Case 1, Delisle Industries Financial Review

BUSN 6020

Corporate Finance

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Submitted to:

Professor Dan Thompson

Memorandum

To: Micheline Rousseau
From: Jolly Jeffers, CMC
Subject: Financial review of Delisle Industries
Date: February 11, 2011

Liquidity

Delisle Industries' liquidity is in a precarious position and could lead to the company going bankrupt if not addressed expeditiously. Both its Current and Cash ratios have progressively deteriorated over the 5 years, and as of 2010, both ratios are less than 50% of the industry average. The root cause of the problem is the company's continued reliance on the current portion of long-term debt and the stretching of Accounts Payable terms to finance its rapid growth. The continued reliance on debt has resulted in the company paying huge interest rates on its loan facilities. The problem is further compounded by the 8% overdue interest that the company must pay as a cost of stretching its Accounts Payable, in addition to the 10% premium paid on Raw Materials to the Edmonton distributor.

While Delisle must be commended for their aggressive growth agenda in an industry that is primed for expansion, it should adopt an optimal mixture of debt and equity financing and ditch the lopsided debt approach.

Furthermore, Delisle's reliance on Costco as its exclusive distributor has placed the company in an unhealthy position regarding its collection of Accounts Receivable, the net 60 terms which are twice the industry average further reduces Delis e's Cash inflow.

Finally, Delisle's Cash Conversion Cycle and Finished Goods Turnover are both admirable when compared to the industry averages. It must be noted, however, that the continued stretching of its Accounts Payable is a major contributing factor to its stellar Cash Conversion Cycle. Delisle's size and dependence on Costco as its exclusive distributor mean it doesn't have significant bargaining strength to renegotiate the existing 5-year fixed price contract, thus its inability to pass on some of the rising Raw Material and Labour costs to Costco. Hence, its Cost of Sales continues to outpace its Gross Profit, placing further strain on cash balances.

Asset Utilization

Asset utilization simply means how a firm effectively utilizes its current and long-term assets.
In Delisle's case, there are three types of inventories seeing that she is a manufacturing company. Her raw material inventory is being utilized very fast, faster than the industry average, this can be seen as a sign that she is running an effective production of converting the raw materials into work-in-progress inventory, on the other hand, her work-in-progress inventory turnover in days, even though has been declining is way higher than the industry average, but the most important inventory which is the finished good inventory has a low turnover than the industry average, this is a sign that

there is proper utilization of assets, what this means is that her partnership with Costco is beneficial for her finished good inventory turnover.
Her account receivable turnover in days on the other has not been good, she is doing worse than the industry average, which means that she is not getting paid for her finished product as fast as she ought to be. It can be said that Costco(which makes 95% of her sales) many times does not meet up with the net 60 agreement therefore, making AR turnover slow, other reasons could include, poor credit approval, monitoring, and collection processes on Delisle's part, economic situations such as recessions that are preventing the customer's ability to pay, or in Delisle's case the fact that most of her sales are to just one party, which means is that if Costco is late with its account payable, then she won't be able to get her account receivable as fast as she ought to.

Her account payable turnover is also not as good, the dealer provides a net 60 term and charges interest on overdue accounts, Delisle's account payable in days have progressively gotten worse over 5 years, which means that she pays the extra interest charged by the Edmonton distributor, this is with the addition of a 10% premium she pays compared to if she was to get the supplies from the manufacturer directly. This is not recommended as the extra costs she is paying might ultimately increase the cost of production.

Her net operating cycle also known as the cash conversion cycle is impressive compared to the industry average, it has also progressively gotten better over the year, what this means is that it is taking her fewer days to purchase inventory, produce the goods, sell, and receive the amount owed. The problem here is, even though the cash is being converted quickly, Delisle's profits are still low. This could be due to high labour costs due to the shortage of skilled workers, higher production costs due to the high cost of raw materials as discussed above and constant selling prices.
Her fixed asset turnover has also reduced over the years and is lower than the industry average. It particularly dropped in 2009 and this could be because of the introduction of the new production scheduling software, the introduction of new products and the space limitation this year. We think that it is a short-term decline in turnover as introducing new assets or products generally takes time to generate new sales.

