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Case Study Series

Dividend Policy Case Study: Q&H Consumer Products, Inc

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Abstract

This case study focuses on dividend policy for a company in regards to its capital structure, future growth prospects, and relationship with the shareholders. While the firm has regularly paid dividends to its shareholders in the past decade exhibiting consistent growth, it faces a crucial decision. It must decide on whether to reduce its dividends in order have profit retention for investment in product development and long-term growth or continue to pay dividends at the same rate and at the same growth rate. Other major concerns for the company in deciding on a dividend policy include the impact on the stock price and the firm's relationship with its banks.

Keywords: Consumer products, Dividend policy, Dividend growth rate, Cash flow, Debt covenants

Introduction

Valerie Germond has been the Chief Executive Officer of Quigley and Hart (Q&H) Consumer Products, Incorporated for the past ten years. She has spent her entire professional career at Q&H, coming to the company after completing graduate school. Q&H is a consumer product company making items for grooming, healthcare, beauty, fabric care, and baby care, to name a few. More specifically, the company manufactures consumer products such as laundry detergent, tooth paste, men and women's shampoo, and razors. Located in the Midwest, the company has various manufacturing plants across the United States and around the world, making different products and serving diverse markets. While the firm has enjoyed long-term financial and competitive success, analysts, board members, and company employees at various levels, have recently mentioned to Valerie that it was time for changes. It seemed that the company was losing its edge and not the leader of the consumer products industry it once was. Deep inside, Valerie agrees with these individuals having seen Q&H's competitors, in the United States and globally, take some of the firm's market share. She would love to have more money put into research and development so that it can revise its capital structure, improve future growth prospects, and strengthen the company's relationship with its investors. But the question is where to acquire this financial capital. Interest rates are starting to go up and the stock market seems precarious since it is accelerating at a faster pace now than in its entire history. Introducing new, innovative products will definitely help its market share and, in the long term, increase profits and cash flow. One possibility that Valerie has been seriously considering is changing the firm's dividend policy and allowing more cash to go into new product development. The problem is deciding how much to reduce the firm's dividend, the effect on the stock price, and what the reaction will be of the shareholders.

Company Background

Quigley and Hart was started in 1840 as an accidental partnership rather than by design. William Quigley was born in Scotland in 1802 and learned the trade of making soap as a teenager since his parents could not afford to send him to school. He learned to make soap from animal fat and eventually opened his own business in Glasgow, Scotland with $6,124.50 borrowed from various sources. As hard as he tried, his business failed and he ended up in debt for $9,000.00. With nowhere else to turn, he and his young bride, Emily, headed to America in 1825 determined to start a new life and pay off their enormous loan. Quigley eventually landed in Cincinnati where the city's meatpacking industry provided a supply of animal fat that was cheap and plentiful. Quigley also started to experiment with different types of soaps for human use.

John Hart was born in London in 1805 and he came to the United States shortly after his parents died in 1820. As a teenager, he learned candle making as a trade and taught himself how to make soap. He came to America, not only to start a new life, but to earn a substantial living so as to escape the poverty he knew since childhood. While he worked for a year in New York City, he heard that Cincinnati offered him an opportunity to work for soap manufacturers and even explore the possibility of starting his own business. He worked long and hard to put together enough money to start his own soap manufacturing company. He eventually met the sister of Emily Quigley, Mary, who emigrated to America to work in William Quigley's soap manufacturing business. John eventually married Mary who suggested the partnership of Quigley and Hart as soap makers. While at first there was some reluctance between John and William, they formed a partnership in which they would make their own soap and sell directly to the public via their own store in 1840.

As sales grew, so did their families. John and Mary had four children who, over time, became involved in the business in different capacities. William was competitive by nature and once said to John, "Whatever you do, I can do twice as good." William and Emily ended up with eight children who also became involved in the company. The store started to sell other household products and after the Civil War, with Cincinnati and the American economy starting to grow, there was a demand for their products. Quigley and Hart not only opened more stores in Ohio, but started selling their soap across the United States. They eventually put more money into research and development to offer more products to their customers and build up market share. They manufactured their products in Ohio and started to purchase other companies that made household goods.

