

The Rondo Company For MBAF 602 - Financial Decision Making

A context is required for a student working on a case study. In this case assume that your point of view is that of the CFO of Rondo analyzing its strategies on January 1 of the current calendar year.

The Rondo Company is a medium size manufacturing company that manufactured copper, steel, and iron pipe. The company was founded by Bill Rondo, the current president and board chairman. Mr. Rondo owns the majority of the company's outstanding stock. The stock is actively traded on the NASDAQ exchange. Key financial, ownership and market information on Rondo is included in **Appendix A**.

In addition to the normal course of business, Rondo has two interesting opportunities that it is considering.

The first opportunity is a special contract with a long-time customer. The customer wants to enter into a five-year agreement to have Rondo produce a new type of pipe. Key expected financial information on this special project is included in **Appendix B**. In order to take advantage of the project, Rondo would have to invest the amount noted in Appendix B in special purpose equipment. It is unlikely that the contract would be renewed and also unlikely that the new equipment could be adapted to other production. Since the equipment would be special purpose, the expected salvage value is zero.

The second opportunity is the possibility of acquiring a company that makes PVC pipe. This company, Poly Pipe Incorporated (Poly), is smaller than Rondo. It had been started by several previous Rondo managers to take advantage of the new poly vinyl chloride pipe making technology. Although both companies are in the pipe business, their customer bases do not overlap significantly. Metal pipe and PVC pipe are used in different applications. Poly is traded on the NASDAQ pink sheets. The market is not active. The majority of the stock is still owned by the three founders. The remainder of the stock is owned by several hundred stockholders; its ownership is not concentrated. Key financial, market and ownership information on Poly Pipe Inc. is included in **Appendix C**.

In addition to these opportunities, Rondo continues its modest growth. While the company's growth rate has varied over the last 10 years, it currently expects this historical growth rate to continue. However, Rondo is operating near its capacity. As a practical matter, growth will require incremental additions to production equipment.

Rondo's Board of Directors has established several policies. While the Board prefers that these policies be followed, they would modify the policies if it made sense for the company.

- The dividend payout ratio should be between 40% and 50%.
- The debt to total assets ratio should not be higher than 50%. Moreover, the Board's intention is to maintain total debt, including current liabilities, at 55% of assets or lower.
- Annual company growth should continue in the 5% to 10% range. The board will measure growth in the annual increase in Earnings Per Share.
- The company should maintain flexibility in financial transactions. No high risk transactions should be used, nor should the company tie its hands with financial arrangements.

In addition, Mr. Rondo wants to maintain his family ownership in the company at a minimum of 30%. He does not want to be required to purchase any additional stock. Since the Rondo family counts on the dividend payments, he is also adamant about continuing the dividend payments near their current per share rate.

A preliminary analysis by one of the company's interns yielded the following information about other companies in Rondo's industry.

	Industry Average
Current Ratio	1.40
Average Collection Period	45 Days
Days to Sell Inventory (based on cost of goods sold)	40 Days
Total Asset Turnover	1.10
Cash as a Percent of Sales	3%
Total Debt to Total Assets	0.40
Gross Profit Margin	35%
Profit Margin	10%
Return on Assets	11%
Return on Equity	20%

Poly Pipe Incorporated Purchase

Poly is a small company that manufactures PVC pipe. They have been in business for 10 years. Growth has been relatively consistent for the last five years. Poly's products do not compete directly with Rondo's.

Poly's managers want to sell the company. If the sale is to be a cash sale they will require a premium of 50% above the current "market" price to cover taxes and still leave a profit. They would be willing to sell by exchanging shares with an appropriate company, possibly on more favorable terms.

Sources of Funds

The company has investigated several sources of funding for the new project and for future needs. Detailed information and terms on each potential funding source is provided in **Appendix D**. Terms are those required by the provider of funds. While some conditions may be negotiable, most are cast in stone. The potential funding options are summarized below:

Common Stock

New common stock could be issued at the current market price, however, underwriting and other associated costs (noted in Appendix D) must be considered in calculating the total "proceeds" that Rondo would receive.

Mortgage Bond

The ABC Insurance Company, the company that provided the original mortgage bond, is willing to refund it. The current bond would be replaced with a new one, on the terms noted in Appendix D. The loan would be secured by all the assets of Rondo, including any assets acquired in the future.

Convertible Bond

The XYZ Insurance Company is willing to issue a convertible bond. XYZ wants to be able to share in Rondo's success but also retain the ability to remain a creditor if the Company is not successful. Each \$1,000 bond would be convertible into a certain number of shares of Rondo common stock, as noted in Appendix D. In addition, cash dividends would be restricted. Cash dividends could not be paid unless net income was 20% of the value of the bonds outstanding.

