ACCT 6003

Case 3

CompUSA

Group : DOLPHIN

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1. COMPANY BUSINESS AND INDUSTRY CHARACTERISTIC

1.1. Company Background

CompUSA was founded in 1984 as computer retailer to sell computer hardware, software, peripherals and related services. In 1989, CompUSA pioneered the computer superstore format, applying low overhead and offering one stop comprehensive computer shopping. Starting with two stores in 1989, it grew to 106 stores (2,850,000 gross square footage) in 1996 located in 50 metropolitan areas in 33 states of USA. In 1991, it became the first computer superstore chain that listed on the US stock exchange. The company achieved incredible growth during early 1990s, dropped to negative outcome during 1993-1994 but then regained its remarkable performance during 1995-1996 that placed it as the leading player in the industry.

1.2. Industry Analysis

1.2.1. Degree Of Actual and Potential Competition

- Rivalry Among Existing Companies

The company operated in a very dynamic and high competitive sector where technology and channel of distribution were critical factors to outperform in the market. Computer retailers included computer superstores, mail order / direct dealer, office supply superstores, large consumer electronics chains, mass merchandisers and specialty retailers. In 1990s, the market was dominated by large companies. The top 10 US PC product retailers were CompUSA, Best Buy, Computer City, Office Depot, Circuit City, Micro Center, Egghead, Sears, Office Max and Staples. The company also competed directly Dell and Gateway 2000, PC manufacturers that sold direct to the end users through mail order. In retail channel, branded low-margin products dictated increasing sales volume to turn a profit. Rapid technology change caused excess inventory and when the capacity was larger than consumer demand, there was a strong incentive to cut prices, then rivalry became more intense. While superstores had competed on broad selections and low prices to survive, ultimately they had to market higher price points, usually the latest technology. Instead of product variety, the retailers necessarily provided technical support, training and other related services.

- Threat of New Entrants

In the industry with relatively high growth prospect, new players came to the market from time to time. Barriers to entry the market are the need of large investment in the store facilities and products, and high cost of developing store chains. However, smaller scope of business with emphasis on catalog or mail order might need less investment but had to severely compete in the market where margin was squeezed by the large players.

- Threat of Substitute Products

In favor to the PC producers and retailers, there was no any substitute products that had comparable function of PC. However, they had to compete in the fast pace technological change in hardware, software and related peripherals. Product or technology obsolescence became a threat in the industry as the products became outdated within months of introduction to the consumer market. Both hardware and software were subject to constant upgrade or replacement as a result of improvements in underlying technologies or features.

1.2.2. Bargaining Power in Input and Output Markets

- Bargaining Power of Supplier

Competition in the computer industry was intense, ensured by hardware and software manufacturer that regularly cut prices and sought new distribution channel for the products. The computer manufacturing industry was fragmented, with many firms (such as IBM, Dell, Gateway 2000, Compact and others) producing virtually identical products which leading to price war. In term of software, Java and Linux based workstation and server competed Intel and Microsoft Windows based computer. Apple's Macintosh computer system also offered a substitute product. Nevertheless, the software markets were dominated by Intel with microprocessor and Microsoft with DOS and Windows operating system. CompUSA sourced its products from large numbers of supplier and benefited its bargaining power over hardware suppliers but less over software suppliers.

- Bargaining Power of Buyer

In the market, product characteristics were so highly standardized that buyers generally perceived only little real differences in the products. Moreover, the buyers were very well informed through product catalogues, web-site promotions and other publications that made them easier to switch at low cost from one seller to another which induced intense competitive climate throughout the industry. As the buyers became more familiar with the technology, they were less influenced by brand name in their purchase decision. Buyers increasingly viewed computers as commodities and were highly price sensitive in their options.

2. CORPORATE STRATEGY ANALYSIS

CompUSA's objective is to sell computers any way that the customers want to buy them, and it had structured its operating model to meet that objectives.

The base strategy was to offer wide selections of computer products at competitive prices sold by knowledgeable sales representatives in high volumes. The company applied deep discount strategy that supported by purchasing inventory in large quantities at discount from the vendors. Multiple stores were opened in major areas where demand was high enough to absorb the cost. It encouraged impulse purchases through a strategic store layout, which guided shoppers deeper into the store, exposing them to a wider variety of merchandise and eye-catching displays. Benefited from this strategy, the company expanded aggressively. By 1993 however, it experienced losses that were caused by lack of cost and management control and ineffective marketing program in response to market shift.