The total asset turnover, even though it has progressively reduced throughout the course of the 5 years, is still higher than the industry average. This measures the overall efficiency of the firm. For Delisle, a reducing total asset turnover is not a result of lower sales as her sales have increased over the years but could be a result of a higher asset balance which reduces cash and can potentially lead to liquidity problems (The case also mentioned staff were inexperienced using moulding equipment and required considerable training. The inexperience resulted in higher cleaning and other maintenance costs).

Long-term Debt Paying Ability

Financial leverage is desirable, as no company wants to be debt-free but attaining the optimal mix of debt and equity to finance investments should never be discounted at the expense of solely focusing on financial leverage. Delisle's appetite for debt to sustain its growth has hit worrying levels and must be addressed forthwith. By all indications, three of the four covenants governing the revolving credit agreement are being met. The company is achieving a Current Ratio above 1.5, and a Fixed-

Charge Coverage ratio above 1.5, and there is no evidence to suggest audited quarterly and annual financial statements are not being presented to the bank. However, Delisle has exceeded the 60% or less Long-term Debt to Total Capitalization ratio for the past three years. Long-term debt includes interest-bearing long-term liabilities only plus the current portion of long-term debt. Total capitalization is specifically raised to finance the business over the long-term and interest-bearing debt is the riskiest form of funding as non-payment quickly leads to bankruptcy. It stands to reason then, that with 76% of Delisle's Total Capitalization being financed by interest-bearing debt, there is a real possibility of the company going bankrupt in the not-too-distant future if left unchecked.

Furthermore, there is a strong possibility that Delisle will experience Rollover risk when it next negotiates a rollover of the 3-year CAD 5,000,000 revolving credit agreement with the Bank of Montreal due to its sub-par liquidity and profitability ratios and its inability to meet the "Annual Cleanup".

Delisle's continued reliance on debt, stretched Accounts Payable and reinvestment of all profits to sustain the growth of the business is untenable, and the financial statements and some of the financial ratios provide clear evidence of the worrisome situation.

The need to maintain control over a company you created and nurtured is understandable, and one can easily empathize with Micheline Rousseau, who not only wants to live out her dream as an entrepreneur but also that of her father who wants a continued legacy. However, some business decisions require cold quantitative actions and fewer emotions, and this is one such situation. Michelle should acknowledge that if Delisle is to grow sustainably, she must be prepared to relinquish control through the issuance of more equity, and support Westco's decision to sell their stake through an IPO or to another manufacturer. If control is a sticking point, she should consider ditching the growth agenda and consolidating at a size where she can properly manage the company's debts. Ultimately, does she want majority control of a small struggling firm, or is she willing to play a minority role in a large growing organization?

Profitability

Delisle's gross profit margin is below the industry average, and it is getting worse. This could be because of the significant increase in raw material prices in the last five years due to rapid growth in the developing world, and an increase in labour costs. The costs of sale have increased over the years and are significantly higher than the industry average hence, dragging the gross profit down. The advice to Delisle will be to try to

- Try sourcing for alternative sources of raw materials, for example, get from the manufacturer to avoid paying a 10% premium on the raw materials.
- Try to pay within the net period her supplier has extended to her, to prevent the high cost of sales.

Her operating profit margin has also drastically reduced over the year, and it is significantly lower than the industry average. A lot of money being spent on managing the factory, training inexperienced operators, and cleaning and maintenance costs could be the reason for the low operating profit. The factory might have to cut down a little on selling and distribution costs and administration costs to

maximize operating profit margins. The research and development cost is worrisome as it has increased by 1300% in 5 years and this has not necessarily translated into profit.
The factor's net profit margin, which is the company's profitability as a percentage of the net sales, is extremely low; it is 0.35 of the total sales and extremely below the industry average. Currently, Delisle is not making enough profit, and this means that there are low retained earnings being reinvested in the business.
It can be said conclusively that the admin expenses, research and development expenses, interest expenses and the increasingly high cost of sales have been major contributors to the declining profit margins over the years.

