

TLO DEVELOPERS: STRATEGIC OPTIONS

Ethan Chochinov wrote this case under the supervision of Professor Julie Gosse solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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Once again, Leah Graham and Noah Hart sat in the boardroom to look over all their options. It was December 2013, and by early in the new year they wanted to have a clear direction for what should be developed on a parcel of land that their company, TLO Developers (TLO), had been holding for decades. The market seemed ready for a development, and TLO had been looking for ways to diversify its revenue streams, but what should it be? Their job was to determine the best use of the parcel.

COMMERCIAL REAL ESTATE DEVELOPMENT

Developing large commercial buildings, specifically high-rises, was no small task and typically took companies two to three years to complete. This exposed developers to significant financial risk when deciding to go forward with a building since markets could completely change within this time frame. To limit risk, when possible, most new buildings required some level of pre-leasing¹ but were not fully leased in advance. Typically, financing for a large building would not be approved until at least 50 per cent of the building had been pre-leased.

Developing any commercial building was a long, iterative process that happened in three main phases: design, application, and construction. The design phase began with hiring third party architects and developers who met to discuss the general layout of the building and draw up blueprints with the company's vision in mind. Once finished, the development companies went through a long application process to obtain various permits from the area's municipal authority. Many changes to the original design would be made throughout this phase to ensure that all the city's regulations were being met and that all parties were satisfied with the design. Lastly, after everything was approved and financing was secured, the development firm would find a construction company to build the tower through a bidding process.

Two main factors affected the value and rental prices of commercial buildings: location and building quality. Newer buildings in a prime location that were built using top-quality design and materials were considered Class AA and Class A buildings. Generally, other buildings either in a strong location or of good build quality were considered Class B, and those in a poor location and that were of inferior quality in their build (or had worn down because of their age) were considered Class C. Buildings in higher classes were typically more sought-after and commanded higher rental prices.

¹ A pre-lease was a lease on a building that was signed before construction began.

CALGARY, ALBERTA

Calgary, Alberta, was a major Canadian metropolis, with a growing population of 1.1 million.² Calgary's location in Western Canada placed it near the Rocky Mountains and their surrounding national parks. This, in addition to major events such as the Calgary Stampede, helped attract millions of Canadian and international tourists to the city every year. Calgary was also one of Canada's major business hubs, largely due to Alberta's oil sands. Canada had the world's third-largest proven oil reserves, 98 per cent of which was found within the oil sands.³ The abundance of this resource brought significant fortunes to the province and represented over 23 per cent of Alberta's growing gross domestic product.⁴ Nearly every major Canadian oil and gas company was headquartered in Calgary, which created significant demand for office space and an ever-growing downtown centre.

COMMERCIAL REAL ESTATE IN CALGARY⁵

As with most businesses in Alberta, the success of commercial real estate in Calgary was closely linked to the performance of oil and gas. This left buildings crippled with high vacancy rates⁶ and lower rentals at certain times but with full occupancy at others. As the commodity prices increased, the demand for office and industrial space increased, and the fortunes of the companies in the city rose. In 2013, the city was on an upward trajectory after the financial meltdown of 2009, and the demand for commercial real estate had been gaining steam. Announcements were being made to add over three million square feet (sq. ft.) of new downtown office space to an existing base of just over 36 million sq. ft. (see Exhibit 1). Rental rates were increasing, but not at the same crazed level seen before the financial crisis.

Another important metric in commercial real estate was net absorption: the change in occupied space over a period of time. Despite the many new commercial developments in the works, current absorption of commercial real estate in Calgary was negative, meaning less space was being leased than before. Although vacancies in Class AA and Class A buildings were low, vacancies in Class B and Class C buildings were starting to increase, and in some cases had reached double digits. Some analysts were wary of this trend trickling down to Class A or even Class AA properties.⁷

The City of Calgary imposed some limitations on what could be built in different parts of the city. For example, downtown Calgary had a maximum floor area ratio (FAR) of 20. Determining how large a property could be built was calculated by multiplying the FAR by the base size of the plot of land the property sat on. So, in downtown Calgary, a 10,000 sq. ft. site with a maximum FAR of 20 could house a building of up to 200,000 sq. ft.