In response to the operations decline, starting 1995 CompUSA virtually re-invented the company to pursue profitability by switching from Run Of Paper (generic ad space in the newspaper) advertising to circulars, shifting to centralized replenishment system and high margin products were stocked upon instead of items discontinued for not turning a profit, slashed operating costs, revamping the company's hierarchy to push decision making down the ladder, developing non retail businesses that then comprise almost 50% of the revenues, and easily outpace retail growth, investing heavily in training in-store staff, investing in making stores more interactive and user friendly, focusing on building its value-added businesses, like service and support, to nurture and extend client relationships post-sale.

In addition, to overcome the risk of product obsolescence, the company enhanced a high inventory turnover and instituted provision in supply contracts to help partially hedge against the risk of obsolescence. With regard to the on-line market, it opened a web site on the Internet that enabled customers to obtain a wide range of information about CompUSA and encouraged them to browse the on-line catalogue.

CompUSA re-organized itself into operating units that would define its future business strategy and drive growth. It aggressively placed its stores through out the country, from suburban sites to urban market. The company operated multiple businesses to meet the wide-ranging needs of its customers within its category, which are Retail, Corporate Sales, Government Sales, Education Sales, Mail Order, Technical Services and Training.

The company succeeded in applying the turnaround strategies and repositioned itself to be the leading company in the industry. It continuously developed its strategy to strengthen its market position. In 1996, the company acquired PCs Compleat, Inc., a leading direct reseller of brand name personal computers and peripherals. The integration of PCs Compleat expands CompUSA presence in the direct channel. The combination of PCs Compleat direct mail expertise enhanced CompUSA competitive position and enabled to deliver an even higher level of customer service. It also entered into strategic alliance with InfoSource, Inc. for the creation of proprietary computer software training courseware. This alliance provides CompUSA with a source of high-quality computer training courseware and skills assessment software that will differentiate CompUSA from the competition and enhance position as one of the nation's premier providers of software training.

3. KEY SUCCESS FACTORS

The company had identified its distinctive capabilities and matched it with external relationship with suppliers, customers and economic environments in which it operated. Having the competitive advantage, CompUSA outpaced its competitors and gained a leadership position in the market.

As a leading company in the industry with enormous number of stores throughout the country, CompUSA has an economies of scale. The company sourced its products from a large number of suppliers and benefited its leadership position in dealing with the suppliers for low cost procurement. With lower input cost it offered the market a wide range of products at competitive prices.

In the technology related industry where information is a critical factor, the company applied aggressive promotion using publications such as radio, television and newspaper, as well as web site promotion. In the fast paced technological change, products information became an effective means to encourage customers to update with more advanced technology and persuade them to buy new products.

Both changing in consumer demographic and technologies impacted the retail environment. Superstores had to adapt their environments to accommodate all type of buyers, especially first-time buyers, who were the potential growth market. CompUSA addressed the market shift by balancing its classic technology-focused merchandising with more consumer oriented, user-friendly displays and product mix in its stores. The company also improved the responsiveness and efficiency of its sales force. CompUSA redesigned stores by installing clear signage and lowered shelving to make items easier to reach and sales staff easier to find.

In mail order services, CompUSA offered a variety of brands as well as convenient service and replacement options by allowing returns and exchanges through stores. The integration of PCs Compleat with its direct mail expertise enhanced a higher level of service to customers.

CompUSA enhanced technical services which was the highest margin business. It helped customers to integrate scanners, modem and other peripheral equipments with their equipments. It also provided networking support, system integration, software licensing, and over-the phone services to general public on a fee basis. With the concept of ‘one stop shopping’, the company attempted to meet the customers’ needs.

The company also offered software training for businesses at their locations, and in-house to customers. The company’s national presence allowed it to offer standard training all over the country and serve a corporation at all the business’s operating locations under one corporate account. With nation-wide and low price operations, CompUSA was able to successfully bid for local, state, and federal government business and acquiring clients in the educational segment.

With all the key success factors discussed above, CompUSA outpace the competitors and achieve remarkable performance that placed the company as the leading player in the PC retail industry.

