Background

You are the sales executive for a client that purchases about $12,000,000 worth of chemicals from you annually. The average EBIT margin on the products that you sell to this client is about 20%. Presently, the client pays under terms of net 30 days after invoicing. For the most part the client is on time when it comes to paying its invoices. The client's purchasing manager has contacted you and asked you for more favorable payment terms of net 60 days. During the conversation the purchasing manager indicated that these are the terms that she is now receiving from other suppliers including your competitor.

Your relationship with this client is good. The operations contacts are pleased with the quality of your products and the results that they get with them. The operations contacts and the plant's purchasing manager are also pleased with your engineering support and customer service response to problems that they have encountered. You know that your competitor does not deliver the engineering support that your company delivers.

Although the purchasing manager did not indicate it in her conversation with you, you believe that you may be able to get something in exchange for granting an extra 30 day payments terms for a total of 60 days. You have had your eye on an application in which this client presently is using a competitor's product. This business amounts to an additional $3,000,000 annually. Your attraction to getting this business is that you know you can price this particular product at a 30% EBIT margin.

Action YOU Must Take

Before you have any detailed conversations related to this matter with the client, you have to be prepared to negotiate. As such, you need to perform a financial analysis on your proposal to make sure it would benefit your company. In addition, you need to perform a series of "what if" scenarios (a sensitivity analysis) to determine how much you can alter your offer during negotiations before it is no longer financially beneficial to your company.

The following numbered questions/activities will lead you through the financial analysis of this situation. Working alone or in small groups, complete these questions/activities in numerical order.

Financial Analysis

1. If the client is spending $12,000,000 annually with your company under 30 day payment terms, what would be the end of year Accounts Receivable balance for this client? (Assume that the annual sales are spread evenly throughout the year.)

2. If the client continues to spend $12,000,000 annually with your company, and you change the payment terms to 60 days, what would be the new end of year Accounts Receivable balance for this client? (Assume that the annual sales are spread evenly throughout the year.)

3. If you increase the payment terms from 30 days to 60 days for this client, by how much does your Accounts Receivables balance change as a result of these new payment terms?

4. What impact does this change in Accounts Receivable have on your company's cash flow compared to net income?

5. If you are successful in obtaining the $3,000,000 in new business from this client at the same time that you grant the client 60 day payment terms, what would be the end of year Accounts Receivable balance and the corresponding impact on your company's cash flow compared to net income? (Assume that the annual sales are spread evenly throughout the year.)

6. Suppose we go ahead with the new 60-day terms and obtain the increase in annual sales. We then go through one year of $15,000,000 sales. If sales remain at $15,000,000 and terms remain at 60 days for the following year, what will be the end of year Accounts Receivable balance and the corresponding impact on your company's cash flow compared to net income for the second year? (Assume the client continues to pay at 60 days.)

7. Suppose we go ahead with the new 60-day terms and obtain the $3,000,000 increase in annual sales. Our new annual sales to this client are $15,000,000. If we assume that the sales to this client will stay the same over the next three years and that the client will continue to pay at the 60-day limit, it appears as though your company has made a cash investment in this client. Based on your answer to questions # 5 and # 6 above, what is the amount of the cash investment that your company has made and how often does it occur? (Remember that whatever product you deliver gets counted in calculating your company's net income, even though the client may not have paid for it. So the entire sale is incorporated into the calculation of your net income.)

8. What incremental annual after-tax cash flow does the company receive for the investment that it made? Assume there is no increase in your interest payments as a result of the additional cash investment that you made. Also assume that your corporate tax rate is 35%.

New Revenue	$
Costs	($)
EBIT	$
Interest	$
EBT	$
Taxes	($)
Net Income	$
Depreciation	$
Cash Flow	$

9. Using the answers that you calculated for questions # 7 and # 8 above, determine what after-tax annual percentage return the company will obtain on the investment it makes when you negotiate to obtain additional annual revenue of $3,000,000 at an EBIT margin of 30% in exchange for 60-day payment terms. What is the simple payback on the investment? Does this appear to be a good investment for your company?

