

E & S Sales (A)

INTRODUCTION

On April 2, 1984, Klaus Lassig's partner of 18 months walked into his office and said, "Your goals and my goals are not the same anymore. I think it's time we split up the business."

Klaus was devastated. One day earlier, Klaus was encouraged by the success of their small electrical business. E & S Sales was showing signs of a promising future, and both partners had just begun taking salaries from the business. Now, Klaus was on the brink of the biggest challenge of his career. Convinced his partner's announcement was not a late April Fool's joke, he began wondering how he could operate a business on his own, how he could secure the working capital required to sustain a new business, and how he could protect the future of his business.

BACKGROUND

Klaus Lassig was born in East Germany before World War II. Raised in a poor environment, the Lassig family often made due with only a potato or two for dinner. It was no surprise when Klaus first met Americans in 1955 that he was enamored by their material possessions. This impression convinced Klaus to immigrate to America in search of a better lifestyle, and he convinced four friends to leave East Germany with him.

At the age of 18, Klaus and four friends boarded a train destined for West Berlin. They did not take luggage with them for fear of drawing attention to themselves which would cause them to get sent back to East Germany. They successfully made it to West Berlin, and from there to Hanover, Germany. After spending a week in a Hanover refugee camp, Klaus secured a job as a local electrician and began saving money to pay for his fare across the Atlantic. Three years later, Klaus left West Germany and immigrated to Salt Lake City, Utah.

Klaus's electrical skills were in high demand in Salt Lake City, and he quickly found a job with a small electrical firm. Over the years, he noticed several operating inefficiencies in his employer's organization and, when his paychecks began to bounce in 1982, he decided he was capable of managing a business in a more efficient manner. As a result, he and Dayl Simpson¹, a co-worker, formed a partnership named E & S Sales. Klaus had known Dayl for 20 years and he had no reservations about forming a partnership with him.

¹ Names used in this case are fictitious.

Although time constraints prohibited them from creating a written partnership agreement, they orally agreed to the following terms: 1) Each would hold a 50 percent interest; 2) they would share administrative functions; 3) each would actively pursue new business; and 4) each would invest \$20,000 with a promise not to touch the money for at least one year.

\$20,000 represented every penny of Klaus's life savings. He worked hard with E & S Sales during the day, but was forced to clean office buildings in the evenings for \$300 per month which provided income to pay rent, insurance and food. While E & S Sales was off to a solid start, he was not immediately paid for his work. The nature of the electrical industry determined E & S Sales would not be paid on a project until after it was completed; usually eight months after a project had begun.

Klaus was elated when, fifteen months later his partner decided the business was successful enough that they could begin taking out salaries. Klaus purchased a new home and was beginning to see the fulfillment of his American Dream. After all, he was one-half owner of a successful business, lived in an upscale Salt Lake City neighborhood and was working in a promising industry.

E & S SALES

E & S Sales installed electrical components in public and commercial buildings. Klaus and his partner began by selling and installing alarm and intercom systems in schools, churches and hospitals. Klaus and Dayl quickly assumed different roles in the new organization. Klaus managed the sound system and intercom activities and Dayl oversaw the alarm installations.

Each project would take approximately eight months to complete and E & S Sales would be paid in full for a contract upon completion. Due to the size of the activities E & S Sales worked on, only three to four projects could be worked on at any one time. As a result, E & S Sales would recognize revenue only four to five times per year. The risks of such a business were twofold: First, E & S Sales had to be careful to do business with credit-worthy subcontractors who would be capable of paying upon completion of the project. Any company that defaulted on its contract would have a devastating impact on E & S Sales' financial performance. Second, E & S Sales faced pressure to complete each project accurately and promptly. If a contract was not completed according to contract specifications, again E & S Sales' income would be severely impacted. A summary of E & S Sales' initial projects and the dollar amount of their contracts is included as Exhibit 1.

