Transfer of experiential and innovative teaching methods for business education

Leonardo da Vinci Project

Transfer of Innovation

2010-1-PL1-LEO05-11462

Company X

Teaching notes

Przemysław Garsztka

Piotr Pietraszewski

Poznań University of Economics

The project has been funded with support from the European Commission under the Lifelong Learning Programme. This publication reflects the views only of the authors, and the Commission cannot be held responsible for any use which may be made of the information contained therein.

Company X - Teaching Notes

1 Synopsis

Case Study A describes the circumstances surrounding a commercial lending proposal to fund the acquisition of some real-estate for property development purposes.

The proposer is a company that has a long-standing relationship with its bank, but has limited experience of this type of activity.

Similarly, the bank has limited experience of providing funds for property development purposes.

The case provides an opportunity for students to explore and discuss factors that are likely to influence the decision of the bank to provide the requested funds.

The case is set in 2009.

Case Study B discusses the justification for the bank's decision to provide the requested funds to the company for property development purposes.

The case presents an opportunity for students to debate solutions to the problems that emerged following the collapse of financial markets and land values in the aftermath of the global financial crisis.

2 Target Audience

The case studies have been prepared for intermediate and upper intermediate students studying finance, banking and related subjects.

3 Teaching and learning objectives

Following consideration and discussion of **Case Study A**, students should be able to:

- Identify and explain the principal risks to the proposer and the bank of investing in real-estate for property development purposes;
- Demonstrate an understanding of the factors that influence the decision of a bank to provide funds for property development purposes;

- Demonstrate the development of their skills and understanding associated with financial statement analysis;
- Evaluate a commercial lending proposition and provide evidence of an ability to make informed judgments leading to the presentation of reasoned conclusions;
- Demonstrate the development of oral presentation and negotiation skills.

For **Case Study B,** in addition to the above, students should be able to:

- Demonstrate an awareness and understanding of the consequences of a decline in the financial markets and land values in relation to a given situation;
- Present reasoned recommendations and an action plan to address the problems that emerge from the bank's decision to lend.

4 Preparations for the case study discussions

Students should read **Case Study A** before the class and complete the summary analysis form (See Appendix 1). Completion of this form provides evidence of student preparedness and may highlight important gaps in the students' understanding that the instructor can address.

Case Study B The discussion of this case will require students to consider and analyse, where appropriate, the contents of:

Appendix 2: the conditions of the bank's decision to lend
Appendix 3: the financial results of Company X for 3 years
Appendix 4: statistics relating to the real estate market

5 Teaching Plan

Case Study A

Opening discussion (10 minutes)

Introductory question:

Should the bank grant the loan or not?

Depending upon the responses from students, the instructor will be able to follow up on ‘yes’ or ‘no’ answers by summarising (on the board) the principal reasons for the students’ decision.

Opening in this way captures the attention of students from the outset and provides a framework for an exploration of the issues raised. Completion of the summary analysis sheet should facilitate the discussion.

Follow-up questions / Suggested answers:

- *Is Company X a good customer of the bank?*
  Lack of a credit history at the bank; in credit scoring systems it would probably be a good customer but not the best. The teacher should indicate the lack of collateral for the loan in the company’s fixed assets.
  How well placed do you think Company X is to diversify its activities into real-estate / property development?
  Not very well; new area of activity; pretty good location and probably easy and quick money. The teacher should indicate the highly speculative nature of the proposition.
- *How attractive to the bank is the lending proposal? (Ask students to state their evaluation of attractiveness on a scale of 1 to 10 [10 = very attractive])*
- *What are your principal concerns about any decision of the bank to provide the funding requested by Company X? (e.g. its inexperience in property lending)*
  Highly competitive market; successful transactions in the past, but during better economic times; question marks over the company’s financial position.

- *What value would you place on the land as security for the loan?*
  If the requirements are too high, the bank may lose the customer.

Summary questions:

So, what would your decision to lend be now? (ask students to reconsider their earlier decision and to state their view following the case study discussion. Also, ask students to briefly state the most important reason for accepting the funding offer and/or the most important reason for rejecting the proposal.