TLO DEVELOPERS

Company History

Founded in 1965, TLO was a multi-faceted real estate development company known for the diverse portfolio of office, retail, and industrial properties it had acquired, developed, and managed in and around

² "Census Profile, 2016 Census," Statistics Canada, last modified May 30, 2018, accessed August 18, 2017 www12.statcan.gc.ca/census-recensement/2016/dp-pd/prof/index.cfm?Lang=E.

³ Government of Canada, "Oil Resources," Natural Resources Canada, last modified July 25, 2017, accessed July 14, 2017, www.nrcan.gc.ca/energy/oil-sands/18085.

⁴ Government of Alberta, "Mining and Oil and Gas Extraction," ALIS, accessed August 20, 2017, <https://occinfo.alis.alberta.ca/occinfopreview/industries/mining-and-oil-and-gas-extraction.aspx>.

⁵ The majority of the information in this paragraph was obtained through a Cresa report, provided by TLO.

⁶ The vacancy rate was the percentage of all unoccupied units in a rental property.

⁷ Current vacancy rates for Class AA, A, B, and C buildings were 1.98 per cent, 4.94 per cent, 9.43 per cent, and 12.92 per cent, respectively.

Calgary. Whether renovating and re-leasing existing properties or purchasing and developing new or existing land holdings, TLO maintained strong historical and community ties to the city. In fact, TLO's corporate headquarters were housed in a historic building downtown. Renamed the Alecs Graham building in 2005 after the founder of TLO Land & Development, this award-winning property had received great attention and accolades. In keeping with the pioneering spirit of the Calgary business leaders who originally occupied the building, the team at TLO had committed for more than 45 years to offer exceptional customer service to its tenants and leading quality developments throughout Calgary and Western Canada. Currently, TLO had over 550,000 sq. ft. of building space in its company portfolio (see Exhibits 2–5).

TLO owned a multitude of buildings in Calgary, the majority of them used for office and industrial space. Although they had developed one high-rise in the 1980s, TLO did not currently own any high-rises, and most of their properties were located outside of the downtown core. TLO, like most other real estate companies, was lean at only 12 employees. This meant that they relied heavily on their industry relationships and reputation to work with numerous outside companies to complete any project they undertook. By pursuing property acquisitions that complemented the broad TLO portfolio, the company could ensure that the design and development of its high-quality properties identified and integrated the needs of its occupants, making the community a better place to live and work.

TLO took pride in the relationships it had with its current tenants and placed a large value on the positive reputation the company had garnered for itself in the Calgary area. Graham believed that this reputation was built through TLO's focus on its tenants' success and the communities TLO built within each of its properties. Understanding the tenants' businesses and their goals was central to TLO's strategy. Whenever possible, Graham would lease spaces in the same building to companies with similar cultures and ambitions. This practice was designed to create synergies between tenants and provide greater opportunities for everyone. TLO's focus on the property management side of the business was extremely successful and had resulted in some tenants remaining in TLO's buildings for over three decades.

Leah Graham

Leah Graham was the daughter of the late founder of TLO, Alecs Graham, and was now the chief executive officer. Graham took over the management of the company in 2008, and under her leadership the company focused on development. Her background was in investment banking prior to achieving her master of business administration from a major U.S. university, after which she founded three separate oil and gas exploration and development companies. In the 1990s, Graham led TLO's development of the iconic Rocky Mountain Shopping Centre—an award-winning retail complex.

Noah Hart

Graham's drive to start developing TLO's abundance of land prompted her to bring on Noah Hart as senior vice-president of Real Estate and Development. His extensive background in development started in the 1990s when he was developing co-op grocery stores in Western Canada. He was subsequently involved in many other development projects, totalling over \$1 billion, including a high-rise in downtown Calgary with a large property management group. Hart once joked that TLO had enough raw land that he could spend the rest of his career developing it.

COMPETITION

Competition was fierce in the real estate development industry, ranging from massive, multinational companies with deep pockets to small mom-and-pop businesses, all competing for tenants to occupy their spaces.

