

Jones electrical distribution case analysis essay sample



**ASSIGN
BUSTER**

This analysis is based on the 5 questions to the case. We believe that answering them builds a rather exhaustive and clear picture of the state of Jones' business and its strengths and issues and offers a good analysis of its current state. Question A) How well is " Jones Electrical Distribution" performing? What must Jones do well to succeed? Jones Electrical Distribution is electrical supplying company. Since it was established in 2004, the sales have been growing steadily on a year to year basis from \$1624000 in 2004 to \$2224000 in 2006, and furthermore a projected \$2. 7 million in sales for the current financial year of 2007. In the same time profit has been inadequate for the quantity of sales. This data is backed by the very low Profit Margins experienced by the company, most recently only 1, 3% (and only 0. 8% for the first quarter of 2007). As of late, the company has faced a cash shortage and the results of that are becoming evident on its financial statements. Accounts payable have increased dramatically comparing 2006 and 2007.

The same situation is with accounts receivables, showing that less of Jones' clients are willing to pay cash for goods delivered. As a result the use of a discount thanks to fast payment to suppliers has become improbable. Further study of the increase in important components such as accounts receivables and inventory will be discussed in the 3rd section of this case analysis. Here are some vital ratios in analysis the company's performance: $ROA = NI/Total\ Assets$; $ROA = 2.3\%$ for 2004, 4.3% for 2005 and 3.8% for 2006, which means what the profit is per dollar of assets and indicates the Jones doesn't utilize the assets in an efficient manner. $ROE = NI/Total\ Equity$; $ROE = 7.6\%$ for 2004, 13.62% for 2005 and 12.35% for 2006. This ratio

indicates that for every dollar in equity Jones Electrical Distribution generates 0.07, 0.13 and 0.12 cents in profit for 2004, 2005 and 2006 respectively.

To improve the ratio indicators the firm has to increase the Net Income.

Profit Margin = $NI/Sales$; PM = 0.8% for 2004, 1.5% for 2005 and 1.3% for 2006. Profit Margin for the Jones Electrical Distribution is extremely low.

Jones should take advantage of sales discounts. Debt Equity Ratio = $Total\ Debt/Total\ Equity$ = 2.19 times for 2004, 2.12 for 2005 and 2.22 times for 2006. The ratio is showing us the liabilities keep growing. While analyzing the ratios' indicators it is becoming clear that Jones managed the company more successfully in 2005. Perhaps this is helped by the fact that he used all the discounts from suppliers. It is very essential for Jones Electrical Distribution to leverage the net income, which is impossible to do without decreasing the costs of running the business.

Jones Electrical Distribution seems to be a company based on a good sales team who take care are bringing about a very steady yearly growth of between 17% and 18%. This quite remarkable number seems to show an ambition and dedication and profit despite small has also grown at a tempo that seems to slow down unlike that of sales. So it seems that Jones has to try to act to his strengths by supporting the good work of his sales team, but in the meantime the main problems seems to be connected to the Profit Margin. The EBIT of the company or in other words the expenses of making a sale are possibly too high and stifle the growth opportunity and cause a need for external financing. This would be hard to maintain for very long especially for a business of that size. Jones has to try to minimize costs and increase his cash collection as it has been lagging as well. The cash injection of the new <https://assignbuster.com/jones-electrical-distribution-case-analysis-essay-sample/>

line of credit will be a breath of relief but not a long term solution. So only combining the aforementioned measures will allow a thriving business like Jones' to secure a good balance between reducing EFN and not hindering growth.

These points will be further discussed as we go. First let's examine the following Question B) Why does a business that has profit \$30, 000 per year need a bank loan? For the last few years Jones' business has been experiencing a growth according to the apparently good performance of the sales team who have captured a growing demand very well. This however has led to a dilemma for the owner who seems overwhelmed by the decisions connected to maintaining this growth, since preserving it would mean resorting to external financing. The problem the company faces is the liquidity (defined as amount of capital available for investment and spending) for the company and it has been declining. Despite retaining its earnings, the firm has seen trouble maintaining cash growth at the same rate as other assets and liabilities. This is supported by numbers such as the cash ratio which for 2007 has been a meager 0, 06547 falling from a previous 0, 180349 in 2005. Furthermore the inventory needs of the company form an integral part of the company's assets.

