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| Glen Mount Furniture Company | Case 3 |

## Financial Leverage

Purpose: The potential impact of changes in the debt level on earnings per share is the central focus of the case. However, the instructor can derive educational benefits that go well beyond this point. The central figure in the case is frustrated by security analyst’s short-term emphasis on earnings per share and their lack of concern for the long-term fundamentals associated with his firm. This rather common situation can be drawn upon to make for a more dynamic discussion process. The student is given ample opportunities to calculate EPS under different financial leverage strategies and to examine debt ratios, and degrees of leverage.

Relation to Text: The case should follow Chapter 5. Because the case has some elementary valuation considerations as well, it also could be used later in the course.

Complexity: The case is moderately complex. It should require 1 hour.

## Solutions

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| 1. | Sales ($45,500,000 + $500,000 | | | | | $45,500,000 | |
|  | Fixed costs | | | | | 12,900,000 | |
|  | Variable costs (58% of sales) | | | | | 26,390,000 | |
|  | Operating income (EBIT) | | | | | 6,210,000 | |
|  | Interest | | | | | 1,275,000 | |
|  | Earnings before taxes (EBT) | | | | | 4,935,000 | |
|  | Taxes (34%) | | | | | 1,677,900 | |
|  | Earnings after taxes (EAT) | | | | | 3,257,100 | |
|  | Shares | | | | | 2,000,000 | |
|  | Earnings per share | | | | | $1.63 | |
|  |  |  | | | |  | |
| 2. | Earnings per share, 2011 | | | $1.63 | |  | |
|  | Earnings per share, 2010 | | | 1.56 | |  | |
|  | Increase | | | $ .07 | |  | |
|  |  |  | |  | |  | |
|  | Increase | | | $ .07 | | = 4.5% | |
|  | Earnings per share, 2010 | | | 1.56 | |
|  |  |  | | | |  | |
| 3. | Sales | | | | | $45,500,000 | |
|  | Fixed costs | | | | | 12,900,000 | |
|  | Variable costs (58% of sales) | | | | | 26,390,000 | |
|  | Operating income (EBIT) | | | | | 6,210,000 | |
|  | Interest\* | | | | | 2,400,000 | |
|  | Earnings before taxes (EBT) | | | | | 3,810,000 | |
|  | Taxes (34%) | | | | | 1,295,400 | |
|  | Earnings after taxes (EAT) | | | | | 2,514,600 | |
|  | Shares\*\* | | | | | 1,375,000 | |
|  | Earnings per share | | | | | $1.83 | |
|  |  |  | | | |  | |
|  | \*Interest |  | | | |  | |
|  | Old debt 10.625% x $12,000,000 | | = $1,275,000 | |  | | |
|  | New debt 11.250% x $10,000,000 | | = +1,125,000 | |  | | |
|  | Total interest | | $2,400,000 | | | |  |
|  |  |  | | | |  | |
|  | \*\*Shares outstanding 2,000,000 – 625,000 = 1,375,000 | | | | |  | |
|  |  |  | | | |  | |
| 4. | Earnings per share, 2011 (based on more debt) | | | | | $1.83 | |
|  | Earnings per share, 2010 | | | | | 1.56 | |
|  |  | | | | | $ .27 | |
|  |  | | | | |  | |











7. From Figure 2:



After new debt issue:



8. There are two conflicting factors that could influence the stock price.

On the positive side, earnings per share would be twenty cents higher with more debt ($1.83 versus $1.63).

Based on a current price-earnings ratio of about 10 (the repurchase price for the shares is for $16 ($10,000,000 / 625,000) and EPS are currently $1.56), the stock might go up by approximately $2.00 as a result of a $.20 increase in EPS.

Two dollars represents a healthy 12.5% increase from the current value of $16 per share. However, the student must keep in mind that the debt ratio is increasing from 43.2% to 67.9%, which probably would have a negative effect on the price-earnings ratio.

The net effect of the increase in earnings per share versus the likely decrease in the price-earnings ratio can only be conjectured. Security analysts following Glen Mount Furniture Company seem to be highly sensitive to earnings per share performance, but there may be some question about whether the type of financial engineering used to increase the earnings per share will satisfy them. Of course, the firm can argue that the share repurchase is a strong sign of confidence by management in future company performances.

One clue to the eventual reaction of the market to the recapitalization might lie in the data on the debt ratios of other firms in the industry. If 67.9% is perceived to be on the high end, there might be little positive gain associated with the increase in earnings per share. However, if other companies are in this range and the firm is merely taking advantage of underutilized debt capacity, the market reaction might be positive.