Brookfield Properties

Brookfield Properties (Brookfield) was a world leader in developing and managing top-class office towers and owned some of the world's most prestigious buildings in cities such as New York, London, and Dubai. Brookfield had developed seven properties in downtown Calgary and was working on its eighth. Its state-of-the-art designs and large floor plates, typically found in the downtown cores of major cities, helped attract large, multinational companies as tenants, who were willing to pay a premium for their offices. As a publicly traded company, owning over \$40 billion in assets within over 250 properties, Brookfield had deep pockets, access to capital, and corporate experience.⁸ With such a diverse portfolio of buildings and customers, Brookfield could survive economic downturns by supporting losses in one market with gains in others, limiting overall company risk. However, due to its buildings' size and its large tenant lists, Brookfield struggled to respond as quickly to its smaller tenants' needs as did local, privately run companies.

Ronmor Developers Inc.⁹

Ronmor Developers Inc. (Ronmor) was a medium-sized, fast-growing real estate development and property management firm. Since opening its doors in Calgary in the 1980s, Ronmor had built a respectable portfolio of retail, industrial, and office buildings and expanded its operations to Saskatchewan and British Columbia. Although the company had developed office spaces, Ronmor focused most of its efforts on developing and managing large retail spaces such as outdoor malls, business parks, and mixed-use developments.¹⁰ Ronmor had over 6,000 acres of buildable space in Calgary and planned on developing much of it within the near future. Positioning itself as a privately owned, family-run firm, Ronmor aimed to please its tenants with a focus on the upkeep of its buildings and a 24-hour tenant contact line.

CONSUMERS

Large Corporate Businesses

This customer group consisted of large corporations looking for spaces that showcased the success of their businesses. There was great pressure on large companies to uphold their corporate image in order to attract and retain top talent. To accommodate their large size, these consumers required significant amounts of office space and therefore preferred floor plates of 20,000 sq. ft. or larger. Larger floor plates allowed for added efficiency in these businesses, as it reduced their need to spread out over many floors. Bigger companies also valued the ability to custom design their own offices to their needs, and newly constructed buildings allowed for this. Typically, these customers signed five-year leases on their properties, meaning 20 per cent of customers' contracts were up for renewal in any given year. When looking to change locations, this customer group relied on its network of real estate brokers for advice on available vacancies.

⁸ Brookfield Properties, accessed August 7, 2017, www.brookfieldproperties.com/portfolio/.

⁹ Ronmor, accessed July 20, 2017, www.ronmor.ca/; "Ronmor Developers," *The Canadian Business Journal*, www.cbj.ca/ronmor-developers/.

¹⁰ Mixed-use developments combined retail, residential, industrial, or office spaces together within one building.

Small- to Medium-Sized Corporate Businesses

These customers were typically at the end of their contracts and in search of a new office space to relocate their company headquarters. Their decision to move was usually prompted from a need to downsize due to financial difficulties or upgrade as a result of company growth. These consumers were often local to Calgary and were proud of their companies' accomplishments. When looking for new spaces, they typically valued the functionality and price of their new office space and relied on real estate brokers to assist in the process. Location was not as key a concern to this customer group because they did not need to persuade their employees in the same way larger firms did. However, being in the heart of downtown added a degree of prestige to their businesses, which they appreciated, if affordable. It was rare to see a company in this group take up more than one floor of an office building; instead, they would more often split space on a floor with another business.

Retail and Industrial Businesses

These businesses made up the remainder of the commercial real estate space. Retail customers varied greatly in size from small corner shops to large grocery or department stores. In any case, these businesses constantly searched for ways to increase their margins and valued competitive rental prices. Since their businesses primarily serviced customers, locations in high-traffic, densely populated areas were important.

Industrial customers looked for larger spaces with high ceilings capable of housing their equipment and machinery. Typically, they searched for buildings located outside of the city's core that supplied them with ample parking at a low cost. Both of these customer groups needed to run their businesses efficiently and relied heavily on their buildings to do so. This made the relationship with their property manager extremely important: If something went wrong with the building, it could cause a temporary shutdown in operations; therefore, industrial customers expected top-quality service from their property manager to limit this risk, and they worked with real-estate brokers to find a suitable fit.

