Silver City: A Case Study

John R. Mills, University of Nevada Reno, USA
Sonja Pippin, University of Nevada Reno, USA
Charles Carslaw, University of Nevada Reno, USA
Richard Mason, University of Nevada Reno, USA

ABSTRACT

The Silver City Case is designed for an advanced accounting or MBA class and provides students with the opportunity to analyze relevant information extracted from different types of business entities. These range from publicly traded corporations to non-corporate and/or non-public entities. Students are required to make a decision on the viability of a bid on a Request for Proposal (RFP) for a sports facility construction project. The primary objective is to provide a foundation for the evaluation of complex business entities. This requires the dismantling of the business structure to the point that it can be analyzed on an individual entity basis. The achievement of this objective requires students to understand the type of financial information that can be derived from each of the different entities as well as determining the reliability of such information. Furthermore, the case offers opportunities to discuss underlying guarantees that keep the business structures together.

Keywords: business entities, financial ratios, financial analysis, flow-through entities, RFPs, guarantees

INTRODUCTION

Silver City is a city in the western United States that at one time was a boom town during the gold rush period. It had a population in excess of 100,000 in the 1860s and its current population has grown to over 300,000. Parts of the old central downtown area of the city have become depopulated and are in run down condition. The city has started a series of redevelopment projects in its effort to attract more people to live and work in the downtown community. One of the projects is the construction of a Silver Spurs Sports Facility. The city has put out a Request for Proposal (RFP) for the construction, operation and ownership of this sports facility. The city currently owns the land that the Silver Spurs Sports Facility will be built on but will donate the land to the winner of the proposal. The RFP was announced in April 2009. The evaluation process will commence on June 30, 2009 and the winning bid will be announced on September 1, 2009. Construction is expected to start October 1, 2009.

The RFP has resulted in the submission of several proposals by companies with a range of ownership structures. The submissions include bidders from publicly traded corporations who have created Limited Liability Company ("LLC") subsidiaries; joint ventures and other ownership structures. Other submissions come from newly created LLCs composed of a combination of individual investors, partnerships, trusts and LLCs. All the proposers submitted financial information with a year end of December 31, 2008.

The City Council of Silver City selected a group of five senior government officials to be the Sports Facility Review Board (SFRB) ("Board"). The Board will decide on the winning proposal. In addition, the Council decided to hire a group of experts to provide advice to the Board based on their expertise in the areas of financial analysis, economic development, human resources, strategic and operational business plans, and sports complex design. You have been hired to provide the advice in the area of financial analysis.

An area of major concern to the Board is their lack of understanding of corporate financial information. Given the current weak economy, the Board wants assurance that the winner of the proposal has the financial capability to construct the project and the ability to operate the property for an extended period once it has been opened. The city has hired you to evaluate the financial suitability and stability of each of the applicants that have submitted RFPs.

EVALUATION OF AN ENTITY FOR FINANCIAL SUITABILITY

The first applicant that has been referred to you for review is Top Hill Investments, LLC. The Board has provided you with the financial data provided in Appendix A that represents the financial information provided by the Top Hill Investment group. This information and the information below has been provided by Top Hill Investments' company president, John Burch.

Top Hill Investments is a newly formed entity created solely for the Silver Spurs Sports Facility RFP. The joint venture intends to build, own and manage the facility if awarded the bid. The owners are ABC2 Corporation and Silver Nugget, LLC. As shown in Figure 1, ABC2 and Silver Nugget are each 50% owners of Top Hill Investments.

ABC2 is a wholly-owned subsidiary of ABC Corporation, a publicly-traded corporation (Nasdaq: ABC) and the owner/operator of the Stockton City Sports Arena in California. ABC2 has been created by ABC solely as a subsidiary to establish Top Hill. It does not have any significant assets or liabilities. ABC has provided its historic financial statements for the three years ending December 31, 2008 (see Tables C1, C2, and C3).

Silver Nugget, LLC is also a newly-formed entity, formed solely in connection with Top Hill's application for the Silver Spurs Sports Facility proposal. Silver Nugget is a jointly owned company owned by three of the principal partners of BCD Construction Company (John Burch (70%), Steven Cornwall (20%) and Charles Jacobs (10%)). BCD Construction Company is a nationally-known private development company with extensive experience in the development of leading sports complexes.

