
Caritex Cooperative Case Study

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Building a business is never an easy task – add the uncertainty inherent in an emerging market, an undeveloped regulatory environment, and lack of access to reasonably-priced capital and the challenges become almost insurmountable. In spite of the odds emerging markets are full of examples of entrepreneurs that faced these challenges and gone on to create successful businesses providing benefits to their customers, employees, and sources of capital. Unfortunately, many entrepreneurs fail along the way – this is the story of two, Alex and Lucy Ivanov who created a business that was operationally sound but a financial disaster.

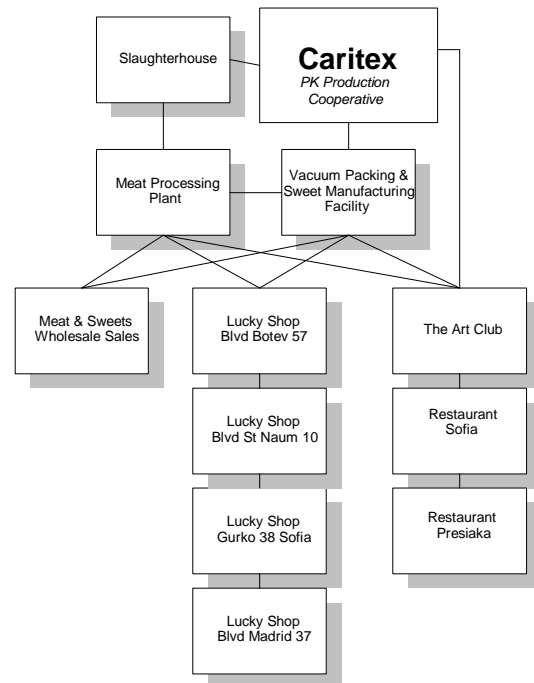
Alex was despondent as he climbed the steps to the office of the United States - Bulgaria Investment Fund (USBIF)¹. He knew the meeting with Tim Smiggen and the loan staff was not going to go well. Smiggen had always been difficult to work with and now that the business that Alex had built was falling down around his feet he was not optimistic. Fourteen months ago Alex had succeeded in borrowing a total of \$400,000 from USBIF – one of the largest loans the fund had made to date – to retire some of the debt held by private creditors. The fund considered this to be a very risky project and the news Alex brought would certainly not be well received. Revenues and operating profits were way down as the country was in the midst of a banking crisis and currency collapse. Further, for the entire period since receiving the loan he had violated virtually all of the loan provisions and supplied USBIF with fraudulent financial statements. Alex was out of money, the remaining private creditors wanted their money back, and he was about to tell USBIF, his Western business partner, that he had lied to them.

¹ The bank was a donor sponsored project designed to provide financing to small and medium enterprises in Bulgaria. As a donor funded project the focus was often more on meeting reporting requirements than in practicing appropriate levels of due diligence or monitoring. The name of the bank and the loan officer are changed.

Background

Alex Ivanov and Lucy Ivanova are the main principals of Caritex, a meat processor with four retail outlets, wholesale operations, and three restaurants. The Ivanov's, along with seven other partners, founded Caritex four years earlier. Operationally, Caritex was one of the largest and most respected meat processors in Bulgaria. By focusing on innovative products, clean and well-stocked stores, and high levels of customer service, Caritex rapidly gained customers in a market used to 45 years of shoddy products, limited choice, and non-existent customer service.

Exhibit I
Caritex Organizational Structure



Source: Interview with Lucy Ivanova

In four years, Alex and Lucy had grown revenues to over \$3,000,000 a year with over \$500,000 in operating profit. Unfortunately, the operating cash flow was now no longer sufficient to cover the interest charges and principal repayments to the private creditors who had provided the funds Alex and Lucy used for growing the business – resulting in a constant state of crisis for Caritex.

By the end of 1995 Caritex had 85 providers of capital, all operating under different arrangements with Alex. Some provided relatively long term financing of six months at an interest rate of 3 percent per month, others provided funds for one to two weeks at a monthly rate in excess of 8 percent per month. Alex was making finance

related payments almost every day and virtually every day one of the creditors would call and request to be paid off early. Alex considered most of their creditors to be friends or at least acquaintances and tried to be as accommodating as possible. When a note came due he would get on his mobile phone with individuals who had placed money with him in the past or a new contact referred by a friend, an employee at Caritex, or someone with a current or past financial interest in the firm. After 4 years Caritex was ready for an infusion of lower cost and longer term financing – which brought them to USBIF.