Preferred Stock

The MNO Insurance Company was willing to offer a preferred stock arrangement. In addition to the preferred stock, MNO wanted warrants to sweeten the deal. Each share

of preferred stock would contain warrants that allowed the purchase of a certain number of shares of Rondo Common stock at the exercise price outlined in Appendix D. In addition, if four consecutive dividends were missed, the preferred stockholders would elect 50% of the board of directors.

Bank Loan

The current bank loan could be extended with additional amounts available, as noted in Appendix D.

Foreign Denominated Loan

A local branch of a Swiss bank is willing to provide Rondo with a loan denominated in Swiss Francs (meaning the proceeds and all payments will be in Swiss Francs). The terms and expected exchange rates are found in Appendix D.

Note: for simplicity this case assumes that all interest payments on loans, bonds, and preferred stock are paid annually. You should know that bank loans have a wide variety of interest-payment arrangements, virtually all bonds have semiannual interest payments and preferred stock dividends are generally paid quarterly.

Key Study Questions

Throughout the course you will be asked to address the following issues:

- How is Rondo doing at this point in time?
- What are Rondo's financing needs for the next 6 years? Include the new project in your calculations but don't include the purchase of Poly.
- Is the new project a good deal? Why or why not?
- Are funds available internally?
- Are there any Board of Directors policies that you would suggest be changed? Why?
- Evaluate the Swiss Frank loan
- Which financing source should be used to finance the new project and the company's continuing growth?
- Should Rondo purchase Poly? What should the offer be?

RONDO CASE - APPENDIX A

BALANCE SHEET (as of 12/31)

	2003	2004	2005
ASSETS			
Current Assets			
Cash	1,469,000	2,032,500	2,460,000
Accounts Receivable	9,000,000	9,375,000	9,750,000
Inventory	4,125,000	4,625,000	5,250,000
Total Current Assets	14,594,000	16,032,500	17,460,000
PPE			
Equipment	19,000,000	18,375,000	17,500,000
Property and Plant	16,000,000	15,375,000	14,750,000
Total PP&E	35,000,000	33,750,000	32,250,000
TOTAL ASSETS	49,594,000	49,782,500	49,710,000
LIABILITIES			
Current Liabilities			
Accounts Payable	1,500,000	2,250,000	2,500,000
Current Portion of Bank Loan	2,500,000	2,500,000	2,500,000
Accruals	3,375,000	3,500,000	3,750,000
Total Current Liabilities	7,375,000	8,250,000	8,750,000
Long-Term Debt			
Bank Loan	10,000,000	7,500,000	5,000,000
Mortgage Bond	5,000,000	5,000,000	5,000,000
Total Long-Term Debt	15,000,000	12,500,000	10,000,000
Total Liabilities	22,375,000	20,750,000	18,750,000
Equity			
Common Stock	9,587,500	9,587,500	9,587,500
Retained Earnings	17,631,500	19,445,000	21,372,500
Total Equity	27,219,000	29,032,500	30,960,000
TOTAL LIABILITIES & EQUITY	49,594,000	49,782,500	49,710,000

Notes to Rondo's Balance Sheet:

Bank Loan Information

Original Amount Borrowed	15,000,000
Current Amount Outstanding	7,500,000
Interest Rate	6.00%
Principal Payment Amt per Year	2,500,000
Year of Final Payment	2008
Interest & Principal Pmts Due	December

Mortgage Bond Information

Original Amount Borrowed	5,000,000
Current Amount Outstanding	5,000,000
Interest Rate	7.50%
Principal Payment Amt per Year	500,000
Principal Payments Begin in Year	2010
Year of Final Payment	2019
Interest and Principal Pmts Due	December

INCOME STATEMENT (for year ending 12/31)

