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Aldubaikhi, Ammar and Alsayyed, Nidal

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Financial Analysis for Frontier Communications Corp. (FTR)

Ammar Aldubaikhi

Doctorate Researcher at Lamar University

Ammar.aldubaikhi@hotmail.com

NIDAL A ALSAYYED

PhD in Islamic Economics, Banking, and Finance

http://groups.google.com/group/nidal_islamic-finance

Abstract

Frontier Communications (FTR) was founded in 1935 as Citizens Utilities and became a pure-play telecom network operator in 2004. It has rural profile, less competition, and less regulatory reform exposure. Its business & Broadband are 64% of customer revenues. The firm is facing high financial risk as it is highly geared plus it is also less liquid as it cannot meet it short-term obligations if they fall due.

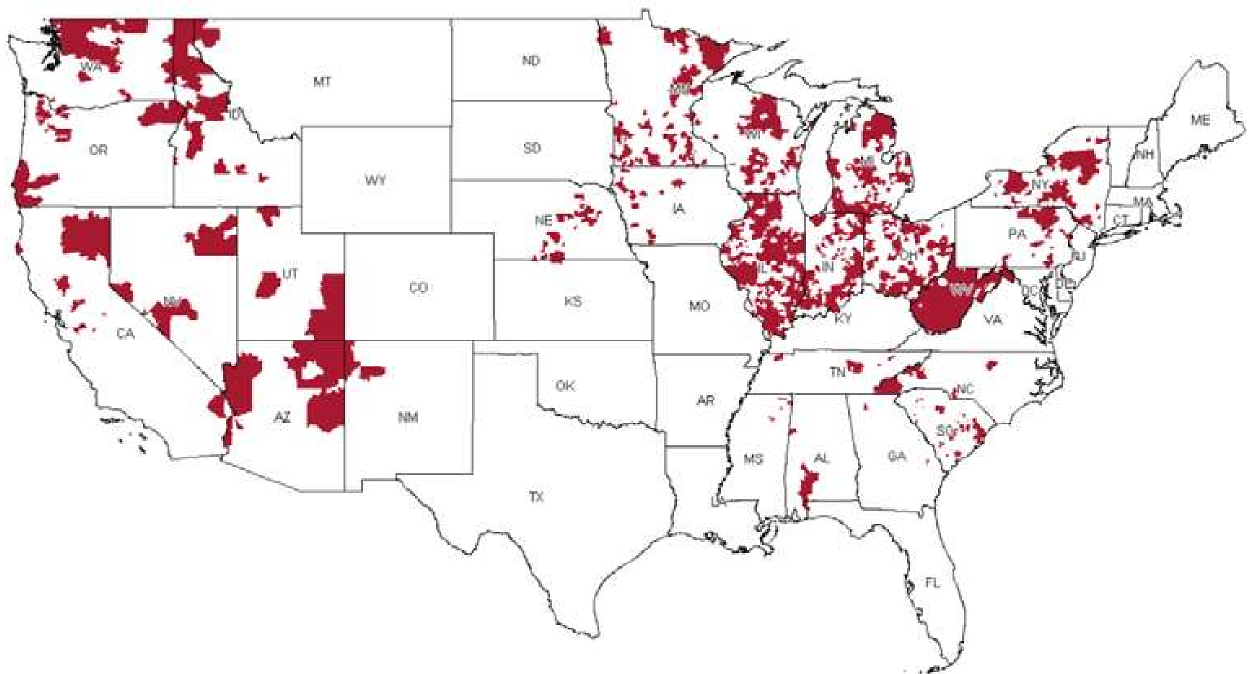
Description of company

Overview

Frontier Communications (FTR) was founded in 1935 as Citizens Utilities and became a pure-play telecom network operator in 2004. Frontier Communications Corporation is the largest pure rural telecommunications carrier in the United States.

Major Markets

Frontier commination is expand broadband availability in new markets towards Legacy Frontier’s 91%. It has rural profile, less competition, and less regulatory reform exposure. Its business & Broadband are 64% of customer revenues. Frontier operates in 27 states with approximately 14,800 employees.



Products

Frontier’s has several types of products. Frontier’s services include voice, High-Speed Internet, satellite video, wireless Internet data access, data security solutions, bundled offerings, specialized bundles for small businesses and home

offices, and advanced business communications Access Solutions for medium and large businesses.

