Question 5

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(a)

(i) Interest Cover

$$\frac{\text{Net Profit before interest}}{\text{Interest}} \qquad \frac{65{,}000 + 30{,}000}{30{,}000} \qquad = \qquad \textbf{3.17 times} \quad [8]$$

(ii) Cash Purchases

$$\frac{\text{Creditors}}{\text{Credit Purchases}} \times 12 = 2 \qquad \frac{77{,}000 \times 12}{2} = 462{,}000$$

(opening stock + purchases – closing stock = cost of sales)
(Purchases = 725,000 – 60,000 + 65,000 = 730,000)

Cash Purchases 730,000 – 462,000 = **268,000** [10]

(iii) Dividend Cover

$$\frac{\text{Net Profit after Preference Dividend}}{\text{Ordinary Dividend}} \qquad \frac{65{,}000 - 5{,}000}{45{,}000} \qquad = \qquad \textbf{1.33 times} \quad [8]$$

(iv) Market Price

$$\frac{\text{Market Price}}{\text{EPS}} = 10 \qquad \frac{\text{Market Price}}{15} = 10 \qquad = \qquad \textbf{150 cent} \quad [9]$$

(v) Dividend Yield

$$\frac{\text{Dividend per share}}{\text{Market Price}} \times 100 \qquad \frac{11.25 \times 100}{150} \qquad = \qquad \textbf{7.5\%} \quad [10]$$

Question 5 (b)

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The debenture holders would be **concerned** with the following:

Dividend Policy [7]
The dividend cover is 1.33 times. Last year's dividend cover was 1.4 times. This is a worsening trend. The DPS last year was 15c while this year it is 11.25c. Based on this year's profit of €65,000, the dividends proposed of €50,000 are excessive. More of the profits should be retained for the repayment of debentures. The % of profits given out is 75%. In 2008, the % given out was 71%.

Security - Real Value of the 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 €820,000 of which, intangible assets are €180,000 leaving net assets excluding intangibles of €640,000. It would be prudent to ascertain the real value of fixed assets as there are no write-offs like depreciation. However, the debenture holders would feel secure because of the excess in value of fixed assets over the loan of €300,000. There are investments of €95,000 but the debenture holders would be disappointed at the fact that the investments have dropped from their value of €120,000.

Profitability [7]
The return on capital employed for 2009 is 11.80%. Last year the return was 13%. It has disimproved by 1.20% and this fall indicates an unhealthy trend. If this downward trend continues, there is a risk of having to sell the fixed assets in order to repay debentures. The company is in a profitable position as the return of 11.80% is better than the return from risk free investments of less than 5% and is above the debenture interest rate of 8%. The company is making <u>less</u> efficient use of resources this year.

Liquidity [7]
The company has a very serious liquidity problem. Last year the quick ratio was 1:1 but this year the quick ratio has fallen to 0.36:1. The company now has only 36c available to pay every €1 owed in the short term. The worsening of the ratio indicates a difficulty in paying debts including future interest. If this trend continues, the ability to pay interest would come under pressure and funds would not be available to invest for the purpose of repaying the loan.

Gearing [7]
The company is lowly geared. In 2009, the gearing was at 43.48%. The gearing has worsened from 37% of total capital in 2008. Interest cover was 4.7 times but is now down to 3.2 times. This worsening trend could make interest payments more difficult.

Sector [5]
The overall worsening state of the economy is having a very negative effect on the dairy industry and there are also risks of over production and low cost competition.
The long term prospects are not encouraging in the dairy industry due to outside influences.

Question 5 (c)

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I would advise my friend **not** to buy shares in Hebe plc for the following reasons: [3]

Share Price [4]
The share value has fallen from €1.80 to €1.50 [30c] since 2009 and is likely to continue in its downward movement based on current year performance. There is a lack of stock market confidence and may discourage investment.

Dividends [4]
Dividend per share is 11.25c. The dividend per share has dropped from 15c
The dividend yield has dropped from 8.3% to 7.5%. Whilst the rate is good the trend is not.

Reserves [2]
The dividend cover is low and dropping. The firm is not retaining enough profits to build up reserves. The company's dividend cover has dropped from 1.4 times to 1.33 times.

Sector [2]
Dairy industry is not performing well and future is unsure.

Liquidity
Company has a serious liquidity problem. The company now has only 36c available to pay every €1 owed in the short term.

Profitability
Profitability is worsening. The return on capital employed for 2009 is 11.80%. Last year the return was 13%. It has disimproved by 1.20% and this fall indicates an unhealthy trend.

Price Earnings Ratio
Ratio is ten. It would take 10 years to earn back current price at current earnings.