

Case analysis of kota fibers, ltd

Business



Case Analysis of Kota Fibers, Ltd Name Date Executive summary Kota Fibers, Ltd engages in yarn production in Kota Town, India. Textile millers use the yarn to make traditional dresses (saris) for women in India. Kota Fibers has been in operation since 1962 and has over the years faced an annual growth rate of 15 percent. This due to the rapid growth of the female population in India.

In January 2001, the Managing director of the company Ms. Pundir realized that the company has been surprisingly hit by a cash shortage. The company's liquidity problems had a number of negative implications on its operations.

Delivery of customer orders had to be postponed as it had to pay excise duty on a cash basis, before the loaded trucks can leave the company gates. In addition, its Banker, the All-India Bank had become wary of the company's financial health owing to the high frequency of overdraft requests.

Given this situation the bank's lending officer demanded a financial forecast before he could advance further loans to the company. From an analysis of the company's financial statements it will look into main causes of the weak liquidity position that Kota Fibers is holding.

It will also include current credit standing while comparing it to the projected results. It will look inventory turn around, sales and production and production increasing as a means of salvaging the situation. It is imperative for one to calculate the company financial ratio in order to determine the problems that this company is facing.

The recommendation offered will help Mr. Pundir to increase cash flow and be able to be a profitable company. This will include rejecting the 80 days net that has been proposed by Pondicherry Textiles as this will increase inventory and accept proposal by the Purchasing Agent and Transportation Manager that will help in reducing inventory thus increasing liquidity.

Overview of the company Kota Fiber, Ltd was founded in 1962 as a small nylon fiber producing company in Kota, India. Right from the beginning, the company has maintained a high growth rate and success in this line of business. It sources raw materials from domestic market, which it processes into yarns and supplies them to domestic textile mills.

These millers, in turn use the yarn to weave saris. Indian women wear the colorful saris as their traditional dress.

The saris have a high demand in Indian given the high population of women which ranges at 500 million. On average, an Indian woman buys three saris a year. Given that each sari requires 8 yards of cloths, the annual demand for yards as faced by Kota fibers and its competitor's amounts to over 12 billion yards of fabric.

Kota has a fairly stable market for its processed yarns. As such, the demand for yarn in each year follows a consistent pattern with fluctuations being predictable. This owes to the fact that as India's population continues to grow so does the demand for saris.

Moreover, the demand for saris gains a major boost from the hundreds of festivals observed by the Indian population and gets to an all time high during the most celebrated festival of the year, the Diwali. The implication is

that Kota Fiber experiences peak demand of yarns at around late summer and early fall, when the celebrations take place.

After supplying yarns to millers, the latter sells them to cloth merchants, who have direct customer relations with the neighboring community. The merchants' often offer credit to their customers, accumulates inventory prior to the peak season but maintains low inventory at other times.

Kota and other suppliers compete for the market share through quality services, competitive prices and attractive credit terms. Ms. Pundir acts as the managing director of Kota Fibers. In addition, she is the principal owner of this family business together with 11 other shareholders.

Statement of Problems The company faces a number of problems that put into risk successful operations. The key problem arises from the inability to maintain sufficient liquidity levels. The resultant cash shortage has precipitated the company's problems such as the ability to pay excise tax.

As detailed from the case study, a 15% excise tax on sales has to be paid in cash before any of the distributors' trucks leave the company. The other key problem pertains to the repayment of loans advanced to the company. The All- India bank maintains the company's cash balances, as well as grants it a line of credit.

A line of credit in this context refers to an arrangement between a firm and a financial institution in which the bank sets a maximum loan balance which the firm can draw on provided it does not surpass the maximum limit.

A line of credit differs from a conventional loan in that the undrawn amount does not attract any interest, is unsecured and the borrower can draw the remaining amount at any time. However, problems were emerging at the company given that it had overdrawn from its bank account for three times in a row. The problems in repayment had prompted the lending official to decline to a request to overdraw and, Ms. Pundir had to intervene by assuring him that payments would be cleared in two months time.