Ratio Analysis

Profitability ratios

The profitability as measured by return on assets, gross profit margin, and net margin shows a decline in the firm profitability position from 2006 to 2010. This implies that the firm efficiency in controlling its cost has declined throughout the five years thus the company's cost of production, operating, cost of sales and financing cost have progressively increased during the five years. This means if the trend continues the company will be unable to pay it short-term obligations and shareholders will not be able to receive reasonable returns on their investments in form of dividends.

On the other hand, the company has been under-performing in terms of profitability compared to other firms in the industry although its 5 years gross margin average is 90.6% compared to the industry average of 54.1% (FrontierCommunications, 2011). This means it efficiently controlled its cost of sales but the other ratios were below the industry averages meaning that it was inefficient in controlling finance and operating costs.

Asset Utilisation ratio

The asset utilization ratio as measured by asset turnover indicates a decline in the firm utilization of fixed asset in generating revenue, as it decreased from 30% to 0.21 in 2010 compared to 2006; this means that the firm has been inefficient in utilization of its fixed assets to earn revenue. The firm is under-performing in terms of

utilization of its fixed assets compared with the industry average of 0.5, implying that the firm was inefficient compared to most firms in the industry.

Leverage ratios

The firm leverage ratio is gauged by debt to equity ratio, debt ratio or financial leverage; these ratios are very high for the five years although in 2010 the debt to equity and debt ratios had decreased by 64% and 79% respectively over the past five years. This means that the financial risk is reducing but the company is still very highly geared when compared to the industry average of 4.3 and 3.5 for the firm in terms of financial leverage it means that the firm is less financially risky compared to other firms in the industry.

Liquidity ratios

The liquidity ratio as measured by quick ratio and current ratio shows a decline in the firm liquidity position from 2006 to 2010 as it has reduced by 80% and 74% to 0.57 and 0.78 for quick and current ratio respectively. The quick ratio decline as compared to current ratio indicates that the firm holds a significant amount of its current assets in stocks. The situation implies that the firm will not be able to meet its short-term maturity obligations on time as the current liabilities are not subsequently and sufficiently covered by the current assets. The firm is under-performing in terms of liquidity as compared with the industry average of 0.66 and 0.79 of quick ratio and current ratio respectively, implying that the firm holds a greater amount of current liability as compared to other firms in the industry.

Working Capital Analysis

Most people consider that increase in sales can be a solution to any type of business problem, most often that is the case, but sales should be made on sound policies based on current assets and adequate working capital. There are usually two form of working capital: net working capital and gross working capital (Accountingissue.info, 2011).

Net working capital is determined by subtracting current liabilities from current assets while gross working capital is normally current assets; thus, insufficient working capital can be corrected by reducing sales or raising the current assets by either selling the inventories or retained earnings (Accountingissue.info, 2011). The following ratios can be used to assess the Frontier Communication Corp. net working capital.

Current ratio

In the fiscal year ended 2010, 2009, 2008, 2007 and 2006 the firm current ratios were at 0.78, 1.73, 1.22, 1.18 and 2.99 respectively (FrontierCommunications, 2011); this implies that throughout the five years the firm current ratio was high in 2006 but reduced in 2007 by 61% to 1.18 while in 2008 it increased by 3.4% to 1.22. In 2009 the ratio further increased by 42% but it reduced in 2010 by 55%, thus the firm current assets can only cover current liabilities 0.78 times in 2010 which is not satisfactory. This means that the firm is facing liquidity risks as it cannot meet short-term obligations.

Working capital turnover ratio

The firm working turnover ratio in 2010 was negative indicating that it was very low compared to previous four years with the highest ratio in 2007 of 28.74 and the least was 2.39 in 2006 (FrontierCommunications, 2011). In 2007 the ratio

dropped by 72% to 7.37 which further dropped by 266% to -12.21; this ratio assists the managers in determining whether the firm is lopsided with slow or fixed assets, and it sets off net revenue to net assets (Accountingissue.info, 2011). The firm ratio is very low and it signals under-trading and also show that the firm does not need additional finances to sustain the financial structure.

Current debt to net worth ratio

The firm must not have credit that surpasses the invested capital; the ratio gauges the percentage of finances that present creditors put in to the firm's operations (Accountingissue.info, 2011). In 2010 the ratio of the firm dropped by 77% to 28% compared to 2009 while in 2008, 2007 and 2006 the ratios were at 74%, 45% and 40% respectively FrontierCommunications (2011). This means that in 2009 the company was in serious trouble as the ratio had exceeded 75%.

Funded debt to net working capital ratio

In all the financial years the long-term debt surpassed the net working capital as it was more than zero except for 2010 which was negative as a result of less current asset compared to current liabilities, this means that the excess current assets cannot cover the long-term debt if they fall due.