Because Silver Nugget is a newly formed entity with no historical financial information, net worth statements (Table C4) and summarized tax return information (Table C5) of all of the investors in Silver Nugget have been included in the RFP. In addition to the net worth of its owners, Silver Nugget has arranged a further \$150 million undrawn line of credit (hard copy of credit agreement included) from the Burch Family II Trust. Information concerning the Burch Family II Trust is provided in Table C6. This trust was specifically set up by Burch family members to fund certain investments projects. Thus, while trust income is generally not distributed, the trustee has the flexibility to distribute trust assets to Burch family members and to pledge funds for certain investment projects.

PROPOSED COST OF THE SILVER SPUR SPORTS FACILITY

Top Hill has provided estimated cost information on the proposed Silver Spurs Sports Facility as shown in Table C7. The total proposed cost is estimated to be \$700 million. The cost includes \$180 million for highway improvements that will provide easier access to the stadium and parking. This was one of the required improvements suggested by the City in order to have a viable bid. Top Hill also submitted together with the bid a letter of intent from First West Bank which indicates the bank would be willing to extend a five year \$400 million senior security loan if the owners of Top Hill Investments make an upfront \$300 million equity contribution to the project. This type of arrangement between lending institution and bidder is relatively common. Top Hill must provide \$300 million in cash at the signing date of the agreement with the bank. Note that in order to be considered by the Board, they would expect the bank agreement to be in place at the time when the proposal is submitted.

Sports Facility Review Board wants advice about the financial viability of this proposal. The Board is apprehensive because the proposal from Top Hill Investments is from a newly formed corporation with no financial history. They are very impressed with the design of the proposed facility and the personalities of the proposers and they feel that the \$700 million cost is a reasonable estimate. They are, however, concerned about where the funds will come from for constructing and operating the sports facility. They are particularly worried about the reliability of the financial information provided by the Silver Nugget investors. They have asked you to provide them with a financial analysis that will enable them to decide whether this bid is a viable candidate for awarding the sports facility contract and to advise them on further information they should seek before finalizing their decision.

The SFRB also notes that the financials provided were for the year ending December 31, 2008. The current year (2009) has been identified as a recession year with anticipated recovery in the third quarter of 2010. They point

out that the stock market has dropped considerably and that the bankers are being more restrictive about loans. After carefully evaluating all financial information provided to you, what is your advice to Board?

POTENTIAL CASE QUESTIONS

A. Ownership Structure

Develop an overview of the different types of business entities involved in this bid. Provide a summary of the strengths and weaknesses associated with each type of business enterprise. Specifically, research the following characteristics for each of the entity involved:

- Limited liability of the entity's owner(s)
- Tax treatment of the entity's earnings
- Tax treatment of contributions to and distributions from the entity
- Restrictions regarding who can be an owner of the entity

Remember that your presentation is to the Board who has very limited private business expertise.

B. Publicly Traded Corporations

- 1) Prepare a financial statement analysis for the Board on ABC2's parent ABC. This should include both ratio and trend analysis.
 - a) Determine the financial ratios that are relevant to determine :
 - i. the liquidity of the companies,
 - ii. the solvency of the companies, and
 - iii. the profitability of the companies.
 - b) Identify the business group that should be used to make industry comparisons and identify appropriate benchmark ratios.
 - c) Provide an excel spreadsheet with the ratios and trends
- 2) Use this information to write a report providing recommendations in terms of the ABC2's and ABC's ability to fund this project.
- 3) What additional information should you seek to evaluate this type of entity?
- 4) Would your answer be different if you were told that the ABC also has a \$300 million revolving bank line of credit?

C. Non-Corporate and/or Non-Public Entities

- 1) Identify problems that need to be addressed when dealing with the financial analysis of Silver Nugget and the net worth statements provided by its owners?
- 2) Cash flow statements are required to be provided with public corporations. Is it possible to prepare equivalent cash flow information from the information provided by the Silver Nugget owners?
- 3) If the Burch Family Trust contributes funding in the form of a loan, how should that funding be treated?

D. All Entities Combined

- 1) Develop a table that addresses the question of what each investor needs to contribute to the project and whether they can meet their expected input with the resources currently available.
- 2) Recall that the timeline of the project calls for submission of the proposals by June 30, 2009 when the evaluation process will commence. The winner will be announced by September 1 and construction is expected to start October 1 of the same year. As suggested in the text, the investors have to put guarantees in place to satisfy the Board as well as the bank. These guarantees will cover the time period from the submittal of the bid until construction starts. What nature and type of guarantee should be provided to cover this period of time? Are there any specific disclosure requirements for these guarantees?