615 8th Street SW

One of the first plots of land acquired by Ales Graham, the founder of TLO, was 615 8th Street SW (615-8th). This downtown plot of land was in a prime location and shared a property line with a multi-storey office building to the west and a parking lot to the east. The total site size of the land was 16,250 sq. ft. with dimensions of 125 feet by 130 feet deep. For the past three decades the site had been home to an outdoor parking lot of roughly 60 stalls. Earlier in the year, the parking lot operator entered into a new lease with TLO and was paying \$30,000 per month. The only costs to the site that TLO was responsible for were the property taxes, which typically increased annually and were expected to be \$85,000 for 2014.

ALTERNATIVES

Graham and Hart were excited to explore the different options regarding the parking lot. For any alternative, TLO would follow its general company policy of a 60/40 loan to equity ratio, meaning only 60 per cent of any project could be funded through debt.¹¹ Additionally, TLO assumed that if any major development were to be built, TLO would take ownership of only 60 per cent of the project. Outside investors would own the remaining 40 per cent and be responsible for all the costs and revenues associated with it.

¹¹ As long as TLO met its bank's pre-leasing guidelines, it would be able to secure debt at a rate of 3.5 per cent.

Status Quo

Graham had been working in real estate for over 20 years and knew all too well the potential for failure when jumping into a project just because the markets were performing well. TLO and 615-8th had been generating a significant profit year after year, and the price of the land continued to appreciate. She considered remaining with the status quo and re-evaluating what to do with the land in 2016 when the parking agreement was up for renewal. This would give TLO more time to scope the market and see how the current projects were panning out. Graham was happy with the growth her company had seen in the previous years and believed that all revenue streams would increase by 5 per cent in the upcoming year. All expenses were expected to remain at the same dollar amount or percentage of sales from the previous year.

Office Development

The multitude of office buildings being announced in Calgary piqued Graham's interest and prompted her to explore the idea of a TLO office development. She knew that there would be a finite demand for future office space, and if the decision was made to go forward, she wanted to get construction up and running quickly.

If pursued, the office building would be of premium quality and considered a Class A building. In order to achieve this, Hart estimated that the cost of construction would be \$500 per square foot. Although the maximum FAR was 20 in Calgary's downtown core, TLO expected that a FAR of 13 would be the most it would ever build in any scenario due to the additional costs and onerous requirements to reach the maximum of 20. Graham and Hart both had extensive connections to various real estate brokers in the city and believed that if they could find the right anchor tenant, they would be able to fill their building up to industry-average rates.

Most office buildings were leased using net leases. A net lease was an agreement that designated the tenant as being solely responsible for all operating costs relating to the asset being leased, in addition to the base rent fee charged by the owner. TLO would charge an average of \$36.22 per square foot to its tenants on top of the operating costs the tenants were responsible for. Net leases took much of the responsibility away from the building owners, as the rent they collected would be predominantly profit. However, the overhead costs of any vacant spaces in the building were the responsibility of the owner and were estimated at \$18 per square foot.

Hotel Development

Graham and Hart wanted to explore the possibility of erecting a new, upscale hotel on 615-8th. Calgary had 11 hotels in the downtown area, and Graham knew them all to be profitable. During Stampede or while large conferences were in town, the room rates could reach as high as \$800 per night, although the average daily rate (ADR) was closer to \$217. Typically, at upscale hotels, a large portion of guests were there on business and stayed Monday to Friday. In fact, the rates tended to go down on weekends because the demand was lower. TLO believed that a new hotel would be welcomed in the city and that the high rates would persist. TLO would not manage the hotel internally; instead, they would hire an experienced third party operator, thus minimizing TLO's responsibility and learning curve. Graham believed all operating costs, including the third party operator, would take up a 62 per cent share of revenues.

Hart and Graham believed that the cost to build the hotel would be \$475 per square foot, including land, all room furniture, fixtures, and amenities. The site would be the same size as the office building and could accommodate an estimated 300 rooms, main-floor lobby, restaurant, and all back-end functions. TLO was unsure how much revenue the restaurant would bring in, but assumed it would break even and act as a means of attracting more customers to the hotel. An encouraging stat on Calgary hotels was that the average occupancy rate had increased from 69.0 per cent in 2009 to 74.7 per cent in 2013. TLO believed that its newer, upscale hotel could charge a 30 per cent premium on the ADR, while still filling its rooms to industry-average rates.