As a result of the firm's liquidity problems, delays in supply of yarns were being experienced.

The implications were a deteriorating relationship with the distributors given that the firm hired them as independent contractors. Furthermore, the firm inconvenienced its customers. This had potentially far reaching implications such as a shift to reliable suppliers. Analysis of the situation Financial analysis Kota Fibers has projected gross sales of INR 90.

0 million in the year 2001. This means that they wish to have an increase of about INR 15 million over the current year. This increase is substantial but there are several financial factors that have to be put into consideration.

These include current credit standing, inventory turn around, sales and production and production scheduling. It is imperative for one to calculate the company financial ratio in order to determine the problems that this company is facing. Profitability ratios This is used to evaluate the profits the firm is gaining with respect to the level of sales, owners investment and level of assets.

For a company to be successful it ought to have a higher gross profit margin. From the financial data, Kota Fibers projected a 16% profitability ratio but they are currently at 13%.

This is an indication that they have a poor profit to sales ratio. For them to increase this ratio, they have to improve in handling their operating costs. Debt ratios With reference to debt to asset ratio, it is quite evident that Kota Fibers has leveraged a minimal amount of money they borrowed from the bank to generate for them profits. This ratio is used to measure the amount of total assets that is paid by the company's creditors.

From the financial reports, in 2000 the firm had a ratio of 11 % and their 2001 projection was 28%. However, this has not been achieved.

This means that they are more indebtedness and more financial leverage. It indicates that they will be using less money to facilitate growth of the company. Liquidity This is the company's ability to change its assets to real cash. From the financial data it is evident that the liquidity ratios in 2000.

The Quick ratio and Current ratio was 1.0 and 2.0 respectively. In 2000 the current ratio was 3.2:1.

This was an indication the Kota Fibers was able to handle the short term challenges that they were likely to face. But, in 2001, this ratio has dropped 1:1. This is way below the recommended level of 2.0 for any manufacturing company. This is an indication that they will not be able to pay their bills.

Asset turnover If we carefully calculate the speed in which Kota Fibers is able to convert credit sale to inflows and outflows, we should look at the inventory turnover. This will be able to measure the company's liquidity and activity. For example, in 2000, Kota Fibers had an inventory turnover of 8.4 and projected an increase of up to 12.1 by 2001.

This is a positive step for the company.

In order for them to achieve this, they should keep the credit terms with Pondicherry Textile the same. However the number they currently have is below the project one. So they need to increase this by increasing the number of total amount of total assets. Aggressive dividend payments Based on data from exhibit 2, the company has over the years operated profitably. A study of the annual income statement for year 2000 shows that the company made INR75,867,480 in gross sales, INR64,487,358 worth of net sales and a net profit of INR2,550,837.

From this impressive performance, the company's managing director Ms. Pundir deemed it worthwhile to pay high dividends to the company's eleven shareholders. Her argument in support of payment of high dividends rested on the belief that such funds when ploughed back into the company were at a higher risk than when returned to the shareholders. However, such a stance may not be the best for Kota fibers in light of its current liquidity problems. Retained profits when ploughed back into the business facilitate growth and increased return on investment.

For Kota Fibers, retaining profits instead of paying high dividends would facilitate the reduction of its bank overdrafts and reinvestment in the

production of higher level inventories. This could be advantageous for Kota given that retained profits are an effective and the cost of equity will be very high. Although such a source may be an opportunity cost for shareholders it promotes growth since less amounts are paid in terms of interests to All-India bank which stood at 14.5%. The reinvestments from retained profits act as a source for further earnings if the investments increase in value and payments of higher dividends takes place.

Kota has higher chances of increasing earnings from reinvestments of retained earnings given the high market demand of saris, and the annual growth rate of 15%. other benefits from the use of retained profits would be the associated flexibility in that the management would have complete control over such funds, and can choose on how much to pay as dividends. The company also avoids the risk of dilution of its ownership, as would have been the case when raising additional funds through external shareholders. Analysis of new dividend and cash balance policies After Ms.

