



Subject: Business Finance 1

Chapter: Unit 3 & 4

**Category: Assignment 2
solutions**

1. Ans: A

2. Ans: D

3. Ans: B

4. Ans: C

Funding temporary spikes with short-term borrowing while keeping long-term financing aligned with average needs is more cost-efficient than overfunding via long-term capital.

5. Ans: A

Internal growth rate = Plowback ratio $\times$ ROE $\times$ (Equity / Net Assets)
 $= 0.70 \times 0.12 \times 0.6 = 0.0504$ or 5.04%

6. Ans: C

A cash budget is focused on cash flow timing—not profits or long-term investments. It ensures the firm has sufficient liquidity to meet short-term obligations.

7. a)

Bid A: LBO – led by an external private equity firm using high debt, intends to delist and overhaul the company.

Bid B: MBO – led by internal management using high debt to take over the company and retain jobs.

b)

LBO risk: Excessive debt burden may lead to insolvency if turnaround fails.

LBO benefit: Profit potential from asset sales, restructuring, and tax advantages.

MBO risk: Management may lack experience in ownership and restructuring under pressure of debt.

MBO benefit: Strong alignment of interests; managers are personally invested in long-term success.

8. Advice of the consulting actuary should cover: Arranging for additional capital to fund higher volume of raw material and production cost Lesser profits while money is reinvested in business higher operational problems due to increased

staff and manufacturing scale like bigger factory space etc.

Lack of management expertise Government policy on monopoly power and mergers Lack of diversification benefits larger scale may attract competitor's attention Seasonality of business may not lead to continued profits

Higher level of compliances like labor laws etc. may now be applicable Higher level of income may be subject to higher tax rates, in turn reducing net profit

9.

- i. The comparison of the opening and closing balances can reveal a net cash inflow or outflow, but cannot show the reasons for that change.
- ii. A cash flow statement provides the reader with details of the extent to which the operating activities are generating (or consuming) cash.
- iii. The cash flow statement also shows the other cash flows, broken down into relevant categories. Thus, the cash flow statement can highlight the fact that a net cash inflow occurred because the company has raised fresh borrowings.
- iv. The statement can also show how that cash inflow was applied.
- v. The cash flow statement makes it easier to reveal whether the net movement was attributable to the working out of a business strategy (e.g. the deliberate investment of surplus cash) or the first sign of a problem (e.g. cash flow problems).

10. One interpretation of the Modigliani and Miller model is that shareholders may suffer a loss because of tax if a company changes its dividend policy. ABC's shareholders clearly prefer capital gains to dividends and so they will suffer a significant tax charge if a dividend is paid without giving them the opportunity to make arrangements. ABC should not retain significant cash balances if there are no investment opportunities available in order to put them to work

It may be better for ABC to inform the markets that the industry is not in a suitable condition to make additional investments and so it will be making a significant dividend payment in due course

The shareholders can then realise some or even all of their equity by selling the shares in advance of the dividend, selling to shareholders whose circumstances lead to them having a preference for dividend income.

11. Capital structure or gearing can affect the profits available to the shareholders.

Debt is relatively cheap source of finance. If the company borrows rather than issuing further share capital then a large proportion of the returns from the resulting investments will be available to the shareholders.

The company can also claim tax relief on the interest and that will further decrease the cost of debt. Debt can also affect the volatility of returns to shareholders. Interest and capital repayment must be paid regardless of whether

the company has had a good year or not. The fact that this fixed commitment must be met means that the company may have very little profit left for the shareholders in leaner years.

Conversely, the fixed return offered to the lenders will mean that any upturn in revenue will lead to all of the excess being passed on to the shareholders. This means that borrowing will accentuate any fluctuations in the operating profit.

12.i) Liquidity preference-

The liquidity preference theory is based on the generally accepted belief that investors prefer liquid assets to illiquid ones. Investors require a greater return to encourage them to commit funds for a longer period. Long-dated stocks are less liquid than short-dated stocks, so yields should be higher for long-dated stocks.

Appropriate examples-

1. Government bonds are usually more marketable and hence more liquid than corporate bonds and therefore corporate bonds have a higher yield to encourage investors to buy relatively illiquid assets.
2. 10 year bonds are relatively less liquid than One year bonds and hence there is a higher yield on 10 year bonds than on One year bonds.

13.

- I. Previously, dividend payout decisions are likely to have been based on the business expansion plans coupled with the preference of the limited number of 1-3 shareholders, which in turn could be based on their own tax position and investment horizon.
- II. Post listing, market sentiment will need to be kept in mind while making dividend payout decisions. Many stock market analysts compare shares to one another on the basis of dividend yields. Stock market analysts will find the share relatively more attractive if the dividend yield is higher.
- III. Long-term insurance business is capital intensive hence aggressive expansion plans will strain profits hence any dividend declaration must be prudent and sustainable.
- IV. Dividend decision should be aligned with the investor base (in terms of tax position and nature of investors). Investors who are putting money in insurance company stocks recognizing the long term return potential of the industry will not be uncomfortable with a modest dividend payout policy. Frequent changes however should be avoided.
- V. Competitor dividend practice should be kept in mind.

