Case Study Assessment- Top Coat Ltd

Task 1.

a) For the analysis, SWOT qualitative framework is used. The details from Top Coat Ltd showed that the company has been working in the same industry for a very long time and has also been able to diversify in various fields. Also, the business has been able to survive in such a competitive market where large companies are also operating. Furthermore, another important strength of Top Coat Ltd has been the continuous upgradation in terms of technological and legislative changes.

Since the paint and coat industry has been one of the major industries for environmental concerns, they need to comply with the guidelines and the criteria fixed by the authorities. The ability of the company to move towards 100 % water-based technology shows the company is determined to be in the market and remain competitive. Working closely with the customer requirements and providing bespoke solutions have also been the major strengths of Top Coat Ltd. The profits are also expected to increase with an increase in margins after the fully water-based solution is implemented. However, on the other hand, the shift towards the 100 % water-based solution requires huge capital investment. Also, the company is planning to take a loan to prepare the required infrastructure and technology for water-based solutions which might affect the financial health of the company which has been mostly working on the reinvested profits for a long period. In other words, Top Coat Ltd has very little debt as compared to its turnover and profits. In terms of opportunities, the company has been in the industry since the early 1900s and has been able to meet customer expectations. The paint and coatings industry has also been growing continuously in the commercial sectors such as the railway, automotive, rail, and defence. Top Coat has already been working for customers in these sectors and the next opportunity lies in the real estate sector, especially in the commercial spaces. Since the company has already started to work in that field it can create space in that segment also. Furthermore, it can create business opportunities outside the UK also which can become another major source of revenue and growth. Lastly, the continuous upgradation in the legislation related to paints and their ingredients might be a major threat to the company. Also, the move towards complete water-based solutions might attract other big players in this field. In addition, the slowdown in the UK economy in terms of the construction sector and the automotive sector might lead to a decline in revenue. Also, the concentration of the automotive industry (especially the electric vehicle) might lead to a decline in production in the UK which is expected to affect the paint and coat business which also affects both the top line and bottom line of Top Coat Ltd. Another important concern might be the increase in the interest rate in the UK, which might increase the interest expense for the company. Since the company is planning to take the loan for the new water-based solutions, the increase in the interest rate might be a concern for the management and the finance team.

b) The management team consists of members most of whom are also shareholders of the company. The managing director of the company (who also holds 40 %) of the equity in the company has a very long experience in the business and also experience working with one of its competitors. This provides an extra edge to the management team who knows how exactly the competitors operate. Also, the managing director is in direct contact with the customers, which allows the management to know the customer expectations and operate accordingly. Operation is one of the core parts of every business and in the case of Top Coat, the operation manager has both the qualification and experience to make the operation process efficient and smooth.

Also, the marketing director has a marketing degree from a reputed university and has already started working on a new sector that was earlier not explored by the company. This clearly shows the management team of the company is strong and efficient. Furthermore, the company's research and development director has experience in water-soluble which the company is trying to shift due to legislative requirements. In addition, the management team also consists of the full-time legislative who ensures that the company complies with all the legislation. Some organizations do not have full-time legislators to work for the company which can lead to big problems sometimes. However, Top Coat has all the required manpower working full time and also most of the top executives have shareholdings in the company which works as an incentive to put some extra effort into the company.

However, the top management executive and the chairman are not young which might lack the new thinking and the approach required for the company. Since the world is changing at a very fast rate, it is important to keep updating the system and technologies accordingly which might require a young and fresh mind in the business. For Top Coat Ltd majority of the shares remains within the family, therefore the next successor is expected to be from the family only. To make the succession successful, it is important to train and prepare the future generation leaders from the early stage and the company has already started to do the same by giving the responsibilities to the younger generations. The senior leaders should guide the younger generations on business operations, and at the same time allow the new generation to implement their ideas.

c) The first risk for Top Coat Ltd is high competition in the market. Since the UK market has some large players in the paint and coat field who can invest a huge amount of money to acquire the market share, the companies like Top coat would find it difficult to survive. Also, the trend in the last few years showed that there has been a significant decline in small independent businesses. Therefore, there is always the risk for big companies to go aggressively into the industry and capture the market share.

Another risk for the company is related to legislative requirements which keep changing and the company has to address them. The recent legislative requirement for the paint company to move towards water-based products has already put a huge financial and operations burden on the company. In the future, if there are more changes in the legislation (which might due to various reasons) the company has to again invest in new infrastructure.