4. KEY ACCOUNTING POLICIES

<u>Merchandise Inventory</u>
Merchandise Inventory are valued at the lower of cost, determined on a weighted average basis, or market.

The company is exposed to the risk of inventory obsolescence. Computer's hardware and software were subject to continuous technological upgrades. A lot of new hardware and software are being introduced to the market from time to time. CompUSA must continuously update its merchandise selections to be able to meet its customers' needs and compete with the other superstores. The company had a high inventory turnover (9.14 times in 1996), which mitigate the risk exposure. The company also instituted contracts with suppliers to partially hedge the obsolete risk. Since the value of the inventory changed as it became outdated due to changes in technology or consumer preferences, it was necessary to provide an allowance for decline in value of inventory, depending on the materiality of the amount.

Account Receivable

As a retail company that sold directly hardware and software to individuals, corporate, and the government, it should not have a large amount of account receivable. Individual buyers usually paid cash or used credit cards, hence credit sales only occurred when the company had transactions with corporate or government. Having receivable turnovers of 13 days in 1995 and 14 days in 1996 that were considerably short period, we believe that the company had little default risk on its account receivable.

Advertising expenses

Advertising expenses are expensed in the month incurred and are subject to reduction by reimbursement from vendors.

We believe that the company used the appropriate policy to recognize its advertising expenses.

Pre-opening Costs

Pre-opening costs, which consist primarily of personnel expenses incurred prior to a store's opening and promotional costs associated with the opening, are deferred to the date of the store's grand opening and are expensed in the month of the store's grand opening.

This accounting policy was appropriate subject to the materiality and the period over which the pre-opening costs were deferred. If the costs involved a material amount while the store opening was done in the next financial year, it would understate the expense and consequently overstated the earning of the period when the costs was incurred. For this reason, we would suggest the company to expense the pre-opening costs when incurred.

Property and Equipment

The company's property and equipment, which consists of furniture, fixtures, and equipment, leasehold improvements, equipment under capital lease, land, and capital project in progress, are stated at their historical cost, and are depreciated over their estimated lives on a straight-line basis.

Estimated lives are as follows:

Furniture and fixtures	5-10 years
Equipment	3-5 years
Leasehold improvements	life of lease
Equipment under capital lease	life of lease

The company leased some of its equipment under capital and operating leases. The operating leases were off balance sheet. The leases agreements were non-cancelable and mainly included renewal options and required the company to pay a proportion of the maintenance cost.
The operating lease contract amounted to $544,839; which was off balance sheet. On the other hand, the amount reported on the Balance Sheet was only $9,448. This could mislead the financial analysis since the assets and liabilities were understated that might cause any valuation, such as ROA and Assets Turnover to be overvalued.
Should the operating leases included in the balance sheet, total assets would increase from $909,337 to $1,454,176, and its total debt would also increase from $583,432 to $1,128,271.
Consequently, the company's ratios in 1996 would be as follows:

	Before adjustment	After adjustment
Return on Assets	0.076	0.056
Assets Turnover	4.846	3.586
Debt to Equity ratio	0.379	2.051
Debt to Assets ratio	0.136	0.460

Merger Transactions
Merger transactions accounted for under the pooling of interest method of accounting. Under this method, the historical book values of the target company's assets, liabilities, and stockholders' equity were carried over onto CompUSA's Consolidated Balance Sheet, and no goodwill or other intangible assets were recognized.
Given the criteria that should be met to adopt this method of accounting (swap shares at least 90% of the target company's stock and perform in a single transaction), when the company did not recognize goodwill, there would be no goodwill amortization charged that led to higher earnings and therefore led to higher stock price. However, it did not lead to different cash flows and therefore did not alter the economic value of the firm.

5. FINANCIAL ANALYSIS

This financial analysis is prepared based on available financial highlights for the years 1992 to 1996. Some financial ratios can not be obtained due to lack of data for certain years. The financial analysis is performed on the basis of comparison with historical performance of the company since there is no industry data for such an analysis. The financial ratios are specified on Attachment – 1.

With consideration that CompUSA reached a remarkable growth in early 1990s but then suffered loss during 1993 – 1994 and by applying its turnaround strategy the company was able to achieved an outstanding growth during 1995 – 1996, we break down the financial analysis into two phases with a short analysis for year 1992 – 1994 and more detail analysis for year 1995 – 1996.

