Assessment of financial health

Health & Medicine

Reocities Home Neighborhoods Making Of Cases inFinance- Final Project Report Friendly Cards, Inc. (1988) Gary Cao Noah N Flom Robert Harris Srini Pidikiti May 1997 TABLE of CONTENTS -- PART 1. Assessment of Financial Health & Pro Formas 1. Review of History and Statement of Financial Health Wendy Beaumont, president of Friendly Cards, Inc. , has rapidly expanded her greeting card business through internal growth and acquisitions. Ms. Beaumont realizes thatmoneyis currently tight, however, she is adamant about future growth and has sought our opinion as to determine her best course of action. In presenting a decision we will first conduct an analysis of the industry, then give a short history of Friendly Cards, Inc. (Friendly), and then examine Friendly's financial statements to determine the financial health of the company.

Industry Information The greeting card industry is dominated by three large companies, (Hallmark, American Greetings, & Gibson), which are referred to as 'The Big Three'. 'The Big Three' dominate market share, and the remaining competitors are predominantly small private andfamilyowned firms. The greeting card industry is characterized high fixed costs due to: large inventory costs, large investment costs in the establishment of efficient distribution lines, and the need for a highly diversified product lines. Market leaders enjoy great economies of scale which tends to hinder new ntrants into the market. As a result, the card industry is capital intensive and very competitive. The number of firms competing in the industry has decreased by an annualized rate of 15% over the last three decades. Exiting firms were typically smaller in size, the majority of which had less than 50 employees. Additionally, the competitive nature of the market results in a high degree of price sensitivity which culminates in smaller margins on sales. Sales tend to be very seasonal in nature with peaks during major holidays.

There is trending toward a larger variety of card offerings (increasing inventories), shorter carrying/selling periods, increased diversification of product lines, and an increase in sales of everyday cards as compared to holiday cards. Friendly Cards, Inc. Beaumont Greeting Card Co. was founded by Wendy Beaumont in 1978, in New York City. She later acquired Lithograph Publishing Co. and took these companies public a year later for $3 a share under the name Friendly Cards, Inc. Friendly has rapidly expanded by acquiring Glitter Greetings of Lansing, Michigan (for cash and equity), whose primary market was selling cards to supermarkets.

Soon thereafter, it acquired Edwards & Co. of Long Beach, New York (for cash), whose primary market was selling juvenile valentines through chain, drug, variety, and discount stores, as well as, to wholesalers and supermarkets. These acquisitions greatly enhanced Friendly's distribution line expanding it to a regional power. Later Friendly acquired a California firm (Friendly Artists) which extended the distribution line to a national basis. Friendly Artists' primary market was prepackaged cards direct to the warehouse.

Twenty-five percent of Friendly's sales are prepackaged boxes, which have a higher margin than regular cards due to lower return rates and lower handling costs. Currently, Friendly appears to be a niche player in the prepackaged box cards market and has avoided entry into the premium card market, thus, avoiding direct competition with the 'Big Three. ' Friendly's sales are more concentrated than the industry with the majority of sales occurring near Christmas at 30% (vs. Industry 32%), and Valentines Day at 25% (vs. Industry 7%). Thus, over 55% of sales occur within a 3 month period.

Plants at Friendly are being used at capacity thus, growth would necessitate further additions or acquiring contract services. Friendly's distribution line is effective for a smaller firm due to its structure. Of twenty salesmen, one-third work on commission thus lowering Friendly's costs. However, one problem with using salesmen on commission and having such a small sales force is the tendency to sell to rack jobbers and wholesale distributors. This decreases the potential margin on cards by two-thirds. Friendly's Financials Sales have increased by over 50% between 1985 to 1987.

Cost of goods sold has decreased as a percentage of sales in each of those years thus, producing an increasing margin (29. 36% in 1985 to 35. 15% in 1987). The rapid growth by acquisition and the national distribution channels that were accomplished by it, have affected the number slightly. In 1986 selling and delivery expenses increased by 1. 45% and this leveled out in 1987. G&A expenses also spiked in '86, reflecting the recent purchase of another company, and then settled back in 1987. However, while sales may have grown rapidly they have not matched the increase in asset growth, which nearly doubled in 1986.

