UNDERWRITING MEMO

Purpose/Recommendation

American Tire Company (ATC) has requested an increase in the Company’s existing revolving line of credit from $6MM to $8MM. This is to allow the Company time to implement measures to increase their competitiveness relative to major players in their industry. This would include an increase in advertising which has historically been deemphasized; this may include hiring a new team to be in charge of all advertising and promotion.

Recommendation for the denial of American Tire Company’s request is based on the following information:

* **Increased Competition –**The competition in the industry is high and increasing with many establishments offering identical products. Barriers of entry into the industry are low and tires can easily be secured from wholesalers. Essentially, companies remain competitive by offering quality service and aggressive pricing strategies. Many of the company’s competitors are offering several car products and services in addition to the selling of tires at further discounted rate.
* **Decreasing Margins and Profitability –** For FY13, the Company reported net income of $460K on revenues of $56.06MM, a 3.5% decrease from the previous year. Gross profit decreased to 30%, a 3% drop from the previous year.
* **High Leverage –** On a total funded debt/operating EBITDA basis, the leverage ratio stands at 4.69x in FY13 vs. 3.49x in FY12.
* **Inadequate Debt Coverage –** The Company’s debt service coverage ratio was 0.56x for FY13. The Company paid $2MM in current maturities on LTD and currently has $6MM in LTD and increased its use of the RLOC $2.07MM, from $3.29MM to $5.36MM.

Key Risk Factors

**Increase in Rubber Prices –** The Company is highly exposed to the world price of rubber. As rubber prices increase, if there is not a simultaneous increase in tire demand from their clients, the company will have difficulty in passing on the price increases to consumers. This will cause gross margins to shrink.

* Mitigating factors:
* The company has managed through downturns in the industry over the past 21 years. However, in the last couple of years ATC has marked down several of its products and increased discounts in order to stay competitive in the industry, causing their margins to shrink substantially. An increase in global rubber prices would further decrease the company’s gross margins and push them further away from profitability.

**Competition Risk –** Competition in the Tire Dealers industry is high and increasing yearly. The industry is highly fragmented and consists of over 12,023 businesses, of which 57.6% are single-location establishments. Rivalry is intense as many firms with similar market share are competing for the same customers and resources. There is very low differentiation in the products and services that each company provides and customers face no switching costs. This increases rivalry as customers can freely switch from one company to another as better opportunities are presented. Small-scale companies also face challenges added from larger tire dealerships with greater market share, as the larger dealers often acquire smaller establishments or run them out of business,

* Mitigating factors:
* American Tire Company is a family owned company, which has been in operation for 21 years, but an increase in competition combined with their recent financial struggles will make it hard for the company to thrive in the upcoming years. A larger rival company, US Tires and More (UST&M), has recently branched out into the state and has caused problems for ATC. UST&M has an aggressive pricing and advertising strategy and has caused ATC to mark down prices and increase discounts to remain competitive.

**Per Capita Disposable Income –** Per capita disposable income influences a consumer’s ability to purchase a good at a specific time. Consumers with a higher amount of disposable income are more likely to replace existing tires with more expensive ones. However, consumers with less disposable income are less likely to purchase expensive tires or to replace existing, worn tires.

* Mitigating factors:
* The increased selling of low-rolling resistance tires will help counteract any decrease in per capita disposable income. Low-rolling resistance tires are a cheaper alternative for consumers than traditional tires and help improve fuel-efficiency. These tires are less expensive to produce and less durable, which will lead to more frequent tire replacement. ATC would be advised to offer the same product, as consumers are making a shift towards more fuel-efficient products. However, if competing companies are also offering similar tires, ATC gains no competitive advantage.

Brief Business Description

American Tire Company is a subchapter S-corporation that operates small retail tire stores which provide U.S. consumers with a complete line and price range of tires for cars and trucks. The Company owns and operates 18 stores throughout Tennessee.

Industry Analysis

The Tire Dealers industry retails tires and tire tubes for passenger cars, sport-utility vehicles and commercial trucks. Currently, the industry is comprised of 12,023 businesses which generate approximately 27.4Bn in annual revenue. As consumers continuously make the shift towards purchasing tires with greater fuel efficiency, the Tire Dealers industry will continue to rebound from the steep revenue declines caused by the recession. During the recession, per capita disposable income plummeted and unemployment soared. The aforementioned led consumers to refrain from purchasing new tires and to maximizing the usage on their existing tires. This significantly diminished sales for all retailers within the industry during the period.

In the five years leading to 2014 the industry’s revenues increased 3.1% annually. This was due to an increase in consumer per capita disposable income, increases in the world demand and price of rubber, and additional sales of low-rolling resistance tires. As fuel prices rose, consumers looked to low-rolling resistance tires as an alternative to counter the growing expenses. These tires are more fuel efficient than traditional or specialty tires but also less durable, which requires for more frequent replacement. During this period the industry also experienced much volatility. The increasingly high volatility of the price rubber caused the cost of goods sold to grow substantially but increased tire demand in the latter half of this period helped counteract this growing trend.

The Tire Dealers industry is set to experience further growth in the upcoming years, with revenues expected to increase at an annual rate of 2.8% leading to 2019. However, there will be challenges for small-scale establishments. The industry has a low level of market share concentration and is very fragmented. The top three industry players account for about 33% of revenue, while the next largest two account for less than 1% each. In the last five years, the major companies have grown their market share by acquiring smaller establishments or simply running them out of business. Many of these smaller businesses offer nearly identical products and there are many alternatives. With low barriers to entry and a projected increase in revenues, it is expected for the total number of establishments to increase in the next five years. Industry players are also facing growing competition from online retailers and mass merchandisers, such as Costco and Walmart, who are offering considerable discounts on products.

Borrower/Management Analysis

The Borrower is American Tire Company. Lawson and Benjamin Gasaway both own 50% of the company. Lawson Gasaway has owned and operated the company since 1993. His brother, Benjamin Gasaway, bought into the company two years after it was founded. The objective of the company is to improve their operating results and increase the company’s revenues through organic growth. American Tire Company is based in Memphis and has 18 stores throughout the state of Tennessee, employing 120 employees.

**Lawson Gasaway (Chairman – owns 50%)**

Lawson has roughly 21 years of experience in the business of tire retail. Lawson founded American Tire Company in 1993 and currently serves as the company Chairman. Prior to the founding of his company Lawson worked at his father’s local full-service gas station. Lawson manages store expansions and the marketing, promotion and the finances of the company and currently has a son who works as a manager at a store location.

**Benjamin Gasaway (President – owns 50%)**

Benjamin is the brother of the company Chairman and bought into the company two years after it was founded. Benjamin currently serves as President and handles day-to-day ATC operations as well as frequently traveling to various ATC locations to meet with store managers personally. Benjamin also currently has a son managing a store location.

**Nupur Patel (Vice President of Finance)**

Nupur has been with American Tire Company for 8 years. He currently serves as the company’s Vice President of Finance. Nupur handles the company’s accounting functions and banking relationships.

**Steven Behringer (Vice President of Human Resources)**