

ANSWER TO TUTORIAL CASE: *Pontoon plc*

	<i>Industry</i>	<i>20X2</i>	<i>20X1</i>
Operating profit before interest and tax to capital employed (ROCE)	15.0%	20.1%	16.8%
Operating profit before interest and tax to sales	10.0%	10.6%	9.8%
Asset turnover (asset utilisation ratio)	1.5 times	1.89 times	1.72 times
Gross profit to sales	35.0%	31.9%	31.7%
Current (working capital) ratio	2.2:1	2.4:1	2.4:1
Quick (acid test) ratio	1.1:1	0.97:1	1.04:1
Average age of trade receivables (collection period)			
- based on year-end	73 days	45 days	34 days
- based on average		37 days	32 days
Average age of inventory (stockholding period)			
- based on year-end	206 days	116 days	83 days
- based on average		95 days	74 days
Interest cover	3 times	8.3 times	6.7 times
Gearing ratio (D/(D+E)) (long-term loan capital / (L-T loan capital + shareholders' funds))	50.0%	24.2%	25.1%

Profitability

The return on capital employed has improved over the year and is significantly better than the industry average. The reason for this must rest with the capital employed, as the net profit margin is approximately consistent with the industry average and the asset turnover is better than the industry average. However, this could arise if the company had a substantial amount of its assets at the end of their useful lives and therefore heavily depreciated and appearing at a low figure amongst the assets in the balance sheet. This does seem to tie in with the fact that the directors are now seeking to re-equip. Recomputing the figures based on their estimates of £4m for the new machinery, constant sales and a saving of £2m in cost of sales reveals a revised asset turnover of 1.63 times – closer to the industry and an improvement in both return on sales and ROCE to 14.9% and 24.3% respectively. The gross profit margin is approximately 3% lower than industry. This requires further investigation as many factors could lead to this, for example, lower sales prices, more costly materials, higher production costs, stock control or valuation problems. The fact that the directors are seeking to modernise manufacturing facilities might imply that production inefficiencies arising from older, outdated, equipment may be restricting gross profit. A quick re-calculation of gross profit margin using a revised cost of sales in line with the directors' estimate of savings hoped for from modernisation reveals a new figure at, or slightly above, the industry average, which may support this latter speculation. (£2m saving in cost of sales delivers a revised gross profit margin of 36.2% - slightly ahead of the industry as a whole)

Liquidity

There has been little change in either the current ratio or the quick ratio over the year, and both are similar to the industry average. Therefore, the liquidity position appears satisfactory, though it is worth observing that the detectable trend appears to be downwards. Any further deterioration may begin to put strain on the liquidity and any course of action which will reduce the liquidity should therefore be avoided, if possible

Interest cover

Interest cover has improved over the year and is well above the typical industry cover. It would appear that there is an ample 'safety margin', should the company wish to issue further loan stock.

Trade receivables

The average age of trade receivables (the collection period) has slightly increased, but still compares very favourably with the industry average. It is interesting to note that sales have increased, despite the apparently less favourable credit terms offered, which would seem to indicate that the lower gross profit margin could reflect lower selling prices than industry (perhaps as well as the higher operating costs mentioned above). Alternatively, the company may be competing successfully on quality or have some sort of "must have" product – possibly by way of a unique or monopoly position – which allows it both to maintain sales prices and operate a tight credit policy compared to the competition. It may just be that they are simply better and more efficient than their rivals at collecting debts. It should be noted, however, that an overly-aggressive credit policy can lead to customer dissatisfaction – especially if there is general and significant competition in the industry on this issue.

Inventory

The average age of inventory (the stockholding period) has slightly increased, but, again, compares very favourably with the industry. The reasons for the wide variance between the industry average and the company's stockholding should be sought, as it is possible that the company may not be stocking sufficient variety or quantity of finished product fully to meet customers' and potential customers' requirements. They may also run the risk of "stock outs" in raw materials as well, thus disrupting the production process. Depending on the nature of Pontoon's business within the sector, it may have proved possible for them to operate just-in-time (JIT) systems for their raw material purchases. In addition, if they are "making to order" rather than for stock, this would in turn lead to lower or negligible levels of finished goods with most of the inventory value resident in work in progress. Aggressive control of inventory levels, through, for example, JIT techniques may reap significant rewards by way of improved asset utilisation, but also carries significant extra risk of disruption to the supply chain, which in turn may result in extra cost. This should be recognised and planned for.