Electrical firms such as E & S Sales secured work by bidding on projects. Bids were usually submitted to a subcontractor that had been awarded the rights to supervise a portion of the project by the general contractor. As an example, a school district that planned to build a new elementary school would request bids from general contractors. These bids would be comprehensive in nature and include the structure's foundation, structural steel, electrical work, plumbing, brick laying, cabinetry and so forth. The

general contractor would then subcontract most of these individual tasks to subcontractors. Specifically, an electrical contractor would secure the rights to design and install all of the electrical projects to be included in the building. Finally, subcontractors would request bids from companies such as E & S Sales to install components of the electrical project, such as an intercom or alarm system. E & S Sales would bid on and secure the rights to install these specific electrical components of a building. Having been awarded the bid, E & S Sales would work with the subcontractor to install its systems. Exhibit 2 visually depicts the hierarchy of contracting.

E & S Sales competed with larger, national firms such as Honeywell, Southern Steel, Trend Tech and Secure Tech. These firms had been in the marketplace for many years, and Klaus and Dayl realized they would need to build a sustainable core competency to successfully compete with these larger firms. Klaus believed E & S Sales was at a disadvantage to these larger firms for two reasons: First, it was a new firm and did not have an established reputation, and second, it did not have the working capital necessary to bid on larger projects.

Despite these disadvantages, E & S Sales was able to underbid larger firms on small, local contracts. When a large firm bid on a local Utah contract, it had to consider the costs of temporarily relocating its employees to Utah. These costs were reflected in its bid. Because E & S Sales was located near most of the contracts it was bidding on, it did not have these additional costs and was able to competitively price its bid.

Furthermore, E & S Sales found an immediate advantage in its local marketing efforts. Through hard work and expertise, Klaus earned a reputation for his extraordinary skill and workmanship. Aware of this reputation, many of the local electrical engineers would ask for his assistance in drawing up electrical plans for the architects of a project. Klaus worked side-by-side with these electrical firms, usually before a subcontractor was awarded the rights to install the components. As a result, Klaus already had relationships with many firms when they requested bids from other companies. The development of these relationships helped E & S Sales secure the rights to work on many projects.

By the beginning of 1984, E & S Sales had established itself as a legitimate provider of small, commercial alarm and sound systems. The partners were working on nine projects, many of which Klaus had helped draw the plans for. They had recently finished the first few projects they had been awarded as the partnership, and the tenants, contractors and electrical engineers were all pleased with their work. Indeed, the future looked bright. Convinced the success was sustainable, Dayl proposed the two partners begin taking a monthly salary from the business. At last, Klaus felt his hard work was paying off.

FRICITION WITHIN E & S SALES

Despite their quick success, differences between the partner's styles were evident. Klaus spent much more time attending to all aspects of the business including marketing, installing components, securing orders from suppliers and working with electrical engineers. Because Klaus was more active in his marketing efforts, he found a larger proportion of E & S Sales' customers and had a greater sense of ownership than did Dayl. While Klaus would often stay at the office until 10:00 PM contacting potential customers and working with electrical engineers, his partner would leave early for an afternoon tee-time. Klaus felt E & S Sales was functioning more like a sole proprietorship than a partnership. Klaus tried to discuss his frustrations with Dayl several times, but Dayl simply justified his actions and excused himself from the room.

On April 2, 1984, Dayl approached Klaus and expressed his intent to split up the business. The only explanation he provided was a difference between the two partner's vision of the firm. Days later, he presented Klaus with a plan to distribute the assets of the business, as shown in Exhibit 4. Although the asset values of the distribution were similar, Klaus noticed the contracts Dayl allocated for himself were with stronger, more stable contractors. Conversely, many of the projects Klaus would be left with were on smaller, less secure projects – Klaus was even concerned that some of the contractors would not be financially capable of paying him.

Klaus challenged Dayl, but learned Dayl had already begun working independently with his self-assigned contracts. Klaus also realized that without a written partnership agreement, he had no legal basis to challenge Dayl. Subsequently, Klaus agreed to the asset and project distribution.