Growth in this company is being funded by improving margins and by increasing leverage, as indicated by the Dupont Data. Although the acquisitions were acquired by both cash and equity, the majority were debt financed, which explains why the ROE figures have increased so dramatically (almost 16%) in the last three years. The activity ratios indicate that the receivable to payable were in arrears by 36 days in 1985 increasing to 52 days in 1987. This is probably a result of increased sales to less creditworthy individuals or inattention to collections. Inventory turnover umbers are shrinking due to the continually larger inventories being carried. Net fixed asset turnover has decreased by 2. 3% between 1985 and 1987. This can be explained by higher growth in assets than in sales. The liquidity ratios indicate that the asset to liability ratio for this company is trending down. The current ratio indicates that the company is becoming slightly more insolvent with a current ratio of 1. 18 during '87. However, by looking at the Quick ratio and discounting for the affect of inventory in the asset number, the company is dramatically less liquid at 0. 67 in 1987.

This indicates that the company is very highly leveraged and is using its large inventory levels in order to support its substantial borrowing needs. Friendly's actual growth rate exceeded the sustainable growth rate in 1986 and was equivalent in 1987. This difference in 1986 produced a need for added debt to finance growth. However excess funds were not needed to fund additional growth in 1987 since the actual rate of growth did not exceed the sustainable rate of growth. This can also be seen in the total debt to equity ratio which increased from 3 in 1985 to 5. 21 in 1986 and reduced to 4. 1 in 1987. The leverage ratios indicate that the bank loans to debt are fairly well matched, with loans being less than receivables, however, increasing in percentage. Interest bearing debt jumped dramatically in 1986 as a result of debt funded acquisitions but continues to level off along with total debt to equity figures in 1987. Finally, debt to assets has increased dramatically in the last three years, increasing by 7. 5% to 82. 5% in 1987. Thus Friendly Cards seems to be very highly leveraged, even more so than other firms in the industry although the trend is to increase debt.

This highly leveraged position coupled with the high fixed costs and low margins characteristic of the industry, exposes Friendly as extremely susceptible to fluctuations in the market. Therefore, further debt growth may not be advisable--especially since it is currently violating its existing debt covenants. However, Continued growth, however, is needed as to allow the company to further take advantage of its existing distribution lines and realize further economies of scale. 1. 2 Review and Evaluation of Pro Forma Statements The parameters that Ms.

Beaumont has set for the pro formas seem reasonalbe for the most part. There are, however, some questionable numbers. For instance, all the forecasts are based on continued sales growth at 20% per year. When compared to astronomical growth rates of 58% in 1986 and 27% in 1987, these estimates appear almost conservative. The majority of the growth in the past, however, were associated with major acquisitions which served to inflate the sales numbers. The historical reluctance to use equity to grow would serve to limit growth if continued into the future.

Furthermore, it may be difficult to continue to grow at such a high rates in an increasingly competitive market. Holding costs of goods runs at 65% of sales and may also present a problem depending on whether the company can continue to manage its costs as it continues to grow. It could be argued that the reason CGS has dropped recently is due to the acquisition of Friendly Artists and the increasing reliance on a sales mix made up of low cost prepackaged boxes of cards. A shift in the mix away from these items could increase costs. Also, further acquisitions will serve to push up delivery and selling costs.

For our purposes, however, holding them flat seems reasonable. The tax rate seems low at 38% but, depending on the new volume of sales and the maximum tax rate for a corporation, this rate could be even higher. And while the rest of the numbers seem to follow their previous assumptions, the inventory turnover, debt to asset, and interest rate assumptions could be assumed differently. As a result of increased competition in the industry, increasing variations of cards as well as shorter holding duration, it is very unlikely that inventory turnover would improve to 1. 1, and it may very well drop well below this number, possibly to 1. 75. Since growth is likely to continue into the future, an increased amount of inventory will be needed for new market areas. Debt to assets needs to decrease, but this will be difficult to do without funding growth by equity rather than debt. The large sales growth assumptions are directly related to acquisitions, thus increasing assets. If this is done through equity, this number is very realistic. Finally, there may be a problem with the assumption that interest rates on LTD will be 11%.

