

WestWood Foods & Drinks GmbH (B). Additional Loan Request

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Introduction

In April 2019, loan officer Anna Koch with the backing of the risk committee of Nassauische Sparkasse (Naspa), granted a 5-year loan of €200,000 and an additional credit line of €150,000 to WestWood Foods & Drinks GmbH, to finance its expansion to the Taunus region. After having thoroughly examined WestWood's financial situation and forecast at the time, Anna Koch concluded there was only very limited risk involved.

However, only little more than a year later, in July 2020, Paul Schulte, the general manager of WestWood, asked Naspa for a 2-year grace period on its outstanding loan and an additional term loan of €350,000. The circumstances had changed a lot since Naspa granted the initial loan, and the decision of whether to grant this request was not an easy one to take.

Events

The company's expansion into the Taunus region did not go as smoothly as planned. The competitors responded to Westwood's market entrance by lowering prices. As a result, WestWood's sales growth was only 4% in 2019, 4 percentage points (pp) lower than forecasted. Moreover, WestWood underestimated the complexity of the logistics and operations associated with the expansion and the opening of the second warehouse. As a result, operational expenses (Opex) increased 5% in 2019, instead of the forecasted 3%.

WestWood's situation was further complicated by the outbreak of the COVID-19 pandemic in March 2020. Initially, the pandemic had a positive effect on WestWood's sales, which were 12% and 5% higher in March and April of 2020 respectively, compared to the same months of the previous year. However, from May onwards, the positive sales impact disappeared.

This case was prepared by Professors Christian Eufinger and Eduardo Martínez Abascal. January 2022.

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Moreover, the lockdown implemented by the German government led to a substantial increase in Opex due to more frequent (almost daily) shipment to clients. The overactivity also induced a deterioration in the days of inventory and days of collection.

In early April 2020, very much to the surprise of Anna Koch, WestWood paid a large dividend of €350,000. The bank learnt shortly thereafter that WestWood's owners used most of the liquidity from the payout to save another of their businesses from bankruptcy: a recent investment in a hotel, which got into severe financial problems because of the COVID-19 pandemic.

The lack of liquidity forced Schulte to delay payments to suppliers. As a result, WestWood lost the early payment discounts offered by their suppliers. While Schulte tried to pass on the higher costs at least partly to its customers by increasing prices, overall, WestWood's gross margin still decreased by almost 1pp.

In June 2020, Anna Koch learnt that two major customers - AWO Bad Marienberg and Sozialwerk St. Georg - terminated their contracts with WestWood at short notice for the following month. These two customers jointly represented 20% of WestWood's total sales. Both clients stated that they were offered better terms from another supplier in their vicinity. Moreover, they were dissatisfied with the lack of punctual supply due to the logistics complications that WestWood experienced because of the COVID-19 pandemic and the enlarged sales area.

Anna received WestWood's financial statements as of June 2020 and was surprised by how an apparently healthy business (i.e., WestWood in 2019) could become a serious credit risk in such a short period of time. Anna Koch immediately called Paul Schulte to arrange a meeting. In the meeting, Schulte explained:

We know it is a tough phase for the company. We work extremely hard to retain our existing customers and gain new ones, especially in the Taunus region where we still see great potential. Our problem is transitory, only for this coming semester, and only due to the pandemic. After that, we will again be a promising and profitable business, which creates jobs in the region and provides an essential service to many rural communities.

For the second semester of this year, we expect sales to be at a similar level as in the first semester, but minus the 20% of AWO Bad Marienberg and Sozialwerk St. Georg. By 2021, we could again reach 13 million in sales. We need to maintain the current Opex level to provide good service and attract new customers, but we don't expect an additional increase in 2021. We don't want to increase prices for our customers in such a difficult time, so our gross margin will stay at about 17%. We also started offering slightly better payment terms to keep and attract customers. Moreover, our days of inventory will be normalized next year at around 8. There is no need for any capital expenditures until the end of next year, and depreciation will be €90,000 up to now. With these figures in mind, we expect losses for this year, which is not surprising considering the horrible pandemic. Hopefully by next year, 2021, we will be profitable again.

We are very confident that we will recover in the medium-term. However, in the meantime, we need a 2-year grace period on the outstanding loan with Naspa and a bridge loan of €350,000 for just 5 years, to have the liquidity to cover expenses and payment obligations.



Legal Implications

Three days after the meeting with Schulte, Anna Koch met with the bank's legal advisor Kurt Schmidt, an experienced and somewhat skeptical lawyer. It seemed clear that if Naspa denied the additional loan and grace period, WestWood would have to file for bankruptcy. Anna wanted to know the implications for Naspa in this event. In the words of Schmidt:

First, we need an estimate of WestWood's liquidation value, that is, the value of the company's assets if they are sold off to repay creditors. To begin with, you usually lose 10% of receivables and other current assets due to bad debts. The inventory will go back to the suppliers since they have reservation of ownership for the unsold inventory.

Regarding the fixed assets—mostly trucks plus some warehouse trolleys and shelving—I doubt they are worth more than €300,000 when sold, of which €100,000 correspond to the two trucks that guarantee our loan. Of the total liquidation value, you must subtract 10% as the fee for the liquidator who manages the sell-off of the company's assets.

In sum, I would be happy if the liquidation of WestWood's assets yields around €700,000. From that money they must first settle the senior debts: salaries and other, that I estimate to be roughly €100,000. What is then left will be distributed among the creditors on a pro rata basis. I have not identified any creditor with a high seniority. Our two outstanding credit lines are unsecured; their total outstanding amount is €230,000.

In sum, if WestWood goes into insolvency and is liquidated, I would expect that we end up with a loss of roughly €150,000. Manageable, but still rather unfortunate given the fact that we granted the loan just last year! And these estimates assume that the owners will not try to quickly collect from customers and divert the cash. Additional uncertainty arises from the fact that WestWood might seek protection under the umbrella of the recent Covid business support measures (see **Exhibit 3**) and suspend the payments unilaterally. We also need to keep in mind that sending them into bankruptcy could also hurt the reputation of our beloved Sparkasse, especially considering the current Covid situation.

Uff, dear Anna, what a tricky situation! Maybe people would attribute the bankruptcy to the pandemic, which might limit our reputational risk. Maybe we can use the Covid support measures that were recently approved by the government (see **Exhibit 3**) to our advantage and gain time. And yet, in my opinion, we would be fooling ourselves and just kicking the can down the road. Anyway, good luck Anna!

A Difficult Decision

Now, Anna had a difficult decision to make: should she cut her losses and recover as much as possible from the outstanding credit while trying to minimize the negative impact on the bank's public image, or should she grant the new loan request, thereby increasing the bank's exposure to WestWood even further?

She asked her team to prepare a clear diagnosis of WestWood's current situation, including an analysis of the failures during the last 15 months. Moreover, she wanted her team to assess the company's prospects in the short-term. Finally, and most importantly, she asked her team to prepare an overview of all viable options that the team could come up with, including their pros and cons. Assume you are Anna Koch. What course of action would you recommend?