The Quigley and Hart children took over management of the company in the latter part of the 19th century and grew the company even further. When the company went public in the early part of the 20th century, they became known as Q&H specializing in household and consumer products, including soap. Ronald Quigley, who became the company's president in 1895, felt that in order to attract investors and more financial capital, they would run a very fiscally prudent operation. But they would also offer dividends as a reward to shareholders for being partners in the business. While the dividends were not high, they were steady and shareholder turnover was very low. Q&H attracted new investors who brought new money into the company, and the dividends kept growing over the years. Q&H acquired the reputation on Wall Street as a company that was highly regarded in the consumer product industry as being innovative with new products, always profitable with good cash flow due to their philosophy of fiscal prudence and having reliable dividend growth over the years.

Current Situation

Valerie Germond is faced with the task of resurrecting her company's reputation as an innovator in the consumer products industry. She wanted to rebuild the company as a leader rather than a follower in terms of innovation when it came to consumer products, whether it was for house cleaning or personal care. The problem is that the industry was changing and so were its customers.

For example, while consumers still purchased house-cleaning products, many of the traditional customers, namely women, were now working outside the home. Therefore, they increasingly used house cleaning services to clean their home. Many women were also marrying later and having children later. The result was that while women may still do the family shopping, many purchased fewer household cleaning products.

Also changing were the different personal care products the younger market was using. At one time just having things as spray-on deodorant, toothpaste, or shaving cream in a can was enough. But younger tastes were changing and she was not sure if her company could keep up with the changes.

To make matters worse, shareholders were expecting dividends to keep rising over time. This meant keeping a dividend growth rate of 3 percent as institutional investors, such as mutual funds and pensions, and individual investors expected. But the problem is coming up with the cash to pay dividends while also putting the necessary funds into research and development in order to come up with new products. Maintaining this delicate balance was probably the biggest challenge facing her and the company. If she could not maintain this over the long term, then the common stock price will start to drop and then stock analysts will have a field day taking the company apart. Compounding the situation, a lower stock price could make the company a target for a hostile takeover that could cost her and the management team their jobs. While she knew she had the support of the Board of Directors, she also knew that they would only go so far with her if the company was not performing on different levels as it was expected to.

Valerie had discussed these issues with the company Chief Financial Officer, Jason Isaacson. They had known each other since they started in the company's management training program straight out of graduate school. They had confidence in one another and well understood the challenges they and Q&H currently faced.

Valerie still had questions and uncertainties that had to be addressed which she put in a memo to Jason and requested a reply in one week.

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Q&H Consumer Products
Home Products since 1840

TO: Jason Isaacson – CFO
FROM: Valerie Germond – CEO
DATE: June 8, 2018

RE: Concerns about dividend growth
Based on our previous conversations regarding dividends and their growth rate, as well as product development for the company, I have some questions. The questions are financial in nature, they are listed below, and I would like to have a detailed reply from you in one week and then a follow-up meeting to discuss them.

1. Given the company's financial forecast (see Financial Statement Exhibit 1.1) and our desire to continue the 3 percent dividend growth rate that the shareholders enjoy, how will the company be able to maintain its capital reinvestment?
2. Also, how will the company be able maintain the 3 percent dividend growth rate and still stay in line with the debt covenants on our outstanding loans?
3. Perhaps, most importantly, how will we be able to maintain a 3 percent dividend growth rate when the possibility of inflation going higher is very real. The problem here is maintaining good investor relations, for the short and long term.
4. What are your suggestions for improvement in key areas of our business and still keep the 3 percent dividend growth rate policy? Is maintaining the current dividend policy realistic or something we will have to reconsider?
5. How will our relationships be with our bankers in terms of our loans and maintaining financial ratios in line with the debt covenants (see Debt Covenants Exhibit 1.2)
6. What are the risks we face regarding keeping our current dividend policy?
7. Finally, is it possible to increase the company's cash flow opportunities? Once this occurs we then have to decide to either maintain the 3 percent dividend growth rate, increase it, or put substantially more funds into research and development?

I look forward to reading your replies and subsequently discussing them with you.