The Monetary Policy Report to Congress indicates that rates should tend to decrease in the future so this rate may be attainable even to such a highly leveraged firm as Friendly. Without more information this estimate seems fine. 1. 3 Financial Policy / Covenants Friendly's apparent financial policy is rapid growth by debt. This debt-financed growth may be due to a ownership issues that could affects Ms. Beaumont's control over her company. The financials indicate that growth is also taking place at the expense of margins, as indicated by the Dupont data.

The company believes in the economies of scale of the industry and appears to be establishing a national distribution network. While costly in the short run, this strategy may enable a viable and profitable position in the industry. The elements of Friendly's financial policy appear to be the following. Friendly's capital structure mix is governed by a debt orientation. Its debt/assets ratio is currently at 82. 5% which places is significantly below the AAA rate. AAA bonds are listed at 9. 7% while Friendly can only borrow at 11. 5%.

While equity has been used in recent acquisitions there is a strong preference by management to use debt funding. Without question, Friendly is at an integral juncture. Existing lines of credit are maxed out and the bank is imposing new covenants on future loans: bank loans ; 85% of AR and liabilities not to exceed three times the BV of the company. Friendly currently has a $6. 25 million line of credit. Under the current structure Friendly will be in violation in 1987 with bank loans at 87% of AR and debt to equity is at 3. 13 times.

Significantly, bank and trade credit for Friendly is expected to reach over $9 million in Dec. '87. Long term and short term debt are both fueling growth. The basis is assumed to be the prime rate (which is 8. 5%) plus 2. 5% points. This is assumed to be a fixed rate established at the time of borrowing. The company's currency is the U. S. dollar and the company does not have any exotica policy to mention. Control of the company rests solely with Ms. Beaumont as she is both the president and the leading shareholder, possessing 55% of the stock. An additional 20% of the stock is owned by employees and officers of the company.

Finally, earnings are retained for future growth and meeting current obligations. There are no dividend payments and the stock has depreciated in value from a high of $15 a share. PART 2. Decisions faced by Ms. Beaumont 2. 1 Envelope Machine Investment Evaluation of the Envelope Machine We do not agree that the investment in the envelope machine will result in a return of 31%. The reason for this is that the working capital needed to fund the machine would be funded by additional debt by the company. The interest on the debt needs to be considered before evaluating the total return on the investment.

Under this scenario, and considering that Friendly Cards' interest on debt is 11% the interest expense is $22, 000 per year before taxes. Our Estimated Annual savings from Operation of Envelope Machine, Years 1 through 8 (Dollar figures in thousands) is as follows: Savings: Outlays for envelopes purchased in 1987 $1, 500 Incremental expenses from manufacturing envelopes: Materials$ 902 Warehouse 94 Labor 91 Depreciation 62 Total Expenses $1, 149 Increase in Profit before Taxes (decrease in COGS) 351 Interest Expense on Working Capital 22

Actual Increase in Profit before Taxes 339 Increase in Income Taxes @. 38 125 Increase in profit after taxes $ 204 The projected Cash flows for the investment in the machine are: (attachments). Based upon the cash flows projected in the above Table the internal Rate of Return on the investment is 26%. Based upon Friendly Cards Cost of Equity which is 20% (Appendix WACC) buying the machine with all equity at 20% or debt at 11% is recommended Financial Effects of Investment The Financial effects of buying the envelope machine are can be examined in detail in Appendix Machine.

The activity ratios for Friendly if the investment in the machine is made are: (attachments). The investment in the machine has the following effects: * Decreases Cost of Goods Sold by about 1. 5 % which in turn increases the Gross Margins * Decreases Inventory Turnover from 1. 91 to 1. 86 * Increases Funds needed in 1988 by $418, 000, in 1989 by $323, 000 and in 1990 by $112, 000. * Earnings per share increase to $2. 89 in 1990 from $2.