Hotel customers, specifically those who travelled often, had strong brand loyalty to hotels, which heavily influenced their purchasing decisions. Graham knew that if TLO were to pursue this option, it would have to be under the banner of another hotel company: TLO's hotel would be a franchisee of a larger company that was expected to charge a 4 per cent royalty on revenues. Graham wondered what she should look for in a franchisor and how those qualities would affect demand.

Taking over the Parking Lot

TLO viewed the parking lot as an easy, low-risk revenue stream and appreciated its value; however, Graham constantly found herself questioning if it would be worthwhile to manage the lot in-house. Graham knew that with the technology now used in parking lots, overhead costs were low, and she wondered how many spots she would need to sell to break even. She was unsure how many spots were currently occupied but assumed for the most part that it was full. Still, she pondered how difficult it would be to cover all the costs under an alternative like this and, ultimately, if the extra work would bring in additional profitability.

Parking spots varied in price based on many factors, but Graham imagined that she would be able to charge \$500 per spot, per month. Each spot would require a year-round agreement from the occupant. The parking lot would utilize the same gate and scanning system currently on the property that TLO owned. Each car would need a yearly parking tag that triggered the gate to open. TLO would be responsible for ordering, distributing, and paying for each parking tag, for a cost of \$90 per tag. Graham believed that the only other additional costs that TLO would incur were lot maintenance, at \$500 per month, and a \$15,000 share of a TLO employee's salary to represent the time managing it.

Sell the Business

TLO had been buying, developing, and updating all of its holdings for over 50 years and two generations. During this time its portfolio of commercial developments had attracted the attention of many larger real estate companies who were eager to break into the Calgary market. Graham had no intention of leaving the industry any time soon but thought it wise to consider every option. With growing interest in TLO and a well-performing oil and gas market, Graham wondered if now would be the best time to sell the company.

CONCLUSION

This decision weighed heavily on Graham and Hart. Both knew that TLO had the resources and experience to start a major development, but was this the right one? Was TLO ready to jump into a major project and compete with some of the world's biggest development companies? Or was it wiser to step on the brakes and consider a different alternative?

EXHIBIT 1: FUTURE OFFICE BUILDING DEVELOPMENTS IN DOWNTOWN CALGARY

Building	Total Square Feet	Anchor Tenant	Anchor Tenant Area (Square Feet)
Brookfield Place Calgary - East	1,400,000	Cenovus Energy Inc.	1,000,000
707 Fifth Street SW	564,000	Brion Energy Corp.	250,000
20/20 4th Street	130,539	Hopewell Energy	52,000
First Alberta Place	311,145	Bankers Petroleum Ltd.	29,900
First Canadian Centre	508,688	Canadian Association of Petroleum Producers	27,000
Eighth Avenue Place - West	840,000	Pembina Pipeline Corp.	27,000

Source: Company files.

EXHIBIT 2: INCOME STATEMENTS AND FINANCIAL RATIOS (UNAUDITED) FOR YEARS ENDING DECEMBER 31

	2013	%	2012	%	2011	%
Revenue:						
Rental income						
Base rent	\$7,206,077		\$6,639,417		\$6,583,915	
Property tax recoveries	\$1,149,390		\$1,147,945		\$1,116,245	
Operating cost recoveries	\$1,682,592		\$1,624,931		\$1,685,115	
Management fees and other income	<u>\$299,351</u>		<u>\$211,412</u>		<u>\$236,801</u>	
Total revenue	\$10,337,410		\$9,623,705		\$9,622,076	
Expenses:						
Operating costs	\$1,954,679	18.9	\$1,968,020	20.4	\$2,011,306	20.9
Property taxes	\$1,553,063	15.0	\$1,574,328	16.4	\$1,597,293	16.6
Leasing commissions	\$248,377	2.4	\$121,211	1.3	\$309,532	3.2
General and administrative expenses	\$1,863,952	18.0	\$1,373,243	14.3	\$1,214,976	12.6
Management bonuses	\$339,500	3.3	\$315,000	3.3	\$485,000	5.0
Bad debt expense	\$15,890	0.2	\$69,373	0.7	\$39,102	0.4
Amortization	\$1,764,969	17.1	\$1,712,875	17.8	\$1,629,346	16.9
Total expenses	<u>\$7,740,430</u>	74.9	<u>\$7,134,050</u>	74.1	<u>\$7,286,555</u>	75.7
Net income before interest and tax	\$2,596,980		\$2,489,655		\$2,335,521	
Interest expense	\$1,802,184	17.4%	\$2,009,580	20.9	\$2,357,713	24.5
Gain on disposal of rental property	-	0.0%	-	0.0	\$3,526,594	36.7
Net income before taxes	\$794,796	7.7%	\$480,075	5.0	\$3,504,402	36.4
Income tax	<u>\$250,813</u>	2.4	<u>\$87,226</u>	0.9	<u>\$582,466</u>	6.1
Net income	\$543,983	5.3	\$392,849	4.1	\$2,921,936	30.4