5.1. Phase 1 : Year 1992 – 1994

By year 1993, the aggressive expansion done by the company since early 1990s was not followed by adequate management and cost control, and proper strategy to match with the market shift in PC industry that incurred continuous losses until year 1994. EPS was down from $ 0.30 in 1992 to $ 0.25 in 1993 then turned out to be a loss of $ 0.44 per share in 1994. Although the assets turnover slightly increased by 10% from 4.15 in 1993 to 4.57 in 1994, the company operated at high costs that caused a severe drop in efficiency, which reflected in negative operating income and EBIT in 1994. Margin to Sales decreased from 13% in 1993 to 12% in 1994 while EBIT to Sales decreased from 1.42% in 1993 to negative 0.32% in 1994.

5.2. Phase 2 : Year 1995 – 1996

Operating Analysis

The company achieved a spectacular growth in 1996 reflected in the EPS that doubled the past year, from $0.60 in 1995 to $1.28 in 1996.
It was obvious that the turn around strategy enabled the company to effectively utilize its resources as reflected by the increase in ROE by 38%, from 13% in 1995 to 18% in 1996 and ROA by 81%, from 4.2% in 1995 to 7.6% in 1996.
With bottom line focus and cost cutting program, the company was able to double the profit margin from 0.8% to 1.6%, which derived mainly from increasing operating efficiency (EBIT/Margin) from 11% in 1995 to 20% in 1996.
However, Assets Turnover was slightly decreased, principally due to the acquisition of PCs Compleat, Inc. and store expansion from 85 stores in 1995 to 106 stores in 1996. The company was expected to see the benefit from the expansion in the following years.

Investing Analysis

Based on the data availability to calculate the investing ratios, we concluded that the company was able to effectively utilize its working capital. Receivable turnover and inventory turnover were relatively high, reflected in 12 days collection and 39 days inventory storage that might mitigate the risk of un-collectible receivable and inventory obsolescence. With 37 days payable, that was shorter than the total 51 days for receivables and inventory, the company needed to finance 14 days working capital, which involved a relatively low source of fund that could be backed up by the receivable turnover.

Financing Analysis

As part of the outstanding performance, the liquidity increased by 6% in current ratio, from 1.56 in 1995 to 1.66 in 1996 while cash ratio almost doubled from 0.29 in 1995 to 0.45 in 1996. However, the ratio of cash flow from operations to current liabilities decreased by 54% from 0.40 in 1995 to 0.19 in 1996 since high growth in sales was normally followed by increasing procurement and consequently the payables also increased. With 37 days payables compared to 51 days receivables and inventories, it reflected the need of additional working capital.

Despite the increasing short-term payables due to operational growth, in 1996 the company strengthened its capital structure by issuing new common stocks that added nearly $80 million of equity. For this reason, Debt to Equity Ratio decreased by 42%, from 0.66 in 1995 to 0.38 in 1996, while Debt to Asset Ratio decreased by 29%, from 0.19 in 1995 to 0.14 in 1996.
Since the operations was financed by trade payables and additional equity fund, the company did not expose to interest bearing obligations and considering the strong liquidity position the company did not have any problem with its ability to meet its obligations. It showed by the increased interest coverage ratio from 3.4 in 1995 to 8.4 in 1996, while pretax cash flow from operation was tenfold the interest expense.

<u>Cash Flow Analysis</u>
Cash flow from operations decreased by 35%, from $135.6 million in 1995 to $87.7 million in 1996, in line with the need to finance working capital. The cash flow from operations then used to finance increasing capital expenditure in 1996 that caused the cash available for financing activities dropped from $106.119 million in 1995 to $39.728 in 1996. Free cash flow of $38.796 million was available for shareholders.
In 1996, there was no significant debt payment from the outstanding debt of 1995, and the company raised equity fund that generated $79.344 million from new shares issuance. This resulted in the increased of cash balance.