	2003	2004	2005
Sales	41,250,000	46,250,000	50,000,000
Cost of Goods Sold	<u>(28,875,000)</u>	<u>(32,375,000)</u>	<u>(35,000,000)</u>
Gross Profit	12,375,000	13,875,000	15,000,000
Selling, General & Admin	(4,560,000)	(5,205,000)	(5,850,000)
Depreciation	<u>(1,500,000)</u>	<u>(1,500,000)</u>	<u>(1,750,000)</u>
Earnings Before Interest & Taxes	6,315,000	7,170,000	7,400,000
Interest	<u>(1,275,000)</u>	<u>(1,125,000)</u>	<u>(975,000)</u>
Earnings Before Taxes	5,040,000	6,045,000	6,425,000
Income Tax @ 40%	(2,016,000)	(2,418,000)	(2,570,000)
NET INCOME	3,024,000	3,627,000	3,855,000
Shares Outstanding	1,000,000	1,000,000	1,000,000
Earnings per Share	3.02	3.63	3.86
Dividends Paid	1,512,000	1,813,500	1,927,500
Increase in Retained Earnings	1,512,000	1,813,500	1,927,500
Market Price Per Share	62		
Mr. Rondo's Share Ownership	60.00%		
Rondo Company Beta	1.20		

Appendix B - Special Project Information

Term of the Agreement (Years)	5.00
Initial Capital Expenditure for equipment (\$ millions)	6.25
Expected Annual EBIT Contribution (\$ millions)	2.00
Expected Annual Sales (\$ millions)	7.50
Expected Salvage Value of equipment (\$ millions)	0.00

Poly Incorporated - Appendix C

**Balance Sheet
for the Year Ending December 31 2005**

ASSETS

Current Assets

Cash	2,250,000
Accounts Receivable	5,250,000
Inventory	8,125,000
Total Current Assets	15,625,000

PPE

Equipment	9,375,000
Property and Plant	5,000,000
Total PP&E	14,375,000

TOTAL ASSETS	30,000,000
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LIABILITIES

Current Liabilities

Accounts Payable	4,375,000
Accruals	1,875,000
Total Current Liabilities	6,250,000

Long-Term Debt

Bank Loan	5,000,000
Total Long-Term Debt	5,000,000

Total Liabilities	11,250,000
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Equity

Common Stock	2,500,000
Retained Earnings	16,250,000
Total Equity	18,750,000

TOTAL LIABILITIES & EQUITY	30,000,000
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**Income Statement
for the Year Ending December 31 2005**

Sales	31,250,000
Cost of Goods Sold	21,875,000
Gross Profit	9,375,000

Selling, General & Admin	2,229,168
Depreciation	1,437,500
Earnings Before Interest & Taxes	5,708,333

Interest	500,000
Earnings Before Taxes	5,208,333

Income Tax @ 40%	2,083,333
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NET INCOME	3,125,000
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Shares Outstanding	1,100,000
Earnings per Share	2.84
Dividends Paid	0
Market Price of One Share of Stock	36

Potential Funding Sources - Financial Terms (Appendix D)

Common Stock Terms

Price at which new stock could be issued	\$62
Underwriting Costs per Share	\$9

Mortgage Bond

Total Amount Offered w/out Poly Pipe Purchase	\$8 mm
Total Amount Offered w/ Poly Pipe Purchase	\$13 mm
Interest Rate	9.00%
Repayment of Principal per Year (% of Loan)	10.00%
Total Term of Loan (years)	10 years
Payments	Annual
Payment Date	December

Convertible Bond

Total Amount Offered	\$10 mm
Interest Rate	8.63%
Repayment of Principal per Year (% of Loan)	none
Total Term of Loan (years)	10 years
Payments	Annual
Payment Date	December
# of Shares per \$1000 bond if converted	15.625

Preferred Stock

Total Amount Offered w/out Poly Pipe Purchase	\$8 mm
Total Amount Offered w/ Poly Pipe Purchase	\$13 mm
Dividend Rate	9.38%
Dividend Payments	Annual
Dividend Payment Date	December
Par Value per Share	\$100
Callable after 15 years at price per share of	\$105
Number of Warrants per Preferred Stock Share	13
Strike Price of each Warrant (\$ per Rondo share)	\$77.00

Bank Loan

Total Amount Offered w/out Poly Pipe Purchase	\$10 mm
Interest Rate	11.50%
Principal Payments per Year	\$2 mm
Principal Repayment Begins	2006
Payments	Annual
Payment Date	December

Swiss Loan

Total Amount Offered w/out Poly Pipe Purchase (Francs)	10 mm sf
Total Amount Offered w/ Poly Pipe Purchase	18 mm sf
Interest Rate	6.75%
Repayment of Principal per Year (% of Loan)	10.00%
Total Term of Loan (years)	10 years
Payments	Annual
Payment Date	December
Payment Currency	Swiss Franc

Expected Exchange Rates (Swiss Francs / Dollar)

<u>Year</u>	<u>Avg Rate</u>
2005	1.33
2006	1.29
2007	1.25
2008	1.21
2009	1.17
2010	1.14
2011	1.10