Case 36

Brown's Nursery (Part A)

Jo Brown's nursery operation has grown from a small herb plot into a thriving nursery business. There are 10 full-time employees and 20 seasonal (part-time) employees. For the last three years taxable income for Brown's Nursery has been steady at $350,000 per year.

While Jo is pleased with the current success of the nursery, she is considering a new contract to supply a local grocery chain with fresh herbs year round. The grocery chain's current supplier is retiring in a year and is planning to sell his business to one of the other grocery chains he also supplies. Rather than assigning a large portion of her current capacity to this contract, she is considering expanding production. Jo has been offered a 5-year contract, starting in 1 year.

To service this new contract without reducing current operations requires purchasing an adjacent piece of land and constructing additional greenhouse space. The property can be purchased for $200,000. The most economical solution to the greenhouse addition is to construct two modular greenhouses for $70,000 each. The modular greenhouses have a useful life of 12 years and a $5000 salvage value. Startup expenses are expected to be $22,500. The purchase of the land, construction of the greenhouses, and startup are projected to require one year. Incremental working capital for this project is $90,000 beginning with startup.

Sales from the contract are forecast at $380,000 each year. Variable costs are estimated at $250,000 the first year, and Jo believes they will decrease at the rate of $5000 per year, as they become expert in growing the new items in the new greenhouses.

Incremental variable overhead for the new space is expected to be $30,000 per year but when the total overhead is re-allocated (based on square feet under glass) the new production will be charged $45,000 per year.

Upon completion of the 5-year contract, Jo believes she can either obtain another contract from this customer, obtain a similar contract from another grocery chain, use the project's assets to meet increased demand for herbs from current customers of the original operation, or dispose of the project's assets. She believes the land can be sold for what was paid for it and each greenhouse is expected to have a market value of $40,000 at the end of the 5-year contract. This decision will be made early enough in the fifth year of the contract to dispose of the project's assets in that year.

The state tax rate is 11%. Jo uses an after-tax MARR of 12%.