Recommendations

Delisle Industries has carved out a niche for themselves in the plastic manufacturing industry. Their ability to replicate timeless wooden patio furniture using plastic, the scope for growth in plastic fencing, their ability to create sheds that can be easily assembled, and their distribution relationship with Costco, a premier retailer, are strong indicators for potential success. However, the presence of these indicators does not mean much, as evidenced in the financial statements and ratios if the company lacks the right strategy. Delisle's growth strategy is unsustainable because management is not fully exploiting the company's strengths operationally and financially, and as such the company is failing in its bid to improve its liquidity, ensuring its survival in the short-term, and will subsequently fail in its long-term bid to increase share prices

Delisle should first assess its current product offering, we suggest they discontinue manufacturing the plant holders as the margins are slim, and there is no unique selling proposition for this product. They should concentrate on producing sheds, rain barrels, patio furniture and fencing. They should adopt an incremental growth strategy. They should seize purchasing any new equipment and focus on improving the utilization of their existing assets. The establishment of a new production facility in Winnipeg should be pursued as this would solve their space and talent issues. The company could then effectively implement a continuous production process. The availability of higher skilled employees would also result in cost reduction as there will be less need for clean-up and other maintenance costs that were influenced by inexperienced employees. Finally, Delisle should consider leasing or selling some of its unused assets in the short-term to boost its cash flow.

The exclusive distribution deal with Costco should be renegotiated. Delisle should negotiate room to increase prices as a percentage of increases in cost and should push for a net 30 Accounts Receivable agreement which is more in line with the industry standard. This in turn would help Delisle to meet its Accounts Payable terms of net 60. They should remove the exclusivity from the contract and diversify their customer base by negotiating contracts with other distributors. This will reduce Costco's power in the relationship, while mitigating the risk of being left without a distributor should Costco decide to exit the contract.

The renegotiation of shorter Accounts Receivable terms and price adjustments will improve not only the pace of cash collections, but also the amounts. Delisle should consider more attractive early payment discounts, for example, 3/15 net 30. The issuance of equity would provide much needed cash that could be used to reduce the existing debt burden. Delisle should seek to purchase raw materials directly from the manufacturer as opposed to continuing with the distributor and incurring the 10% premium. They should negotiate early payment discounts with the manufacturers, that way they can benefit from paying their Accounts Payable earlier, thus removing that 8% overdue interest. The implementation of a continuous production process would automatically reduce inventory storage cost, as raw materials would be converted quicker into finished goods and finished goods could be shipped earlier to distributors.

Delisle should make a concerted effort to finance future growth with equity through the issuance of new shares, only considering extremely low-cost debt.

Delisle Industries **Ratio Table**

	2006	2007	2008	2009	2010	2010 Industry Averages
Liquidity						
Current Ratio	2.41	2.01	1.73	1.59	1.51	3.17
Cash Ratio	0.19	0.17	0.13	0.07	0.05	0.16
Asset Management						
Raw Material Turnover in Days	23.62	21.66	23.06	21.01	22.32	33.86
Work-In-Progress Turnover in Days	30.58	28.28	25.13	20.07	17.14	9.69
Finished Goods Turnover in Days	28.06	32.86	33.69	37.85	46.50	96.54
A/R Turnover in Days	59.79	60.63	59.75	62.05	58.95	30.44
A/P Turnover in Days	61.58	78.71	83.74	85.09	88.74	59.47
Cash Conversion Cycle	80.48	64.72	57.90	55.89	56.17	111.06
Fixed Assets Turnover	2.61	2.88	2.10	1.95	1.86	2.19
Total Asset Turnover	1.37	1.42	1.21	1.17	1.13	1.00
Long-term Debt-Paying Ability						
LT Debt to Total Capitalization	45.39%	47.11%	61.68%	70.48%	75.84%	32.00%
Fixed Charge Coverage	9.97	9.12	4.83	3.38	2.84	2.06
Profitability						
Gross Margin	30.51%	28.84%	28.12%	27.28%	25.89%	42.00%
Operating Profit Margin	11.06%	10.22%	6.90%	4.42%	3.76%	15.55%
Net Profit Margin	6.22%	5.67%	2.92%	1.04%	0.35%	9.08%
ROA	10.56%	10.16%	6.44%	4.52%	4.04%	5.90%
ROE	19.42%	20.32%	12.18%	5.49%	2.24%	14.71%

Exhibit 1: Ratio Table

Exhibit 2: Vertical Analysis (Income Statement)

