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# Answers

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### Section C

#### Pumice Co

(a)(i) Forecast statement of financial position for Pumice Co

<b>Assets</b>	<b>\$,000</b>
Non-current assets	60,018
Current assets	
Inventory	4,394
Trade receivables	15,979
Cash	<u>700</u>
	21,073
<b>Total assets</b>	<b>81,091</b>
Equity and liabilities	\$,000
Equity	6,000
Reserves	<u>40,818</u>
Total equity	46,818
Non-current liabilities	26,000
Current liabilities	
Trade payables	5,273
Overdraft	<u>3,000</u>
	8,273
<b>Total equity and liabilities</b>	<b>81,091</b>

#### *Workings*

Non-current assets =  $54,070 \times 1.11 = \$60,017,700$

Revenue =  $80,768 \times 1.187 = \$95,871,616$

Cost of sales =  $95,871,616 \times 0.33 = \$31,637,633$

Inventory =  $31,637,633 \times 50/360 = \$4,394,116$

Trade receivables =  $95,871,616 \times 60/360 = \$15,978,603$

Reserves =  $34,000 + 6,818 = \$40,818,000$

Non-current liabilities =  $18,000 + 8,000 = \$26,000,000$

Trade payables =  $31,637,633 \times 60/360 = \$5,272,939$

#### (a)(ii) *Trade payables payment period*

Currently this is  $(9,690/27,700) \times 360 = 126$  days

The company is targeting 60 days, a reduction of  $(126 - 60) = 66$  days

This looks to be ambitious.

*Current ratio*

Currently this is  $17,120/13,190 = 1.30$  times

After the expansion this becomes  $21,073/8,273 = 2.55$  times

This suggests the company is looking to increase solvency.

*Revenue/net working capital*

Net working capital currently =  $4,000 + 12,320 - 9,690 = \$6,630,000$

Revised net working capital =  $4,394 + 15,979 - 5,273 = \$15,100,000$

Revenue/NWC currently =  $80,768/6,630 = 12.18$  times

Revised revenue/NWC =  $95,872/15,100 = 6.35$  times

There would be a substantial increase in the capital supporting revenue.

**(b)(i)** *Changes in working capital investment policy*

Working capital investment policy considers the level of current assets used to support revenue generation in relation to different companies.

A company adopts an aggressive working capital investment policy relative to another company if it uses a lower level of current assets to support a similar level of revenue generation. Conversely, the second company adopts a conservative working capital investment policy relative to the first company.

While there are no companies here with which to compare Pumice Co's working capital investment policy, the effect of implementing the proposed changes in working capital can be measured by the revenue/current assets ratio. This shows that no significant change has occurred as a result of implementing the proposed changes in working capital, as it has only changed from 4.72 times to 4.55 times.

Revenue/current assets appears a less sensitive measure of working capital investment policy than revenue/net working capital, which has changed from 12.18 times to 6.35 times as a result of the decreased reliance on short-term working capital funding implicit in the proposed changes in working capital.

*Workings*

Revenue/current assets now =  $80,768/17,120 = 4.72$  times

Revised revenue/current assets =  $95,872/21,073 = 4.55$  times

Net working capital currently =  $4,000 + 12,320 - 9,690 = \$6,630,000$

Revised net working capital =  $4,394 + 15,979 - 5,273 = \$15,100,000$

Revenue/NWC currently =  $80,768/6,630 = 12.18$  times

Revised revenue/NWC =  $95,872/15,100 = 6.35$  times

**(b)(ii) Changes in working capital funding policy**

Working capital funding policy can be characterised as conservative, matching or aggressive, depending on the extent to which fluctuating current assets and permanent current assets are financed from short-term or long-term sources.

A conservative funding policy will use long-term funds to finance permanent current assets and a proportion of fluctuating current assets. This is a lower-risk policy as long-term funds are less risky than short-term funds from a company perspective, but as long-term funds are more expensive than short-term funds, this policy also decreases profitability.

An aggressive funding policy will use short-term funds to finance fluctuating current assets and a proportion of permanent current assets. This is a higher-risk policy as short-term funds are more risky than long-term funds from a company perspective, but as short-term funds are cheaper than long-term funds, this policy also increases profitability.

