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Robert C. Higgins Sep-11

Recommended Cases to Accompany Analysis for Financial Management, 10e

This note offers chapter-by-chapter recommendations of cases that work well with *Analysis for Financial Management*, tips on finding other quality cases, and advice on preparing course packets.

As you review these recommendations, keep in mind that cases can be quite personal, so that what works well for one instructor may not work for others. Be prepared, then, for some trial-and-error as you search for cases that meet your needs. Remember too that the cases I am about to mention are from a necessarily short list that I have used successfully in the past, or intend to use in the near future. I am sure there are many other highly effective cases of which I am unaware. Indeed, if you spot any glaring omissions in my recommended list, please let me know.

Sources of Cases

Cases are available in two forms: published casebooks and individual cases. The two most popular corporate finance casebooks are:

- Bruner, Robert F., Kenneth Eades, and Michael Schill, *Case Studies in Finance*, 6th ed. New York: McGraw-Hill, 2010.
- Kester, Carl, W., Richard S. Ruback and Peter Tufano, *Case Problems in Finance*, 12th ed. Burr Ridge, IL: Irwin, 2005.

Casebooks are undeniably convenient, but ordering individual cases from multiple sources offers significant advantages. Use of individual cases greatly increases the range of options, enables the instructor to tailor his course more precisely to student needs, and offers multiple perspectives on the subject matter. And because all of the cases in the two books just mentioned are also available individually, there are few disadvantages to using individual cases.

Reliance on individual cases used to require working with reluctant, ill-informed bookstores, or securing copyright permissions and overseeing reproduction and sale of the cases to students. Today the principal websites offering cases have greatly simplified the process and reduced the logistical burden borne by instructors.

The Principal Case Collections

Here are the web addresses of the principal case collections. Access to these sites is restricted to registered users, but registration is a simple process for bonafide instructors. All of the sites offer searchs, and full-text copies of many cases are available as pdf files. Teaching notes are also often available on request.

- <u>https://hbsp.harvard.edu/</u>.Harvard Business School is the major provider of business cases. This site offers abstracts of Harvard cases and full-text copies of most. The site also contains cases prepared by faculty at other schools including Babson, Northwestern, and Stanford.
- <u>https://store.darden.virginia.edu/</u>. The Darden Graduate School of Business at the University of Virginia is second only to Harvard as a source of business cases. Importantly, the site provides

access to cases written by Bob Bruner, Ken Eades, and Michael Schill, three of the best finance case writers working today.

- <u>www.ivey.uwo.ca/cases</u>. The Richard Ivey School of Business at the University of Western Ontario is producing a number of finance cases with particular strength in entrepreneurial finance and Asian finance.
- <u>www.ecchatbabson.org</u>. The European Case Clearing House is a consortium of primarily European universities that offers access to business cases with emphasis on international management. Consortium members include IMD, INSEAD, and Cranfield University.

Course Pack Preparation

McGraw-Hill offers access to cases and help in preparing course packs in hard copy and digital form. You can view and order cases, and contribute your own materials at <u>www.mcgrawhillcreate.com</u>.

Recommended Cases (Roughly in order of increasing difficulty.)

All recommended cases come with teaching notes, and many provide Excel spreadsheets of case exhibits.

Chapters 1 and 2 Interpreting Financial Statements and Evaluating Financial Performance

1. Case of the Unidentified Industries -- 2006

ard
96
es

The case contains common-size balance sheets and financial ratios for 14 companies, each representative of a different industry. The challenge is to identify the industries from the structure of the financial statements. This very short case can be distributed and discussed in the same class, excellent for the first day of class.

2. WestJet Airlines Ltd.: Investment Strategy

Source:	Ivey School of Business (Available on Harvard site.)
Case Number:	909N23
Length:	15 pages
Year:	2009

A portfolio manager is considering investment in a rapidly growing Canadian airline. To support his analysis, he asks his team to assemble comparative financial data on WestJet and key competitors. The heart of the case is analysis of these data. The case can be used to build skill in analyzing financial ratios, to identify the key determinants of profits, cash flow, return on equity, and value as seen by investors.