Exhibit II
Caritex
Company Development
1992 – 1995

Year	Highlights	Sales			Total
		Stores	Restaurants	Wholesale	
1992	Opened two stores	\$ 907,000	-	-	\$ 907,000
1993	Five stores, meat processing, warehouse & salad facility, and a cafe & employee restaurant	\$ 1,400,000	5,000	395,000	\$ 1,800,000
1994	Closed two & opened one store, closed cafe & opened Restaurant Lucky	\$ 1,760,000	30,000	910,000	\$ 2,700,000
1995	Opened <i>Art Club</i> , Established Wholesale market in Botevgrad, converted salad facility to sweets facility	\$ 1,716,000	249,000	1,118,000	\$ 3,083,000

source: interview with Lucy Ivanova

Recent Financial Performance

At the beginning of 1996 Caritex appeared to be in a relatively good operational condition. Sales had increased by more than 40 percent from the previous year; they had succeeded in opening one of the most popular restaurants in Sofia in the past year, and in four years Alex and Lucy had created equity in the business of more than \$300,000. The first part of 1996 saw a significant turn for the worse.

While sales were up 5 percent for the first five months (compared to the same period in 1995), margins were not as strong as the past and the price of debt was increasing as the overall economic situation in Bulgaria worsened – resulting in a posted loss of almost \$90,000 for the first five months of 1996.

Exhibit III
Caritex
Results of Operations
1992 – 1996

	1996 (5 months)	1995	1994	1993	1992
Net Revenue	\$ 1,445,372	\$ 3,303,708	\$ 2,700,000	\$ 1,800,000	\$ 907,000
Cost of Goods Sold	1,011,761	2,187,399	2,014,300	1,334,301	625,084
Gross Profit	433,612	1,116,309	685,700	465,699	281,916
General and Administrative	144,537	295,102	230,800	108,000	54,420
Wages and Salaries	130,084	252,065	175,500	135,000	63,490
Miscellaneous	21,681	36,054	25,877	14,657	31,254
Total Operating Expenses	296,301	583,220	432,177	257,657	149,164
Operating Profits	137,310	533,089	253,523	208,042	132,752
Financial Expenses	226,393	550,695	184,322	97,400	34,150
Net Income (Loss) Before Tax	\$ (89,083)	\$ (17,606)	\$ 69,201	\$ 110,642	\$ 98,602

source: company records

Exhibit IV
Caritex
Balance Sheet(s)

	5/30/1996	12/31/1995	12/31/1994	12/31/1993	12/31/1992	2/28/1992
Current Assets						
Cash	\$ 5,450	\$ 15,386	\$ 23,331	\$ 38,653	\$ 27,467	\$ 1,800
Receivables	74,307	70,769	38,112	27,300	-	-
Inventory	98,234	93,556	72,981	57,995	42,300	28,000
Total Current Assets	177,991	179,711	134,424	123,948	69,767	29,800
Plant & Equipment (net)						
Buildings and Improvements	560,439	560,439	385,100	332,335	91,250	55,000
Machinery and Equipment	434,349	434,349	353,419	315,222	72,300	38,700
Automobiles	95,551	95,551	63,250	42,755	14,000	-
Total Plant & Equipment	1,090,339	1,090,339	801,769	690,312	177,550	93,700
Total Assets	\$ 1,268,330	\$ 1,270,050	\$ 936,193	\$ 814,260	\$ 247,317	\$ 123,500
Liabilities & Owners' Equity						
Current Liabilities						
Demand Notes	905,572	855,572	545,405	519,836	97,715	75,000
Accounts Payable	96,831	80,216	53,600	27,330	-	-
Accrued Liabilities	45,671	24,923	10,243	9,350	2,500	-
Total Current Liabilities	1,048,074	960,711	609,248	556,516	100,215	75,000
Long-Term Debt						
Paid in Capital	48,500	48,500	48,500	48,500	48,500	48,500
Retained Earnings	171,756	260,839	278,445	209,244	98,602	-
Total Shareholders' Equity	220,256	309,339	326,945	257,744	147,102	48,500
Total Liabilities & Owners' Equity	\$ 1,268,330	\$ 1,270,050	\$ 936,193	\$ 814,260	\$ 247,317	\$ 123,500

source: company records

Initial Loan Request

In the spring of 1996 Alex and his other partners had all come to the same conclusion – that if they were to survive they must reduce their debt burden, or at least lower the cost. They also all agreed that significant growth

opportunities existed and they were excited and proud to be part of Caritex. They jointly made the decision to pursue more conventional bank financing through USBIF. Using bank financing was not foreign to Caritex; they had taken and paid off a number of short-term working capital loans.