Gearing

Although the company's gearing level has remained constant at 1:3, this represents three times as much equity to long-term borrowings as the industry average. The level of gearing appears very low in relation to the industry average. This caution may be the product of a general risk-aversion on the part of the board. This is very typical of well-founded, smaller, closely controlled businesses (especially in the owner-managed small to medium-sized enterprise (SME) sector) – and this is a smallish, recently listed, company. We can also note that comment is made concerning the wide-ranging fluctuations in sales and profits to which the industry is prone. It is exactly this variability/volatility in demand (sales) and earnings (profits) that defines the level of business risk observable in a company. In the light of this relatively high business risk, Pontoon's reluctance deliberately to take on extra financial risk by borrowing becomes more understandable – and is, arguably, reassuring! Nevertheless, assuming the market continues to be comfortable with a sector capital gearing of 1:1, there is considerable room for manoeuvre in raising additional loan capital should the company wish to take this route - there is probably plenty of "borrowing capacity" here.

Conclusion

The company is generally in a very sound financial position, with profitability and gearing better than, and liquidity close to the industry averages. This situation looks set to improve further if the investment goes ahead and the company can achieve the savings estimated by the directors. This will deliver higher return on capital employed from higher margins on a revised capital base which will bring a reduced asset utilisation more in line with the industry. It will also improve the gross margin up to, and perhaps slightly beyond, the industry average. Perhaps Pontoon has been a little behind the rest in bringing itself up to date! One conclusion from the analysis would therefore be that this investment appears to be a sound decision.

Care needs to be taken not to put the liquidity under too much strain – it is already showing a slight downward trend away from the industry average, though probably not sufficient for serious worry. With this in mind, although the pay-back from the investment (at €1m a year after tax) is quite quick, it would probably rule out using an overdraft to fund the investment – despite the potentially attractive flexibility of this option. This reinforces the general rule that long-term assets should not normally be financed by short-term funding – and you can't get any shorter term funding than an overdraft repayable on demand!

Questions also need to be asked as to how Pontoon can operate with such short debtor collection and stockholding periods compared to the industry at large. There are many possible explanations, but, while on the face of it the position shows Pontoon in a good light, it is important to establish that the company is not incurring undue commercial risk by what appears to be quite an aggressive approach to managing its working capital.

As far as borrowing risk is concerned, the high interest cover indicates that the company would probably be able to meet the higher interest charges should it decide to borrow more – despite the risk attached to potential fluctuations in profit levels. The issuing of debentures would lead to an increase in gearing, which would bring the company closer to the industry average. The current low level of gearing indicates that the company should be able to raise long-term loans without affecting financial stability. Indeed, it might well be that management is taking an overly risk-averse attitude to borrowing and needs to be more responsive to its shareholders' interests and the enhanced returns to them available from a higher level of gearing.

However, the company's good profitability and earnings per share might well support a rights issue at a reasonable price per share, which, while not diluting equity too much, might be less costly to service in terms of a maintainable cash dividend. The company's good financial health therefore leaves it in the enviable position of being able to choose the source of finance under few constraints. The final decision would be aided by some calculations of the effect on EPS, gearing and ROCE of the two methods suggested.

In practice, the company could adopt a mixture of sources – while, if the methods were truly mutually exclusive – some “rule of thumb” calculations indicate that, on balance, the long-term borrowing is marginally more attractive. If the idea of locking into a 20 year loan seems to lack flexibility and be potentially expensive in the long run, it might be possible to consider a medium-term loan of – say – 5 or 6 years which could easily be serviced and repaid from the extra expected cash flow.