Delisle Income Statement Vertical Analysis (%) For the Years 2006-2010						
	2006	2007	2008	2009	2010	2010 Industry Averages
Sales	100	100	100	100	100	100
Cost of Sales	69.49	71.16	71.88	72.72	74.11	58
Gross Profit	30.51	28.84	28.12	27.28	25.89	42
Selling and Distribution	10.99	9.38	9.55	9.23	8.39	14.45
Research and Development	0.97	1.74	1.94	2.70	2.66	1.56
Administration	3.67	4.02	4.95	5.81	5.71	5.67
Amortization	3.83	3.48	4.77	5.12	5.37	
Operating profit	11.06	10.22	6.90	4.42	3.76	15.55
Interest	1.49	1.50	2.42	2.82	3.22	1.59
Earnings before Taxes	9.56	8.72	4.49	1.59	0.54	13.97
Taxes	3.35	3.05	1.57	0.56	0.19	4.89
Net Income	6.22	5.67	2.92	1.04	0.35	9.08

Exhibit 3: Vertical Analysis (Balance Sheet)

Delisle Balance Sheet Vertical Analysis (%) For Years 2006-2010						
	2006	2007	2008	2009	2010	2010 Industry Averages
Cash	3.66	4.29	3.17	1.65	1.21	16.45
A/R	22.44	23.54	19.76	19.91	18.28	8.34
RM Inventory	6.16	5.98	5.48	4.90	5.13	5.38
WIP Inventory	7.98	7.81	5.97	4.68	3.94	1.54
Finished Goods Inventory	7.32	9.08	8.01	8.83	10.69	15.34
Total Current Assets	47.55	50.71	42.40	39.98	39.25	47.05
L,P,&E, Net	50.22	47.49	56.20	58.94	59.65	45.65
Intangibles	2.24	1.80	1.40	1.08	1.11	7.3
Total Assets	100	100	100	100	100	100
A/P	16.06	21.75	19.91	19.86	20.39	9.45
Current Portion of LT Debt	3.64	3.52	4.65	5.28	5.61	5.39
Total Current Liabilities	19.70	25.27	24.56	25.13	26.00	14.84
Long-term Debt	36.45	35.21	46.53	52.77	56.12	23.45
Shareholders' Equity	43.85	39.52	28.91	22.10	17.88	61.71
Total Liabilities and Equities	100	100	100	100	100	100

Exhibit 4: Horizontal Analysis (Income Statement)

Delisle Income Statement Horizontal Analysis (%) For the years 2006-2010					
	2006	2007	2008	2009	2010
Sales	100.00	174.02	262.42	389.81	476.25
Cost of Sales	100.00	178.21	271.44	407.93	507.93
Gross Profit	100.00	164.48	241.87	348.54	404.09
Selling and Distribution	100.00	148.49	228.04	327.23	363.64
Research and Development	100.00	312.12	526.59	1087.34	1307.59
Administration	100.00	190.93	354.44	617.80	741.45
Amortization	100.00	158.08	327.04	521.65	667.68
Operating profit	100.00	160.91	163.89	155.83	162.08
Interest	100.00	175.23	424.87	737.59	1026.67
Earnings before Taxes	100.00	158.67	123.15	65.02	27.12
Taxes	100.00	158.67	123.15	65.02	27.12
Net Income	100.00	158.67	123.15	65.02	27.12

Exhibit 5: Horizontal Analysis (Balance Sheet)

Delisle Balance Sheet Horizontal Analysis (%) For the years 2006-2010					
	2006	2007	2008	2009	2010
Cash	100.00	197.25	258.13	205.46	190.93
A/R	100.00	176.47	262.25	404.55	469.61
RM Inventory	100.00	163.38	264.95	362.83	479.81
WIP Inventory	100.00	164.78	223.09	267.74	284.75
Finished Goods Inventory	100.00	208.72	325.94	550.23	841.69
Total Current Assets	100.00	179.38	265.52	383.31	475.76
L,P,&E, Net	100.00	159.08	333.28	535.08	684.71
Intangibles	100.00	135.71	186.73	219.85	285.04
Total Assets	100.00	168.21	297.79	455.87	576.42
A/P	100.00	227.79	369.15	563.70	731.99
Current Portion of LT Debt	100.00	162.49	380.15	659.95	887.47
Total Current Liabilities	100.00	215.71	371.18	581.50	760.75
Long-term Debt	100.00	162.49	380.15	659.95	887.47
Shareholders' Equity	100.00	151.62	196.34	229.77	235.03
Total Liabilities and Equities	100.00	168.21	297.79	455.87	576.42

