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# Financial Ratio Analysis: Milan Fashions Coat Company Case Study

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**Abstract**

This case study focuses on a firm's debt situation as it attempts to expand its manufacturing operations. The firm needs financial capital to grow but its business venture and financial situation are considered risky and it must approach a commercial bank in order to acquire funds. A bank lending officer must examine the firm's financial statements and evaluate whether a loan is possible. The lending officer must examine key segments of the firm's financial statements, perform ratio analysis, and then render a decision as to whether to extend the loan or not.

**Keywords:** Ratio analysis, Current ratio, Long-term debt-to-Equity ratio, Debt-to-Equity ratio, Total Debt ratio, Financial leverage ratio, Inventory turnover, Fixed asset turnover, Debt-to-Capital ratio, Interest coverage ratio, Return on Assets

## Introduction

Joseph Florentine is the Chief Executive Officer of Milan Fashions Coat Company[1], an outer wear apparel coat manufacturer located in Paterson, New Jersey, and he, along with his brother and president of the firm, Thomas, are trying to expand the company. The company manufactures coats and outwear for women, children, and men for different markets and ages. The company is looking to grow their manufacturing operations in Paterson and possibly the larger city of Newark since there is plenty of vacant space to build. With new tax incentives and a ready workforce, the brothers feel it is a good time to borrow money in order to take their business to the next step. Based upon studies conducted by a local university's economic and finance department, Milan Fashions could further diversify their product line, increase their market share, and watch revenues and net profits grow by 20 to 25% in the next decade even with the ups and downs of the macroeconomy. They want to sell their product overseas knowing it will be a tough sell given the tariffs they will face in foreign markets and the strong dollar. While Milan Fashions has seen its share of bad times, the marketplace is better for online sales even with the traditional brick-and-mortar stores on the downside. Milan Fashions is also looking to branch out into direct sales via the internet to retail consumers which will allow the company to diversify their revenue stream. But in order to do this, the company needs financial capital and borrowing is a possibility the brothers are seriously examining.

## Company Background

Milan Fashions Coat Company started as a small factory employing 50 workers in 1970 in the industrial city of Paterson, New Jersey by two immigrant brothers, Joseph and Thomas Florentine. They had worked a number of years in the garment industry and knew how to manufacture coats and other outerwear that stores in New York City, the New York-New Jersey metropolitan area and across the country sold during the fall and winter season. They were able to increase production rapidly since they emphasized speed and quality work. They received the material needed to make the coats from the individuals who contracted the work and cut, sewed, assembled, and bagged the coats that were shipped to distribution centers for different retail stores.

[1] Fictitious company used to perform ratio analysis.

It sometimes meant working long, long hours during the week and on weekends to get out the orders on time. But the orders were always met on a timely basis and the quality exceeded the store's expectations. Milan Fashions was able to move into larger production facilities as the orders grew in number and volume, and this meant hiring more workers and expanding their manufacturing operations. But it also meant having to diversify the product line they would handle: going from women's winter coats to jackets for children to men's coats and outerwear. The transition was not easy, but they tried and enjoyed their successes and learned from their failures. When things were tough it sometimes meant laying off workers and when times improved, to hire them back. But either way, the business was growing in terms of revenue, production, cash flow, orders from stores, and profits.

However, it was time to make changes in the business model since the retail market was changing, yet again. When the internet was starting to make small dents in the retail industry, the brothers felt they should take a gamble and further diversify their business operations by taking a different approach: direct sales to customers. They decided to skip catalog sales altogether and try selling via the internet. At first, it was learning experience, but after a while they were able to use the latest technology available, hire the right people who knew about the technology, and sell directly to retail customers through their own designs. This also meant hiring coat designers who knew what each market for men, women, and children wanted. It took a bit of time for the process to work, but after a number of mistakes which they readily learned from and a great deal of investment capital, their idea took off. They still made their product in the United States in an urban environment which they felt was a key selling point. But they felt they needed to expand their operations even further while interest rates were still relatively low.