Q&H CONSUMER PRODUCTS, INCORPORATED					
Pro-forma financial statement assumptions:	**2018**	**2019**	**2020**	**2021**	**2022**
Income Statement Assumptions					
Revenue growth percentage	5%	6%	7%	8%	8%
Gross profit percentage	49%	50%	51%	51%	52%
Selling, General and Administrative Expense growth percentage	3%	3%	3%	3%	3%
Research & Development growth percentage	100%	30%	20%	10%	5%
Interest rate	7%	7%	7%	7%	7%
Tax rate	34%	34%	34%	34%	34%
Balance Sheet Assumptions					
Net Receivables as a percent of sales	16%	16%	16%	16%	16%
Inventory as a percent of sales	10%	10%	10%	10%	10%
Other current assets as a percent of sales	0.0%	0.0%	0.0%	0.0%	0.0%
Net Property, Plant and Equipment (additional investment)	$ 2,000	$ 2,000	$ 1,500	$ 1,500	$ 1,500
Long Term Investments (additional investment)	$ -	$ -	$ -	$ -	$ -
Good Will (additional investment)	$ -	$ -	$ -	$ -	$ -
Intangible Assets (additional investment)	$ -	$ -	$ -	$ -	$ -
Accounts Payable as a percent of sales	4.5%	4.5%	4.5%	4.5%	4.5%

Income Statement (all numbers in millions)										
	Actual Financial Statements					Pro-Forma Financial Statements				
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Revenues	$35,000	$36,050	$36,125	$35,421	$35,012	$36,763	$38,968	$41,696	$45,032	$48,634
Cost of goods sold	$17,453	$18,532	$18,423	$18,960	$19,254	$18,749	$19,484	$20,431	$22,066	$23,345
Gross Profit	**$17,547**	**$17,518**	**$17,702**	**$16,461**	**$15,758**	**$18,014**	**$19,484**	**$21,265**	**$22,966**	**$25,290**
as a percent of Sales	*50%*	*49%*	*49%*	*46%*	*45%*	*49%*	*50%*	*51%*	*51%*	*52%*
Operating Expenses										
Selling, General & Admin Expense	$9,521	$9,745	$9,236	$9,321	$9,012	$9,282	$9,561	$9,848	$10,143	$10,447
Research & Development	$3,125	$3,012	$2,895	$2,941	$3,102	$6,204	$8,065	$9,678	$10,646	$11,178
Total operating expenses	$12,646	$12,757	$12,131	$12,262	$12,114	$15,486	$17,626	$19,526	$20,789	$21,626
Operating Income (EBIT)	**$4,901**	**$4,761**	**$5,571**	**$4,199**	**$3,644**	**$2,527**	**$1,858**	**$1,739**	**$2,177**	**$3,664**
as a percent of Sales	*14%*	*13%*	*15%*	*12%*	*10%*	*7%*	*5%*	*4%*	*5%*	*8%*
Interest Expenses	$110	$111	$107	$112	$111	$110	$110	$110	$110	$110
Profit Before Taxes (EBT)	**$4,791**	**$4,650**	**$5,464**	**$4,087**	**$3,533**	**$2,417**	**$1,748**	**$1,629**	**$2,067**	**$3,554**
as a percent of Sales	*14%*	*13%*	*16%*	*12%*	*10%*	*7%*	*5%*	*5%*	*6%*	*10%*
Taxes	$1,629	$791	$929	$695	$601	$411	$297	$277	$351	$604
Net Income	**$3,162**	**$3,860**	**$4,535**	**$3,392**	**$2,932**	**$2,006**	**$1,451**	**$1,352**	**$1,715**	**$2,950**
as a percent of Sales	*9%*	*11%*	*13%*	*10%*	*8%*	*6%*	*4%*	*4%*	*5%*	*8%*
Dividends Paid	**$1,581**	**$1,628**	**$1,677**	**$1,728**	**$1,779**	**$1,833**	**$1,888**	**$1,944**	**$2,003**	**$2,063**
Payout Ratio	*50%*	*42%*	*37%*	*51%*	*61%*	*91%*	*130%*	*144%*	*117%*	*70%*
Dividend Growth		*3%*	*3%*	*3%*	*3%*	*3%*	*3%*	*3%*	*3%*	*3%*