This feedback could be written on the board (e.g. list the top five arguments for and against granting the loan). This tactic allows the instructor to bring the session to an organized and meaningful close and provides an opportunity for the students to reflect upon their decision. It should help the students to check their level of understanding of the issues raised and provide the instructor with a measure of the extent to which the teaching and learning objectives have been achieved.

This session could be extended beyond 5 to 10 minutes (depending on how the instructor wishes to bring the case study discussion to an end). See below for an alternative ending to the session:

Reinforcing the learning

This case provides a valuable opportunity to undertake a role play:

Students in favour of the **decision to lend** could be asked to play the role of the bank manager and to highlight the reasons for **rejecting** the loan proposal from Company X

Students in favour of the **decision to reject** could be asked to play the role of Company X and to present to the bank the reasons why the proposal **should be accepted**.

Such a role play would take up to 20 minutes to conduct.

A further 10 minutes could be taken up by asking students who have subsequently changed their decision why they had done so.

Closing question: What do you think happened in this case in reality?

Did the bank lend or not?

The instructor reveals that the bank did grant the facility and what the terms were for the loan that was granted.

This leads into a consideration of Case Study B at a follow-up session.

Case Study B.

The instructor announces that the loan was granted and the terms under which the facility was made available to Company X.

The next part of the session (25 minutes) is devoted to a consideration of the students' appraisal of the financial performance and position of Company X and their evaluation of the real-estate market.

The students are then invited to 'brainstorm' possible options for the bank to take, leading into a discussion about the consequences of the options put forward. These options and their implications could be recorded on the board (15 – 20 minutes).

Final question to students: *What would you do?*

The instructor could reveal that typically a bank will consider the 'first loss to be the best loss'. In this context the likelihood is that the bank will primarily be intent on making sure it does not suffer a loss or have to write-off of its exposure to Company X. Its primary objective will be to protect the interests of its depositors, even if this means severing its relationship with Company X and forcing the company into receivership. A decision to defer a request for the company to repay its borrowing, which might mean the instigation of legal proceedings, could mean that the loss to the bank would increase through further deterioration in land values – the primary security for the loan. This possibility is likely to precipitate a formal request for the company to repay its outstanding commitments to the bank.

The instructor can then reveal what actually happened.

Appendix 1. Summary analysis form

- Company X is:

a) The big company engaged in the real estate trade	Y	N
b) Small business real estate brokerage	Y	N
c) Developer involved in the construction of new dwellings	Y	N
d) Small company providing financial intermediation services	Y	N

- Financing entity is:

a) A large attractive building plot in the center of the city	Y	N
b) A small, but very attractive building plot in the center of the city	Y	N
c) Large, but unattractive land on the outskirts of the city	Y	N
d) A large, attractive building plot on the outskirts of the city	Y	N

- Raiffeisen Bank Poland experienced in this type of service:

a) Most of the loans granted by the Bank for investments developer	Y	N
b) Approximately half of the loans for investments developer	Y	N
c) Less than 5% of the loans for investments developer	Y	N
d) This is the first such loan and hence the problem	Y	N

- In order to grant the loan is still needed:

a) Approval of the Credit Committee	Y	N
b) Approval of the Regional Director of Credit Risk	Y	N
c) Complementary documents by Jack Kowalski	Y	N
d) Additional security for the loan provided by John Doe	Y	N

Appendix 2: What happened next? (first quarter 2009)

- The bank's Credit Committee decided to grant funding for the loan.
- The terms and conditions attached to the loan were: Gross Profit of about 6 million PLN; Cost of Materials & Consumables reduced from 2.6 million to 0.187 million; SG&A-Expenses and Personnel Expenses to be no more than 0.066 million; Company has no fixed assets. Almost all are investments in shares and securities.

What happened next?

- In September 2009 there was a collapse in the market – caused by the financial crisis and the "crash" in the stock market. This resulted in the portfolio of shares purchased by the company, mainly from the sWIG80, losing up to 80% of their value.
- The real estate market collapsed and land prices fell significantly (by up to 50%). The loan to value ratio of the property purchased with the bank's funds exceeded 100%.
- Reduction in demand for the services provided by the company due to competition in the property development / housing market. The company was not able to generate sufficient income to cover the fixed costs of the business.