**Current Situation**

Milan Fashions is ultimately looking to expand its manufacturing operations and this means selling more of its products via the internet. The company saw it would have to do the following:

- Expand their presence on the internet by enhancing the company's website. This meant making it more interactive as well as innovative. Here a potential customer would have the ability to design a coat or outerwear online given the fabric, styles, and designs that the company had available. This would allow the customer to be creative and add more accessories to the coat and have an idea what the item would cost. This type of custom-made coat or outwear would allow the customer to have variety in their styles and design, and stay within their budget.
- The enhancement of the online sales would also mean a possible creation of a customer service department to handle technical issues as well as customer complaints. These were bound to happen since there will always be some errors in the manufacturing process or with the online system.
- The manufacturing operations would have to be enhanced and rearranged in order to handle unique customer orders. This meant having the variety of fabrics and materials available for the coats and outwear, the cutting of the fabrics and materials, and assembling, inspecting, and preparation for shipment of the order. With enough orders coming in, then there would be little to no idle time of the employees in the manufacturing facility.
- The logistics could be handled by working with noted delivery companies which could ship the completed product from the manufacturing facility as soon as the item was completed. There would be an extra charge for delivery on rush orders.

After meetings with the Chief Financial Officer, Stefano Pugliese, and hiring of consultants to give advice on how to expand their operations, it was decided that they should seek a loan of $3 million. The amount requested would be broken down as:

| | |
|---|---|
| Expand, enhance, and maintain company website | $1,000,000 |
| Expand and enhance manufacturing operations | $1,500,000 |
| Creation and maintenance of customer service center | $500,000 |
| **Total loan request** | **$3,000,000** |

This would be the largest loan the company ever made and there was some trepidation on the part of Joseph and Thomas. But they felt this was the time to take their company to the next step or else face diminishing returns and profits in the coming years. They understood that coat and outwear manufacturing in the United States was under severe pressure from foreign competitors and that they needed to do something new and different. There was still plenty of vacant land by their manufacturing facility which could make expansion fairly easy to do. Also, with help from the city, county, and state governments, such a move was possible. The real trick was getting the loan from the bank that Milan Fashions had long done business with.

**Financial Information**

Joseph and Thomas decided to first approach the bank where they had a line of credit and had received business loans in the past, First United. They had approached the bank on numerous occasions for small and large loans and this would be the largest they had ever applied for. After consulting with the relationship manager at the bank, Joseph and Thomas would need to provide the bank with their income statements and balance sheets from 2012 to 2016. From there the bank's commercial lending officer and credit analyst would perform the following ratio analysis:

- Current ratio
- Long-term debt-to-Equity ratio
- Debt-to-Equity ratio
- Total Debt ratio
- Financial leverage ratio
- Inventory turnover
- Fixed asset turnover
- Debt-to-Capital ratio
- Interest coverage ratio
- Return on Assets

***Assignment:***

# *First United Bank*
# *Paterson, New Jersey*
## *Serving the Greater Paterson Community since 1949*

***To:*** Associate Credit Analyst
***From:*** Ralph Vicente – Senior Vice President, Commercial Loan Division
***Date:*** March 9, 2017
***Re:*** Milan Fashions Coat Company

The Milan Fashions Coat Company produces and sells to retail stores various types of coats and outerwear including women's, children's and men's outer garments. They are looking to expand and diversify their product line and sell on-line so they are coming to us for a $3 million commercial loan. The company's five most recent balance sheets and income statements were presented to First United in order to support their loan request. As you can see from the attached income statements and balance sheets from 2012 to 2016, they have had increases in net sales since 2012 but their net income has been up and down for the same time period.

The amount requested is broken down as:

| | |
|---|---|
| Expand, enhance, and maintain company website | $1,000,000 |
| Expand and enhance manufacturing operations | $1,500,000 |
| Creation and maintenance of customer service center | $500,000 |
| **Total loan request** | **$3,000,000** |

Milan Fashions Coat Company has been a long-time client of the bank and borrowed funds from us on previous occasions. The company has grown in terms of sales, assets, and equity; however, this is the largest loan that the company has ever applied for in their entire history.

