Padgett paper products company-analysis for the options essay sample

Economics, Money

Options:-Portion of debt through insurance company-Continue at 90 day terms-Factor receivables-Collateralize assets-Mortgage general purpose building-Independent Canadian Financing-Flat dividends-Payment Terms – accelerate receipt-LIFO / FIFOEvery available option has a positive and a negative aspect to it. Here we will decipher what option gives Padgett Paper Products the best financial structure, provides the most flexibility for continued growth, and reduces the risk for all parties involved.

It is preferred by Padgett Paper Product’s management to continue at 90 day terms, however this may not be the best choice for the company or for Caslon. There is a chance that the company may be audited after the 1997 fiscal year and Calson would prefer that new terms would be worked out and shown on the financial reports in a more favorable outcome for Padgett. Another problem with the 90 day terms is that there are no covenants or collateral set in place because Padgett’s management did not want to lose direct control over the company. They also felt that the fact that the notes can be called in 90 days was appealing to the note holders as protection; however this could be a huge disadvantage to Padgett if too many people called their loans at one time.

By factoring their receivables Padgett Paper Products could increase their cash flow in a short amount of time. A factoring firm would give Padgett a percent of their sales right away and the factoring firm would have to wait the payment term to get their money and collect it as well. (The Smart Choice) By letting someone else deal with collecting their receivables Padgett could decrease the amount they were paying employees in the

collections department, if not remove this department completely. Padgett has a higher average collection period versus that of the industry. Meaning, since sales are taking so long to be turned into cash they have less cash on hand to reinvest. (Brigham) By factoring out receivables Padgett would be advanced cash from a factoring firm immediately rather than waiting around two months (see exhibit 7a) for this cash.

This also transfers the risk of not being able to collect from a customer to the factoring firm rather than Padgett. However they would have to make sure the cost of hiring a factoring firm is worth getting a percentage of their sales up front. Padgett could outsource their factoring to a firm called Full Force Factoring, where they cash advance 97% of sales. Whereas the industry standard is right around 80%. (The Smart Choice)Currently very few of Padgett Paper Product's customers are taking advantage of the two percent discount that is offered to customers if they pay within ten days, versus paying the full amount in 30 days. (Case Studies in Finance)

Accounts receivable turnover ratio is lower than the industry average (see exhibit 7a). The average collection period is twice as long as the payment terms. This means that Padgett's recourse for late payment is not strict enough and that maybe they need to consider increasing the penalty for late payment. If they could persuade customers to take this discount this would increase cash flow for the company as well as the account receivables turnover ratio for the year. However without offering more of a discount it seems that this has not been advantageous to customers in the past so it is unlikely to change.

The use of debt through an insurance company has several positives and negatives. Positives of debt through an insurance company are that you have a longer maturity schedule than that of the bank. The bank would be stretched beyond appropriate levels; they require payment within five years. Padgett cannot afford to repay in that period with its projected “ undedicated” cash flows being only $1 million each successive year. Use of the “ undedicated” cash flows would require eight years to retire the debt. (Case Studies in Finance) If Padgett were to default on the loan it could put the business of both the bank and Padgett Paper Products in dire straits. A positive of using debt through an insurance company is that they have no problem with the size of the loan and availability of the money. Another advantage is that payments will be level and interest rate will be fixed, since the boards forecast for the future is very pessimistic.

The negatives of using debt through an insurance company have nothing to do with the financing or numbers. It is the management who was entirely against the idea. They believed that long-term fixed rates were too high, even though they had yet to return to early 1995 levels, where they were significantly higher. Another problem management had with the use of debt through insurance was that they did not like that there would be an extravagant set of covenants. More specifically Ruhl said that he disliked the type of covenant that could put the company in default without any action of management. “ Violation of a debt-capital ratio, for instance,” explained Ruhl with great relish, “ could occur as a result of an adverse year rather than anything we do. ” (Case Studies in Finance)

Management, Ruhl, was extremely adamant about not agreeing to something that was out of his control. Ruhl actually preferred the informal loan, saying it was ‘ friendly’. This shows how much management does not know about financial decisions. Spreading the debt out over a longer period of time would improve the quick and current ratios. (see exhibit 7a) A negative of the loan itself is that if Padgett were to have the cash to prepay the loan they would face difficulty because the insurance company wants provisions to discourage prepayment. One way around this is to lower the amount of the loan, which may not be a bad idea anyways.