6. ANALYSIS OF THE MARKET EXPECTATION ON SHARE PRICE

After experiencing tough years of continuing losses in 1993–1994, CompUSA re-evaluated its strategy and started to restructure its business. It switched from voracious expansion that caused billions loss to bottom-line focus in pursuit of profitability. That strategy has led the company to regain its remarkable performance since 1995 wherein its sales grew 32% following by 30% in 1996. For the fiscal year 1995 it made a profit of $24 billion instead of a loss of $17 billion in the previous year. It continued to gain $ 60 billion in 1996, which was about 2.5 times the 1995 profit. The company benefited from its turnaround strategy and placed it as the nation's leading company in the industry. Moreover, in the rapid growth of personal computer (PC) industry, in 1995 superstores that accounted for 13% of total market had a growth rate of 13.5% that is relatively high compared to 11.5% growth rate for the whole US PC industry. The industry expected to grow at 15% per annum for the next several years. Thus, the growth rate of computer superstore including CompUSA was estimated to surpass 15% per annum.

Using the management forecast for total sales of $ 4,600 million in 1997 and $ 5,790 million in 1998 and financial performance of 1995 – 1996, we draw the assumptions and estimate the financial projection that appeared to be made by the market as specified in Attachment 2. The summary of assumption is as follows:

- Annual sales growth was 22% with terminal growth rate of 9%. This terminal growth rate was based on average normal growth of five portfolios of US firms. [1]

[1] Palepu Haley Bernard, Business Analysis and Valuation Using Financial Statements (2000), pg. 10-3.

- Net Operating Profit After Tax (NOPAT) to Sales was 2.2%, considering that the market would probably expect that in the following years the company could maintain its spectacular growth in NOPAT/Sales of past year. It increased from 1.1% in 1995 to 1.8% in 1996, and the market expected it to reach 2.2% in the following years.
- Working Capital to Sales and Long Term Asset to Sales were 3%, in line with the rates in 1996.
- Net Debt to Equity was 10% : 90%.
- Cost of equity was 13.8% resulting from risk free rate plus risk premium, as follows: 6.7% + (1.25 x 5.68%).
- Average tax rate was estimated to be 38%, based on tax expense to EBT in 1996.
- After Tax Cost of Debt was 6.3% resulting from after tax interest expense divided by average debt: 7,742/123,480 = 6.3%

Based on these assumptions, the value per share was estimated to be $53 per share.

The market expected CompUSA to maintain its high recent growth and achieve profitability as forecast given its developing strategy in the intense market competition. Having substantial growth prospect, the spectacular results of 1996 operations was revealed in its periodic reports that enhance the market confidence on its performance and boosted the company's value especially in the second semester of fiscal year 1996. The share was traded at relatively stable price in the first semester of 1996 but then sharply increased in the second semester that the price in June 1996 was twofold compared to that in December 1995. The market high expectation and confidence on the company's achievements continued to push the price much higher in the next quarter and reach $54 per share at 30th September 1996, following the financial report of year 1996.

7. SHARE VALUATION

Based on the historical financial performance of CompUSA and our analysis on the industry and company business, we prepare the financial forecast by using the following assumptions:

- Annual sales growth was 15% considering the growth of entire PC industry in USA.
- As the average growth rates of five portfolios of US firms were ranging from 7% - 9%, we assumed 7% for the terminal growth rate.
- NOPAT to Sales was 1.8%, assuming that the company could maintain the 1996 rate.
- Working Capital to Sales and Long term Assets to Sales were 3%, in line with the historical rates.
- Net Debt to Equity was 10% : 90%, in line with the historical rates.
- Cost of Equity was 13.8%
- Average tax rate was 38%, based on the tax expense to EBT in 1996.
- After Tax Cost of Debt was 6.5%, based on the after tax interest expense divided by the average debt in 1996.

Given the projection parameters specified in Attachment 3, the fair value for CompUSA was $24.70 per share ($1,114.9 million) with total value of the company $1,255.9 million. The value was far below the market price of $54 as at Sept 30, 1996. It was priced at P/E ratio of 42, indicating that the market expected a substantial growth prospect of the company. The market also expected that in the following years the company would benefit from its acquisition of PCs Compleat, Inc. and investment in Info Source, Inc. and would continue developing its business strategy.

Even though the company was well placed in the industry, the intense competition and market shift might be a threat that can cause some difficulties in maintaining the company's high achievement in 1996.

Given the historical performance and growth prospect of the company, we consider the share price of $54 was relatively too high. It was probably due to emotional response of the market on the remarkable 1996 performance that result in an abnormal increase of share price. For this reasons, back in September 1996 we recommended to any holder of the CompUSA's shares to sell the stocks.