Furthermore, another risk for the company is the financial burden of investment required to move to 100 % water-based products. The company is planning to invest around £ 1000K for the new infrastructure for water-based products and the fund will be raised through debt. In this case, debt financing means the company has to pay the interest on the debt which could put a burden on the company's financials. On the other hand, the recession in the construction sector and the concentration of the automotive industry in China might lead to a decline in the demand for coats and paint in this industry. Increasing costs and reducing demand for the product might create a financial problem for Top Coat Ltd. Also, a pandemic like Covid-19 might be affecting the overall business of Top Coat Ltd in the future.

Task 2

a) The balance sheet CFADS or cash flow for Top Coat Ltd shows that the EBITDA has increased from £745K in 2018 to £838K in 2019 which is an increase of 12.33%. Similarly, the turnover for the company has increased from £15540K in 2017 to £16800 K in 2019. A close look at the turnover has shown that the increase in turnover in 2019 from 2018 was higher as compared to the increase in 2018 from the previous year. In terms of the cost of goods sold the cost declined in 2019 by around 1 % as compared to the previous year. However, on the other hand, the operating expenses have increased from £4817 in 2018 to £5208 in 2019, which is an increase of 8.11 %. Even though the increase in the operating cost is lower than the increase in the turnover between 2017 to 2019, however, the data suggests that the operating cost has increased by more than 16 % from 2018 to 2019 which needs to be controlled. Also, the PBIT margin of 3 % is considered to be low for this type of business. Since the company is one of the leading companies in the top coat segment, the margins were expected to be higher than 3 %.

   Furthermore, the total fixed assets for the company have also increased over the period. The fixed assets value in 2017 was £1620 which has increased to £1830 in 2019. Among the fixed assets, the land and buildings remained the same, and the increase in plant and machinery has led to an increase in the fixed assets. It shows that the company is investing more in capital assets which helps the company to produce more and with more production comes economies of scale. The growth in fixed assets has been funded by retained profits and not debt. This is good financial management. In terms of the current assets, the current assets have also increased from £5778K to £7460K. The biggest contributor to the current assets was debtors which have increased from £3068 K to £4560K. This would suggest that Invoice Finance is appropriate. If Invoice Finance was used this could release say £4,560 * 75% = £3,420 of cash immediately. This could be used to fund the acquisition of fixed assets. The company has also increased its stocks over the period. However, the decrease in the cash from £350K to only £105K might be a major concern for the company. It has been seen that companies even with higher profits face financial difficulties if the cash flow is not strong. Also, the forecast has shown that the working capital movement is expected to be negative in the coming years due to various factors such as the pandemic and slowdown in the UK economy. However, the EBITDA is expected to increase with a reduction in cost due to a shift towards water-based solutions and also economies of scale.

In terms of loans, there has been a sharp increase in the term loan and the overdraft from £90K in 2017 to 235K in 2019, and an increase in the loan means an increase in the interest payment which also negatively affects the cash flow of the business. However, for Top Coat Ltd, the among of debt is relatively low compared to its retained profits. In addition, there is an increase in the current liabilities (which have to be paid within a year). The current liabilities have increased from £3665K to £4667 in 2019. Since the credit has to be paid within a year, the company should maintain enough liquid assets to be able to repay the credit which again negatively affects the cash flow of the company.

The forecast has also indicated that the working capital movement will reduce from positive £847K in 2020 to negative working capital of £(176)K in 2022. Furthermore, the company is planning to take a loan of £1000K to establish the plant for the water-based solution, which will put more burden on the interest payment in coming years. Based on the analysis, it can be said, that the company has strong numbers in terms of turnover and profits, and the same is expected to increase in coming years, however, Top Coat Ltd should be concerned about the cash flow movement which might face some difficulties due to increasing number of debtors, increasing stock, increasing operating cost and also increase in the interest income. Furthermore, the macroeconomic conditions for the paint and coat industry are expected to be volatile due to various external factors such as the pandemic effect, recession in the UK, shift of the automotive industries in other countries, etc.

b) The given information about Top Coat Ltd shows that the company already has a term loan which was £510K in 2017 which increased to £590K in 2019. In addition to the term loan, the company also has an overdraft loan which has increased significantly from £90K in 2017 to £235K in 2019. Having the term and the overdraft loan, the company must pay the interest as well as the principal amount in instalments. The company is expected to pay a total of £271K in terms of interest and capital every year assuming that the interest rate will not change further. The debt/EBITDA (590/838 = 0.7) for the year 2019 indicated that the company can pay the debt in less than one year as the EBITDA (£838K) is higher than the term loan of the company which is only £590K.