The use of the outright owned general purpose building is a great way to get access to previously untapped funds. The warehouse has lot of liquidity making it a perfect security for a mortgage. Mortgaging the warehouse also reduces the risk of the bank and Padgett Paper Product. This option provides for a longer maturity schedule making it more conducive to Padgett’s ability to pay back the loan. Padgett has a decreasing times-interest-earned ratio, (see exhibit 7a) this means that they are using their income to pay back debt instead of using income to invest in new positive net present value projects. They want to keep the times-interest-earned ratio low, the higher the ratio gets the greater the undesirable lack of debt. (Brigham) The disadvantages to mortgaging the general purpose building are the same as debt through the insurance company, management is against this option as well. Mainly management is against the option because of the restrictive covenants and volatility of interest rates.

Using Canadian financing is a great way to reduce risk. Spreading the risk over two banks gives both banks and the company a better advantage in the market. This provides for an untapped source of leverage. This means that Padgett has more to invest in business operations without increasing its equity. A potential negative in using Canadian financing is that Padgett is unfamiliar with Canadian laws and practices.

Another option to consider is switching inventory accounting methods. An important concept to know here is that beginning inventory in addition to net purchases minus ending inventory will give the cost of goods sold. Even though LIFO is not a good indicator of ending inventories value (because the left over inventory might be extremely old) it results in a valuation that is much lower than today's prices which will reduce the taxes that Padgett would pay on income. LIFO results in lower net income because the cost of goods sold is higher. Padgett's inventory turnover ratio has been unstable during the use of FIFO. Once switched to LIFO the inventory turnover ratio is expected to increase, (see exhibit 6) from forecasting done for 1997.

As a result of this ratio increasing the days to sell inventory ratio will decrease. This would be an advantage to the company because inventory would not be sitting idle for around 171 days as it is currently. (see exhibit 7a) By process of decreasing the days to sell inventory ratio the cash conversion cycle would decline as well. Since prices generally rise over time because of inflation, this method records the sale of the most expensive inventory first and thereby decreases Padgett's profit. Because the last units in are sold first, we leave the oldest units for ending inventory which use a

lower price to calculate ending inventory. As the value of the ending inventory being lower, according to the formula for cost of goods sold above, cost of goods sold would be higher.

A shift to LIFO inventory valuation would save Padgett more cash than the cost of implementing the system which would result in a tax benefit of $500, 000 for Padgett Paper Products Company. (Case Studies in Finance)Flat dividends would provide excess capital to reinvest within the company or for new projects, which will decrease the amount of debt. However, the owners of Padgett are not in favor of this option because a “ significant payout” was considered important by the management. (Case Studies in Finance) Also, flat dividends will show as a negative signal to outsiders from the actions of the company to the stock market.

Assets will have to be collateralized in a majority of available options. Some of the options available to be collateralized by Padgett are their warehouse building, Canadian operation, or other assets within the company. Not only will this reduce risk to the bank but also to Padgett. If the loan has a security to back it then the bank has less risk, because if Padgett does default then the bank can seize the asset as collateral and gain back what they have lost. The only down fall of this is that it will restrict management’s flexibility.

In conclusion we found that it would be better for Padgett Paper Products if they were to not get a loan exclusively from Calson Bank. Instead they should collateralize assets and add covenants, get a mortgage on the general purpose building, obtain independent Canadian financing, shift from

FIFO to LIFO method for inventory, establish relationships for factoring receivables, accelerate customer payment terms, and pursue long-term financing from various sources. This proposed change in capital structure will increase levels of financing to optimize debt to equity levels and achieve greater tax shield benefits.

Works Cited

Brigham, Eugene F. , and Phillip R. Daves. Intermediate Financial Management. 8th ed. Mason: Thomson South-Western, 2004.

Case Studies in Finance: Managing for Corporate Value Creation. 4th ed. McGraw-Hill/Irwin, 2008.

Consolidated Papers INC. “ Annual Report to Stockholders. ” 18 Apr. 1995. SEC Filings. LexisNexis. Rod Library, Cedar Falls. 15 Feb. 2009. Keyword: paper.

Duns Analytical Services. Industry Norms and Key Business Ratios. Murray Hill: Dun and Bradstreet Information Services, 1994.

Industry and Financial Consulting Services. Industry Norms and Key Business Ratios. Rep. 1-3. Bethlehem: Dun and Bradstreet Information Services, 1995-1997.

The Smart Choice for Greater Profits. Full Force Factoring. 12 Feb. 2009.