The consequences

- The collapse of the stock market created difficulties in recovering the capital invested (very low liquidity regarding the shares purchased by the company meant there was the possibility of a significant loss in the event of a sale of its shares).
- Repayment of the loan was threatened. The bank became very anxious to protect its position and to avoid any loss on its exposure to Company X.

At the beginning of 2010:

- The value of the property does not cover the loan.
- Company X does not have any other assets.
- The value of the shares held by Company X could settle the debt to the bank, but it would be very detrimental to Company X and probably lead to receivership / liquidation.

The view of the Credit Risk Department

Its top priority is to protect the interests of its depositors.

An urgent resolution of the debt repayment problem of Company X is required.

Appendix 3: Financial data for 3 years

	Dec-07 PLN thou.	Dec-08 PLN thou.	Sep-09 PLN thou.
Total Revenues	5 761.64	6 560.06	99.82
CoS/ CoGS / Cost of Materials & Consumables TCM	2 623.61	187.43	40.51
Gross Profit	3 138.03	6 372.63	59.31
Personnel Expenses TCM	0.95	11.11	9.00
Rental and Lease Expenses	-	-	-
SG&A-Expenses, Other Operating Expenses	3.74	55.21	877.74
EBITDA	3 133.34	6 306.31	- 827.43
Depreciation and Amortization TCM	0.00	5.56	10.19
EBIT	3 133.34	6 300.76	- 837.62
Interest Income	0.07	-	-
Income from Investm. in Subsidiaries/Affiliates	-	-	-
FX Gains	-	-	-
Other Ordinary Financial Income	-	-	-
Financial Income	0.07	-	-
Interest Expenses	222.12	4.87	86.79
Loss from Investm. in Subsidiaries/Affiliates	-	-	-
FX Losses	-	-	-
Other Ordinary Financial Expenses	8.16	-	-
Financial Expenses	230.27	4.87	86.79
Ordinary Income	2 903.13	6 295.89	- 924.42
Extraordinary Income	0.01	455.69	-
thereof gain on disposal of fixed ass. & investm.	-	-	-
thereof revaluation of fixed ass. & investm.	-	-	-
thereof FX gains	-	-	-
thereof adjustments to current assets	-	-	-
thereof release of provisions	-	-	-
thereof positive effects of accounting changes	-	-	-
Extraordinary Expenses	455.69	0.82	-
thereof loss on disposal of fixed ass. & investm.	-	-	-
thereof write-down of fixed ass. & investm.	-	-	-
thereof FX losses	-	-	-
thereof adjustments to current assets	455.69	-	-
thereof transfer to provisions	-	-	-
thereof negative effects of accounting change	-	-	-
thereof amort. of goodwill (not stable in value)	-	-	-
thereof restructuring charges	-	-	-
Extraordinary Results	- 455.68	454.87	-
Pre-Tax Profit / Loss	2 447.45	6 750.76	- 924.42
Income Tax	- 566.84	-1 111.80	-
Net Profit / Loss	1 880.62	5 638.95	- 924.42

Appendix 4: Data on the real estate market (optional)

	2002	2003	2004	2005	2006	2007	2008	2009
For sale or rent (thousands)	23.82	23.844	24.23	33.047	37.96	46.878	66.703	72.353
Total supply of residential units (thousands)	99.089	162.686	108.117	114.066	115.353	133.826	165.189	160.079
Total number of housing units built & sold (thousands)	-	76.4	81.5	70.8	67.9	65.8	77.5	60.9
Total number of street houses built & sold (hundreds)	-	32.3	26.1	22.1	24.8	16.5	14.7	5.7
Projects for flats and houses where licenses have been issued (in thousands)	86	98.9	114.9	123.9	168.4	247.7	230.1	178.8

The total supply of residential units increased during the period 2002- 2008 on average by 5.3 thousand a year. The number of units for sale or rent increased during the same period on average by 6.7 thousands a year. But sales were worse. The total number of housing units built and sold decreased on average by 1.3 thousands a year, and in the case of street houses sales decreased by 3.3 hundreds a year. In 2009 the total number of street houses sold decreased by about 61% compared to 2008 (and the total number of housing units sold in 2009 decreased by about 21.4%). The number of licenses issued for projects involving flats and houses increased in 2002-2008 on average by 28 thousands, but in 2009 decreased by 22.3%. All this shows the collapse of the real estate market which took place in 2009.