The two partners would independently complete the projects they were working on and would use most of the revenues to settle the firm's liabilities, after which the firm would be dissolved. As a result, Klaus would take very little income from the business, especially if some of his contracts became insolvent as he expected.

The break-up of E & S Sales was sure to have a devastating financial impact on Klaus for two reasons: First, due to E & S Sales' breakup, he would not draw the monthly income he had begun to expect; and second, any new contracts he began working on independently would not provide any income until after the contract was completed -- eight months away.

For three weeks, Klaus could not sleep at night. Although E & S Sales would finance the completion of the projects he was currently working on, he worried about how he could survive on his own once these projects were completed. The financial pressures not only affected his personal income, but crippled his ability to find new business in the following ways:

- Klaus could not afford the materials and components necessary to complete the projects should he secure a bid. The cost of these components often totaled one-half of the total bid and represented a major investment.
- Klaus did not have the financial resources to pay employees for bids he was able to secure. Many of the projects he would bid on required the help of four electrical technicians, who relied on bi-weekly wages for their work. How could he employ a workforce without capital?

Ideally, Klaus would like to pursue larger projects because they were more profitable. However, bigger projects only magnified the problems listed above as they took more time to complete, required a greater number of employees and utilized more materials. Each of these factors translated into a need for a greater amount of working capital. Klaus's biggest hurdle, should he move forward on his own, centered around his need for capital.

In the late hours of the night, Klaus would lay awake considering the options available to him. He considered the pros and cons of each option but felt handcuffed by his limited funds. As a result, he focused his attention on developing methods of financing his new business endeavors.

FINANCING OPTIONS AVAILABLE TO KLAUS

1. Seek prepayment: As one alternative, Klaus considered seeking prepayment from the subcontractors he would be working with. Under this alternative, Klaus would include provisions in his bid that would request payments in periodic installments. While this was not standard practice in the industry, Klaus trusted the existing relationships he maintained with many of the subcontractors would enable this possibility. Still, this alternative was risky and the results were not guaranteed for two reasons:

First, like E & S Sales, subcontractors were not paid until a project was completed in its entirety. As a result, Klaus would be asking subcontractors to pay him for work that they themselves had not been paid for. He knew this alternative would not be feasible without benefiting the subcontractor in some way. Klaus was unsure what he could offer that would make this alternative attractive to a subcontractor.

Second, requesting prepayment would send a signal to the subcontractors. Klaus wondered if subcontractors would be willing to do business with a company that showed signs of financial distress. This was especially important because many of the components and systems Klaus installed were protected by warranties. Beyond Klaus' ability to simply install the system, subcontractors may question whether his company would be around long enough to maintain and service the system beyond the completion of the project.

2. Seek external financing: As a second alternative, Klaus considered seeking financing from financial institutions or private investors. He believed external financing could come from two sources: a) banks; and b) venture capitalists. Each of these options had inherent advantages and disadvantages.

A revolving line of credit from a bank would provide Klaus with the working capital necessary to see a project through its completion. The most attractive feature of a bank loan was the fact that Klaus would not give up ownership of his company. However, Klaus knew he was unlikely to qualify for such a loan. Furthermore, interest rates were unusually high (see Exhibit 5) and interest on a bank loan would reduce his gross profits considerably.

Venture capitalists could be another source of external funding for Klaus. While he felt money from a venture capitalist would come more easily than from a bank, Klaus was hesitant to pursue such financing for several reasons: First, venture capitalists usually provided capital to a firm by purchasing convertible preferred stock. As a result, Klaus would share ownership with the venture firm. Second, although preferred stock did not come with voter rights, Klaus knew that the venture capitalists could convert their preferred shares into common shares and trump Klaus's decisions. Finally, Klaus was concerned with the amount of time it would take to complete the process of securing venture capital. He believed it would take at least two months to create a business plan, sell his ideas to the financiers and receive funding. Klaus did not have that much time.

Regardless of whether Klaus chose to pursue either bank financing or venture capital, he knew he would need to prepare pro-forma financial statements. He was especially interested to calculate the amount of external financing needed. Although it was late at night, he quickly jotted some rough numbers on a legal pad that would help him create these financial statements. His notes are included as Exhibit 6.

