The Verbrugge Publishing Company’s 2007 balance sheet and income statement are as follows (in millions of dollars).

Balance Sheet

Current assets $168 Current liabilities $42

Net fixed assets 153 Advance payments 78

Goodwill 15 Reserves 6

$6 preferred stock, $112.50 par value 135

(1,200,000 shares)

$10.50 preferred stock, no par, callable at $150 9

(60,000 shares)

Common stock, $1.50 par value 9

(6,000,000 shares)

Retained earnings 57

Total assets $336 Total claims $336

Income Statement

Net sales $540.0

Operating expense $516.0

Net operating income $24.0

Other income $3.0

EBT $27.0

Taxes (50%) $13.5

Net income $13.5

Dividends on $6 preferred 7.2

Dividends on $10.50 preferred 0.6

Income available to common stockholders $5.7

Verbrugge and its creditors have agreed upon a voluntary reorganization plan. In this plan, each share of the $6 preferred will be exchanged for one share of $2.40 preferred with a par value of $37.50 plus one 8% subordinated income debenture with a par value of $75. The $10.50 preferred issue will be retired with cash.

1. Construct the pro forma balance sheet assuming that reorganization takes place. Show the new preferred stock at its par value.
2. Construct the pro forma income statement. What is the income available to common shareholders in the proposed recapitalization?
3. Required earnings is defined as the amount that is just enough to meet fixed charges (debenture interest and/or preferred dividends). What are the required pre-tax earnings before and after the recapitalization?
4. How is the debt ratio affected by the reorganization? If you were a holder of Verbrugge’s common stock, would you vote in favor of the reorganization?

Text Answers

1. Total assets: $327m
2. Income: $7M
3. Before: $15.6

After: $13M

1. Before: 35.7%

After: 64.2%