Continental carriers, inc.

Business, Company

Continental Carriers, Inc. (CCI) should take on the long-term debt tofinancethe acquisition of Midland Freight, Inc. for a few reasons. The company is heavy on assets, the debt ratio will only grow to 0. 40 with the added $50M in debt. Also, the firm will benefit from an added $2M in a tax shield and be able to return $12. 7M a year to its stockholders and investors, instead of $8. 9M if equity is raised to finance the acquisition. Lastly, the stock price and earnings per share will increase to $3. 87 in comparison to an equity-financed acquisition of $2. 72 per share.

CCI would be taking a somewhat high risk by issuing additional stock due to the uncertainty about the offering price. Having a low P/E ratio withrespectto the rest of the market, and the replacement cost of the firm being greater than its book value (argument 3), there is a good chance that the current stock price and the proposed offering prices are too low. Although long-term debt is a better financing choice a few of the drawbacks are pointed out. Debt holders claim profit before equity holders, so the chance that profits may be lower than expected, increases risk to equity may reduce or impede stock value.

However, in extreme financial situations such as a recession period, CCI would still be able to increase its cash during a recession period with all debt capital structure. Also, there is a remaining 12. 5 million that would have to be paid at the expiration of the bonds, but that could be paid off by issuing new bonds or additional equity at that time. Five members of the board raised comments that have been addressed as follows: 1. The argument of the debt financing being a risky venture since the proposition was to pay out to a sinking fund does not make sense.

Over the course of the next seven years, CCI had a historical growth in revenue of 9%. This growth along with the $2M tax shelter would easily pay for the sinking fund. In addition, by buying back bonds annually, the interest expense is further decreased, thus creating less of a burden on the cash flow. In contrast, an equity-financed acquisition would spread the net income out over 3 million more shares, thereby reducing the dividend pay-out to shareholders. 2. Another director argued that with equity financing, the shareholders will yield a 10% EBIT of $5M.

Furthermore, this director posited that 3 million shares at $1. 50 in dividends would only yield $4. 5 million dollars in a cash outflow, thereby increasing the company's equity by the difference each year. This argument does not account for the $2M tax shelter that is gain in the debt financing. The expected pay-out per share when using debt financing would be $1. 7 per share compared to $1. 2 per share of equity financing. The total dividend pay out is also 1. 3 M less for debt financing. Since 71% of the assets are fixed assets, Debt ratio of . 4 and current ratio of 1. 34 does not seem to be a bad number.

3. Another director argued that the share price was a steal at $17. 75/share and according to his calculations he yielded a book value share price of $45/share. In addition, the equity value ($202, 500) was currently less than the replacement cost of the firm ($253, 100). Our calculations are in agreement with this argument, which supports the debt financing option. One reason for such a low stock price could be the fact the CCI is all equity

financed, which may signal to the market that the firm is having trouble with its cash-flows and therefore does not have faith in its future.

4. Our calculations are also in agreement with the fourth director, assuming that EBIT does increase to $34M it would yield an earnings per share of $2. 72 and the use of debt would increase the earnings per share to $3. 87 with the cost of the sinking fund at only $0. 56 per share. However, pre-acquisition numbers range between $7. 2M and $15. 3M. The Midland deal only promised an added cash flow of $8. 4M. CCI could only expect to see their EBIT grow to $23. 7M. Using a more modest growth, the EPS would result in $2. 49 and $1.

90 (debt and equity) respectively. This possibility still favors debt financing. 5. The last director argued for a preferred stock in lieu of a bond issue. This alternative would yield a preferred stock pay-out of $5. 25M. The bond alternative would yield a total stockholder pay-out of $7. 04M. Furthermore, an equity financed project will likely lower the overall stock price, which would offset the benefits of a preferred stock with a dividend of $10. 50. Preferred stock issuance is not good for existing board members and especially common stock holders.

It provides a fixed dividend pay out of 5. 25 M to the preferred stock holder and leaves the common stock holder with only 3. 7 M, which equals a dividend level of only $. 83 per share. The common stock holder would be left with only $. 22 per share if EBIT grew to only 23. 7M. Given that CCI is currently light on debt, the tax-shield resulting from debt, and that a greater return would be realized by stockholders under the issue new debt

alternative, it is recommended that CGI pursue their opportunity to sell 50 million in bonds to the California insurance company.