However, the company is planning to take an additional loan of £1000K to fund the new plant and the company is planning to spend £250K in extending and modifying the already existing facility. Furthermore, another £500K in acquiring and installing the new water-based production facility. The remaining £250K on extending the research and development facility. With the additional loan and the given forecast, if the company takes the loan of £1000K and with forecasted EBITDA, it will take more than 1.66 years to repay the loan if all the EBITDA is used to repay the loan. Based on the debt/EBITDA, the repayment capacity of the company is strong enough. Also, the company can opt for invoice financing, in which the bank can provide the loan to pay the debtors and the company can use the profits to acquire the fixed assets, as it is planning to move towards water-based solutions in near future.

Another important way to analyze the repayment capacity of Top Coat Lt is through sensitivity analysis, which helps the management and the lender to analyze the consequences of various risks on the performance of the business and its cash generation capacity. In the case of Top Coat Ltd, the turnover is continuously improving and the forecast also shows strong growth in coming years. On the other hand, the cost of goods is not increasing compared to the turnover which might increase the gross profit for the company. In addition, the CFADS (which shows the available cash flow for debt service) for Top Coat is also expected to improve significantly in the coming years. Even though the CFADS of the top coat was negative in 2019 it is expected to increase to £503K in 2022. With positive cash flow available for the company, Top Coat Ltd is expected to pay back its loan of £1000K along with the existing term loan. However, the entire debt repayment is based on the assumption that the turnover will grow at 5 % and if the company is not able to achieve such growth the cash flow might be affected. Even in that case, the company will have positive CFADS, however, the loan repayment tenure would increase.

Another important factor to consider in the repayment capacity is the capital investment by the company of £1000K. Even though the company might face some challenges in the cash flow in the initial years, it might create huge cash flow for the company once it achieves economies of scale with the new plant. On one hand, the cost of production is expected to be low with the water-based solutions which will automatically increase the margins, on the other hand, with economies of scale, the cost of production will further go down.

However, various factors might lead to a decline in the profits of the company. For example, the car manufacturing companies are one of the major customers of Top Coat Ltd and as per the recent trend, the auto sector is moving towards the electric segments and most of the manufacturing is concentrated in China, which might affect the paint industry in the UK also. Furthermore, the UK economy is expected to go through a recession in the coming years which might reduce the demand for the paint and coat industry also, since the demand for different sectors is interrelated. In addition, the unforeseen, pandemic-like situation might lead to a decline in demand which will also reduce the CFADS and the company might find it difficult to repay the loan. Similarly, the entry of new players in the water-based solution might increase the competition in the market which will force the prices to decrease. The decrease in price with the cost of the goods remaining constant, the profit will start declining. Therefore, some risk factors are associated with lending, however, the positive factors outnumbered the risk factors given the forecasts for Top Coat Ltd.

Task 3.

a) In terms of the credit recommendation, based on the given information and the analysis, it is recommended to take a long-term loan from the bank for the instalment of new infrastructure for the water-based solution. Various indicators suggest that the customer should take a long-term loan for the project.

The first reason is the repayment capacity of the company. This has been discussed in the previous section also, that Top Coat Ltd can repay the loan as the EBITDA of the company has shown strong growth in the previous years and also the forecast shows that the profits are going to improve in coming years also. The break-even sales for the company in the year 2019 were£15292K. However, the company has sales more than break-even sales which means that the company is earning a good profit margin. Furthermore, the margin of safety for the company is £1507K which is very robust. The forecasted EBITDA is even stronger than the current values which show that the company can repay its debt if it takes the loan.

Another important indicator that has been taken into consideration is the financing break even, which shows the required sales to cover the cost including the fiancé cost along with the interest payment and the operating expenses. For Top coat Ltd, the sales required for the financing break even in 2022 is £17127 K whereas the forecasted sales in 2022 are£17640 which provides a safety margin of £512K. This indicates the ability of Top Coat Ltd to the repayment of the long-term loan.