AUTHOR INFORMATION

John Mills is a Professor of Accounting at the University of Nevada, Reno. He holds a Doctor of Philosophy in Business Administration from the University of Colorado, Boulder, an MBA and a BS degree in Business Administration from the University of Nevada, Reno. His area of specialty is in financial accounting and disclosure. He has also specialized in consulting work dealing with casino accounting issues. He has published extensively on specialized topics such as cash flow analysis, money laundering regulations and casino controls and compliance testing.

Sonja Pippin is an Assistant Professor at the University of Nevada, Reno. She holds a Doctor of Philosophy in Business Administration and a Master's Degree in Accounting (Tax); both from Texas Tech University. She teaches tax courses with a focus on taxation of business entities and consults for a local CPA firm. She has published in several academic and practitioner-oriented journals. Her research interests include legal tax research, technology acceptance in the accounting and tax environment, and tax policy.

Richard Mason is Chair of Accounting and an Associate Professor at the University of Nevada, Reno. He holds a Doctor of Philosophy in Business Administration from the University of Connecticut, a Juris Doctor degree from St. John's University School of Law, and a BBA in Accounting from Hofstra University. He has been admitted to practice law in New York since 1981. His area of specialty is in taxation. He has published extensively on various tax and financial accounting topics.

Charles Carslaw is an Associate Professor at the University of Nevada Reno. He teaches intermediate, advanced and international accounting courses. He specializes in financial reporting issues and works extensively with Native American tribal governments and their commercial enterprises. He has published extensively in academic and practitioner journals. His research interests include specialized financial accounting & auditing topics as well as government/not-for profit issues.

APPENDIX A

Ownership Structure and Financial Information of Top Hill Investments, LLC

The investment proposal (RFP) for the Silver Spurs construction project is put forth by an investment entity with an ownership structure as presented in Figure 1 below. The investing company is owned by the Silver Nugget LLC, a new flow-through entity formed by three individuals: Burch, Cornwall, and Darwin. The other owner is a corporation owned by ABC Corporation, a public entity (C Corporation).

Figure 1: Ownership Structure

Table C1: Balance Sheet

ABC Corporation Statement of Financial Position			
In millions of USD			
	12/31/2008	12/31/2007	12/31/2006
Assets			
Cash	\$ 57.32	\$ 59.68	\$ 130.76
Marketable Securities	39.25	78.00	8.20
Receivables	46.86	52.70	45.56
Inventories	4.51	3.98	6.53
Other Current Assets	11.89	9.25	6.34
Total Current Assets	159.83	203.61	197.39
Prop., Plant & Equipment	1,713.37	1,528.53	1,494.00
Accumulated Depreciation	410.19	371.22	315.31
Intangibles	297.78	248.82	248.97
Deposits & Other Assets	221.34	312.33	172.04
Total Assets	1,982.13	1,922.07	1,797.09
Accounts Payable	37.51	29.58	19.27
Current Portion of Long-Term Debt	2.54	0.77	0.64
Income Taxes	22.18	22.48	20.07
Other Current Liabilities	150.08	143.48	142.52
Total Current Liabilities	212.31	196.31	182.50
Deferred Revenues	229.64	202.45	206.17
Long-Term Debt	375.01	367.32	368.39
Other Long-Term Liabilities	6.08	0.87	0.07
Total Liabilities	823.04	766.95	757.13
Common Stock	0.52	0.53	0.53
Capital Surplus	621.53	698.40	699.88
Retained Earnings	537.04	456.19	339.55
Total Shareholders' Equity	1,159.09	1,155.12	1,039.96
Total Liabilities and Shareholder's Equity	1,982.13	1,922.07	1,797.09

Table C2: Income Statement

ABC Corporation Income Statement Years Ending			
In millions of USD			
	12/31/2008	12/31/2007	12/31/2006
Net Sales	\$ 816.56	\$ 798.37	\$ 740.13
Cost of Goods Sold	362.52	348.79	327.98
Gross Profit	454.04	449.58	412.15
SG & A Expense	132.09	193.58	95.99
Depreciation & Amortization	80.21	56.83	50.89
Operating Income	241.74	199.17	265.27
Non-Operating (Income) Loss	53.25	(5.45)	(8.67)
Interest Expense	15.63	12.35	12.69
Income Before Taxes	172.86	192.27	261.25
Income Taxes	86.67	75.47	101.88
Net Income	86.19	116.80	159.37