Pundir and bookkeeper Mr. Mehta held a discussion to analyze the company's situation, Pundir reached on a decision in which the quarterly dividends to be paid to the shareholders would be INR500,000.

The total dividends to be paid per year would amount to 2 million. In year 2000, the company's income statement indicates that the company recorded INR2,550,837 in net profit. Impliedly the remaining cash balance would be INR550,837. Hence a substantial part of the company's earnings are used to pay dividends whilst the company continues to experience an acute shortage of cash.

In addition, Pundir after the reassessment gave orders that the company's cash balance should not fall below INR750, 000.

The target was, therefore, unrealistic given that the cash balance to be carried down for year 2001 was INR550, 837. A shortfall of 199, 163 exists.

Cash Cycle The cash cycle is one of the measures of management effectiveness. In general, it shows how fast a business entity can convert available cash balances to more cash on hand. The flow of cash in a business such as Kota Ltd starts with the conversion of cash into accounts payable and inventory, to accounts receivable through sales and back into cash in hand.

A lower cash cycle is better for a company as it implies that it have sufficient cash balances to meet recurrent expenditure or other short term obligations.

As a management tool, cash cycle assists in comparison of a company's performance to that of competitors. It can as well be used in the evaluation of potential investments. In assessing Kota's cash cycle, activity ratios, to be taken into account include accounts payable, accounts receivable and inventory turnover. In this case, accounts payable represents a liability while inventory and accounts receivable are Kota's short term assets.

An analysis of these ratios provide a basis in which one can gauge the financial health of the company through an evaluation of how the company manages its short term assets and liabilities to come up with cash balances.

Factors impacting on Kato's cash cycle From the case study, raw material suppliers avail credit to Kato Fibers that is payable in 30.

The company, therefore, has to ensure that they meet this deadline in order to ensure the cash cycle through the purchase of supplies and production of inventory. The inventory in form of yarns is then sold to textile millers.

As a result of high competition levels, Kato has to sell on credit to such millers. In the mean time, Kato has to wait until the textile millers have sold to cloth merchants. Since production at Kato does not halt when the first batch of yarns is sold, the company continues to borrow to purchase supplies until when it receives payments from the textile millers. In other words, the company has to finance the entire production of saris right from purchase of raw materials to the moment the final products reaches the consumer.

The cash cycle is given by the sum of inventory turnover in days and receivables turnover in days less the payables turnover in days. Using exhibit 2 and 3 the Kato's cash cycle for year 2000 can be calculated as follows: a. inventory turnover = $\frac{\text{COGS}}{\text{average inventory}}$ $\frac{53,865,911}{964,474} = 55.85$ Days inventory outstanding = $\frac{365}{55.85} = 6.54$ days It, therefore, takes 6 days for Kato to sell its entire inventory. b.

accounts receivable turnover $\frac{\text{Net sales}}{\text{accounts receivables}} = \frac{64,487,358}{10,606,473} = 6.08$ Days sales outstanding = $\frac{365}{6.08} = 60$ days c. accounts payable turnover $\frac{\text{Purchases of raw materials}}{\text{accounts payable}} = \frac{42,419,371}{759,535} = 55.85$ Days payable outstanding = $\frac{365}{55.85} = 6.54$ days The sum of days sales outstanding and days inventory outstanding gives the operating cycle Operating cycle = 60 days Cash cycle = operating cycle - days payable outstanding $60 - 12 = 48$ days From the cash cycle,

receivable turnover is 16 days compared an accounts payable turnover of 6 days.

It therefore, takes Kota longer to collect payments from textile millers than it takes to pay suppliers.

Accounts receivables can be perceived as loans to the textile millers. As such, the company incurs losses when the payment period extends. The receivables ties up money that can be used for further investment. In the case that suppliers would allow for longer payment periods Kota could benefit from the chance to invest more.

Financial Forecast A financial forecast can be defined as a prediction of future business condition likely to affect a firm. A forecast makes use of trends from a company's historical data, as well as external historical data.