53 in 1990 without investment * By making the investment in the machine Friendly would not be able to meet both of the covenants required by the bank The ratio of the bank loans to receivables exceeds . 85 in all three periods. * Ratio of Friendly's total liabilities to the book value of the company's net worth exceed 3 in 1988 and 1989 which do not meet the covenant but in 1990 the ratio drops down to 2. 94 where it meets the covenants. 2. 2 Evaluation of West Coast Offer (New Equity) We agree with Ms. McConville's conclusion that Friendly should accept the offer from the West Coast Group at the terms stated if that was the only option available to Friendly Cards. The advantages of this proposal would be: Agency costs will be only 5% compared to the actual costs if an investment bank was used to sell securities of the company in a public offering. * The infusion of equity would enable Friendly to meet all the covenants required by the banks (Appendix WC) enabling Friendly to continue its rapid growth without any financial restrictions from the bank. * The equity infusion would enable Friendly to invest in the envelope making machine and reduce its cost structure and still meet all covenants required by the bank. * The uncertainty about how many securities will be sold if a public stock offering is held is eliminated. Continuing rapid growth would enable Friendly to retain most of the sales representatives who might shift to a competing firm if growth is slowed to enable Friendly to meet its financial covenants * The price that Friendly is getting is more than reasonable based upon the present value of the discounted cash flows as shown in (Appendix Valuation) Disadvantages of accepting the proposal would be: * Loss of control. Ms. Beaumont's who presently owns 55% of the outstanding shares would own 40. 37% of the company after the equity infusion.

Even though along with the employees of the company she would own 60% of the company she would not be able to make unilateral decisions. * The West Coast Investors who would own 26% of the company would have a significant say in how the company should be run which may affect the current management structure and aversely effect their ability to mange the company as they wish. * Reduction of EPS. Earnings per share would be reduced to $2. 29 per share from the projected $2. 89 per share in 1990 with the purchase of the machine and without equity infusion due to the dilution effect of the new shares.

This earnings dilution would probably result in a lower share price. (Approximately $18. 32 instead of $23. 12 considering a price multiple of 8). 2. 3. Valuation of Creative Designs, Inc. Capital Structure Argument Ms. Beaumont had been considering a possible acquisition of Creative Designs, Inc. (CD), a small mid-western manufacturer of studio cards. She had examined the details of CD's operations for four months, and believed that under her management, CD could immediately reduce cost of goods sold by 5%, and reduce other expenses by 10%.

If Friendly acquires CD in early 1988, assumptions are made that CD's sales would stay flat during 1988 but would grow at 6% per year thereafter. Based on the following table from case facts, there is a wide range of Debt-to-Equity Ratios for the four companies within the same industry. American Greetings'(AG) D/E ratio increased from 0. 35 in 1985 to 0. 63 in 1987. The reason for this upward trend was that American Greetings had diversified its business segments; from solely relying on greeting card sales AG expanded into gift wrap and stationary goods, such as playing cards, gift-books, and college study guides.

Such diversification efforts demanded higher debt levels. In addition, AG was a large company with annual sales of $1, 174 million in 1987, up 16% from 1985. Gibson Greeting's (GG)D/E ratio decreased from 0. 71 in 1985 to 0. 49 in 1987. The reason for this downward trend was that Gibson was a relatively small company, with annual sales of $359 million in 1987, an 8. 8% increase from 1985. GG's growth rate was significantly lower than American Greetings. The total debt-to-equity ratio of Creative Designs would decrease over the next several years.