What USBIF offered was unique to Bulgaria at the time – relatively long term financing and a fixed interest rate. Alex made the strategic decision to ask for financing for two purposes, 1) for funds to retire the private debt the company currently had outstanding, and 2) for additional equipment for expanding capacity and for introducing new, higher end, products to the market. Having one main supplier of capital with fixed terms would allow Alex and Caritex to concentrate on the operations side of the business, instead of dealing with finance-related issues on a daily basis. Having the new equipment would allow the firm to tap into a growing market of discerning consumers willing to pay a higher price for new and higher-quality products. As part of the initial loan request Alex and Lucy provided their views on Caritex:

Alex Ivanov

Why Caritex? People need food. So we supposed the foodstuffs business will develop without significant government regulation (i.e. state monopolies). We developed four stores because it is easier to supply several rather than a single store. Consumer demand for better quality and a wider variety of meat products led us into meat processing. The Caritex name has become synonymous with quality. The changing consumer preferences and requirements have forced us to constantly improve our quality and offer new products.



Strengths Good marketing, excellent work of the different divisions, the ability to identify new markets, and the constant improvement of production techniques and equipment.

Weaknesses It's very hard to work with people with poor work habits (some of our production and shop employees). We also suffer from a lack of computerization and a lack of working capital, which leads to hasty decisions and higher prices for raw materials.

How do you see the future? Our strategic plan is to buy more stores, to build two or three new clubs like the Art Club and to establish lasting contacts with our customers. At present the only factor holding us back is trying to find the necessary investment or partners to build a new meat processing plant.

Lucy Ivanova

Why Caritex? I've worked for Caritex from the very beginning. I'm one of the co-founders. There are several reasons we decided to expand. The most important reason being we were bored with just operating a single small store. We wanted greater and more complex challenges. We found out that it really was not very hard to open the second store. We have discovered a formula for success. We were one of the first to be concerned with customer satisfaction. By providing our customers with high quality products at reasonable prices we developed a loyal customer base.



Strengths We produce high quality sausages with raw materials of guaranteed origin. The great variety of products makes us independent and ensures consistency in supply. Our sausages and meat products are very good and meet the preferences of Bulgarian consumers. When marketing the products we try to stay one step ahead of the competition by doing things that have not been done before. We have many friends due to our honest business practices to our employees, customers, suppliers, and anyone else we deal with.

Weaknesses Our rapid growth has led us into situations requiring immediate responses without the necessary time for proper planning and evaluation. I would like more educated and qualified people to work in our company. The lack of financial resources has prevented us from realizing many of our ideas.

How do you see the future? I would like in five years for people to accept the name of Caritex as they do Coca-Cola, Pepsi, Ford, and GM; that the Caritex trademark guarantees consistency, quality, and value. I wish that the employees would be proud they work with Caritex and for the company to live as a family. Our immediate goals are to build a new slaughterhouse and meat processing plant that meet Western standards and open several restaurants.

I'm convinced we have created something good that will last!

Market Analysis

Bulgaria is a small country approximately the size of Tennessee bordered by Romania, Turkey, Greece, Serbia, Macedonia, and the Black Sea. The country has a long history and is known for its accomplishments in agriculture, wine production, rose oil, yogurt, opera and folk singers, its 1994 world cup soccer team, tourism, success in Olympic rhythmic gymnastics, weightlifting, and boxing, and its computer industry, particularly its software talent. The

current population of Bulgaria is approximately 8.5 million with a significant portion of the population over 50.

