Continental Carriers, Inc.

In May 1988, Elizabeth Thorp, treasurer of Continental Carriers, Inc. (CCI) was considering the advantages and disadvantages of several alternative methods of financing CCI's acquisition of Midland Freight, Inc. At a recent meeting of the board of directors, there had been substantial disagreement as to the best method of financing the acquisition. After the meeting Ms. Thorp was asked by John Evans, president of CCI, to assess the arguments presented by the various directors and to outline a position to be taken by the management at the June directors' meeting.

CCI was a regulated general commodities motor carrier whose routes ran the length of the Pacific Coast, from Oregon and California to the industrial Midwest, and from Chicago to several points in Texas. Founded in 1952 by three brothers, the firm experienced little growth until the mid-1970s. At that point Mr. Evans joined the firm as president after many years as an executive of a major eastern carrier. Mr. Evans first concentrated his efforts on expanding CCI's revenues on existing routes through an intensive marketing effort and a renewed emphasis on improving service. In 1982, utilizing the proceeds of CCI's initial public offering of common stock, Mr. Evans began a program designed to reduce operating costs through a combination of extensive computerization of operations and improvement in terminal facilities. As a result of these changes, CCI became a large and profitable concern, widely respected in the industry for its aggressive management.

By 1988, Mr. Evans and the directors of the company had come to the conclusion that the key to continued expansion in revenues and income was a policy of selected acquisitions. After a study of potential candidates for acquisition, negotiations began with Midland Freight, Inc., a common carrier serving Michigan and Indiana from Chicago. The owners of Midland agreed to sell the firm to CCI for $50 million in cash. Mr. Evans felt that Midland was an outstanding acquisition in that it would expand CCI's route system and seemed well suited for the type of marketing and cost reduction programs that had fostered CCI's growth. The board had unanimously approved the merger.

CCI's lawyers felt that no difficulty would be encountered in gaining the approval of the Interstate Commerce Commission for the merger, and the closing date for the acquisition was set for October 1, 1988. Mr. Evans realized that the funds for the Midland acquisition would have to be raised from outside sources. Given that Midland would add $8.4 million in earnings before interest and taxes (EBIT) to CCI on an annual basis, he felt that such external financing would not be difficult to obtain.

CCI's management had followed a consistent policy of avoiding long-term debt. The company had met its needs through use of retained earnings supplemented with the proceeds of the 1982 stock offering and infrequent short-term bank loans. As of 1988, CCI's capitalization consisted

This case was prepared as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

of common stock and surplus with no fixed debt of any kind. Most of the common stock was held by management itself. Ownership of the remaining stock was widely distributed, and there was no real dominant interest other than management. CCI's shares were traded infrequently in the over-the-counter market. Discussions with an investment banker led Ms. Thorp to believe that, barring a major market decline, new common stock could be sold to the public at $17.75 a share. After underwriting fees and expenses, the net proceeds to the company would be $16.75 a share. Thus, if common stock was used, the acquisition would require issuance of 3 million new shares.

For the past few years, Ms. Thorp and Mr. Evans had been disappointed in the market performance of CCI's common stock (see **Exhibit 1**). Consequently, they decided to reconsider the firm's policy of avoiding long-term debt (see **Exhibit 2**). It was felt that such a change might be justified by the anticipated stability of CCI's future earnings. Ms. Thorp had determined that the firm could sell $50 million in bonds to a California insurance company. The interest rate on these bonds would be 10% and they would mature in 15 years. An annual sinking fund of $2.5 million would be required, leaving $12.5 million outstanding at maturity. Although the bonds' terms would create a sizable need for cash, Ms. Thorp felt that they were the best that could be obtained.

In addition, Ms. Thorp had calculated that, given the tax deductibility of bond interest and CCI's current marginal tax rate of 40%, (34% federal corporate income tax; 9% deductible state and local corporate income taxes) the 10% rate was the equivalent of 6% on an after-tax basis. In contrast, she felt that the stock at $16.75 a share and a dividend of $1.50 a share would cost CCI nearly 9%. This cost comparison made the debt alternative seem desirable to Ms. Thorp.

At the May directors' meeting, the Midland acquisition received enthusiastic approval. Ms. Thorp then decided to sound out the board as to their sentiments regarding the possibility of financing the acquisition with long-term debt rather than with common stock. She presented the foregoing cost calculations. To her concern, an acrimonious debate broke out among all the directors concerning financing policy.