I would like you to analyze the company's loan request and financial statements. You must provide the following:

A. Calculate the financial ratios for 2016 and 2015 comparing them to the industry norms found on the page following the financial statements.
B. Of the financial ratios that are used for the industry standard, which do you feel are most important when determining whether First United should approve the loan to Milan Fashions? What do you feel are the **strong and weak points of the company** in your financial analysis?
C. Based upon your financial ratio analysis, what questions would you like to propose to management to gain clarity on the business operations?
D. Based upon the financial ratio analysis you will have performed on Milan Fashions, would do you recommend that there should be an approval of the loan request? I want you to state your analysis in a detailed memorandum to me by Monday of next week. I would like to discuss your analysis and hear your ideas on Milan Fashions in a meeting on Tuesday. The clients will be in our offices next Friday to discuss their loan request. Please feel free to contact me if there are any questions on this matter.

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**Milan Fashions Income Statements As of December 31st, 2012, to 2016**

| | 2016 | 2015 | 2014 | 2013 | 2012 |
|---|---|---|---|---|---|
| **Revenues** | | | | | |
| Net sales | $777,228 | $774,635 | $772,897 | $770,524 | $768,126 |
| Rental income | 36,000 | 36,000 | 36,000 | 36,000 | 36,000 |
| Total revenues | 813,228 | 810,635 | 808,897 | 806,524 | 804,126 |
| **Costs and expenses** | | | | | |
| Cost of sales | 325,848 | 315,698 | 313,548 | 312,587 | 311,523 |
| Operating, selling, general and administrative expenses | 82,653 | 80,564 | 79,012 | 78,245 | 77,428 |
| Depreciation | 325,789 | 335,648 | 337,840 | 332,587 | 331,429 |
| **Operating income** | **78,938** | **78,725** | **78,497** | **83,105** | **83,746** |
| **Interest** | | | | | |
| Debt | 2,525 | 2,755 | 2,874 | 2,984 | 2,845 |
| Capital leases | 1,235 | 1,336 | 1,125 | 1,249 | 1,352 |
| Interest income | (198) | (180) | 125 | 115 | 89 |
| Interest, net | 3,958 | 4,271 | 3,874 | 4,118 | 4,108 |
| Income from continuing operations before income taxes | 74,980 | 74,454 | 74,623 | 78,987 | 79,638 |
| **Provision for income taxes** | | | | | |
| Current income tax expense | 8,201 | 7,902 | 7,525 | 7,684 | 7,459 |
| Deferred income tax expense | (1,023) | (946) | 876 | 782 | 658 |
| Total provision for income taxes | 9,224 | 8,848 | 6,649 | 6,902 | 6,801 |
| Income from continuing operations | 65,756 | 65,606 | 67,974 | 72,085 | 72,837 |
| Income (loss) from discontinued operations, net of income taxes | 0 | (657) | 525 | 125 | 257 |
| **Net income** | **$65,756** | **$64,949** | **$68,499** | **$72,210** | **$73,094** |

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**Milan Fashions Balance Sheets As of December 31st, 2012, to 2016**