Current Economic Conditions

The fears of an inability to make \$1.2 billion in foreign debt payments created a financial crisis in the spring of 1996. Since the beginning of 1996 the exchange rate dropped from 71 (Lev/\$) to almost 130 (Lev/\$). In an attempt to slow the devaluation the central bank raised interest rates from 34 to 108 percent during this same period. Foreign reserves also plummeted; by the end of April, 1996 foreign reserves held in Bulgaria shrank to \$650 million from \$1.3 billion at the end of 1995. Obviously, the effects of the current crises are far-reaching and present an extreme economic danger for the country. Emil Harsev, former deputy governor of the central bank, states, ***“This will freeze all investments.”*** (Financial Times, Monday, May 13, 1996 pp. 18)

On a more positive note, after a dismal five years the Bulgarian economy showed evidence of bottoming-out and rebounding in the last two years. Real GDP figures were up in 1994 and 1995; inflation was down to approximately 32 percent last year, from over 80 percent in 1994. Further, several major multi-national corporations made significant investments in Bulgaria in 1994; McDonalds, Pizza-Hut, Kentucky Fried Chicken, and British Petroleum established world-class operations.

Consumption Expenditures & Patterns

The Bulgarian diet has traditionally consisted of domestically produced bread, cheese, yogurt, meat, and vegetables. The last few years have seen an increase in availability of a wider variety of foods; however, low consumer purchasing power limits much of the population to traditional foods except on special occasions.

Pork is the meat of choice, followed by chicken and beef, with lamb and mutton reserved for holidays. Sausages made of edible offal are in high demand by those with low incomes because it is less expensive than other meats. Total meat consumption in Bulgaria in 1994 was approximately 357,000,000 kilos, down from 459,000,000 kilos in 1989. Falling income levels, increased prices, and the upheaval in state-owned meat processing companies all contributed to the reduced consumption.

A wealthier segment of the population has emerged which is demanding higher quality and more variety in food choices. Many private stores now carry Western-style canned food items and other products.

The Private Meat Processing Industry

One of the major success stories of the Bulgarian transition to a market economy is the performance of the private meat processors. From virtually no presence to a 70

percent market share by the beginning of 1996, the private meat processing industry has shown a phenomenal rate of growth the last four years. Between 1993 and 1994 the industry almost doubled its production capacity.

A study funded by USAID and prepared by PRAGMA² on the private meat processing industry estimates that almost 370 firms exist in the private sector with a majority of the companies falling into one of two categories; firms engaged in processing only (60 percent) and firms engaged in a greater number of steps in the production process (e.g., raising animals, owning a slaughterhouse, restaurant, and/or retail shops). PRAGMA found that 57 percent of the firms interviewed were producing 1 to 2 tons a day and engaged only in processing. Forty percent had semi-integrated operations and were processing up to 5 tons a day and three percent of the firms surveyed had fully integrated modern facilities.

Industry Trends The PRAGMA study outlined several challenges and opportunities facing the industry:

1. Compliance with the sanitation standards.

Compliance under the time frame outlined by the Bulgarian government is extremely difficult, if not impossible. Compliance will require tremendous capital investment for most firms; given the current economic and political situation in Bulgaria this is not a likely occurrence in the near term. Second, no standard model exists for design or physical setup; which makes individual meat processors responsible for getting governmental approval on every step of process; from design to completion. Third, the support industry of providers of infrastructure, equipment manufactures, and suppliers in Bulgaria are not equipped to supply local meat processors with the inputs they need to meet the requirements. The study recommends an extension of three to five years for compliance for small firms. They argue that without the extension more than 75 percent of the firms will be in noncompliance by the middle of 1996.

2. A maturing market

Over the past four years the private meat processing industry has grown from nothing to almost 370 profitable firms. Growth will continue, but success will require a more focused effort as the market matures. Over the next five years higher income levels will result in consumers demanding higher quality products. Modernization of

² PRAGMA is an US-based private international development-consulting firm with offices in many emerging markets. Pragma provides technical and management consulting services for development projects worldwide.

existing facilities and higher sanitation standards will increase production efficiency and competition. And, the continued integration of Bulgaria into the European Community and the renewed ties with Russia will lead to greater export opportunities.

3. Backward integration

As competition grows companies will look for ways to differentiate themselves from their competitors. Many companies will respond to the increase in competition by bringing as many of the production steps under their control as possible. For instance, a number of firms have their own slaughterhouses and distribute through their own stores; a few even have their own restaurants. For many firms the next step is adding livestock production to the operating cycle. This step will help reduce fluctuations in supplies; creating a competitive advantage for firms with this level of control over the production cycle.

4. Land restitution

Obtaining suppliers of quality raw materials on a regular basis are an issue for all processors. Part of the problem is due to the lack of progress in the restoration of land. Producers have not had the ability to effectively integrate livestock production with meat processing because of their inability to contract for or purchase tracts of land of sufficient size.