Exhibit 6: Cash Flow Statements

Delisle Cash flow Statement For Year Ending December 31, 2007 (in CAD)			
Operations			
Net Income		1,480,939	
Add:			
Amortization	908,884		
Increase in Accounts Payable	2,249,530		
Increase in Accrued Expenses	249,654	3,408,068	
Less:			
Increase in Accounts Receivable	1,880,940		
Increase In Inventory	1,866,493	3,747,433	1,141,574
Investing			
L, P, & E, net		-4,160,784	
Intangibles		-87,500	-4,248,284
Financing			
Loan		2,496,540	
Issuance of equity		1,000,000	3,496,540
Change in Cash and Cash Equivalents			389,830
Cash and cash equivalents, January 1, 2007			400,840
Cash and cash equivalents, December 31, 2007			790,670

Delisle Cash flow Statement For Year Ending December 31, 2008 (in CAD)			
Operations			
Net Income		1,149,413	
Add:			
Amortization	1,880,284		
Increase in Accounts Payable	2,488,357		
Increase in Accrued Expenses	869,645	5,238,286	
Less:			
Increase in Accounts Receivable	2,109,800		
Increase In Inventory	2,136,040	4,245,840	2,141,859
Investing			
L, P, & E, net		-11,469,284	
Intangibles		-125,000	-11,594,284
Financing			
Loan		8,696,446	
Issuance of equity		1,000,000	9,696,446
Change in Cash and Cash Equivalents			244,021
Cash and cash equivalents, January 1, 2008			790,670
Cash and cash equivalents, December 31, 2008			1,034,690

Delisle Cash flow Statement For Year Ending December 31, 2009 (in CAD)			
Operations			
Net Income		606,811	
Add:			
Amortization	2,999,199		
Increase in Accounts Payable	3,424,769		
Increase in Accrued Expenses	1,117,906	7,541,874	
Less:			
Increase in Accounts Receivable	3,500,000		
Increase In Inventory	2,850,510	6,350,510	1,798,175
Investing			
L, P, & E, net		-14,107,209	
Intangibles		-81,140	-14,188,349
Financing			
Loan		11,179,063	
Issuance of equity		1,000,000	12,179,063
Change in Cash and Cash Equivalents			-211,111
Cash and cash equivalents, January 1, 2009			1,034,690
Cash and cash equivalents, December 31, 2009			823,580

Delisle Cash Flow Statements For Year Ending December 31, 2010 (in CAD)			
Operations			
Net Income		253,112	
Add:			
Amortization	3,838,790		
Increase in Accounts Payable	2,962,446		
Increase in Accrued Expenses	908,987	7,710,223	
Less:			
Increase in Accounts Receivable	1,600,080		
Increase In Inventory	3,276,670	4,876,750	3,086,585
Investing			
L,P, & E, net		-12,075,000	
Intangibles		-159,700	-12,234,700
Financing			
Loan		9,089,874	
Issuance of equity		0	9,089,874
Change in Cash and Cash Equivalents			-58,241
Cash and cash equivalents, January 1, 2010			823,580
Cash and cash equivalents, December 31, 2010			765,340

Exhibit 7: 5-Way Analysis of ROE

Delisle Analysis of ROE						
	EBIT/Sales	EBT/EBIT	NI/EBT	Total Asset Turnover	Debt Ratio	ROE
2006	11.06%	86.50%	65.00%	1.3698	43.85%	19.42%
2007	10.22%	85.30%	65.00%	1.4172	60.48%	13.28%
2008	6.90%	65.00%	65.00%	1.2071	71.09%	4.95%
2009	4.42%	36.09%	65.00%	1.1713	77.90%	1.56%
2010	3.76%	14.47%	65.00%	1.1318	82.12%	0.49%

	2006/2007	2007/2008	2008/2009	2009/2010
ROE Component	Incremental change	Incremental change	Incremental change	Incremental change
Total asset turnover	0.67%	-1.97%	-0.14%	-0.05%
Operating profit margin	-1.51%	-3.67%	-1.73%	-0.23%
Interest burden ratio	-0.26%	-1.82%	-1.37%	-0.77%
Tax burden ratio	0.00%	0.00%	0.00%	0.00%
Debt ratio	-5.04%	-0.87%	-0.15%	-0.02%
Total	-6.14%	-8.33%	-3.39%	-1.07%