Major investments in last 5 years

In 2006 the firm initiated new client operations strategy by opening a call center in the region of Deland, Fla. while in 2009 the company carried on with investment in Broadband Networks in West Virginia plus it acquired Verizon assets building the country's biggest countryside provider of communication services in 2010 (FrontierCommunications, 2011). The company created nationwide Fiber Optic Network in 2010 and in 2011 the firm invested $24.7 million in increasing Broadband

accessibility and internet speed (FrontierCommunications, 2011); it expanded ROADM Network in enhancing flexibility, connectivity and reliability and provided Netbooks to link Ohio Eco Graduates. The firm has made these major investments in order to build a state-of-the-art net that considerably increases competences and facilitates clients to benefit from higher internet speed (FrontierCommunications, 2011).

Financial Structure analysis

Short-term borrowings

The firm short-term borrowings are made up of accounts payable, short long-term debt and other current liabilities; the current liabilities have increased by 238% in the past five successive years to $1,439.357 million (Yahoo.com, 2011).

Long-term debt

The firm is financed by long term debt of $7,983.693 million which is an increase of 79% over the last five years; it is also financed by other long-term liabilities such as deferred liability charges, minority interest and other liability, which amount to $3,270.47 million and which is an increase of 286% in the past five years (Yahoo.com, 2011).

The Relationship between Long-term debt and short-term debt

Short-term debts have a maturity period of less than one year and normally include bank loans that have comparatively low rate of interest; on the other hand, long-term debts comprise of bonds and loans which have maturity period longer than one year (Go4funding.com, 2010). These loans and bonds usually bear higher rate of interest, since lenders require superior rate of return, which trade-off superior risk of lending cash for a longer period (Go4funding.com, 2010). The total outstanding

obligations both long-term and short-term are significant indicators of the firm's financial health. In case the firm has no adequate assets or cash to cover loan or bond reimbursements, it may encounter bankruptcy (Johnson, 2011). According to liquidity ratio FTR is not able to meet it short-term obligations as it has to cover the current debts and other current liabilities.

Owners' Equity

The owners' funds are made up of common stock, retained earnings, treasury stock, capital surplus and other stockholder equity; the firm equity has increased by 391.17% during the past five successive years and the end result was $5,196.74, million this increase was as a result of huge increase in capital surplus by 478% in 2010 compared to 2009 (Yahoo.com, 2011).

The Relationship between equity and debt

The relationship between debt and equity is the ratio between the total amount unsettled to all kinds of creditors and the sum of capital owned by shareholders where both equity and debt make up the company's capital structure (Johnson, 2011). The debt to equity ratio is concerned with the monetary health of the company and the nature of its own investment policies; for instance, taken in separation a company that has greater debt against its capital holdings appear to be in financial risk or inadequately managed. This can make the shareholders be concerned as greater debt might make it hard for the company to disburse what it owes and meet shareholders expectation in case of dissolution (Johnson, 2011).

Debt funding is cheaper than equity or selling of shares, therefore greater debt might signify a persistent strategy that will reimburse off towards the end. This is particularly true among companies with a lot of cash flows. If cash flows are high,

then a company with large amount of debt versus equity is not in any financial difficulty. On the other hand, greater equity may mean the firm is slow-moving plus it's not employing its equity to funding new expansion, therefore debt and equity should not be taken in separation (Johnson, 2011) as they make up the firm capital structure.

The debt to equity ratio is the best method to establish the health of a company and its general policies, but it ought to be taken in context of capital intensive companies. For example, automotive and petroleum are always having greater debts due to high-priced equipments therefore, the main issue here is cash flows rather than the ratios (Johnson, 2011). According to leverage ratio the FTR is highly geared meaning that the proportion of debt which is long-term in nature is high compared to the owners' supplied funds. This means that the firm is facing leverage risk since it does not have enough cash flow to pay all the liabilities.

Use of debt and equity

The FTR can use debt and equity for profitability borrowing that is if a company can make higher rate of returns than interest rate at which it has a loan; this turns out to be profitable for the company to borrow funds. For example, if a company made fifteen per cent on its investment and borrowed money at eight per cent it can make seven per cent on the borrowed funds and this will boost the company's return on equity (Go4funding.com, 2010).

The company can use debt and equity to calculate risk given that the more debt that is employed the higher the risk, and thus the company might be forced to liquidate and end up being out of business. This is the case because even though equity investors and owners will not make an effort to put a corporation out of

business, debtors might if the company is unable to make interest and most importantly payments. Therefore, debt have to be adequate where the possessors of the company get attractive returns while on the other hand the risk should not be so high to put the company at a greater risk which means that the FTR has to reduce its debt financing; equity financing can be used to fund the firm's expansion project (Go4funding.com, 2010).