3. Krispy Kreme Doughnuts, Inc.

Source: Case Number:	Darden UVA-F-1479
Length:	16 pages
Year:	2005

For a time Krispy Kreme was one of the fastest growing companies in America, but this all ended in late 2004 after a series of announcements caused investors to reassess the company's prospects. The reader's challenge is to analyze these announcements and the company's financial statements to determine what went wrong and how serious the situation really is. The case is intended as a first look at financial statement analysis.

4. Sears, Roebuck and Co. vs. Wal-Mart Stores, Inc.

Source:	Harvard
Case Number:	101011
Length:	19 pages
Year:	1997

Sears and Wal-Mart have very similar returns on equity in 1997. The challenge is to understand how each company generated its ROE and to decide which of the two has better performance.

Chapter 3 Financial Forecasting

1. Clarkson Lumber Co.

Source:	Harvard
Case Number:	297013
Length:	6 pages
Year:	1997

An updated version of an old chestnut, this best seller asks students to assess the performance of a small, rapidly growing business, to project the need for future external financing, and to consider alternative means of managing company growth.

2. Toy World

Source:	Harvard
Case Number:	295073
Length:	6 pages
Year:	1994

Another updated version of a perennial best seller, Toy World operates in a highly seasonal business. Large production efficiencies can be achieved by switching from seasonal to level production, but inventories and the need for external financing will rise. Students must make a monthly pro forma projection and assess the tradeoffs of switching to level production.

3. SureCut Shears, Inc.

Source:	Harvard
Case Number:	297013
Length:	8 pages
Year:	1996

SureCut Shears is suffering through a recession and cannot repay its bank loan on time. Students must decide why the company is unable to repay, project the company's future ability to repay, and propose a plan that protects the bank and, hopefully, meets the company's needs.

4. Hampton Machine Tool Co

Source:	Harvard
Case Number:	280103
Length:	6 pages
Year:	1979

A best-selling case despite its age, Hampton Machine Tool provides valuable drill in constructing pro forma forecasts and cash budgets, and in reconciling the two. The case also exercises skills in financial statement analysis, and offers an intriguing introduction to long-term financial issues to be covered later in the course.

Chapters 4 Managing Growth

1. Kochman, Reidt & Haigh, Inc.

Source:	Harvard
Case Number:	294056
Length:	12 pages
Year:	1993

This is an introductory, overview case. KR&H is a small, rapidly growing company that needs to find a balance between its capital expenditures and available financing. What growth rate can it afford, and where should the money to finance the growth come from?

2. Horniman Horticulture

Source:	Darden
Case Number:	UVA-F-1512
Length:	5 pages
Year:	2006

At the end of 2005, this small company is experiencing booming demand and improving margins coupled with a distressing decline in cash balances. The case highlights the difference between cash flow and profits, as well as the negative effect of growth on cash flow. The case can be used to introduce financial ratio analysis, develop the concept of the cash cycle, stress the importance of working capital management, and the value of financial modeling.

3. Ceres Gardening Company: Funding Growth in Organic Products

Source:	Harvard
Case Number:	4017
Length:	10 pages
Year:	2009

This case is a rewrite of the classic O.M. Scott case. The company is a leading player in the growing organic gardening industry. Their distribution depends heavily on retail sales through independent nurseries and garden centers. Because these small dealers are unable to finance much inventory, Ceres has crafted a special program, which offers steep discounts and vendor financing. Ceres hopes both to accelerate its penetration into new retail accounts and to encourage dealers to accept more inventory in anticipation of seasonal sales. A key focus is the relationship between marketing strategy and credit

policy. The case invites students to analyze a range of financial information and to make financial projections. Discovery that Ceres rapid growth is due largely to stuffing the distribution pipeline and that real problems lie ahead creates a great ending to the discussion.