Balance Sheet (all numbers in thousands)											
	Actual Financial Statements						Pro-Forma Financial Statements				
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Assets											
Cash and Cash Equivalents	$771	$1,724	$3,709	$7,177	$8,399	$8,595	$6,964	$5,264	$3,797	$2,505	$2,329
Short-term Investments	$85	$45	$78	$94	$32	$57	$57	$57	$57	$57	$57
Net Receivables	$4,375	$4,875	$5,102	$5,006	$4,987	$5,135	$5,882	$6,235	$6,671	$7,205	$7,782
Inventory	$3,025	$2,908	$2,987	$2,845	$2,999	$3,154	$3,676	$3,897	$4,170	$4,503	$4,863
Other Current Assets	$25	$25	$25	$25	$25	$25	$25	$25	$25	$25	$25
Total Current Assets	**$8,281**	**$9,577**	**$11,901**	**$15,147**	**$16,442**	**$16,966**	**$16,604**	**$15,478**	**$14,720**	**$14,295**	**$15,056**
Net Property, Plant & Equipment	$12,012	$12,452	$12,354	$11,998	$12,305	$12,874	$13,662	$14,450	$14,738	$15,026	$15,314
Long Term Investments	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Goodwill	$1,500	$1,500	$1,500	$1,500	$1,500	$1,500	$1,500	$1,500	$1,500	$1,500	$1,500
Intangible Assets	$105	$105	$105	$105	$105	$105	$105	$105	$105	$105	$105
Total Long Term Assets	**$13,617**	**$14,057**	**$13,959**	**$13,603**	**$13,910**	**$14,479**	**$15,267**	**$16,055**	**$16,343**	**$16,631**	**$16,919**
Total Assets	**$21,898**	**$23,634**	**$25,860**	**$28,750**	**$30,352**	**$31,445**	**$31,871**	**$31,533**	**$31,063**	**$30,926**	**$31,975**
Liabilities											
Accounts Payable	$1,455	$1,498	$1,503	$1,574	$1,497	$1,402	$1,654	$1,754	$1,876	$2,026	$2,189
Short-Term Debt	$258	$269	$267	$248	$287	$302	$302	$302	$302	$302	$302
Other current Liabilities	$212	$212	$212	$212	$212	$212	$212	$212	$212	$212	$212
Total Current Liabilities	**$1,925**	**$1,979**	**$1,982**	**$2,034**	**$1,996**	**$1,916**	**$2,168**	**$2,268**	**$2,390**	**$2,540**	**$2,703**
Long term Debt	$1,205	$1,306	$1,298	$1,278	$1,254	$1,274	$1,274	$1,274	$1,274	$1,274	$1,274
Other Long term Liabilities	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Total Long term Liabilities	**$1,205**	**$1,306**	**$1,298**	**$1,278**	**$1,254**	**$1,274**	**$1,274**	**$1,274**	**$1,274**	**$1,274**	**$1,274**
Total Liabilities	**$3,130**	**$3,285**	**$3,280**	**$3,312**	**$3,250**	**$3,190**	**$3,442**	**$3,542**	**$3,664**	**$3,814**	**$3,977**
Stockholders' Equity											
Common Stock at Par Value	$25	$25	$25	$25	$25	$25	$25	$25	$25	$25	$25
Paid-in Capital	$200	$200	$200	$200	$200	$200	$200	$200	$200	$200	$200
Retained Earnings	$18,543	$20,124	$22,355	$25,213	$26,877	$28,030	$28,204	$27,766	$27,174	$26,887	$27,773
Treasury Stock	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Total Stockholders' Equity	**$18,768**	**$20,349**	**$22,580**	**$25,438**	**$27,102**	**$28,255**	**$28,429**	**$27,991**	**$27,399**	**$27,112**	**$27,998**
Total Liabilities and Stockholders' I	**$21,898**	**$23,634**	**$25,860**	**$28,750**	**$30,352**	**$31,445**	**$31,871**	**$31,533**	**$31,063**	**$30,926**	**$31,975**