3. Seek another partner: Klaus had two or three friends in the industry that he could approach about becoming his partner. However, Dayl, his trusted partner with E & S Sales, was the cause of his current problems and Klaus was unwilling to place himself in this position again. He wondered how he could structure a new partnership to avoid such problems. Furthermore, his new partner would need to be willing to contribute 100 percent of the working capital necessary to finance the initial projects. This would be a tough sale to a potential partner.

4. Partner with a national firm: Klaus had competed extensively with large, national firms such as Honeywell, Southern Steel and Trend Tech throughout his course of business with E & S Sales. He had even relied on them occasionally for supplies and technical expertise. He believed he had established a strong reputation among these firms and could partner with one of them, if necessary. Klaus was often able to outbid these national firms on local projects because he did not have the expenses of relocating employees and equipment.

Klaus wondered if one of these firms would consider entering into a partnership with him to bid on local business. If feasible, Honeywell, for example would finance the project and employ Klaus to install the system. If Klaus chose to pursue this course of action, he wondered how he could protect himself through a partnership agreement.

5. A combination of the alternatives above: Finally, Klaus wondered if there was a combination of alternatives that would enable him to maintain his independence and have access to necessary financing.

OTHER OPTIONS AVAILABLE TO KLAUS

In addition to the various methods of financing the new business outlined above, Klaus was also considering two alternatives that would not require extensive capital. They included:

1. Pursuing other lines of business: Klaus believed he could successfully market and install home security systems. He had installed a home security system for his friend before and felt this was an industry that would grow in the future. An advantage to this alternative would be the amount of time a project would take to complete. Depending on the sophistication of the system, Klaus believed he could install a system in five to 14 days. As a result, he would be paid on a project within six weeks from securing the contract.

However, Klaus also immediately saw many disadvantages to pursuing this course of business. He recognized that to succeed he would need to spend much more time marketing his product and wondered if this would reduce his profits. Furthermore, Klaus had enjoyed the challenge of designing and installing sophisticated systems with E & S Sales. Installing home security systems would be relatively easy for Klaus. He worried that this line of work would not be challenging enough for him. Finally, Klaus had a difficult time collecting payment from his friend when he installed his home security system. Klaus was concerned about the amount of time and effort it would take to collect from his customers.

Despite these concerns, Klaus knew that home security systems would provide him with relatively quick income. This was currently his highest priority.

2. Finding full-time employment: Klaus considered the stability that a full-time job would provide. Qualified workers in his industry were in extremely high demand and he knew that he could quickly find full-time employment with one of his competitors if he wanted.

CONCLUSION

At 3:30 AM, Klaus looked over the alternatives before him. Each had advantages and disadvantages, and he believed he might need to pursue more than one option. For example, bank financing appeared very attractive, but he needed a back-up plan should his request for financing be turned down.

Furthermore, he recognized most of the options he was considering required the help of other individuals or firms. He was hesitant to enlist the help of other partners, but concluded that some could bring resources he needed. He resolved to create a written partnership agreement and wondered what components he could include to protect himself from any future problems.

He turned off the light and walked to his bed, afraid of the decisions that would await him in the morning. Three things he was certain of: 1) He needed to prioritize which options to pursue; 2) he needed to attract capital to sustain the initial operations of a new business; and 3) he needed to identify what issues to address in a partnership agreement.

Exhibit 1: E & S Sales' Clients

<u>Client</u>²	<u>Contract Amount (Gross Profit)</u>	<u>Actual/Expected Completion Date</u>
Jordan School District	\$ 35,000	June 15, 1983
Granite School District	40,000	August 30, 1983
Altaview Hospital	48,500	November 15, 1983
Salt Lake County	32,000	November 30, 1983
Salt Lake School District	30,000	December 15, 1983
Provo School District	43,250	January 10., 1984
Regional Medical Center	40,000	March 18, 1984
Intermountain Health Care	28,500	April 30, 1984
Jordan School District	62,000	July 20, 1984
Salt Lake County	34,000	August 1, 1984
Intermountain Health Care	35,500	August 15, 1984
Utah County	42,000	November 1, 1984
LDS Church	30,000	November 30, 1984
Okland Construction	48,000	January 12, 1985
TOTAL	\$ 548,750	

² Clients names are fictitious.