4. Kota Fibres, Ltd.

Source:	Darden
Case Number:	UVA-F-1359
Length:	19 pages
Year:	2001

A rapidly growing, profitable company is running out of money. Why? What can Mrs. Pundir do about the situation, in the short run, in the long run?

5. Advanced Medical Technology Corp.

Source:	Harvard
Case Number:	9-287-028
Length:	6 pages
Year:	1986

Growth from the lender's perspective. This is a somewhat advanced bank lending case. I have often used it as a midterm exam. Student projections for this rapidly growing company usually look good, but can the bank believe the company's projections? If not, can the bank structure a loan to this potentially valuable account that protects the bank in the likely event the company does not live up to its promises -- again? Old but effective.

6. Jones Electrical Distribution

Harvard
4179
6 pages
2010

Jones Electrical needs increased bank financing due to rapid growth. Readers must determine the reason for the rising bank borrowing, estimate future borrowing needs, and assess the attractiveness of the loan to the bank. The case highlights the difference between profit and cash flow, and it allows for introduction of sustainable growth analysis.

Chapters 5 and 6 Financial Instruments and Markets and The Financing Decision

1. Blaine Kitchenware, Inc.: Capital Structure

Source:	Harvard
Case Number:	4040
Length:	9 pages
Year:	2009

A diversified mid-sized manufacturer of kitchen tools considers a stock repurchase in response to an unsolicited takeover. The company must determine the optimal debt capacity and capital structure, and subsequently estimate the resulting change in firm value and stock price. Attention is also given to the value of interest tax shields.

2. Bed, Bath & Beyond: Capital Structure Decision

Source:	Kellogg School
Case Number:	KEL082 (Available on Harvard site.)
Length:	14 pages
Year:	2004

The company has no long-term debt. In early 2004, interest rates were at an all-time low, making it an attractive time to consider issuing debt and executing either a share repurchase or a one-time special dividend. Students are invited to analyze several capital structure proposals. The case covers issues in capital structure, debt management, leasing, and long-term financing.

3. California Pizza Kitchen

Source:	Darden
Case Number:	UVA-F-1553
Length:	17 pages
Year:	2008

Management is considering a debt-financed stock buyback program. The case is intended to provide an introduction to the Modigliani and Miller capital structure irrelevance propositions and the concept of debt tax shields.

4. Sealed Air Corp's Leverage Recapitalization (A)

Source:	Harvard
Case Number:	294122
Length:	21 pages
Year:	1989

Sealed Air is a Harvard best seller and one of my favorite cases, especially with executives. It describes Sealed Air's leveraged recapitalization. Students must understand the accounting for the transaction, the market's response to the transaction, and most importantly, why in the world a company would consciously put itself at risk like this. Is value created, what is the source? The case is an excellent platform for discussing the ties between leverage and value, especially the incentive effects of leverage.

5. Stone Container Corporation (A)

Source:	Harvard
Case Number:	297047
Length:	15 pages
Year:	1993

Stone Container has used copious amounts of debt financing to finance acquisitions in a highly cyclical industry. Now it faces the prospect of defaulting on its debt. The challenge is to evaluate several strategies, including a stock issue. A one-page (B) case describes the collapse of the company's stock when it announces a new equity issue, clearly illustrating the importance of market signaling. The question in the (B) case is what to do now? This is a nice companion to Sealed Air where a high debt ratio appears to create considerable value. Here high debt has gotten the company into a serious mess.

6. Diageo plc

Harvard
201033
16 pages
2000

Diageo plc introduces students to the static-tradeoff theory of capital structure as actually implemented in a major firm and presents use of simulation to capture the impact of different business policies under uncertainty.