Cost of capital

cost of equity

$$E_s = R_f + \beta_s(R_m - R_f).$$

β = 0.78

Rf=4.375% (risk free rate for a 30 year U.S. treasury bond)

Rm= 23.96%

Es= 4.375% + 0.78(23.96% - 4.375%)

Es= 19.65%

The company yield to maturity is 6.85% which is the price the firm must pay to the providers of credit finances and the after tax cost of debt assuming tax rate of 39.5% is 4.14% (6.85% x (1- 0.395) (Morningstar.com, 2011).

Therefore, the cost of capital can be estimated as shown below;

K_c = K_e (Equity/capital employed) + K_d(1-t)(Debt/Capital employed)

Where K_c, K_d and t are cost of capital, cost of debt and tax rate respectively.

= 19.65% x (5,196,740,000/16,450,873,000) + 4.14% x (11,254,133,000/16,450,873,000)

= 9.04%

Conclusion

I would not invest in Frontier Communication Corp. Because its profitability is deteriorating as years progresses as a result of inefficiency in controlling business cost such as operating, finance and cost of sales. The firm is also facing high financial risk as it is highly geared plus it is also less liquid as it cannot meet it short-term obligations if they fall due.

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1- Appendices

Table 1: Ratio Analysis

	2010	2009	2008	2007	2006	Industry Average
PROFITABILITY RATIOS						
Return On Assets	3.97	5.33	5.92	6.62	8.52	10.53
Return On Invested Capital	5.28	7.06	7.62	8.23	10.41	
Cash Flow To Sales	31.58	35.52	35.11	38.02	41.00	30.87
Cost of Goods Sold To Sales	31.27	29.75	27.43	10.15	8.46	
Gross Profit Margin	45.20	47.76	47.45	65.59	68.02	39.41
Operating Profit Margin	23.94	30.14	29.06	30.26	31.82	20.57
Pretax Margin	7.12	9.07	12.77	15.11	19.28	
Net Margin	4.02	5.70	8.17	9.54	17.01	
ASSET UTILIZATION RATIOS	**2010**	**2009**	**2008**	**2007**	**2006**	
Asset Turnover	0.21	0.31	0.32	0.31	0.30	0.44
Capital Expend Pct Total Assets	8.40	3.72	3.97	4.65	4.18	
Capital Expend Pct Sales	15.22	12.09	12.89	14.04	13.27	
LEVERAGE RATIOS	**2010**	**2009**	**2008**	**2007**	**2006**	

Total Debt Pct Common Equity	159.02	146.53	910.43	474.93	425.32	-166.9
LT Debt Pct Common Equity	153.63	1,463.36	909.69	474.69	421.61	-180.64
LT Debt Pct Total Capital	60.51	93.39	90.10	82.60	80.83	46.75
Equity Pct Total Capital	39.39	6.38	9.90	17.40	19.17	
Total Debt Pct Total Assets	46.19	69.80	68.60	65.32	66.26	
Common Equity Pct Total Assets	29.05	4.76	7.53	13.75	15.58	
Total Capital Pct Total Assets	73.75	74.63	76.08	79.03	81.26	
Cash Dividend Coverage Ratio	2.27	2.41	2.47	2.55	2.57	17.86
Working Cap Pct Total Capital	-2.36	5.60	1.63	1.36	15.35	
LIQUIDITY RATIOS	**2010**	**2009**	**2008**	**2007**	**2006**	
Quick Ratio	0.57	1.40	1.01	1.03	2.89	0.92
Current Ratio	0.78	1.73	1.22	1.18	2.99	1.02
Cash And Eqt Pct Current Assets	22.27	52.74	34.97	43.21	81.78	63.58
Receivables Pct Current Assets	50.36	28.05	47.49	44.79	14.75	
Accounts Receivable Days	36.48	35.59	37.28	34.28	35.21	29.34

Table 2: Working Capital Ratios

		2010	2009	2008	2007	2006
1	Working capital turnover ratio					
	Net sales/ Net working capital	-12.21	7.37	26.26	28.74	2.39
2	Current Debt to Net Worth Ratio					
	Current liabilities/ Tangible net Worth	0.28	1.20	0.74	0.45	0.40
3	Funded Debt to Net Working Capital Ratio					
	Long-term Debt/Net working capital	-25.68	16.68	55.43	60.53	5.27