Furthermore, the cash flow is another important factor considered for deciding the credit recommendations for the bank customers. Companies with good EBITDA also faces a cash shortage due to different reasons such as the high value of stock holdings, problem in the collection of payments, investments in capital expenditure, etc. However, in the case of Top Coat Ltd, the CFDSA shows robust results for the forecasted values. Even though Covid-19 affected the company in 2020, it recovered well in 2021 and the sales are again going up. Also, the CFDSA in 2022 is expected to be £503K which is much higher than the previous years, when the CFDSA was negative.

The long-term loan has been recommended for Top Coat Ltd and one of the major reasons has been the mortgage which can be provided by the company. As per the given information, the market value of the existing company premises is £3000 K which is enough to cover the loan value of £1000K even if the company fails to repay the debt due to various reasons.

In contrast, there are various risk factors associated with the long-term loan for Top Coat Ltd. Firstly, the company is moving towards a 100 % water-based solution, which might take some time to pick up. The company is also in the initial stage in terms of research and development. If the water-based solution, did not pick up as expected, the forecasted sales will reduce which will affect all other metrics. Similarly, the continuously changing regulatory requirements for the paint industry have made it difficult to forecast anything in the industry with high probability. Therefore, the company might face financial challenges if there are any further changes as the company is investing the entire loan amount on building the required infrastructure for the new water-based technology.

Therefore Top Coat Ltd should take the long-term loan for at least 15 years as the repayment requirements for a loan less than 15 years require more funds to repay the capital and the interest. Even though the company has a safety margin higher than the required repayments, it is better to take the long-term loan as the investment is for the new technology which might take some time to give the returns.

b) Top coat Ltd already has a term loan where the company is obliged to pay £271K every year (including both the capital and the interest payment). Therefore, while funding the company, the bank should provide the loan in instalments. This will not put the entire burden on the company at once and allow the timely repayment of the loan. Since the company has already provided the information on how the given loan will be spent, the bank can provide the loan accordingly. For example, the £250K will be used for extending and modifying existing factory facilities, so developing the new infrastructure takes some time and the bank can provide the loan based on the bills provided by the company. Since the company is already paying the interest and capital repayment for the existing term loan, it is important to have the covenants and conditions which can be used by the bank to monitor the performance and reduce the risks.

Different types of covenants can be used by the banks to monitor the performance and also to trigger the alarm button for the loan they have provided. In this case, the bank should use different covenants namely the Debt Service Cover (this includes EBITDA to Debt Service Liabilities and the CFADS to Debt Service Liability and Net Cash Flow to Debt Service liability). The debt service liability is the amount required to pay both the short and long-term interest and the capital payments.

Other types of covenants are interest cover and leverage. For Top Coat Ltd, the interest cover and the leverage should be used as the Debt Service Cover is mostly used for the large overdraft loan. In this case, the bank is providing the long-term loan so the bank must ensure that EBITDA to interest ratio is higher than 1 so that the company is earning enough profit to pay the interest. Also, the directors of Top Coat Ltd have not promised any covenants previously, therefore the personal guarantee of the directors can also be taken into consideration.

c) There were various options through which Top Coat Ltd could finance the required £1000K capital requirements such as selling the equity of the company to other investors, offering the IPO of the company, and allowing the general public to invest in the company and finance through re-investing. Selling the shares to another investor could have one of the options, however, to do the same the shares have to be diluted and the Top Coat Ltd has always been the family business and the promoters do not want to lose the ownership of the company, as to raise the £1000K capital, a significant percentage of the shares had to be diluted. Another option was to go public with an IPO, however, that requires a long procedure and due diligence. Also, it is not a guarantee that the share will get a fair price when listed. Also, a certain percentage of the share had to be diluted in that case. The reinvesting of the profits was one of the options, however, it would take a very long time for the company to collect the required fund only through re-investment. On the other hand, the company has a strong financial position and can repay the loan (both capital and interest) comfortably. Also, it is recommended that the company have some loan exposure so that the financial metrics of the company are on track, and with the obligation to repay the loan, the promoters, and shareholders can be controlled for doing anything wrong. Also, the interest payment can be used to take the tax rebate in most nations. On the other hand, for the bank also, providing a loan to a company with a strong financial position, is a good investment that provides safe and good returns. Therefore, providing a long terms loan to Top Coat Ltd is a win-win situation for both the concerned parties. Both parties can gain from the loan. Top Coat Ltd will get the required fund for its new facility and can establish itself as an important player in water-based products, on the other hand, the bank gets its return on investment with minimum risk.