7. Loewen Group, Inc. (Abridged)

Source:	Harvard
Case Number:	201082
Length:	13 pages
Year:	2001

Loewen is a publicly traded funeral home and cemetery consolidator. Much like Stone Container discussed above, it faces imminent financial distress due to aggressive use of debt. Restructuring the debt is potentially very costly to creditors, shareholders, suppliers, and other corporate stakeholders. The case illustrates the cost of financial distress, basic restructuring options, and the determinants of capital structure.

8. Threshold Sports, LLC

Source:	Darden
Case Number:	UVA-F-1347
Length:	25 pages
Year:	2001

This entrepreneurial firm needs \$500,000 in external financing to meet its ambitious growth objectives. Financing options include debt, equity and convertible preferred stock. The decision depends in part on the estimated value of the business. Students have the opportunity to reflect on the merits of convertible preferred stock for financing entrepreneurial companies.

9. Conor Medsystems

Source:	Harvard
Case Number:	804180
Length:	29 pages
Year:	2004

The company has developed a drug-eluting stent that could capture significant share of the \$5 billion global market. The chief executive is considering alternative sources of financing to test the device. The purpose of the case is to introduce issues in entrepreneurial finance.

Chapter 7 Discounted Cash Flow Techniques

1. Fonderia Di Torino S.P.A.

Source:	Darden
Case Number:	UVA-F-1350
Length:	4 pages
Year:	2000

Should Francesca Cerini purchase a Vulcan Mold-Maker? This is a simple, introductory capital budgeting case.

2. Whirlpool Europe

Source:	Harvard
Case Number:	202017
Length:	7 pages
Year:	1999

The company is contemplating an investment in an enterprise resource planning system. Students must estimate relevant cash flows and calculate figures of merit for the investment.

3. Victoria Chemicals PLC (A) The Merseyside Project

Source:	Darden
Case Number:	UVA-F-1543
Length:	9 pages
Year:	2008

I can't say enough good things about this case. I often devote two sessions to the case, the first focusing on the mechanics of calculating NPVs and IRRs, the second on determining the relevant costs and benefits for the investment. The case nicely sets up discussions of many of the thornier issues in determining relevant cash flows. A second case, <u>Victoria Chemicals PLC (B): Merseyside and Rotterdam Projects</u>, introduces mutually exclusive alternatives, issues in administering capital budgeting systems, and an introduction to real options.

4. Energy Gel: A New Product Introduction (A)

Source:	Kellogg School (Available on Harvard site.)
Case Number:	KEL083
Length:	11 pages
Year:	2003

The case asks readers to evaluate a possible new product introduction. Topics include sunk costs, incremental costs, cannibalization, shared facilities, and inflation. A final exam with my suggested answers, an Excel file with my analysis of the investment, and the case exhibits are available at Energy Gel: A New Product Introduction.

5. Stryker Corp.: In-sourcing PCBs

Harvard
207121
6 pages
2007

Frustrated by unreliable suppliers, Stryker's Instruments business is considering a proposed investment to manufacture printed circuit boards in-house. This is an apparently simple case that forces the reader to define the scope and tenor of an investment and to place the analysis in a broader strategic context. Good for emphasizing that there is much more to investment analysis than arithmetic. My teaching note, case exhibits, and an accompanying analysis are available at <u>Stryker Corp.: In-sourcing PCBs</u>.

6. Genzyme/Geltex Pharmaceuticals Joint Venture

Source:	Darden
Case Number:	UVA-F-1254
Length:	15 pages
Year:	1997

This case enables students to perform a simulation analysis on a capital expenditure opportunity. Be sure to order the Excel spreadsheet that accompanies the case, UVA-S-F-1254. It provides a conventional discounted cash flow analysis of the investment. Using information in the case, students assign probability distributions to uncertain variables and simulate the results. Students can use Crystal Ball to perform the simulation, which is available on a trial basis as described in Chapter 3.

Chapter 8 Risk Analysis in Investment Decisions

1. Nike, Inc.: Cost of Capital

Source:	Darden
Case Number:	UVA-F-1353
Length:	8 pages
Year:	2001

A portfolio manager seeks to estimate Nike's cost of capital as part of a DCF valuation of the company for investment purposes. An introductory, straight-forward WACC estimation exercise.

