation	$6	$8	$19
Insurance	$24	$28	$36
Office Expenses	$57	$70	$101
Rent	$24	$29	$32
Salaries	$304	$415	$549
Telephone & Utilities	$20	$41	$46
Total Operating Expense	$491	$676	$892
Operating Profit/(Loss)	$78	$112	$166
Other Inc. (Exp.)	$0	$0	$0
Interest Expense (-)	($24)	-$40	-$76
Total Other Inc. (Exp.)	($24)	-$40	-$76
Pretax Profit	$54	$72	$90
Income Tax	$8	$11	$14
Net Income	$46	$61	$76

Construction Supply, Inc. Indirect Statement of Cash Flow ($000s)				
	Account		Year 2	Year 3
1	Net Income After Tax		$61	$76
2	Depreciation & Amortization		$8	$19
3	Accounts Receivable	Decrease (Increase)	($133)	($206)
4	Inventory	Decrease (Increase)	($225)	($483)
5	Other current Assets	Decrease (Increase)	($6)	($1)
6	Accounts Payable	Increase (Decrease)	$164	$256
7	Accrued Expenses	Increase (Decrease)	$24	$51
8	Income Tax Payable & Deferred Tax	Increase (Decrease)	$3	$3
9	Other Current Liabilities	Increase (Decrease)	$0	$0
10	Other Noncurrent Liabilities	Increase (Decrease)	$0	$0
11	*OPERATING CASH FLOW (OCF)*		($104)	($285)
12	Marketable Securities	Decrease (Increase)	$0	$0
13	Long-Term Investment	Increase (Decrease)	$0	$0
14	Gross Fixed Assets	Decrease (Increase)	($36)	($69)
15	Nonrecurring Gain (loss)		$0	$0
16	Intangible & Other Noncurrent Assets	Decrease (Increase)	$0	$0
17	*INVESTING CASH FLOW (ICF)*		($36)	($69)
18	**Cash Flow Before Financing**	**(line 11 + 17)**	**($140)**	**($354)**
19	Short-Term Bank Debt	Increase (Decrease)	$117	$293
20	Long-Term Bank Debt	Increase (Decrease)	$26	$55
21	Subordinated Debt	Increase (Decrease)	$0	$0
22	Capital Stock	Increase (Decrease)	$0	$0
23	Dividends Paid		$0	$0
24	Adjustments to Retained Earnings		$0	$0
25	Minority Interest		$0	$0
26	*FINANCING CASH FLOW (FCF)*		$143	$348
27	**TOTAL CASH FLOW**	**(line 11+17+26)**	$3	($6)
28	Beginning Cash		$24	$27
29	Plus, Operating Cash Flow	(line 11)	($104)	($285)
30	Investing Cash Flow	(line 17)	($36)	($69)
31	Financing Cash Flow	(line 26)	$143	$348
32	*ENDING CASH*		$27	$21

Construction Supply, Inc. Ratio Analysis Year 1 - Year 3				
	Year 1	Year 2	Year 3	Industry Benchmark
Liquidity/Solvency				
Current	1.70	1.48	1.32	1.70
Quick	0.70	0.59	0.47	0.90
Leverage				
Debt to Equity	1.44	2.07	3.50	1.30
Working Capital	$296	$351	$426	N/A
Profitability				
Gross Profit %	24.8%	24.0%	23.5%	24.7%
Pretax Profit Margin %	2.4%	2.2%	2.0%	3.2%
Operating Efficiency - Productivity				
Sales to Assets	2.85	2.74	2.33	2.70
Return on Assets	6.7%	6.0%	4.7%	6.5%
Return on Equity	18.4%	20.3%	20.9%	15.7%
AR Turnover (times/year)	8.4	8.1	7.4	8.4
AR Collection Days	43.4	45.1	49.6	43
Inventory Turnover (times/year)	4.2	3.9	3.1	6.8
Days in Inventory	87	93	119	54
AP Turnover (times/year)	9.5	7.2	5.7	9.6
Accounts Payable Days	38	51	64	38
Cash Flow				
Interest Coverage	n/a	n/a	n/a	
Debt Service Coverage	n/a	n/a	n/a	
Bankruptcy Indicator				
Z-Score			2.9	