| | *2016* | *2015* | *2014* | *2013* | *2012* |
|---|---|---|---|---|---|
| ***Assets*** | | | | | |
| Cash and cash equivalents | $889,200 | $844,470 | $950,251 | $925,000 | $901,250 |
| Receivables, net | 787,900 | 748,505 | 725,253 | 625,879 | 610,253 |
| Inventories | 60,600 | 55,070 | 50,161 | 45,232 | 40,649 |
| Prepaid expenses | 69,900 | 83,395 | 52,124 | 32,589 | 98,536 |
| Current assets of discontinued operations | 0 | (32,589) | 215 | 350 | 450 |
| Total current assets | 1,807,600 | 1,698,851 | 1,778,004 | 1,629,050 | 1,651,138 |
| ***Property and equipment*** | | | | | |
| Property, plant and equipment, gross | 400,000 | 350,000 | 300,254 | 250,623 | 200,623 |
| Less: Accumulated depreciation | (100,789) | (90,500) | (80,456) | (75,239) | (50,467) |
| Property, plant and equipment, net | 299,211 | 259,500 | 219,798 | 175,384 | 150,156 |
| ***Property under capital leases*** | | | | | |
| Property under capital leases | 745,000 | 759,900 | 700,564 | 698,425 | 658,954 |
| Less: Accumulated amortization | (425,800) | (434,316) | (425,687) | (415,687) | (400,253) |
| Property under capital leases, net | 319,200 | 325,584 | 274,877 | 282,738 | 258,701 |
| Goodwill | 15,559 | 15,860 | 14,625 | 13,568 | 12,569 |
| Other assets and deferred charges | 689,908 | 689,577 | 568,356 | 558,239 | 568,542 |
| ***Total Assets*** | ***$3,131,478*** | ***$2,989,372*** | ***$2,855,660*** | ***$2,658,979*** | ***$2,641,106*** |
| | | | | | |
| ***Liabilities*** | | | | | |
| ***Current liabilities*** | | | | | |
| Short-term borrowings | $50,000 | $90,074 | $41,922 | $35,698 | $37,894 |
| Accounts payable | 8,180 | 5,000 | 5,250 | 5,236 | 5,258 |
| Accrued liabilities | 4,818 | 6,239 | 5,698 | 5,000 | 4,689 |
| Accrued income taxes | 4,400 | 4,000 | 4,134 | 4,036 | 4,235 |
| Long-term debt due within 12 months | 13,760 | 20,500 | 19,438 | 25,120 | 28,369 |
| Obligation under capital leases due within 12 months | 2,760 | 2,400 | 2,008 | 2,958 | 895 |
| Total current liabilities | 83,918 | 128,213 | 78,450 | 78,048 | 81,340 |
| Long-term debt | 88,160 | 90,000 | 87,636 | 92,000 | 95,456 |
| Long-term obligations under capital leases | 94,480 | 41,048 | 47,872 | 44,658 | 45,254 |
| Deferred income taxes | 14,480 | 14,500 | 15,498 | 16,879 | 17,568 |
| ***Total liabilities*** | 281,038 | 273,761 | 229,456 | 231,585 | 239,618 |
| ***Equity*** | | | | | |
| Common stock | 2,728,000 | 2,625,411 | 2,543,800 | 2,345,894 | 2,280,879 |
| Capital in excess of par value | 34,640 | 28,200 | 35,040 | 35,235 | 32,232 |
| Retained earnings | 17,800 | 12,000 | 15,684 | 15,687 | 14,127 |
| Accumulated other comprehensive income (loss) | 70,000 | 50,000 | 31,680 | 30,578 | 74,250 |
| ***Total equity*** | 2,850,440 | 2,715,611 | 2,626,204 | 2,427,394 | 2,401,488 |
| | | | | | |
| ***Total liabilities and equity*** | ***$3,131,478*** | ***$2,989,372*** | ***$2,855,660*** | ***$2,658,979*** | ***$2,641,106*** |

**Industry Financial Ratio Standards**

| Ratio | Industry Norm | Milan Fashions Ratios 2015 | Evaluation* |
|---|---|---|---|
| Current ratio | 4.5 times | | |
| Long-term debt-to-Equity ratio | 12% | | |
| Debt-to-Equity ratio | 30% | | |
| Total Debt ratio | 20% | | |
| Financial leverage ratio | 1.10 | | |
| Inventory turnover | 7 times | | |
| Fixed asset turnover | 1.8 times | | |
| Debt-to-Capital ratio | 43.4% | | |
| Interest coverage ratio | 5.0 times | | |
| Return on Assets | 8.4% | | |

| Ratio | Industry Norm | Milan Fashions Ratios 2016 | Evaluation* |
|---|---|---|---|
| Current ratio | 4.5 times | | |
| Long-term debt-to-Equity ratio | 12% | | |
| Debt-to-Equity ratio | 30% | | |
| Total Debt ratio | 20% | | |
| Financial leverage ratio | 1.10 | | |
| Inventory turnover | 7 times | | |
| Fixed asset turnover | 1.8 times | | |
| Debt-to-Capital ratio | 43.4% | | |
| Interest coverage ratio | 5.0 times | | |
| Return on Assets | 8.4% | | |

*Possible ratings: Good (Highest); Fair (Middle); Poor (Lowest)

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