2. <u>Teletech Corporation</u>, 2005

Source:	Darden
Case Number:	UVA-F-1485
Length:	15 pages
Year:	2005

This is an intermediate level cost of capital case. Should Teletech use a single hurdle rate or multiple rates that reflect the risk of its separate divisions? How difficult is it to estimate divisional capital costs? Are division hurdle rates useful in the assessment of divisional performance?

3. Beta Management Company

Source:	Harvard
Case Number:	292122
Length:	5 pages
Year:	1991

Beta Management is a vehicle for exploring diversifiable risk. A portfolio manager is considering adding one of two stocks to her diversified portfolio. One has a higher standard deviation of returns but a lower beta. Although rather mechanical and getting old, the case is one of the few introductory platforms for exploring investment risk.

4. Pearson Capital Management

Source:	Higgins (Case, teaching note, and other files are
	available at Pearson Capital Management.)
Case Number:	NA
Length:	17 pages
Year:	2009

An individual wants to invest \$2.5 million for his retirement. He meets with the principal of a local money management firm, who describes his firm's investment philosophy and offers empirical evidence supporting its efficacy. The philosophy is generally consistent with modern portfolio theory, encompassing such notions as diversification, beta risk, the market line, and alpha return. The case also alludes to several investment styles, as well as active versus passive investing. Evidence favoring the company's investment philosophy includes alpha returns on several portfolios over 30 years and various sub-periods. The reader's challenge is to make sense of this information, to identify how the company might add value compared to investing directly and ultimately to decide how best to invest the \$2.5 million. The case can be used to talk about basic concepts of risk and return, diversification, and beta risk, as well as the intuition underlying the efficient market hypothesis and the capital asset pricing model. I wrote this case to replace <u>Beta Management</u> and have been quite pleased with the classroom results.

5. LaFarge Manufacturing, Inc.

Source:	Higgins (Case and other files are available at LaFarge Manufacturing, Inc.)
Case Number:	NA
Length:	4 pages
Year:	2001

This is an introductory, real options case. LaFarge is considering a major investment to be made in two-stages. Conventional analysis indicates it is uneconomic, but when the second stage is made conditional on success of the first stage, it becomes attractive.

6. Wind Resources, Inc.

Source:	Higgins (Case, teaching note, and other files are
	available at Wind Resources, Inc.)
Case Number:	NA
Length:	17pages
Year:	2005

Based on the actual sale of a wind farm in Southern California, this is a realistic real options case. A consultant's conventional analysis indicates the wind farm is worth some \$13 million. But the property need not be developed immediately, and ROA analysis suggests this flexibility almost doubles the investment's value. In addition to ROA, students learn a good bit about the economics of alternative energy.

7. Valmont Industries

Source:	Darden
Case Number:	UVA-F-1191
Length:	21 pages
Year:	1993

This case is a nice introduction to Economic Value Added.

Chapter 9 Business Valuation and Corporate Restructuring

1. The Takeover of the Norton Company

Harvard
291002
15 pages
1990

This case is getting old, but remains one of my favorites. An undisguised case, it describes BTR plc's attempted hostile takeover of Norton Company. The case appendix presents seven alternative methods of valuing Norton, the last two of which are discounted cash flow valuations. I find this an effective introduction to discounted cash flow business valuation. Most of the class is devoted to understanding and assessing the valuations in the appendix. The May 2, 1990 Washington Post, page 63, contains a fascinating description of the lengths Norton went to avoid takeover and the eventual outcome. The French firm Compagnie de Saint-Gobain acquired Norton for the ridiculously high price of \$90 a share and the written promise not to meaningfully change the company. There is no teaching note, but my discussion outline and other materials are available at The Takeover of the Norton Company.