Since CD's sales in 1987 was $5 million, it was much smaller than the above two companies. Based on the pro forma financial statements for the period of 1988 to 1990, we see growing sales and EBIT. As a small-size manufacturer, the best capital structure would be: financing its operations mainly by internal growth and a significant reduction in the company's debt levels. Ms. Beaumont wanted to acquire CD for the following reasons: * In the highly competitive market with high cost in distribution and low margin, Friendly had to grow in order to survive, and CD was a good target; Since CD's shareholders agreed to the acquisition by stock-exchange, " pooling of interests" accounting method would be used, and the consolidated financial statements more attractive than without CD, and Friendly need not record goodwill (if any) and avoid amortization of goodwill; * Since CD had a relatively low debt level and a very low " bank loan to receivable ratio", while Friendly had difficulty meeting its bank borrowing restrictions, acquiring CD would make possible for Friendly to meet the covenants; Friendly can easily integrate CD to its high growth strategy, and expand Friendly's market presence in the mid-western region. Weighted Average Cost of Capital Assumptions (WACC) Based on the case facts that the premium for equity risk was 6% on long-term governmental bond rate of 8. 37%, we may calculate the unleveraged beta for American Greetings and Gibson Greeting, and use a derived estimate as a proxy for CD's unleveraged beta. 1987 Financial Data for Two Large Publicly Traded Companies To be conservative, we assume the unleveraged beta for CD is 0. 77.

Since the cost of debt was 11% and the tax rate was 38%, we calculated CD's cost of equity is 13. 97% in 1988, and the weighted average cost of capital (WACC) is 11. 07%. Over the next five years, CD's WACC would increase to 11. 92% in 1992 due to the decreasing D/E ratio and therefore the tax shield effect. Cash Flows, Terminal Value, Equity Value Valuations In addition to the above information on WACC and sales growth rate, we have made the following assumptions: * Sales will stay flat in 1988, but will grow at 6% per year after 1989. * Cost of goods sold will stay at 55. 2% of sales level. * Depreciation, " Selling, delivery, and warehousing expenses", and " general and administrative expenses" will grow proportionately to sales growth. * Increased Retained Earnings will be used to reduce long-term debt. * Prepaid expenses will increase by a small amount each year. * Interest expenses will decrease over the period since the debt level will decrease. * No dividend will be paid after 1988. Based on the above assumptions, we found that the total present value for CD was $4. 349 million. Adjusting for the interest-bearing loans totaling $1. million, the net worth of CD would be $3. 049 million, $1. 168 million higher than the calculated value of the stock exchange ($1. 881 million). This indicates that acquiring CD is a good transaction for Friendly. 2. 4 Pooling Implications (Friendly + CD) By using the " pooling of interests" accounting method, we constructed the Friendly and CD consolidated financial statements. (see Appendix Valuation - Friendly + CD) The impact on 1988 pro forma financial statements is as follows: * New bank loans needed decreased from $1. 585 million to $1. 357 million; * EPS increased from $1. 7 to $1. 73; * Net profit margin increased from 4. 96% to 5. 49%; * Assets turnover increased from 1. 01 to 1. 03; * ROA increased from 5. 01% to 5. 49%; * ROE decreased from 25. 23% to 20. 5%; * Days in Receivable reduced from 157 to 149; * Bank loan to receivable ratio decreased from 0. 9 to 0. 74; * Interest bearing debt to equity ratio decreased from 2. 62 to 1. 92; * Total debt to equity ratio decreased from 4. 04 to 2. 62. The overall impact of acquiring CD to CF is positive. The result of pooling is in line with Friendly Cards' financial strategy.

In the long run, acquisition of CD would become an integral part of Friendly Cards' strategic plan for the next few years to achieve a higher growth rate and increased market share. In the short run, acquisition of CD would meet Friendly Cards' immediate financial needs enabling the company to meet the bank's covenants, specifically, to reduce the " bank loan to receivable" ratio to an estimated 0. 9 in 1988 to 0. 85 or lower, and to decrease " total liabilities to equity ratio" from an estimate 4. 04 in 1988 to 3 or lower. The result of pooling shows that these two requirements are met. 2. 5 Friendly Cards Stock Valuation

