

## Question 5

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(a) **Interest Cover**

$$\frac{\text{Net profit before interest}}{\text{Interest}} = \frac{75,000}{20,000} = 3.75 \text{ times (9)}$$

**Earnings per share**

$$\frac{\text{Net profit after Pref Div}}{\text{Number of ordinary shares}} = \frac{52,000}{300,000} = 17.33c \text{ (9)}$$

**Cash Sales**

$$\frac{\text{Debtors} \times 12}{\text{Credit sales}} = 2 \quad \text{Credit Sales} = \frac{48,000 \times 12}{2}$$
$$\text{Credit sales} = 288,000$$
$$\text{Cash sales} = 890,000 - 288,000 = \text{€}602,000 \text{ (9)}$$

**Period to recoup price**

$$\frac{\text{Market price}}{\text{Dividend per share}} = \frac{200}{15} = 13.34 \text{ years (9)}$$

**Dividend yield for 2004**

$$\frac{\text{Dividend per share} \times 100}{\text{Market price}} = \frac{18 \times 100}{210} = 8.57\% \text{ (9)}$$

(b) **The debenture holders would be dissatisfied with the following:**

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### **Dividend Policy** (7)

Based on this years earnings the dividends proposed €48,000 are excessive. The dividend cover is 1.15 Times. More of the profits should be retained or put aside for the repayment of the debentures.

### **Security - Real value of Fixed assets** (7)

The debentures are secured on the fixed assets. The debenture holders would be interested in the size of the assets to make sure that there is enough security for the loan. There are fixed assets of €575,000 of which, intangible assets are €150,000 leaving net assets excluding intangibles of €425,000. It would be prudent to ascertain the real value of fixed assets. However the debenture holders would feel secure because of the excess in value of fixed assets over loan, particularly because of the investments of €90,000.

## **Question 5 - continued**

### **Profitability**

(7)

The return on capital employed for 2005 is 12.56%. Last year the return was 14.2%. This fall indicates an unhealthy trend. The company is in a profitable position as the return of 12.56% is better than the return from risk free investments of less than 5% and is above the debenture interest rate of 10%. If the downward trend continues there is a risk of having to sell the fixed assets in order to repay debentures.

### **Liquidity**

(7)

The company has a serious liquidity problem. Last year, the quick ratio was 1.2:1. This year the quick ratio has fallen to 0.7:1. The company now has only 70c available for every euro owed in the short term. The worsening of the ratio indicates a difficulty paying debts including future interest. If this trend continues ability to pay interest would come under pressure and funds would not be available to invest for the purpose of repaying loan.

### **Gearing - Interest Cover**

(7)

The company is lowly geared. In 2005, the gearing was at 41.8%. The gearing has slipped from 35% of total capital in 2004. Interest cover was 5 times but is now down to 3.75 times. This worsening trend could jeopardise interest payment

### **Sector**

(5)

The long-term prospects are not encouraging in the dairy industry. There is a risk of over production and low cost competition.

### **Market Value**

The market value of one share in 2004 was €2.10 while in 2005 it has dropped to €2. The earnings per share has dropped from 19c to 17.33c. The share may be overpriced as it takes 11.54 years to recover its market price.

These would indicate a lack of public confidence in the company and may discourage investment.

### **(c) Raise cash and improve liquidity by:**

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1. Paying out lower dividends
2. Selling investments rather than issuing debentures.
3. Issuing more shares.
4. Improving gross profit percentage of 21.9% by reducing cost of sales or by passing on the increased costs.
5. Diversifying into other areas
6. Collection of debts more quickly
7. Sale and lease back