The cattle industry should develop quickly once land restitution begins to make real progress. However, real restitution will require significant progress on the part of the government.

Competition

5. Credit and banking.

A lack of available and affordable credit is significantly hampering the development of the meat processing industry. Bank loan are hard to obtain, tied to the US dollar, and often require collateral in excess of 300%. A majority of meat processors consider the need for credit a major concern.

6. Cyclical price changes

Fluctuation in livestock prices is another major challenge. Prices are low at the time of slaughter and high at the time of gestation; leading to shortages and uncertainty for processors. Proper herd management techniques can contribute greatly to reducing uncertainty and price fluctuations.

7. Modernization

The increase in competition and higher sanitation requirement will result in modernization of equipment and facilities. This will lead to better-trained production personnel, more sophisticated management and administration techniques (e.g., better accounting systems) and sales marketing staffs for larger operations. Companies that hope to survive will have to become smarter, more competitive, and more efficient.

8. Market Projections

The PRAGMA study projects an overall growth rate of 7.5 percent per year for the next five years.

Exhibit V
Caritex
Major Competitors

	Production Level/ Tons per Day		Products	Markets
Techno Income	2		All products	Sofia
Kokoday	10		Fresh Sausage	Sofia
Yaneks	8		Good Sliced & Packaged Meats	Dobrich, Sofia
Bonioborot	12-15		All products	National
Karol	2		Good Raw Dried	Blagoevgrad
Akanig	1		German-Type Sausage	Sofia
Escusiana	3		Dried Sausages	Sofia
Chech	3		All products	Tarnovo
Microart	1.5		German-Type Products	Sofia, Varna
Caritex	5		All products	Sofia, Botevgrad, Lovech

source: interview with Lucy Ivanova

A number of companies producing quality products have emerged over the last several years. Bonioborot in Lovech produces approximately 12 to 15 tons a day of good quality products. Karol in Razlog specializes in drying meat and has production of about two tons a day. Microart in Belene produces high quality, high price German-type products. Most of the major producers have grown significantly over the last several years without having to contend with much direct competition.

Target Market

Caritex focuses on three major target market segments: distributors, higher-income consumers, and low-income consumers. The main concern of the low-income consumer is value and price with price being an extremely important factor in buying decisions. Recent trends in purchases by this group include the purchase of smaller quantities of meat with each trip to the store. This is a direct result of the continuing economic difficulties in Bulgaria. Incomes have not kept up with rising food prices; consequently, it is harder for consumers to purchase meat in the same quantities as in the past.

The higher-income consumer looks for specialty goods such as deli meats and higher-priced cuts. Presentation of the product plays an important role in their purchasing decisions.

The needs and concerns of the first two groups are of obvious importance to the distributor since their main concern is finding products they can resell at a profit. Other concerns are consistency in quality and volume, delivery terms, and payment terms. Payment terms have become a significant issue with the economic downturn with distributors requesting more favorable payment terms.

Major Customers At the present time Caritex sells to approximately 80 distributors. Independent distributors purchase approximately 85 of the total volume and resell to retailers. Agents or owners of retail establishments purchase the remaining 15 percent. Most customers have worked with Caritex for more than two years.

Financial Projections

The pro forma financial statements for the loan request were based on the following major assumptions:

- Production immediately increases by three tons a day. Caritex has taken steps to ensure markets for the additional production. This spring they will establish an additional wholesale market in Bourgas. This market should do well because of

its proximity to the major summer tourist centers on the Black Sea where meat prices are significantly higher than in other parts of Bulgaria.

- Caritex expects to sell 1.5 tons of fresh meat and meat products a day at the new market. Caritex's largest single customer, Bodinor, has agreed to take the equivalent of 1.5 tons a day at current market prices, more than doubling their current purchases. In addition, wholesale customers in Sofia, Sevlievo, Gabrovo, and Lovech have expressed interest in purchasing additional product.
- With the additional production equipment, and a third shift, the production limit of the existing operations will exceed 12 tons a day. The projections assume sales of eight tons or less per day (4.5 to 5 tons a day from the existing facility and the additional three tons a day from the new equipment).
- Caritex receives funding of \$1,150,000 to 1) replace approximately \$900,000 in private debt with an average monthly cost of 5 percent with bank debt with a monthly cost of 1.25 percent (15 percent per year). Total expected annual savings in interest payments \$405,000 (\$540,000 - \$135,000 = \$405,000). 2) \$220,000 for the purchase of new equipment, and 3) \$30,000 for additional working capital
- Caritex has signed contracts securing the additional raw materials needed for the increased production.