Source: Company files.

**EXHIBIT 3: STATEMENTS OF RETAINED EARNINGS (UNAUDITED) FOR YEARS ENDING
DECEMBER 31**

	2013	2012	2011
Retained earnings, beginning of year	\$64,540,529	\$64,147,680	\$61,225,744
Net income	\$ 543,983	\$ 392,849	\$2,921,936
Retained earnings, end of year	\$65,084,512	\$64,540,529	\$64,147,680

Source: Company files.

EXHIBIT 4: BALANCE SHEETS (UNAUDITED) FOR YEARS AT DECEMBER 31

	2013	2012	2011
Assets			
Current assets:			
Cash	\$0	\$665,582	\$412,332
Accounts receivable	\$61,762	\$94,674	\$275,627
Prepaid expenses	\$50,834	\$49,599	\$16,865
Due from related parties	\$83,316	\$64,507	\$312,541
Deposits	\$10,590	\$10,590	\$128,407
Total current assets	\$206,502	\$884,952	\$1,145,772
Fixed assets:			
Deferred costs and other assets	\$300,646	\$268,914	\$221,240
Land	\$34,231,695	\$32,259,918	\$32,652,120
Net buildings and improvements	\$63,252,388	\$64,429,137	\$65,212,440
Net furniture and equipment	\$4,618,405	\$4,712,945	\$4,770,243
Net fixed assets	\$102,403,134	\$101,670,914	\$102,856,043
Total assets	\$102,609,636	\$102,555,866	\$104,001,815
Liabilities			
Current liabilities:			
Line of credit	\$6,000,133	\$ 0	\$0
Accounts payable and accrued liabilities	\$1,023,457	\$1,146,682	\$827,531
Tenant deposits	\$510,159	\$420,564	\$384,299
Current portion of mortgages payable	\$4,241,801	\$4,248,561	\$1,285,977
Promissory notes payable	\$1,715,560	\$3,915,560	\$4,315,560
Income taxes payable	\$224,346	\$94,426	\$582,466
Total current liabilities	\$13,715,456	\$9,825,793	\$7,395,833
Long-term liabilities:			
Asset retirement obligations	\$1,120,909	\$1,099,093	\$1,077,274
Mortgages payable	\$20,327,311	\$24,729,003	\$29,019,580
Total long-term liabilities	\$21,448,220	\$25,828,096	\$30,096,854
Total liabilities	\$35,163,676	\$35,653,889	\$37,492,687
Equity:			
Common shares	\$5	\$5	\$5
Preferred shares	\$2,331,251	\$2,331,251	\$2,331,251
Retained earnings	\$65,114,704	\$64,570,721	\$64,177,872
Total equity	\$67,445,960	\$66,901,977	\$66,509,128
Total liabilities and equity	\$102,609,636	\$102,555,866	\$104,001,815

Source: Company files.

EXHIBIT 5: FINANCIAL RATIOS

	2013		2012		2011
PROFITABILITY					
Return on average equity	1%		1%		9%
LIQUIDITY					
Current ratio	0.02:1		0.09:1		0.15:1
EFFICIENCY					
Age of receivables	2 days		4 days		10 days
STABILITY					
Net worth to total assets	66.7%		65.2%		64.9%
Interest coverage	1.44:1		1.24:1		0.99:1
GROWTH	2012–2013				2011–2012
Sales	7.4%				0.0%
Net income	38.5%				-86.6%
Total assets	0.1%				-1.4%
Equity	1%				1%

Source: Company files.