It projects such trends in such a manner that decision makers can to some extent reliably get information on the financial status of the firm at a future time. Therefore, a financial forecast does not necessarily act as a planning tool but an estimate of a company's future success. The bookkeeper Mr. Mehta made use of a financial forecast to have a rough estimate of year 2001 likely profits, demand for yarns, likely cost of production and the time and amounts of funds to be borrowed.

Mehta made use of the sales forecast method to predict amounts for items in the balance sheet and income statements.

A forecast serves several purposes. First, financial institutions require the document to assess the ability of a firm to remain profitable and, therefore,

repay any loans advanced to it. A forecast also acts as a guide, for the company to venture in only those products that it can produce profitably. In addition, the company can utilize a forecast to monitor operations and make relevant changes at the appropriate time. Annual clean up of the loan The bank needs an annual clean up of the loan to assess the company's financial soundness.

It has to take place since a line of credit serves the purpose of assisting a business with extra cash balances in periods when demand for such cash is at its peak level. Otherwise, when a company has undergone a peak sales period, and its receivables have being settled, the demand for cash to replenish inventory is low. A cleanup, therefore, assures the bank that cash is not being used for normal financing. The fact that such loans do not require security may result into credit risk for the financial institutions.

Without adequate information as to the financial health of Kota Fibers, the bank should not continue to waiver the covenant. As earlier stated, the company could be using the funds to finance its normal operations.

In a situation where the prospects of financial success are bleak the banks may loss its funds or experience a credit risk situation. However, the presence of a financial forecast will assist the bank assess the truth of the claims that company's cash is tied up in the inventory. Condition that the Memos offer to Ms. Pundir Exhibit 4: Memo from Fields Sales Manger

This means that Pondicherry Textile is going to become one of the largest accounts that Kota Fibers will have. Their sales will be INR 6 million which

had not been reflected in their sales forecast. In addition, an increase of the credit terms to 80 days.

Exhibit 5: Memo for transportation manager With the new road that has been constructed between New Delhi and Kota, supply products will be more reliable. This means that there will be a reduction in raw material inventory from the original 60 day to 30 days. Exhibit 6: Memo from Purchasing Agent The main supply of polyester pellets will be Hibachi Chemicals.

This will also reduced the inventory of pellets from 60 day to 3 days. Exhibit 7: Memo from Operation Manager The objective is to level yearly production.

This has numerous advantages like: lowering manufacturing risk, there will be a stronger work force and gross profit margin is likely increase.

Conclusions and recommendations From the current analysis, it is evident that Ms. Pundir is faced with the imminent challenge of resolving his limited cash flow. Since her management style is delegative, it is imperative that she carefully analyzes the financial position before she takes any action.

For a company that has been profitable for the last 40 years, she should put more focus on the company's liquidity and have a clear plan for the future. Kota Fibers has to convert some of their assets into cash for them to pay bills and stick to the 2001 projections.

Based on the asset turnover, the company is operating on a favorable level. However, the 80 days net that has been proposed by Pondicherry Textiles is more likely to reduce the amount of cash thus leading to the increase in liabilities. Ms. Pundir should reject this offer as this will have a drawback on her business.

The two proposals suggested by Purchasing Agent and Transportation Manager should be approved as they help in reducing inventory. A reduction of the raw material inventory and finished products will result in fewer inventories and this will increase liquidity.

Kota Fibers has to come up with a good strategy to generate profit using the 2001 projection as a blue print. This will be forced to improve their level of indebtedness and operating efficiencies in order to make the shareholder have more confidence in the company. Since Kota Fibers is face with the obstacle of shortage of cash, it should se their assets to generate sales by increasing the amount of total assets that they have. This can be evaluated by the debt to equity ratio as it will act as a clear indicator of how to increase their liquidity. Before implementing any of this changes, it is imperative that Mr. Pundir should hold a shareholder meeting and inform them about the strategic changes he is going to make.

This will allow for a better approach towards solving the deadlock that this company is facing. Once the shareholders are aware of this situation, they may be willing to reinvest in the business to ensure it reaches its projected goals.