The working capital needed represents the increase in inventory required to reach approximate production of 8 tons per day. The production equipment will help Caritex in two major areas; by increasing total capacity and by permitting the introduction of products that carry a higher profit margin. The purchase of the new vacuum packaging equipment will allow Caritex to offer higher-priced shrink-wrapped meat products. Shrink-wrapped products carry a significant price premium relative to meat sold without packaging because it gives consumers more control over the size of their purchase and has a much longer shelf life than unpackaged meat products.

Exhibit VII
Caritex
Pro Forma Income Statement(s)
For year ending May 30,

	1997	1998	1999
Revenue	\$ 5,572,754	\$ 5,916,470	\$ 6,281,385
COGS	3,914,091	4,155,504	4,411,806
Gross Profit	1,658,663	1,760,966	1,869,579
General and Administrative	469,306	498,252	528,983
Wages and Salaries	267,591	284,096	301,618
Depreciation	91,774	91,774	91,774
Miscellaneous	55,728	59,165	62,814
Total Operating Expenses	884,399	933,287	985,189
Operating Profits	774,264	827,680	884,390
Interest expense	172,500	122,824	65,697
Earnings Before Taxes	601,764	704,856	818,693
Taxes	180,529	211,457	245,608
Net Income (Loss)	<u>\$ 421,235</u>	<u>\$ 493,399</u>	<u>\$ 573,085</u>

Loan Approval

Initially, Tim Smiggen of USBIF was a little skeptical about the project. Tim was a recently minted MBA grad with about four years of experience in Bulgaria. In four years he had seen his share of wild projects and dreamers. While Caritex was an operating business they had employed a highly aggressive financing approach in building their business; an approach that would make any banker very nervous. However, with a little cajoling, Smiggen and USBIF agreed to at least look at the project. They spent a little over a month visiting the facilities, trying the products, and speaking with the customers, suppliers, and employees. USBIF was impressed with the operations of the firm, and the glowing terms in which those associated or doing business with Caritex spoke of the firm. Interestingly, the only group USBIF did not speak with were the private creditors Alex was trying to buy out. In the end, USBIF agreed to fund the loan. They offered Caritex \$400,000 to refinance existing debt, provided the existing partners put up their personal property (mainly apartments) as collateral (in addition to the business assets). The loan carried an interest rate of 15 percent per year, a five year payback and a one year grace period on the principal (interest only payments the first year). USBIF also imposed a number of restrictive covenants. The most important being that 1) Alex was not allowed to borrow funds from private creditors in the future. And, 2) the remaining creditors (those not paid off) would have their claims converted to equity and would no longer receive monthly payments of any kind. They would only be entitled to dividends once the obligation to USBIF was fully satisfied.

Creditors paid off would have to sign a statement indicating the money they received fully satisfies their claims against Caritex. USBIF would also require the remaining creditor who converted to equity to agree in writing to the transfer of their claim to equity. Due to the personal relationship that existed between Alex and his creditors, USBIF left it up to Alex to obtain the needed signatures.

Exhibit VIII
Caritex
Pro Forma Balance Sheet(s)
As of

	5/30/1997	5/30/1998	5/30/1999
Current Assets			
Cash	\$ 112,333	\$ 308,718	\$ 527,173
Receivables	111,455	118,329	125,628
Inventory	156,564	166,220	176,472
Total Current Assets	380,352	593,268	829,273
Plant & Equipment			
Buildings and Improvements	560,439	560,439	560,439
Machinery and Equipment	655,070	655,070	655,070
Automobiles	95,551	95,551	95,551
Total Plant & Equipment	1,311,060	1,311,060	1,311,060
Less: Accumulated Depreciation	91,774	183,548	275,323
Net Plant & Equipment	1,219,286	1,127,512	1,035,737
Total Assets	<u>\$ 1,599,637</u>	<u>\$ 1,720,779</u>	<u>\$ 1,865,010</u>
Liabilities & Owners' Equity			
Current Liabilities			
Demand Notes	-	-	-
Accounts Payable	111,455	118,329	125,628
Accrued Liabilities	27,864	29,582	31,407
Total Current Liabilities	139,319	147,911	157,035
Long-Term Debt	818,826	437,977	(0)
Paid in Capital	48,500	48,500	48,500
Retained Earnings	592,992	1,086,390	1,659,476
Total Shareholders' Equity	641,492	1,134,890	1,707,976
Total Liabilities & Shareholders' Equity	<u>\$ 1,599,637</u>	<u>\$ 1,720,779</u>	<u>\$ 1,865,010</u>

