Financial Health Assessment: Delisle Industries Memorandum

By Group 3: Shivani Shah, Fahad Al Rasheed, & Maya Gite

Link to Financials from Phase 1:

https://babsonmy.sharepoint.com/:x:/r/personal/falrasheed1_babson_edu/_layouts/15/Doc.aspx?sourcedoc=%7B5b092872-8aa4-432b-84909e5be2a1e933%7D&action=edit&activeCell=%27Ratio%20Analysis%20%27!C5&wdinitialsession=045bb278-3f2d-4d7397e0ccfc2ae1e6e2&wdrldsc=4&wdrldc=1&wdrldr=AccessTokenExpiredWarning%2CRefreshingExpiredAccessT

As financial consultants, we took on the role of analyzing these statements to make informed, data-driven recommendations and assessments to the CEO regarding a possible investment related to the proposed expansion.

SECTION 1: LIQUIDITY

Looking first at liquidity, which refers to how quickly a financial asset or security can be converted into cash without losing significant value, we noticed that Delisle Industries might have some liquidity issues. Delisle relies heavily on its revolving credit agreement with the Bank of Montreal to manage seasonal fluctuations in working capital. The company needs to ensure it pays down the remaining credit to zero once a year, indicating a potential strain on liquidity. Furthermore, in our analysis of liquidity, the following metrics have helped us establish the company's position.

The current ratio, for example, displays Delisle's (DI) liquidity situation and its capacity to settle current debts with its entire current asset base, which consists of cash, inventory, and account receivables. The better the company's liquidity position, the higher the ratio. Between 2006 and 2010, the current ratio dropped from 2.41 to 1.51. There are $1.51 in current assets for every $1 in current liabilities at Delisle Industries (DI). The current ratio's declining trend indicates that either they have been taking on excessive debt, or their cash balance has been depleted. Its volatility, which ranged from 2.41 to 2.01 between 2006 and 2007, could be an indication of operational risk, which could lower the company's worth.

Building off this, another critical metric is Days Sales Outstanding, Accordingly, the average time in 2006 for DI to obtain payment for a transaction was 59.79 days (about 2 months). Their best DSO was 62.05 in 2009, while their lowest was 58.95 in 2010. DI's DSO is still significantly higher than the suggested level of less than 45, which denotes a good cash flow, even though they were able to lower it by 0.84 between 2006 and 2010. An unsatisfactory cash flow may be indicated by a high DSO, which implies that DI is selling its goods to clients on credit and may be waiting a prolonged period to obtain the money back.

SECTION 2: ASSET MANAGEMENT

Furthermore, Delisle Industries has trouble keeping track of its inventories when it comes to asset management, especially when it comes to seasonal items that need a sizable, finished goods inventory. The reliance on batch production has led to higher inventories, potentially impacting cash flow and warehouse space. As mentioned, the company has a three-year, $5,000,000 revolving credit agreement and has remortgaged its production facility and negotiated term loans for equipment purchases. Delisle needs to carefully manage its long-term debt-to-total-capitalization ratio, which should not exceed 60%, to ensure sustainable growth and debt servicing.

Between 2006 and 2010, there was a 95% reduction in the Return on Assets. This is particularly problematic since it shows that Delisle overinvested in its assets and is now mismanaging them. As a result, it will be necessary to optimize the management of the fixed assets now in place. Since many additional fixed assets will be bought, company growth for a new factory will need to be reevaluated. But ROA considers more than simply fixed assets like land, buildings, and machinery. Additionally, it makes use of present assets like cash and inventory. Several line items, including an increase in completed goods inventory, are responsible for the increase in total assets, even if Delisle still saw a 7% decline in revenue between 2019 and 2020. The Net Income had a significant decline of 73% between 2006 and 2010. If net income is consistently declining, this could be a sign that Delisle is running low on cash.

SECTION 3: LONG-TERM DEBT PAYING ABILITY

The long-term debt amount rose by 787% overall between 2006 and 2010, compared to the base year of 2006. The interest expense grew by 927 percent between 2006 and 2010 compared to the base year. Though these are notable increases, DI's financial situation must be examined. 2010 had a 376% increase in sales over the base year of 2006. In addition, the gross profit percentage increased by 304% over the baseline year. Despite a linear but significant increase, these numbers nevertheless lag well below the debt that Delisle incurred.

