

Glen Mount Furniture Company

Furniture magnate Carl Thompson couldn't believe the amount of pressure security analysts could put on a firm. The Glen Mount Furniture Company was a leading manufacturer of fine home furnishings and distributed its product directly to department stores, independent home furnishing retailers, and a few regional furniture chains. The firm specialized in bedroom, dining room, and living room furniture and had three plants in North Carolina and two in Virginia. Its home office was in High Point, North Carolina.

In a recent presentation to the Atlanta chapter of the Financial Analysts Federation, Carl Thompson barely had taken a bite out of his salad when two analysts from Smith Barney, Harris Upham & Co., a stock brokerage firm, began asking questions. They were particularly concerned about Glen Mount's growth rate in earnings per share.

Carl was aware that security analysts considered earnings performance to be important, but he was somewhat distressed by the fact that this seemed to be their overriding concern. It bothered him that the firm had just spent over \$10 million to develop exciting new product lines, modernize production facilities, and expand distribution capabilities, and yet all the questions seemed to deal with near term earnings performance. He felt that he would

eventually have an opportunity to discuss the above-mentioned management initiatives and their impact on the company for the next decade, but current earnings per share seemed to gather the attention of the analysts.

Carl knew only too well from past experience that the earnings performance of the firm would affect the company's price-earnings ratio and its market value. Furthermore, before Carl became president of Glen Mount Furniture Company, he had attended a six-week Executive Development Program at the Harvard Business School in which he heard a number of professors stress the importance of the goal of stockholder wealth maximization. He often wondered if other items were not equally important to the company, such as community service (the firm donated \$60,000 a year to a local university to help supplement faculty salaries for outstanding professors). He also had a sense of pride that his firm provided employment to over 500 people in the area. He was not sure that the security analysts would consider these items to be of particular importance.

With all of these thoughts in mind, his upcoming meeting with Chief Financial Officer Barbara Bainesworth became particularly important.

When Barbara arrived, she had a number of financial documents to review for the purpose of making key decisions. In Figure 1, she showed the earnings performance of the company over the last five years. Figure 2 provided a current balance sheet, and Figure 3 represented an abbreviated income statement for 2001.

The firm was considering buying back 625,000 shares of stock outstanding at \$16 per share. This would represent \$10 million in total. The funds to purchase the shares would be acquired from a new bond issue that would carry an interest rate of 11.25 percent. The bond would have a 15-year life. The firm was in a 34 percent tax bracket.

Figure 1 Earnings per share for the last five years

Year	1 st Quarter	2 nd Quarter	3 rd Quarter	4 th Quarter	Yearly Total
1997	\$.23	\$.25	\$.19	\$.34	\$1.01
1998	.26	.28	.27	.41	1.22
1999	.34	.36	.33	.48	1.51
2000	.35	.37	.34	.49	1.55
2001	.35	.36	.36	.49	1.56

Figure 2

GLEN MOUNT FURNITURE COMPANY

Balance Sheet

December 31, 2001

Assets

Current assets:	
Cash	\$ 350,000
Marketable securities	90,000
Accounts receivable	5,000,000
Inventory	7,000,000
Total current assets	<u>12,440,000</u>
Other Assets:	
Investments	5,000,000
Fixed Assets	
Plant and equipment	27,060,000
Less: Accumulated depreciation	<u>4,000,000</u>
Net plant and equipment	23,060,000
Total assets	<u>\$40,500,000</u>

Liabilities and Stockholders' Equity

Current liabilities:	
Accounts payable	\$ 4,400,000
Wages payable	150,000
Accrued expenses	950,000
Total current liabilities	<u>5,500,000</u>
Long-term liabilities	
Bonds payable, 10.625%	12,000,000
Stockholders' equity	
Common stock, \$1 par value, 2,000,000 shares	2,000,000
Capital in excess of par	8,000,000
Retained earnings	13,000,000
Total stockholders' equity	<u>23,000,000</u>
Total liabilities and stockholders' equity	<u>40,500,000</u>

Figure 3

GLEN MOUNT FURNITURE COMPANY

Abbreviated Income Statement

For the Year Ended December 31, 2001

Sales	\$45,000,000
Less: Fixed Costs	12,900,000
Less: Variable Costs (58% of sales).....	<u>26,100,000</u>
Operating income (EBIT).....	\$ 6,000,000
Less: Interest	<u>1,275,000</u>
Earnings before taxes (EBT)	\$ 4,725,000
Less: Taxes (34%)	<u>1,606,500</u>
Earnings after taxes (EAT).....	\$ 3,118,500
Shares	2,000,000
Earnings per share	\$ 1.56

Required

1. Project earnings per share for 2002 assuming that sales increase by \$500,000. Use Figure 3 as the model for the calculation. Further assume that the capital structure is not changed.
2. By what percent did earnings per share increase from 2001 to 2002?
3. Now assume that \$10 million of debt replaces 625,000 shares of common stock as described in the case. The interest on the new debt will be 11.250 percent. What will projected earnings per share be for 2002 based on the anticipated sales increase of \$500,000?
4. Based on your answer to question 3, by what percent would earnings per share increase from 2001 to 2002?
5. Compute the degree of financial leverage (DFL) for the answer to question 1 and for the answer to question 3.
6. Using the formula in footnote 3 of Chapter 5, compute degree of combined leverage (DCL) for the answer to question 1 and the answer to question 3.
7. What is the total debt to assets ratio as shown in the 2001 balance sheet (Figure 2)? What will it be if \$10 million worth of stockholders' equity is replaced with debt?
8. What do you think might happen to the stock price as a result of replacing \$10 million worth of stockholders' equity with debt? Consider any relevant factors.