Alex was a little disappointed when he heard the proposal. \$400,000 would take care of his most expensive debt, however it wouldn't help him get the equipment or working capital he wanted for expansion. Also, he knew the remaining creditors would not be happy with the arrangement – how could he explain to them that this was in their interest? The existing partners were also little concerned about putting up their personal property as collateral. For most of them it meant putting up the apartment in which they lived. For Alex it meant putting up the apartment owned by his parents. Alex pleaded with his partners that it was the only way forward and he was sure Caritex would be alright. Lucy supported her partner and husband, noting that Caritex had always been lucky in the past. In the end Alex accepted the terms of the loan and provided the signed agreements from his creditors.

The Meeting

Fast-forward fourteen months...

With Smiggen looking ill, Alex began to explain what happened after they received the loan. Within a month he was again borrowing money from private creditors. Alex explained he had no choice as sales were off more than 25 percent from levels achieved in 1995 and that most of his creditors were his friends and they needed the money to live on – he said that he simply could not turn them away. Within fourteen months Alex had increased the private debt load by more than twice the amount he had borrowed from USBIF, with some of the funds priced at more than 20 percent per month. Alex was also having significant trouble making the current interest payments and his creditors were becoming more insistent about getting their money back. Caritex was also two months behind on their promised principal payments to USBIF. By November of 1997 Alex had exhausted all of his sources of funds – at any price. No one was willing to give him any more money.

Smiggen sat for what must have been 10 minutes in stunned silence. Finally, he took a deep breath and said – wait a second, your creditors signed agreements switching their claims to equity and we have received monthly financials from you for more than a year and the financials indicate the business was profitable with a much-improved balance sheet. Alex simply shrugged and looked at his hands and mumbled something about if he had

received all of the money he had asked for they wouldn't be in this position...

Questions:

- 1) Analyze the pro forma financial statements in relationship with the historic statements; do the assumptions made in the preparation of the initial pro forma statement seem reasonable?
- 2) Revise the projections to reflect a loan of \$400,000 instead of the requested \$1,150,000; do the projections support the granting of the loan?
- 3) How could have USBIF better monitored the loan?
- 4) What responsibility, if any, did USBIF/Caritex have to educate the suppliers of capital on the differences between debt and equity?
- 5) Given that USBIF would only loan \$400,000 to Caritex did a better use of the funds exist besides paying off some of the existing creditors?
- 6) How much responsibility, if any, does USBIF bear in the financial collapse of Caritex?
- 7) What should USBIF do now?

Appendix I

Caritex Actual results of operations for the fourteen months following the disbursement of the loan

	pre loan disbursement 5/96 to 8/96	1st Quarter 9/1/96 to 11/30/96	2nd Quarter 12/1/96 to 2/28/97	3rd Quarter 3/1/97 to 5/31/97	4th Quarter 6/1/97 to 8/31/97	Annual 9/1/96 to 8/31/97	2 months 9/1/97 to 10/31/97
Net Revenue	\$ 515,411	\$ 640,260	\$ 610,950	\$ 587,230	\$ 427,623	\$ 2,266,063	\$ 374,221
Cost of Goods Sold	371,096	473,792	445,994	440,423	329,270	1,689,478	269,439
Gross Profit	144,315	166,468	164,957	146,808	98,353	576,585	104,782
General and Administrative	51,541	65,319	70,440	85,401	70,532	291,692	31,334
Wages	41,233	54,648	67,205	76,505	53,505	251,863	25,505
Depreciation	19,081	19,081	19,081	19,081	19,081	76,324	12,721
Miscellaneous	12,435	14,998	7,018	14,443	7,681	44,140	5,681
Total Operating Expenses	124,290	154,046	163,744	195,429	150,799	664,018	75,241
Operating Profits	20,025	12,421	1,213	(48,622)	(52,446)	(87,434)	29,541
Financial Expenses	111,028	137,647	165,043	230,066	315,940	848,696	273,726
Earnings (Loss) Before Tax	\$ (91,003)	\$ (125,226)	\$ (163,830)	\$ (278,687)	\$ (368,386)	\$ (936,129)	\$ (244,185)