A matching funding policy would apply the matching principle in using short-term funds to finance fluctuating current assets and using long-term funds to finance permanent current assets.

While there is insufficient information to determine the relative levels of permanent and fluctuating current assets, implementing the proposed changes in working capital shows a substantial movement to using long-term funds rather than short-term funds. Before the expansion, 77% of current assets are financed from short-term funds (trade payables plus overdraft). After the expansion, only 39% of current assets would be financed for short-term funds and 61% would be financed from long-term funds. This change is also apparent from the increase in the current ratio from 1.30 times to 2.55 times.

The proposed changes in working capital therefore suggest a movement by Pumice Co from an aggressive working capital funding policy to a conservative working capital funding policy.

This view is also evidenced by the \$4,917,000 decrease in short-term funds relative to the \$3,953,000 increase in current assets and the \$14,818,000 increase in long-term funds: the company's current reliance on short-term funds has been reversed.

*Workings*

Current assets financed by short-term funds:

Before expansion =  $100 \times (13,190/17,120) = 77\%$

After expansion =  $100 \times (8,273/21,073) = 39\%$

Decrease in short-term funds =  $13,190 - 8,273 = \$4,917,000$

Increase in current assets =  $21,073 - 17,120 = \$3,953,000$

Increase in long-term funds =  $(46,818 + 26,000) - (40,000 + 18,000) = \$14,818,000$

**LaForge Co**

**(a)(i) TERP**

Current number of shares =  $\$35\text{m} / \$0.50 = 70\text{m}$

Issue price =  $\$2.60 \times (1 - 0.3) = \$1.82$  per share

Number of shares to be issued =  $\$25.48\text{m} / \$1.82 = 14$  million shares

TERP =  $(70\text{m} \times \$2.60 + \$25.48\text{m}) / (70\text{m} + 14\text{m}) = \$2.47$  per share

Alternatively:

Ratio of issued shares =  $14\text{m}:70\text{m} = 0.2$ , and therefore a 1 for 5 issue

TERP =  $(\$1.82 + 5 \times \$2.60) / (1 + 5) = \$2.47$  per share

**(a)(ii) Value of a right (VOR)**

VOR per new share =  $\$2.47 - \$1.82 = \$0.65$  per new share

VOR per existing share =  $\$0.65 \times 14\text{m} / 70\text{m} = \$0.13$  per existing share

Alternately using 1 for 5 ratio =  $\$0.65 / 5 = \$0.13$  per existing share

**(b)(i) Rights issue**

Forecast PAT =  $\$16.56\text{m} + \$4.5\text{m} \times (1 - 0.2) = \$20.16\text{m}$

Forecast EPS =  $\$20.16\text{m} / 84\text{m} = \$0.24$  per share

Forecast share price =  $\$0.24 \times 11 = \$2.64$  per share

**(b)(ii) Loan notes**

Extra interest =  $\$25.48\text{m} \times 6\% = \$1.53\text{m}$

Forecast PAT =  $\$16.56\text{m} + (\$4.5\text{m} - \$1.53\text{m}) \times (1 - 0.2) = \$18.94\text{m}$

Forecast EPS =  $\$18.94\text{m} / 70\text{m} = \$0.2706$  per share

Forecast share price =  $\$0.2706 \times 11 = \$2.98$  per share

### **(c) Methods of issuing new equity shares**

#### **Rights issue**

A rights issue involves issuing shares to the existing shareholders in proportion to their existing holding. Rights issues are often successful, easier to price and are cheaper to arrange than a public issue but the amount of finance raised is limited as there is a finite amount that shareholders will be willing to invest. A rights issue would be mandatory if shareholders have not elected to waive their pre-emptive rights.

#### **Private placing**

A private placing is when a company, usually with the assistance of an intermediary, seeks out new investors on a one-to-one basis. Shares are normally issued to financial institutions when performing a placing rather than to individuals. This can be a useful source of new equity for an unlisted company but control of the company will be diluted as a result. A placing is also cheaper to arrange than a public issue but only useful for relatively small issues.

#### **Public offer**

If the company is listed, it may undertake a public offer whereby shares are offered for sale to the public at large. This is an expensive way of issuing shares as there are significant regulatory costs involved and like the placing, control of the existing shareholders will be diluted. A public issue will, however, allow very large amounts of equity finance to be raised, and will also give a wide spread of ownership.