2. Adecco S.A.'s Acquisition of Olsten Corp.

Source:	Harvard
Case Number:	201068
Length:	18 pages
Year:	2001

In this undisguised case, Adecco wants to value the staffing operations of Olsten Corp., a U.S. firm. Readers are asked to execute a DCF valuation of Olsten and to wrestle with several realistic complications. Suggested answers to a midterm exam of mine and a valuation of Olsten are available at Adecco S.A.'s Acquisition of Olsten Corp.

3. JetBlue Airways IPO Valuation

Source: Case Number	Darden UVA-F-1415
Length:	20 pages
Year:	2002

The case describes the pricing of JetBlue's IPO. Students are invited to confirm or reject the current filing price range using DCF and comparable trades valuation techniques. The epilogue indicates that the stock price jumped 67 percent on the first day, inviting discussion of the underwriting process and the underpricing phenomenon. This is a reasonably challenging case with considerable ambiguity.

4. Stanley Black & Decker, Inc.

Source:	Harvard
Case Number:	211067
Length:	4 pages
Year:	2011

This brief case enables readers to calculate the anticipated value of the cost synergies in an undisguised merger. It allows readers to explore the allocation of the value created among shareholders and managers of the two companies. In addition to mergers and acquisitions, the case raises issues in compensation and corporate governance.

5. Valuation of Airthread Connections

Source:	Harvard
Case Number:	4236
Length:	15 pages
Year:	2007

Described by the authors as a capstone valuation case in an introductory graduate finance course, this case considers business valuation in the face of changing capital structure. It requires readers to understand the relative strengths of DCF and APV valuation and to select the proper technique for the task at hand.

6. Flinder Values and Controls

Source:	Darden
Case Number:	4236
Length:	15 pages
Year:	2007

In this group negotiation exercise, RSE International is interested in acquiring Flinder Values and Controls. Participants representing the two companies must complete a relatively straight-forward valuation of the two companies and negotiate a selling price. The case provides supplementary private information to each side in the negotiation.

Analysis for Financial Management, 10e

SUGGESTED ANSWERS TO EVEN-NUMBERED PROBLEMS

Chapter 2

2)

- a. Price-to-earnings ratios are highly dependent on future growth expectations. I would thus expect high growth Google to have the higher ratio than low growth GM.
- b. The financial institution should have the higher debt to equity ratio because the liquid, relatively safe nature of its assets enables it to borrow more money at attractive rates. And in the case of banks, deposit insurance enables the institution to collect low cost deposits. The principal asset of financial institutions tends to be relatively safe loans that generate relatively predictable income streams. The uncertain income stream of the high tech company makes it less creditworthy.
- c. The appliance manufacturer should have the higher profit margin because it adds more value to its product than a grocer does and hence can charge a higher markup over cost.
- d. The jewelry store should have the higher current ratio. Jewelry stores typically need to have a lot of expensive display inventory on hand and often offer time payment plans to customers. Online bookstores, on the other hand, typically carry little inventory and rely on credit card sales involving little accounts receivable.
- 4) a. ROE will most likely fall. The numerator of the ratio, net income, will decline because the acquired company is losing money. Unless the acquiring firm's equity declines due to the acquisition, a highly unlikely event, ROE will decline.
 - b. This, however, is not important to the decision. This is another example of the *timing* problem. If the technology company has great promise, it may make complete sense to acquire the business even though it is currently losing money. The proper way to evaluate the acquisition is by estimating the target's fair market value and acquiring it at a lower price. This is the topic of Chapter 9.
- 6) Your colleague's argument has several holes in it.
 - a. He has forgotten the *timing* problem. The investment has consequences over many years, and it is inappropriate to base the decision on only one year's results. As will be discussed beginning in Chapter 7, the appropriate rate of return for evaluating investment opportunities is not the division's accounting ROI but a rate that specifically incorporates the time value of money.

b. Your company's performance appraisal system is faulty. Investment return should be judged against a minimum acceptable return, not the division's historical return. An irrational implication of the performance system used by your company is that divisions with very low returns will want to make lots of investments because many will promise returns higher than the division's ROI. Conversely, high return divisions, such as yours, will find few opportunities beating the division's ROI. We will look at this issue again in Chapter 8 as part of our look at Economic Value Added.