Exhibit 2: The Hierarchy of Contracting

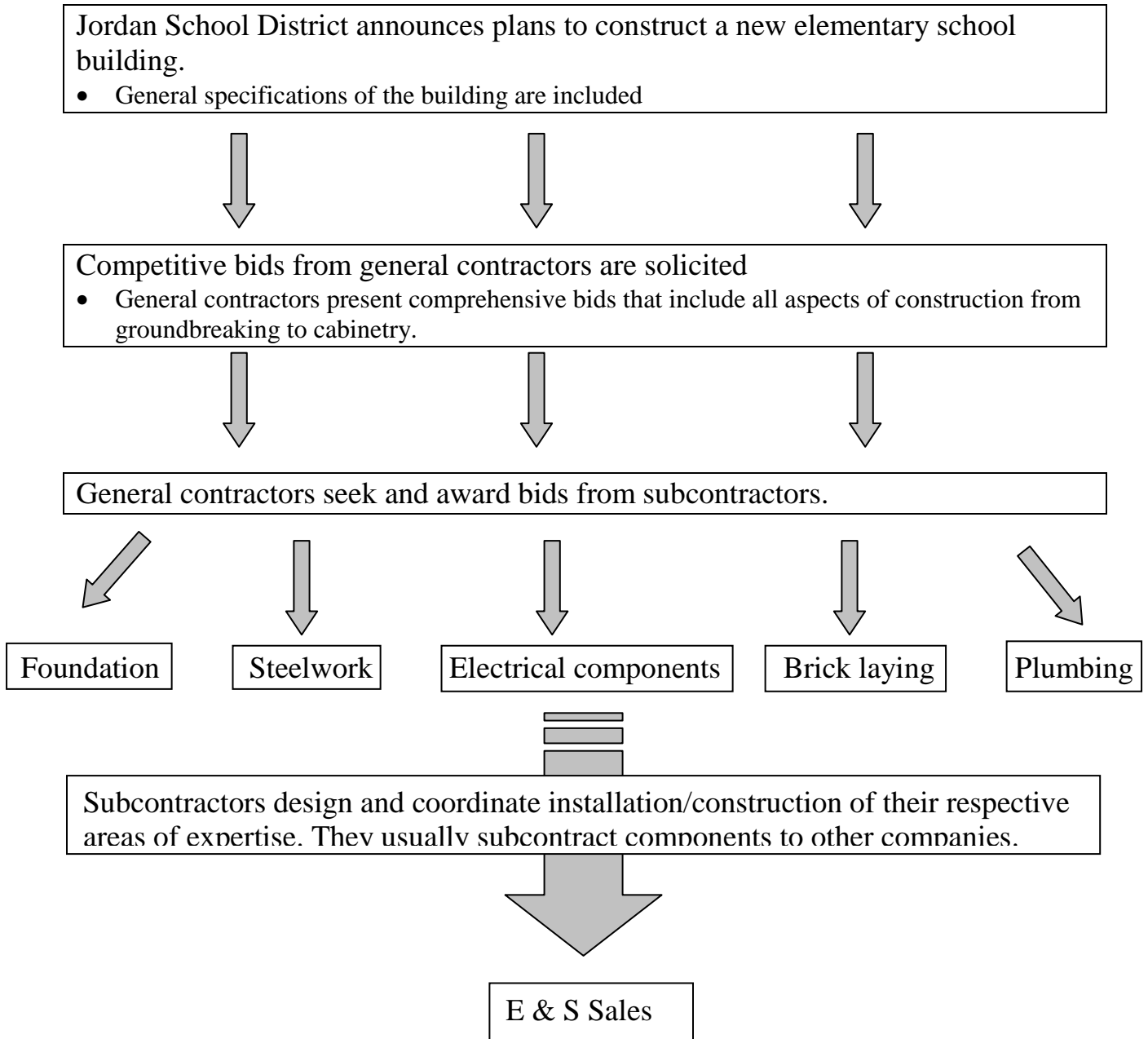


Exhibit 3: E & S Sales Financial Statements

*E & S Sales
Balance Sheet
For Years Ended December 31*

<i>Assets</i>	<u>1984</u>	<u>1983</u>
Cash	\$ 26,178	\$ 12,118
Accounts Receivable	-	428
Less Allowance for bad debt	-	(428)
Inventories	-	-
Deposits	<u>300</u>	<u>294</u>
<i>Current Assets</i>	<i>\$ 26,478</i>	<i>\$ 12,412</i>
PP&E	40,520	40,214
Less accumulated depreciation	(25,560)	(12,780)
Intangible Assets	505	505
Less accumulated amortization	<u>(202)</u>	<u>(101)</u>
<i>Total Assets</i>	<i>\$ 41,741</i>	<i>\$ 40,250</i>
<hr/>		
<i>Liabilities & Stockholder's Equity</i>		
Accounts Payable	\$ -	\$ -
Accrued Taxes	12,894	14,312
Mortgages, Notes, Bonds Payable	<u>20,000</u>	<u>20,000</u>
<i>Total Liabilities</i>	<i>\$ 32,894</i>	<i>\$ 34,312</i>
Capital Stock	40,000	40,000
Shareholders Prev. Taxed Undist. Taxable Income	(15,596)	(15,596)
Accumulated Adjustments Account	<u>(22,663)</u>	<u>(24,154)</u>
<i>Total Equity</i>	<i>\$ 1,741</i>	<i>\$ 250</i>
<i>Total Liabilities & Stockholder's Equity</i>	<i>\$ 41,741</i>	<i>\$ 40,250</i>

*E & S Sales
Income Statement
For Period Ending December 31, 1984*

Sales	\$ 1,346,695
Cost of Goods Sold	<u>(929,066)</u>
Gross Profit	\$ 417,629
Selling & Admin. Exp.	(381,360)
Depreciation	<u>(14,375)</u>
Operating Profit (EBIT)	\$ 21,894