Also, it is crucial to evaluate the debt position in relation to earnings before interest, taxes, and depreciation to obtain a better knowledge of it. The Times Interest Earned Ratios for the years 2006–2010 were 7.4, 6.80, 2.86, 1.56, and 1.17. The TIE ratio should typically be above 2.5, indicating a lower level of financial risk. Delisle's financial risk increased during this time since the ratio dropped significantly below the cutoff. It is reasonable to assume that absent intervention, this ratio will keep declining at this rate. This sharp fall has also had a significant effect on net income, which increased slightly in 2007 before declining by 73% overall in 2010 compared to the base year of 2006. The growth in COGS, R&D, administration, and amortization was more than the growth in revenue, despite interest expense being the second-largest percentage growth on the Horizontal Income Statement Analysis. Delisle Industries is spending more money, resulting in a decline in financial performance.

SECTION 4: PROFITABILITY

Since 2006, when it was 31%, Delisle's gross profit margin has decreased, reaching 26% in 2010. As the business's net income margin for 2009 and 2010 was 1% and 0%, respectively, it is currently not profitable. Despite the fact that sales have grown year since 2006, net income dropped to -176% of what it was in the base year of 2006. In 2006, the operating profit margin was 11%; as of 2010, it is 4%. Overall, Delisle has experienced pressure to diversify into new product lines, which has increased its research and development (R&D) from 1% in 2006 to 3% currently. The cost of administration is one of the other operational cost increases.

Additionally, interest expenses increased from 1% of net sales in 2006 to 3% of net sales in 2010. In general, Delisle needs to increase their profitability.

Additionally, segwaying into some profitability analysis based on the vertical analysis financial exhibits, we have ascertained some significant financial issues the company is facing in relation to their operations and financing. Looking at the vertical analysis of Delisle's balance sheet, the company's gross profit margin is a whopping 15% lower than the industry average in 2010. This could be because Delisle's cost of goods sold is almost 16% higher while their operating profit is around 4% lower. These numbers all point to a problem with the manufacturing and operating expenses, which are impacting profitability. The COGS is clearly too high yet surprisingly, the company's R&D costs are much lower than the industry average. In terms of the future, the company might want to consider restructuring their costs and balancing them out to ensure greater profits.

SECTION 5: RECCOMENDATIONS & ASSESSMENTS

Liquidity Enhancement Strategies: Delisle should consider divesting from non-essential assets to bolster their liquidity metrics. The plant holder segment has underperformed, due to intense competition from cost-effective international manufacturers. It would be advisable for Delisle to discontinue this line of products and redirect their investments towards assets that enhance the production efficiency of more lucrative offerings, such as patio furniture.

Alternative Liquidity Strategy: If it is hard to discontinue, instead of outright discontinuation, partnering with a company that has a strong distribution network in markets less penetrated by low-cost overseas competition could rejuvenate this segment. This move would allow Delisle to retain a stake in the plant holder market while reallocating a portion of its resources and capital towards advancing production capabilities and innovation in their high-potential patio furniture range.

Enhancing Long-Term Debt Repayment Capacity: Considering the significant rise in debt and associated interest expenses, it is advisable for Delisle to re-evaluate and negotiate more advantageous credit terms. Furthermore, issuing equity shares could serve as a strategic measure to decrease the company's leverage, thereby reducing both debt and interest obligations. This move would not only alleviate financial pressure but also potentially elevate net income.

SECTION 6: DILIGENCE QUESTIONS/TOPICS

Some items that we would further research in terms of Due Diligence for the possible expansion include the following:

1) **Business Expansion and Risk Management**: Delisle Industries is currently considering an expansion. Are there any potential risks or challenges associated with the expansion, and how does Delisle intend to mitigate them? In other words what are the risk management strategies the company has in place? *Sources for these questions could include HBR: Risk Management Strategies or the Case Study of Delisle Industries to determine if any revealing details suggest their past strategies.*
2) **Bank of Montreal Partnership:** Will the current company expansion be supported by the Bank of Montreal? This is the location where Delisle will be getting some of their financing from, has this plan been thoroughly checked through with them? A source for this information can be acquired through discussions with Bank of Montreal loan

officers. Since Delisle has a previous relationship with the bank, finding out this information would be directly from those who had approved their lending limits

3) **Operational Risk**: With its reliance on a single distributor, will the company be able to optimize operational excellence and minimize bottlenecks? Or will it restrict the company's ability to expand and scale up? This information can be achieved through conversations with the distributor to discuss their methods in deriving an efficient process for scalable operations. New training policies, factory methods, and other changes to the distribution process can be checked via these departments or management.
4) **Delisle Industries Loans:** In a more quantative perspective, the corporation owed over $35 million in debt as of 2010. Can DI provide a breakdown of the loan terms and the distribution of funds from the loan to get a clearer idea of the need for a significant rise in debt? Sources or deeper insight can include Delisle's finance and accounting department, which would provide a breakdown of how they plan for these funds to be used.