Caritex
Balance Sheet(s) as of the date of the loan disbursement and the end of each
quarter and fourteen months following the disbursement of the loan

	8/31/1996	11/30/1996	2/28/1997	5/30/1997	8/31/1997	10/31/1997
Current Assets						
Cash	\$ 5,384	\$ 2,950	\$ 3,449	\$ 4,172	\$ 2,167	\$ 870
Receivables	78,023	80,364	86,793	94,604	96,496	93,601
Inventory	93,322	79,324	72,978	69,329	65,863	62,569
Total Current Assets	176,729	162,637	163,219	168,105	164,526	157,041
Plant & Equipment (net)						
Buildings and Improvements	560,439	560,439	560,439	560,439	560,439	560,439
Machinery and Equipment	434,349	434,349	434,349	434,349	434,349	434,349
Automobiles	95,551	95,551	95,551	95,551	85,334	85,334
Gross Plant & Equipment	1,090,339	1,090,339	1,090,339	1,090,339	1,080,122	1,080,122
Less: Accumulated Depreciation	19,081	38,162	57,243	76,324	92,180	104,900
Net Plant & Equipment	1,071,258	1,052,177	1,033,096	1,014,015	987,942	975,222
Total Assets	\$ 1,247,987	\$ 1,214,814	\$ 1,196,316	\$ 1,182,120	\$ 1,152,468	\$ 1,132,262
Liabilities & Owners' Equity						
Current Liabilities						
Demand Notes	\$ 581,986	\$ 681,374	\$ 833,571	\$ 1,102,901	\$ 1,433,048	\$ 1,648,290
Accounts Payable	91,989	85,550	79,562	75,584	77,851	81,744
Accrued Liabilities	44,758	43,862	42,985	42,125	48,444	53,289
Total Current Liabilities	718,733	810,787	956,118	1,220,610	1,559,343	1,783,322
Long-Term Debt	400,000	400,000	400,000	400,000	400,000	400,000
Paid in Capital	48,500	48,500	48,500	48,500	48,500	48,500
Retained Earnings	80,754	(44,472)	(208,302)	(486,990)	(855,376)	(1,099,561)
Total Shareholders' Equity	129,254	4,028	(159,802)	(438,490)	(806,876)	(1,051,061)
Total Liabilities & Owners' Equity	\$ 1,247,987	\$ 1,214,814	\$ 1,196,315	\$ 1,182,120	\$ 1,152,468	\$ 1,132,262

note – in June of 1997 Alex sold one of the company cars. This was in direct violation of the loan provisions as the car served as collateral.

Caritex
Collateral Status

	Book/Market Value	Replacement Cost	Liquidation Value
Buildings and Improvements	\$ 560,439	\$ 560,439	\$ 84,000
Equipment	434,349	434,349	173,740
Automobiles	85,334	85,000	17,000
Personal Property - Apartments	180,000	210,000	147,000
	\$ 1,260,122	\$ 1,289,788	\$ 421,740

Buildings and Improvements – Caritex owned two retail outlets that had a combined replacement cost in excess of \$100,000. However, the market for such property was thin and it was hard to gauge the actual price and the length of time required to sell. Higgins discounted the replacement cost by 30 percent as an estimate of liquidation value. Everything else in this category represents leasehold improvements and, as such, has no liquidation value.

Equipment – Most of the equipment was in good condition, however Bulgaria didn't seem to have much of

a secondary market for such equipment. Caritex's major competitors preferred new equipment and with the economic turmoil of the last twelve months none of the major producers was expanding (or even thinking about expanding). A discount of 60 percent was applied to the historic cost.

Automobiles – During the past year Alex had sold one of the newer company cars, in obvious violation of the loan agreement. Most of the cars were old and would not be easy to sell or generate much cash in a sale.

Apartments – The apartments were in good locations in Sofia and would probably sell within six months to a year. However, foreclosing on a primary residence was an extremely time consuming and tedious procedure. Taking possession of the apartments would probably take at least five years.

On paper, USBIF held enough collateral to cover the amount owed on the loan. However, bankruptcy in Bulgaria was a long, drawn out procedure that would take at least several years to implement. In the meantime Alex and the other principals of Caritex would have the use of the assets and practically speaking, would have the ability to sell off anything that wasn't nailed down. The real property was a slightly different story; USBIF held a mortgage on the property that was registered with the municipal court and Caritex could not sell it without having the lien on the property removed.

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