Assumptions: Capital structure Based upon the pro forma financial statements and the bank covenants' requirements, we assume the capital structure to be 75% debt and 25% equity. Any other capital structures with the reduction of debt would make it more difficult to get additional capital through equity. We need the debt financing to be able to meet Ms. Beaumont's growth requirment. Discount rates We assume the cost of debt to be 11%. This is based upon the following facts: In early 1988, interest rates were declining, the 10-year Treasury Notes rate declined from 9. 52% in October 1987 to 8. 9% in January 1988; even though the short-term Prime Rate increased to 9. 07% by October 1987, it had decreased to 8. 5% by January 1988; furthermore, the Federal Reserves Monetary Policy Report(Jan. 1988) stated that " high rates of capacity utilization and low unemployment suggest the needs in maintaining progress toward price stability", indicating that interest rates would stabilize at the present level. Also the need to reduce the trade deficit, business and labor would continue to exercise restraint in price and wage behavior, indicating the Fed would hold interest rate at the present level, or even reduce them.

We assume the interest rates would hold stable at the present level of 8. 5% and that the lending institution will continue its premium of 2. 5% over prime. We assume all the funding for the debt to be short term as most of the debt would be used to fund the current assets (receivable and inventories). This would be a proper matching of funds. Based on the valuation of Friendly Cards, we found that * FCFE Method (Free Cash Flows for Equity): the valuation was -$. 95 per share ; * Free Cash Flow for Capital: the valuation was -$5. 5 per share ; * Book Value Method: using 11/2 times Book Value the valuation was $7. 40 ; * P/E ratio (multiple) method: using the industry average P/E ratio of 7, the valuation was $9. 50 per share.

(Please refer to appendix Valuation - Friendly Cards, Inc.) The only way the company's stock price was worth $8 to $9. 50 per share was that West Coast Investors and Creative Designs valued the company using a Price to Earnings multiple method. **Note** We attempted to back out a discounted cash flow model that would justify an $8 or $9. 50 share price.

By altering certain assumptions, most specifically the sales growth rate we can achieve positive valuations of the stock price. Slower growth in sales PART 3 Overall Assessment Our recommendation to Ms. Beaumont is to (1) First, acquire CD with a stock exchange of 198, 000 shares at $9. 5/share, (2) With the additional leverage obtained by the CD acquisition, purchase the envelope machine. As evidenced by the above matrix and graphs, even though Friendly Cards would achieve a higher EPS by not acquiring CD but buying the machine, it would not meet the bank covenants.

Advantages of our recommendation: * Meet all of the bank's covenants; * Meet Ms. Beaumont's growth needs; * Meet Ms. Beaumont's requirement on D/E ratio of 2 by 1990; * Maintain a relatively high level of control for Ms. Beaumont over the company; * Position the company for future growth by providing a more favorable D/E ratio. Disadvantages of our recommendation: * EPS dilution by acquiring CD from $4. 64 per share in 1992 as compared to $4. 15 with the CD acquisition; * Reduce Ms. Beaumont's control from currently 55% to 41. 5% with CD acquisition.

PART 4 Goals for the Financial Structure of Friendly Cards, Inc. 4. 1 Friendly Cards capital structure consideration Our recommendation is that Ms. Beaumont to move Friendly Cards' capital structure closer to 60% debt and

40% equity (a D/E ratio of 1. 5). Our reasoning for such a recommendation is as follows: Flexibility: For future growth and possible acquisitions, Funds for acquiring more assets (another envelope machine!) to reduce costs. Risk: Ability to deal with possibleadversityinto the future (i. e. , low sales) Lower risk level than current D/E ratio Income:

Future growth in earnings due to ability to acquire market share through acquisitions. Further exploit the economies of scale to reduce CGS, Handling and Distribution Costs Control: Maintain controlling interests in the company Timing: Having a higher D/E Friendly can issue equity at more favorable terms at a later date when EPS is higher, the marketenvironmentis " friendlier", and the company will be in a better financial position. Our recommended target capital structure for Friendly Cards, Inc. of 60/40 D/E is realistically attainable within 3-4 years (mid 1991). Friendly Cards Case Attachments