Ms. Thorp was immediately questioned as to the cost of the debt issue, since her figures did not include the annual payment to the sinking fund. One director argued that this represented 8% of the average size of the bond issue over its 15-year life, and he felt that the stock issue had a smaller cost than the bonds. In addition, he emphasized the cash outlay required by the bond alternative and the $12.5 million maturity, especially in view of CCI's already existing lease commitments. He felt that the use of debt added considerable risk to the company, making the common stock more speculative and causing greater variation in market price.

Another director argued for the issuance of common stock because "simple arithmetic" showed that CCI would net 10% or $5 million a year after taxes from the acquisition. Yet, if an additional 3 million shares of common stock were sold, the additional dividend requirement, at the current rate of $1.50 a share, would be only $4.5 million a year. Since management was not considering raising the dividend rate, she could not see how the sale of the common stock would hurt the interests of present stockholders. Further, if there were any immediate sacrifice by existing shareholders, she argued that it would be overcome as expansion of the firm continued. Under these circumstances, she argued that the bond issue should be rejected, given the cash demands it would place on the firm.

On the other hand, one director became very agitated in arguing that the stock was a "steal" at $17.75 a share. He pointed out that CCI's policy of retaining earnings had built the book value of the firm to $45.00 a share as of December 1987. In addition, he felt that the true value of the company was understated, since book value of CCI's assets was considerably below current replacement cost. This director was also worried by the substantial dilution of management's voting control of CCI that was implicit in the 3 million share offering. Thus, he concluded that the sale of common stock at this time would be a "gift" to new shareholders of the substantial value held by current stockholders.

Two directors agreed that sale of stock would dilute the stock's value, but they measured this dilution in terms of earnings per share instead of book or replacement value. These directors anticipated that postacquisition earnings would equal $34 million before interest and taxes. If common stock were sold, earnings per share would be diluted to $2.72. In contrast, the directors argued that the sole use of debt would increase earnings per share to $3.87. The two directors felt that it was not important that the sinking fund equaled $.56 a share each year.

Finally, a director spoke about some personal observations he had made about financing in the trucking industry. First, he noted that CCI was one of the few major common carriers that had no long-term debt in their capital structures, while CCI's price-earnings ratio was among the lowest in the industry. Second, he wondered whether Ms. Thorp had given consideration to the possibility of issuing preferred stock. This director had determined that CCI could sell 500,000 shares of preferred stock bearing a dividend of $10.50 per share and a par value of $100. The director criticized Ms. Thorp for failing to deal with the issues he had raised.

This debate had caused the directors' meeting to run over its scheduled conclusion and no signs of agreement had developed. Ms. Thorp asked that the discussion of financing alternatives be held over until the June meeting to allow her time to prepare additional material. Now, as the date for the meeting approached, Ms. Thorp once again turned her attention to the issues raised at the board meeting. She realized that a considerable number of issues raised by the directors needed to be considered, and she designed a chart to aid in the comparison of the debt and stock alternatives (shown as **Exhibit 3**).

Exhibit 1 Selected Income and Dividend Data, 1982-1988 (thousands of dollars except per share data)

	Operating Revenue	Income Before Taxes	Income After Taxes	Income Per Share	Dividends Per Share	Market Prices per Share of Common Stock	
						High	Low
1982	$ 630,000	$14,490	$7,245	$1.61	$1.00	16 1/4	11 1/4
1983	693,750	16,650	8,325	1.85	1.15	19	14 3/4
1984	737,305	19,170	9,585	2.13	1.25	20 1/8	15
1985	858,460	22,320	11,160	2.48	1.25	23 3/4	17 3/8
1986	926,665	25,020	12,510	2.78	1.25	27 5/8	22 1/4
1987	1,028,570	28,800	15,725	3.49	1.50	25	18 1/2
1988 est.[a]	1,080,000	25,600	15,360	3.41	1.50[b]	20[c]	16 3/8[c]