Table C3: Statement of Cash Flows

ABC Corporation Statement of Cash Flows Years Ending			
In millions of USD			
	12/31/2008	12/31/2007	12/31/2006
Net Income	\$ 86.19	\$ 116.80	\$ 159.37
Depreciation/Amortization	80.21	56.83	50.89
Net (Decrease) in Operating Assets/Liabilities	(2.53)	(17.90)	(91.45)
Other Adjustments-Net	94.24	85.66	27.97
Net Cash Flow from Operating	258.11	241.39	146.78
Net Purchase of Fixed Assets	(96.06)	(110.19)	(248.82)
(Acquisition) Disposition of Businesses	(87.04)	(124.44)	(23.82)
(Increase) Decrease in Investments	38.75	(69.80)	106.80
Other Cash Flow from Investing	0.06	(2.69)	(0.38)
Net Cash Flow from Investing	(144.29)	(307.12)	(166.21)
Issue (Repurchase) of Shares	(81.16)	(0.27)	(0.07)
(Net Repayment) of Debt	(29.91)	(0.64)	(7.51)
Dividends, Other Distribution	(5.29)	(4.27)	(3.20)
Other Cash Inflow (Outflow)	0.17	(0.18)	(0.01)
Net Cash Flow from Financing	(116.19)	(5.36)	(10.78)

Table C4: Financial information for individual investors 12/31/2008

	John Burch	Joseph Cornwall	Charles Darwin
Cash & Equivalents	\$750,000	\$150,650	\$1,450,000
Investments: marketable securities	720,000	80,750,000	10,475,000
Investments: non-marketable securities	42,700,000	45,850,000	25,460,000
Cash value of life insurance			75,000
Total current assets	\$44,170,000	\$126,750,650	\$37,460,000
Retirement investment funds	\$200,000	\$214,295	\$140,860
Business investments	30,500,000		
Personal real estate	700,000	5,000,000	4,000,000
Personal assets - other			800,000
Total assets	\$75,570,000	\$131,964,945	\$42,400,860
Total current liabilities	\$100,500		\$29,500
Mortgage payable		600,500	240,450
Net worth (equity)	\$75,469,500	\$131,364,445	\$42,130,910
Ownership in Silver Nugget LLC	70.00%	20.00%	10.00%
Required contribution to Silver Nugget LLC	\$105,000,000	\$30,000,000	\$15,000,000

Table C5: Tax return information summarized for year ending 12/31/2008

	<u>Burch</u>	<u>Cornwall</u>	<u>Darwin</u>
Wages/Salaries	\$ 8,000	\$ 8,600	\$ 8,900
Taxable interest	\$ 500,000	\$ 466,000	\$ 7,000
Tax exempt interest	\$1,300,000	\$ 1,340,000	\$ 13,900
Dividends	\$ 140,000	\$ 105,000	\$ 33,600
Business income/loss	\$ 4,000	\$ 5,000	
Capital gains/losses	\$3,250,000	\$ 3,300,000	\$ 74,700
Income from partnerships, S corporations & trusts	\$ 14,000	\$ (235,000)	\$ 80,250
Other income		\$ 8,450	
Gross income	\$5,216,000	\$ 4,998,050	\$ 218,350
Personal and other deductions	\$ 100,000	\$ 120,000	\$ 158,000
Exemption	\$ 2,200	\$ 2,200	\$ 1,100
Taxable income (gross income except tax-exempt income less deductions & exemptions)	\$3,813,800	\$ 3,535,850	\$ 45,350

Table C6: Burch Family Trust: net worth and tax return information (12/31/2008)

Net worth statement	
Cash & Equivalents	\$150,700,000
Investments: marketable securities	120,500,000
Investments: non-marketable securities	62,500,000
Loans to operating companies	50,250,000
Business investments	<u>100,000,000</u>
Total assets	\$483,950,000
Total liabilities	<u>\$600,000</u>
Net worth (equity)	\$483,350,000
Tax Return Information	
Dividends	\$ 537,000
Business income/loss	270,000
Capital gains/losses	(3,000)
Rents, Royalties	48,000
Gross income	852,000
Investment interest expenses	86,000
Charitable contributions	6,800
Other deductions	<u>91,000</u>
Taxable income (gross income except tax-exempt income less deductions & exemptions)	\$ 668,200

Table C7: Total project cost and Funding

Pre-opening cost and payroll	
Mass transit improvement	180,000,000
Contingencies and reserves	60,000,000
Training	2,500,000
Pre-opening cost	50,000,000
Finance cost	7,500,000
Total	300,000,000
Property and equipment	400,000,000
Total project cost	\$700,000,000
Funding:	
Initial contribution – Silver Nugget LLC	\$150,000,000
Initial contribution – ABC Corporation	150,000,000
Total initial contributions	300,000,000
Total asset backed loans	400,000,000
Total funding	\$700,000,000