The current ratio is 1, 543589 while the Quick Ratio ((Assets- Inventory)/Current Liabilities) only 0, 659268. Judging by the increases of Accounts Receivable and Accounts Payable Jones Electrical Distribution is struggling to receive cash immediately at a sale and pay its suppliers fast, losing out on discounts. This further highlights the need of external financing to cover its running costs and avoid problems and tensions between them, <https://assignbuster.com/jones-electrical-distribution-case-analysis-essay-sample/>

suppliers and customers. Upon estimating the External Financing Need, the number showed a need of \$99540. However the company took a loan of 250 000 previously and having in mind that the new deal means termination relations with the previous loaning institution this loan would not be negotiable in repayment.

This puts the financial need much higher having in mind the 250000 loan(plus interest) , plus the remainder of the installments of the buyout of the company from a partner, minus the retained earnings. Also since it is a personal business Jones and his family need the income to cover living expenses. Therefore Jones is considering the \$350000 loan discussed in the case. But as mentioned already this loan will only provide relief for the business in the short run. Let's than investigate some of the other issues that have been plaguing the growth opportunities and examine what they can do about it. Question C) What drove the accounts receivable and inventory balances in 2005 and 2006?

We can see that we have an increase in receivable and in inventory which is logical because if we increase our sales we need to increase our inventory as well in order to sustain the sales gross. But we can also see that the gross of inventory is higher than the gross of receivable especially in 2006. In the mean time we have a stark decrease in term of cash from 2005 to 2006 (53 to 23). This allow us to say that maybe Jones Electrical Distribution should find a new way of managing his inventory in order for them to match more his growth in term of sales. Because now what we can see is that this company has too much inventory compared to the sales, receivable, even if the sales are growing. Taking a look at the turnover inventory ratio shows it <https://assignbuster.com/jones-electrical-distribution-case-analysis-essay-sample/>

is 66 days in 2005 and grows to 76 days in 2006. We can definitely say that they have to find a way to lower this ratio as they have too much inventory on hand.

They have to find a way to make a more in time inventory, maybe by planning based on their sales of the previous year plus their expected growth. If we look at the receivable ratio which is 44 days in 2005 and 43 days in 2006, at the first look we may think that the ratio are not bad. But that for a company in which the revenue model is based on product direct sales 44 or 43 days as receivable turnover is too long. They have to find a way to make their clients pay them in no more than 30 days. They should have a discount incentive for their client to encourage them to pay in less than 30 days. Their problem of cash is enhanced by the long time it takes by the customer to pay their bill. And it is obvious that without a more positive cash flow the company will face a problem of meeting its loan repayments. First we have to discuss the repayment of the current line of credit. Question D) When will Jones be able to repay the current line of credit?

To answer this question we are using the following numbers (all numbers in thousands), and making some assumptions. First we calculated the External Financing Needed (EFN) for 2007, to determine how much cash Jones will need to sustain a healthy cash flow. That amount is \$99, 540.

External Financing Needed for 2007:

$(\text{Assets/Sales}) \cdot \text{change in sales} - \text{Spontaneous liabilities/Sales} \cdot \text{changes in sales} - (\text{Profit margin} \cdot \text{Projected sales}) \cdot (1 - \text{dividends})$

We are also assuming that Jones will use all of his net income to pay off the debt with the Metropolitan Bank. In 2006 he had a Net Income of \$30, 000.

Net Income 2006

The new credit loan has some restraints regarding how much of the credit line Jones is allowed to use. The restraint is 75% of accounts receivable and 50% of inventory. With this restraints Jones will have approx. \$216, 000 available in 2007.