Statement of Cashflow (all numbers in thousands)										
	Actual Financial Statements					Pro-Forma Financial Statements				
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Operating Activities										
Net Income	$3,162	$3,860	$4,535	$3,392	$2,932	$2,006	$1,451	$1,352	$1,715	$2,950
Depreciation	$1,154	$1,203	$1,235	$1,241	$1,212	$1,212	$1,212	$1,212	$1,212	$1,212
Changes in Accounts Receivables	($500)	($227)	$96	$19	($148)	($747)	($353)	($436)	($534)	($576)
Changes in Inventories	$117	($79)	$142	($154)	($155)	($522)	($221)	($273)	($334)	($360)
Changes in Accounts Payables	$43	$5	$71	($77)	($95)	$252	$99	$123	$150	$162
Total Cash Flow from Operating Activities	**$3,976**	**$4,762**	**$6,079**	**$4,421**	**$3,746**	**$2,201**	**$2,188**	**$1,977**	**$2,210**	**$3,387**
Investing Activities										
Capital Expenditures	($1,594)	($1,105)	($879)	($1,548)	($1,781)	($2,000)	($2,000)	($1,500)	($1,500)	($1,500)
Investments	$40	($33)	($16)	$62	($25)	$0	$0	$0	$0	$0
Total Cash Flows from Investing Activities	**($1,554)**	**($1,138)**	**($895)**	**($1,486)**	**($1,806)**	**($2,000)**	**($2,000)**	**($1,500)**	**($1,500)**	**($1,500)**
Financing Activities										
Dividends Paid	($1,581)	($1,628)	($1,677)	($1,728)	($1,779)	($1,833)	($1,888)	($1,944)	($2,003)	($2,063)
Purchase of Treasury Stock	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Borrowings	$112	($10)	($39)	$15	$35	$0	$0	$0	$0	$0
Total Cash Flows from Financing Activities	**($1,469)**	**($1,638)**	**($1,716)**	**($1,713)**	**($1,744)**	**($1,833)**	**($1,888)**	**($1,944)**	**($2,003)**	**($2,063)**
Change in Cash and Cash Equivalents	**$953**	**$1,985**	**$3,468**	**$1,223**	**$196**	**($1,632)**	**($1,699)**	**($1,467)**	**($1,293)**	**($176)**

Financial Statement Analysis (Ratio Analysis)										
	Actual Financial Statements					Pro-Forma Financial Statements				
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Working Capital Ratio	11.9	13.0	14.1	15.2	16.4	14.7	13.9	13.0	12.2	11.8
Cash Conversion Cycle										
Days Sales Outstanding	48.2	50.5	51.1	51.5	52.8	54.7	56.7	56.5	56.2	56.2
Days Inventory Outstanding	62.0	58.1	57.8	56.3	58.3	66.5	70.9	72.1	71.7	73.2
Days Payables Outstanding	(30.9)	(29.6)	(30.5)	(29.6)	(27.5)	(29.7)	(31.9)	(32.4)	(32.3)	(33.0)
Total Conversion Cycle in Days	79.4	79.0	78.4	78.2	83.6	91.4	95.8	96.1	95.7	96.5
Times Interest Earned	43.6	41.9	51.1	36.5	31.8	21.9	15.8	14.8	18.7	32.2
Payout Ratio	50%	42%	37%	51%	61%	91%	130%	144%	117%	70%
Dividend Growth		3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Total Cash Flow to Sales	2.7%	5.5%	9.6%	3.5%	0.6%	-4.4%	-4.4%	-3.5%	-2.9%	-0.4%
EBITDA as a Percent of Sales	17.3%	16.5%	18.8%	15.4%	13.9%	10.2%	7.9%	7.1%	7.5%	10.0%
Operating Cash Flow to Sales	11.4%	13.2%	16.8%	12.5%	10.7%	6.0%	5.6%	4.7%	4.9%	7.0%

Debt Coveneant Levels	
Working Capital Ratio	6:1
Times Interest Earned	10:1
EBITDA as a Percet of Sales	10%
Operating Cash Flow to Sales	9%

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