10. Open the EXCEL file titled "Negotiating Client Payment Terms 8-01-SPREADSHEET.xls". Note that Time 0 represents the beginning of the first year and Time 1 represents the end of the first year. Time 2 represents the end of the second year, Time 3 represents the end of the third year, etc. Inputs are to be entered in the yellow highlighted areas. All highlighted areas must be properly completed before you get the correct answers for NPV and IRR. A tax rate of 35% was assumed. **Note that this spreadsheet assumes that the customer's volume stays constant and your costs stay constant. Therefore, any increase in revenue is due to a higher price and thus a higher EBIT margin. The spreadsheet also assumes that at the end of the contract, the "New Revenue" goes away.** Answer the following questions using the EXCEL spreadsheet.

    a) Enter $3,000,000 as the "New Revenue" in cell C4. Enter 3 as the "Length of the Contract" in cell B6 and enter 0.25, or 25%, as your company's "After-Tax Cost of Capital" in cell B7. If the client agrees to buy $3,000,000 of your product at a 30% EBIT margin for three years, what are the NPV and IRR of the investment that the company makes if the after-tax cost of capital is 25%? Is this a good investment? If the investment is not a good investment, how many years do you have to lock the client in for in order to obtain a good NPV and IRR?

b) Note that there is a positive $500,000 cash flow coming back into the company at the end of the last year of the contract (cells F3 and F18). Where is this cash coming from?

c) Change the "Length of Contract" back to 3 years. What is the lowest amount of "New Revenue" you could negotiate under a 3-year contract in order for this deal to still remain a good investment for your company? Since the customer cannot increase its volume, what is the new EBIT margin at which you must price this deal?

d) Your controller is a little conservative and wants to assume that the client will not pay the last two months of "New Revenue." What is the lowest amount of "New Revenue" that you could negotiate under a three-year contract in order for this deal to still remain a good investment for your company? What EBIT margin does this represent?

(Hint: Your NPV should be greater than zero after you subtract the present value of the cash flow from the last two months of "New Revenue" that will not be paid by the customer at the end of the contract. Note that as you increase the "New Revenue," the Present Value of the Cash Flow from the Last Two Months of "New Revenue" [cell B24] changes also. You can iterate to solve this, or you may use the "Goal Seeker" function wizard under the "Tools" menu to find the value of cell C4 that makes cell B28 just equal to $1. Cell B28 is the NPV – The Present Value of Cash Flow from the Last Two Months of "New Revenue.")

e) If we negotiate a 4-year contract for "New Revenue" of $3,000,000 (EBIT margin = 30%) and we do not receive the last two months of "New Revenue," will this contract be a good investment for the company? Why or Why not?

f) If we negotiate a 5-year contract for "New Revenue" of $3,000,000 (EBIT margin = 30%) and we do not receive the last two months of "New Revenue," will this contract be a good investment for the company? Why or Why not?

11. Given that this customer would not likely agree to a price for the new product that would permit your EBIT margin to be above 30% and given your answers to questions #10 a) through 10 f), what will be your negotiating strategy when you sit down with this customer?

Financial Applications Case Study

	A	B	C	D	E	F	G	H	I
1	**Negotiating Client Payment Terms**								
2	**Time**	**0**	**1**	**2**	**3**	**4**	**5**		
3	**Investment**	**($1,000,000)**	**$0**	**$0**	**$0**	**$0**	**$0**		
4	**New Revenue**			**$0**	**$0**	**$0**	**$0**		
5	**EBIT Margin**		**#DIV/0!**	**0%**	**0%**	**0%**	**0%**	**Inputs**	
6	**Length of Contract**								
7	**After-Tax Cost of Capital**								
8									
9	**Revenue**		$0	$0	$0	$0	$0		
10	**(Costs)**		$0	$0	$0	$0	$0		
11	**EBIT**		$0	$0	$0	$0	$0	**Incremental Income Statement**	
12	**(Interest)**		$0	$0	$0	$0	$0		
13	**EBT**		$0	$0	$0	$0	$0		
14	**(Taxes)**		$0	$0	$0	$0	$0		
15	**Net Income**		$0	$0	$0	$0	$0		
16	**Depreciation**		$0	$0	$0	$0	$0		
17	**After-Tax Cash Inflow**	$0	$0	$0	$0	$0	$0	**Incremental Cash Flow**	
18	**(Cash Outflow)**	($1,000,000)	$0	$0	$0	$0	$0		
19	**Net Cash Flow**	($1,000,000)	$0	$0	$0	$0	$0		
20	**NPV**	**($1,000,000)**							
21	**IRR**	**#NUM!**							
22									
23	**Present Value of Cash Flow**								
24	**From the Last Two Months**	**$0**							
25	**of "New Revenue"**								
26									
27	**NPV - PV of Cash Flow**								
28	**From the Last Two Months**	**($1,000,000)**							
29	**of "New Revenue"**								
30									
31									

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