14. Factors influencing the dividend policy of the company:

- 1) Reaction of the stock market to fluctuations in declared dividends. So managers tend to holdback some profits in good years to be used to reward shareholders during adverse phases of the economic cycle
- 2) Availability of cash. A huge cash pile may lead to a hostile takeover and hence paying out dividends may be preferred.
- 3) Tax position of the company and its shareholders and the relative taxation on capital gains and dividends.
- 4) Requirements for any planned projects and future growth prospects of the industry and the company.
- 5) Past dividend payouts
- 6) Ability to borrow during adverse times.

15. Modigliani and Miller's first irrelevance proposition: The market value of any firm is independent of its capital structure. Modigliani and Miller's second irrelevance proposition: The expected rate of return on the company's shares increases in proportion to the debt-equity ratio, expressed in market values.

16. If a company has accumulated large amounts of cash which it does not need in running the business, or if it wishes to change its capital structure by replacing equity with debt, it will generally undertake a share repurchase or buyback exercise.

Procedure or Ways to Repurchase Shares are:

- a. Purchase of shares in the Open Market, often by a gradual repurchase program over a period of time
- b. Fixed Price Offer - If the company repurchases a stated number of shares at a fixed price (typically at a significantly higher price than the current market value), the shareholders are informed of the company's intention and are free to accept the offer or not.
- c. Tender Offer (either a Dutch or uniform price auction) – In a Dutch auction,

the company states a series of prices at which it is prepared to repurchase shares. Shareholders reply to this offer, informing the company of how many shares they are willing to sell at each price. The company then calculates the lowest price at which it can buy the required number of shares.

- d. Repurchase by Direct Negotiation with a major Shareholder Effect of Share Buyback on Shareholders

17. The motives for growth can therefore be found in the many ways in which growth can help a company achieve its overall aim, including:

1. Increased profitability.

By increasing its output and sales, a business can:

- benefit from economies of scale (i.e. lower average costs, e.g. by buying in bulk, obtaining better credit terms from suppliers, by investing in machinery and techniques that improve productivity);
- increase its market share and hence its market power (i.e. its power to increase prices); and
- expand into new and growing markets.

2. Increased security.

A larger business:

- can defend itself against an unwelcome takeover bid;
- can overcome barriers to entry in new markets;
- can benefit from risk diversification by expanding the product range, especially if the present market seems saturated;
- is a greater threat to a potential rival;
- might face lower transactions costs, i.e. costs of making contracts with other firms;
- might face less uncertainty and/or is in a better position to cope with uncertainty; and
- will obtain more business as it is seen by customers to be a more reliable and secure source of supplies.

3. Increased motivation for managers and employees.

A larger business can:

- provide an environment of increased power, prestige and salary;
- offer decreased employment risk for managers;
- result in improved staff morale;
- often attract more able, more ambitious and more productive staff.

18. Steps taken in an acquisition

The buying process is complex and the advice and expertise of an investment bank will usually be sought.

1. Check government policy and relevant regulations and legislation on acquisitions. For example, in the UK a company must make a cash offer when its shareholding reaches 30% of the target's shares.
2. Obtain shareholders' approval for the purchase of the target's shares.
3. Arrange the raising of finance to purchase the target's shares. The funds could be raised by a rights issue or a new debt issue.
4. Determine the method of payment for the target firm's shares. The acquirer provides cash, loan stock and/or shares of the acquirer's company in exchange for the shares of the target company. Which method is chosen depends on the capital structure of the acquirer and the extent to which the target's shareholders are likely to want to share risk in the larger company of the acquirer.
5. Approach the board of directors of the target company and make an offer. If the directors are receptive to the approach, a friendly takeover can be negotiated. If not, a hostile bid will be made.
6. If the takeover is friendly, discussions will take place, due diligence will be performed (i.e. investigations and checks of financial records, tax records and senior management etc.), a definitive agreement on financial matters and non-financial matters (such as management structures) will be reached, and shareholders and regulators will be asked to approve.
7. In the case of a hostile takeover, the target's board of directors tries to prevent the takeover (possibly taking action to make the target seem less attractive) so the acquirer either withdraws interest or must make a bid directly to the shareholders.

19. Internal growth occurs when a business expands its own operations rather than by operating with other business. This can be achieved in three ways. A firm can expand by:

- Horizontal expansion, i.e. by increasing production of goods or services at the same stage of the production process, e.g. a food manufacturer.
- Vertical expansion, i.e. by developing new operations at a different stage in the production process, e.g. a food manufacturer might move backwards into farming or forwards into retailing.
- Diversification, i.e. by moving into completely different markets, e.g. a mail-order business might expand into radio stations, trains, airlines and banking.

20. The company conducts a very simple business. It buys raw materials for cash, processes them into finished goods, and then sells these goods on credit. The interval between the firm's payment for its raw materials and the collection of payment from the customer is known as the cash cycle or cash conversion period:

Cash cycle

= operating cycle – accounts payable period

= (inventory period + accounts receivable period) – accounts payable period

The delay between initial investment in inventories and the final sale date is called the inventory period.

The delay between the time that the goods are sold and when the customers finally pay their bills is the accounts receivable period.