Funds available from Southern Bank & Trust 2007:

We are assuming that he is using \$146, 430 ($\$216, 000 - \$99, 540 + \$30, 000$) to pay of Metropolitan Bank in 2007. His remaining debt with Metropolitan will therefore be \$103, 570 ($\$250, 000 - 146, 430$). His remaining credit line with Southern Bank & Trust amounts to \$134, 000 ($\$350, 000 - \$216, 000$). When his Accounts Receivables exceeds \$167, 500 and his inventory exceeds \$201, 000 he will have this funds available. The average profit margin for the company is 1, 23%. Projected sales for 2007 are \$2, 700, 000. This will give us a projected net income of \$33, 121 ($\$2, 700, 000 \times 1, 23\%$).

After examining this we can come to a conclusion. We don't think Jones will be able to pay of his current line of credit in the current condition of the firm. The new loan conditions with Southern Bank & Trust is interfering with Jones other possible solutions to his problem. For Jones to be able to use money from the new financial institution, he needs to increase his Accounts Receivables and his Inventory. Both of these actions will have a negative

effect on the company's liquidity. Jones should focus on increasing his profit margin before he focuses on growth. As it says in the case he is a very cautious guy when it comes to money, and " doesn't spend a dime if he don't have to". But he also has a problem with the company financing. His whole growth is paid with short term debt, and he is even paying of his long term debt with short-term credit.

Question E) What could Jones do to reduce the size of the line of credit he needs?

First determined what he really needs at this situation.

-The rapid sales growth from 2004-2007 shows an increasing Net worth Value at slower rate.

| 2004| 2005| 2006| First Quarter 2007|

Net worth| 184| 213| 243| 248|

Table1. Show net worth from 2004-2007(1st quarter)

Year 2004-2005| Year 2005-2006| Year 2006-2007(first quarter)| Year 2007-2008| $213/184 = 1.1576086957$ | $243/213 = 1.1408450704$ | $248/243 = 1.0205761317$ | Close to 1 means no change in net worth value|

Table2. Show net worth value increase over 3 years.

From table 2, this conclude that with increase in number of sales will not result in better net worth, so Jones should opt for a no sales Growth option for his future growth plans. In other words instead of focusing on the increase in sales, the focus should be switched to a more efficient and effective control of costs to affect the low Profit Margin. If Jones manages to increase yearly profits this would in term provide more retained yearning <https://assignbuster.com/jones-electrical-distribution-case-analysis-essay-sample/>

affecting important ratios such as obviously PM and ROA, ROE and his EFN. More funds will be available to support growth at a lower cost since borrowing need would decline. And this is precisely what he should be aiming to do to secure long term health of the business!

Some options include changing suppliers, relocating for tax purposes (even though his problem is mainly in pre tax costs) and maybe cutting part of the sales force or reducing salaries if possible. Furthermore to support his growth the liquidity problem has to be solved quickly. Some further ways to reduce the size of the line of credit to suit his needs mainly in the shorter run include:

1) We need to reduce the account receivable to generate more cash at any particular point of time, for example giving sales discount if buyer pays cash as suggested in Question C), or increase Receivables turnover (Sales/Account Receivable). The higher Receivable turnover means that the company will collect faster on those sales. 2) The main suppliers to Jones Electrical Distribution had terms of 30 days or lag. The later the payment date the better it is. This way the business can take advantage of a secondary line of credit. However this would mean missing out on a 2% discount and has the potential to worsen relationships with suppliers 3)The company could slow down its increasing sales because financial support will be increased according to sales, in other words, increase in sales means larger funds are needed to support inventory which will increase the line of credit. So, without sales growth, there is no need for additional financing. 4) The inventory reducing measures mentioned also will improve liquidity as it seems mismanagement of that deprives the company of some of its cash. If <https://assignbuster.com/jones-electrical-distribution-case-analysis-essay-sample/>

Just in Time inventory is used there will be more cash available at any point, possibly reducing the EFN.