#### **Initial public offering (IPO)**

If the company is not listed, it can list through the process of an IPO which will raise equity at the same time. An IPO will be more expensive than a public offer as there are further regulations having to be complied with, increasing costs. Consequently, only a large company wishing to raise a significant amount of finance would consider this option.

### **(d)**

The director's suggestion of reducing the forthcoming dividend would raise at most, \$5.6m (70m x \$0.08) so in itself, would not be sufficient but would provide 22% (\$5.6m / \$25.48m) of the total required. This would reduce the amount of new external finance needing to be raised, potentially reducing financing cost, but there are further problems with this suggestion.

#### **Signalling effect**

The signalling argument suggests that in the absence of perfect information, for example in a semi-strong form efficient capital market, the dividend announcement will send a message or "signal" to the market. Generally, a reduction in dividend (such as proposed here) could be interpreted as bad news by investors and result in a fall in LaForge Co's share price.

### **Clientele effect**

Different investors have different needs relating to income or capital growth. LaForge Co has consistently paid dividends in the past so switching to a lower/zero pay-out could alienate some shareholders, resulting in large volumes of share sales. Given the different shareholders that LaForge Co has, this could be a real issue for them.

### **Liquidity preference**

Generally, it is thought that shareholders, even those who prefer low pay-outs/high reinvestment, still wish to receive some dividend now as this is a certain return compared with the more risky and uncertain future dividends or capital growth.

### **Recommendation**

Given that LaForge Co is a listed company with different shareholders and has consistently paid dividends in the past, a reduction in dividend could damage shareholder relations and possibly result in reduced shareholder wealth. The reduction in dividend is not recommended.

			<i><b>Marks</b></i>	<i><b>Marks</b></i>
<b>Marking Scheme</b>				
<b>Pumice Co</b>				
<b>(a)</b>	(i)	Non-current assets	0.5	
	(i)	Revenue	0.5	
	(i)	Cost of sales	0.5	
	(i)	Inventory	1	
	(i)	Trade receivables	1	
	(i)	Trade payables	1	
	(i)	Reserves	0.5	
	(i)	Non-current liabilities	0.5	
	(i)	Overdraft/cash	<u>0.5</u>	
				<b><u>6</u></b>
	(ii)	Trade payables period	1	
	(ii)	Current ratio	1	
	(ii)	Revenue/Net working capital	1	
	(ii)	Changes	<u>1</u>	
				<b><u>4</u></b>
<b>(b)</b>	(i)	Aggressive investment policy	1	
	(i)	Conservative investment policy	1	
	(i)	Revenue/Current assets	1	
	(i)	Changes discussion	<u>2</u>	
				<b><u>5</u></b>

	<i><b>Marks</b></i>	<i><b>Marks</b></i>
(ii) Conservative financing policy	1	
(ii) Aggressive financing policy	1	
(ii) Matching financing policy	1	
(ii) Changes discussion	<u>2</u>	
		<u>5</u>
<b>Total marks</b>		<u><b>20</b></u>

		<i><b>Marks</b></i>	<i><b>Marks</b></i>
<b>LaForge Co</b>			
<b>(a)</b>	(i) Existing shares	0.5	
	(i) New shares	0.5	
	(i) Issue price	1	
	(i) TERP	<u>1</u>	
			<b><u>3</u></b>
	(ii) Value of rights per new share	0.5	
	(ii) Value of rights per existing share	<u>0.5</u>	
			<b><u>1</u></b>
<b>(b)</b>	(i) New PAT	0.5	
	(i) EPS	0.5	
	(i) Share price	<u>1</u>	
			<b><u>2</u></b>
	(ii) Interest	0.5	
	(ii) New PAT	1	
	(ii) EPS	0.5	
	(ii) Share price	<u>1</u>	
			<b><u>3</u></b>
<b>(c)</b>	Up to 2 marks per method		<b><u>5</u></b>
<b>(d)</b>	Signalling effect	2	
	Clientele effect	2	

	<i><b>Marks</b></i>	<i><b>Marks</b></i>
Other	1	
Recommendation	<u>1</u>	
		<u>6</u>
<b>Total marks</b>		<b><u>20</u></b>