8) a. R&E Supplies, Inc.

·				
	2008	2009	2010	2011
Profitability ratios:				
Return on equity (%)	30.9	28.6	24.2	16.8
Return on assets (%)	11.3	10.3	7.7	5.0
Return on invested capital (%)	18.7	18.9	17.4	12.9
Profit margin (%)	3.3	2.9	2.4	1.4
Gross margin (%)	16.0	15.0	15.0	14.0
Turnover-control ratios:				
Asset turnover (X)	3.4	3.6	3.2	3.5
Fixed-asset turnover (X)	87.4	111.0	54.6	71.8
Inventory turnover (X)	8.4	8.5	7.1	7.8
Collection period (days	43.8	47.4	47.5	51.1
Days' sales in cash (days)	21.9	14.6	14.6	7.3
Payables period (days)	39.1	45.0	64.7	66.1
Leverage and liquidity ratios:				
Assets to equity (%)	274.5	276.7	314.4	339.3
Total liabilities to assets (%)	63.6	63.9	68.2	70.5
Total liabilities to equity (%)	174.5	176.7	214.4	239.3
Long-term debt to equity (%)	80.5	65.4	54.3	43.9
Times interest earned (X)	7.7	8.0	7.3	6.9
Times burden covered (X)	3.7	4.3	4.0	2.3
Current ratio (X)	2.8	2.4	1.8	1.7
Acid test (X)	1.8	1.5	1.1	1.0

Ratio Analysis

b. Insights

i. All of the profitability ratios are down. ROE, while still respectable, has fallen by almost half, and the profit margin is down by more than half. This suggests problems on the income statement. Full Download: http://alibabadownload.com/product/analysis-for-financial-management-10th-edition-higgins-solutions-manual/

- ii. Leverage is up and liquidity is down. Liabilities now constitute over 70 percent of assets, and the current ratio has fallen almost 40 percent.
- iii. Asset turnover has been reasonably steady, although the collection period has risen over 15 percent. The payables period has almost doubled, and at 66 days, appears quite long.
- iv. R&E Supplies' rapid growth causes a continuing need for external financing. Falling operating margins have exacerbated this need. The company appears to have met this need by reducing liquidity (days sales in cash is down from 21.9 days to 7.3) and by increasing trade financing. At the same time, long-term debt to equity has fallen. The company would probably be advised to replace some of its trade financing with a bank loan, part of which is longer-term. It also should rethink its pricing-growth strategy. One might argue that R&E has been "buying growth" by under-pricing its product.
- 10) a. Liabilities-to-equity ratio = 200/300 = 0.67, Times interest earned = EBIT/interest expense = 120/28 = 4.29 Times burden covered = EBIT/ (interest + (principal repayment/(1-tax rate))) = 120/[28+24/(1-0.40)]= 1.76
 - b. To fail to cover the existing interest payments, the times interest earned ratio has to fall below one. (4.29 1)/4.29 = 76.7%, or (120 28)/120 = 76.7%

To fail to cover the interest and sinking fund payment, the times burden covered ratio has to fall to below one. (1.76-1)/1.76 = 43.2%, or [120-(28+24/(1-0.40))]/120 = 43.3% (The difference is due to rounding.)

To fail to cover interest, principal, and dividend payments we must further subtract the impact of dividends on the EBIT. [120-(28 + ((24 + 0.30*20)/(1-0.4))]/120 = (120 - 78)/120 = 35%)

12) The answer to this problem is available on this Web site. Select Instructor Edition > Choose a Chapter>Chapter 2> C2_Problem_12_Answer.xlsx

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