[a]Excluding the proposed acquisition and its financing

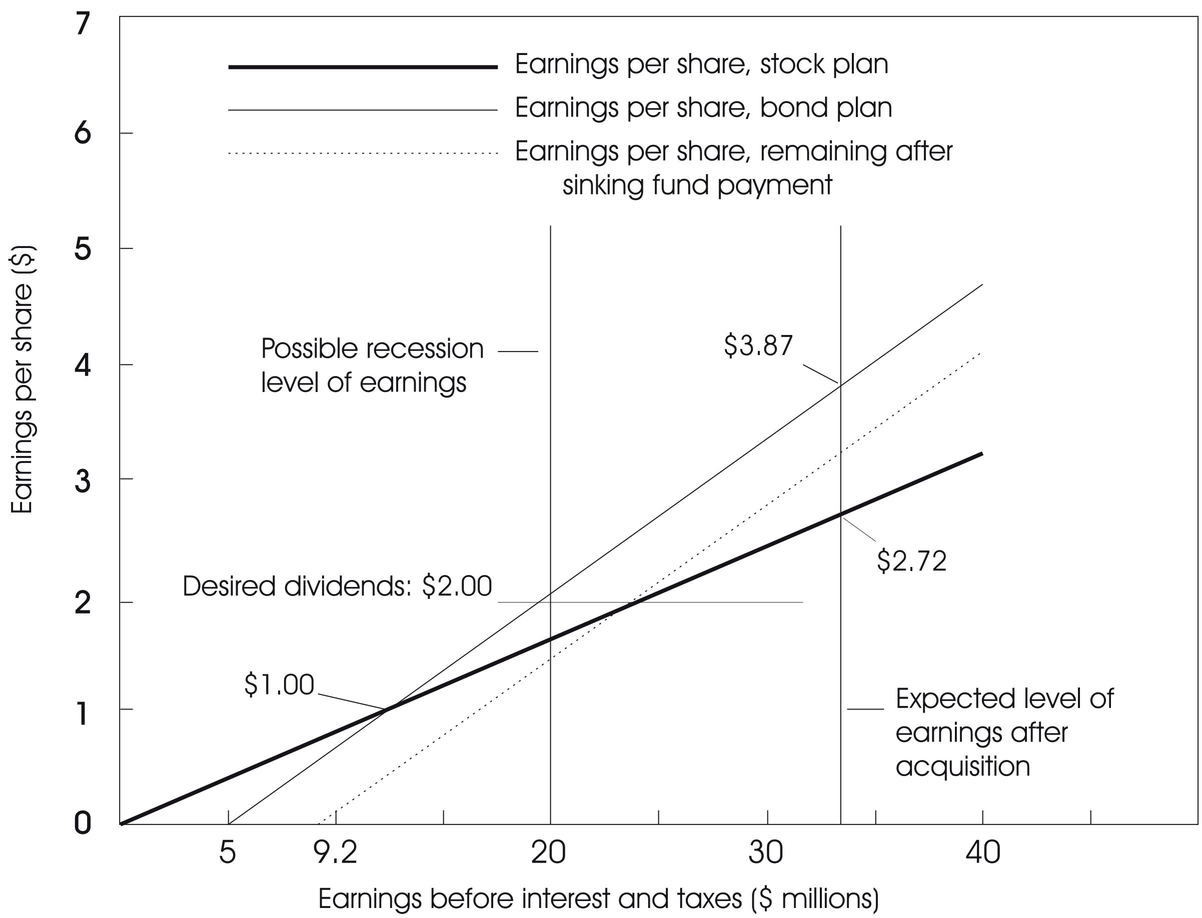
[b]Annual rate

[c]To May 1 (May 1 prices were 18 7/8-19 1/8)

Exhibit 2 Summary Balance Sheet at December 31, 1987 (thousands of dollars)

Cash	$ 19,000
Accounts receivable	38,450
Inventory	8,100
Prepaid expenses	9,100
Current assets	$ 74,650
Carrier operating property (cost)	236,650
Less: Accumulated depreciation	89,100
Net carrier operating property	$147,550
Other assets	30,900
Total assets	$253,100
Accounts payable	$ 25,300
Miscellaneous payables and accruals	20,250
Taxes payable	5,050
Current liabilities	$ 50,600
Common stock ($1 par)	4,500
Paid-in surplus	40,000
Retained earnings	158,000
Stockholders' equity	$202,500
Total liabilities and stockholders' equity	$253,100

Exhibit 3 Analysis of Financial Alternatives



Calculations of Points to Determine Lines (thousands of dollars except per share)

	Bonds	Stock	Bonds	Stock
EBIT	$12,500	$12,500	$34,000	$34,000
Interest 1st year	5,000	--	5,000	--
Taxable earnings	7,500	12,500	29,000	34,000
Tax at 40%	3,000	5,000	11,600	13,600
After-tax earnings	4,500	7,500	17,400	20,400
Earnings per share				
+ 4,500,000	$1.00		$3.87	
+ 7,500,000		$1.00		$2.72
Annual sinking fund	$2,500	--	$2,500	--

Note: The effects of leverage and dilution are indicated by the differing slopes of the lines, and can be expressed: "For each million dollar change in EBIT, the bond plan brings a change in earnings per share that is $.0535 greater than the stock plan. Leverage is favorable from EBIT of $12.5 million upward."