Interest Expense	<u>(20,596)</u>
Earnings Before Taxes (EBT)	\$ 1,298
Taxes	<u>(156)</u>
Net Income	<u>\$ 1,142</u>

Exhibit 4: Distribution of E & S Sales' Assets – Market Value

<u>Amount Given to Dayl</u>		<u>Amount Given to Klaus</u>	
Contracts ³	\$ 338,602	Contracts	\$ 314,859
Personal automobile	10,000	Personal automobile	10,000
Other automobile	3,300	Dodge Van	250
Computer	1,858	Copy Machine	2,100
VW Lease	<u>0</u>	Lettering Machine	<u>300</u>
Total⁴	<u>\$ 353,760</u>	Total	<u>\$ 327,509</u>

Exhibit 5: Interest Rate Environment

**Interest Rate Environment
April 1, 1984**

Prime Rate	11.93%
Federal Funds	10.29%
6 Month CD	10.73%
3 Month Treasury	10.07%
30 Year Treasury	12.65%

³ Represents the contracts each partner was responsible for supervising. Income from these projects would be retained to settle E & S Sales' liabilities upon completion.

⁴ Differences between totals reflect additional equity contributed by Dayl.

Exhibit 6: General Financial Data

April 4, 1984

General Assumptions

- Secure one project per month.
- \$50,000 (gross profit, net of cost of materials/supplies) avg. project size
- 6 months from start to completion (25 weeks)
- Two employees per project
 - @ \$12.30/hr.
 - 40 hour weeks
 - 23 weeks per project
- Selling & Admin. Expenses: \$2,500/mo.
- Interest expense: ? ?
- Taxes: 30% rate (State & Federal)