**Question 35**

You work for a firm of financial advisors and have been asked to analyse the investment performances of the following two companies:

|  |  |  |
| --- | --- | --- |
|  | **Bowlers plc** | **Rounders plc** |
| Profit for the Year after Interest and Tax | £150,000 | £350,000 |
| Ordinary Shares of £1 each | £200,000 | £1,000,000 |
| 5% Preference Shares | £250,000 | Nil |
| 8% Debentures | Nil | £500,000 |
| Ordinary Shares — Market Price | £1·75 | £1·50 |
| Ordinary Dividend per Share | 10p | 8p |

1. You are required to calculate for each company:
2. Dividend Yield
3. Dividend Cover
4. Earnings per Share
5. Price/earnings Ratio

**Answers should be given to two decimal places. 8**

*(*b) (i) By analysis of each of the ratios calculated above, state the advice you would offer   
to a potential investor. **8**

(ii) Calculate the Equity Gearing Ratio for each company. **2**

(iii) Explain which company would be the better investment in periods of high profit. **2**

**Total marks (20)**

**Question 35 — solution**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| (a) | |  | |  | | | | | | | **Bowlers plc** | | | | | | |  | | | **Rounders plc** | | | | | | | | |  | |  | |
|  | | (i) | | **Dividend Yield** | | | | | | |  | | | | | | |  | | |  | | | | | | | | |  | |  | |
|  | |  | | Ordinary Dividend per share | | | |  | | |  | | 10p × 100 | | |  | | |  | | |  | | | 8p × 100 | | | |  | |  |  | |
|  | |  | | Market Price per Share x100% | | | | | | |  | | £1·75 | | |  | | |  | | |  | | | £1·50 | | | |  | |  |  | |
|  | |  | |  | | | | | | | **5·71%** | | | | | | | **(1)** | | | **5·33%** | | | | | | | | | **(1)** | |  | |
|  | |  | |  | | | | | | |  | | | | | | |  | | |  | | | | | | | | |  | |  | |
|  | | (ii) | | **Dividend Cover** | | | | | | |  | | | | | | |  | | |  | | | | | | | | |  | |  | |
|  | |  | | PFY after Tax − Pref Div | | | | | | | 150,000 – 12,500 | | | | | | |  | | |  | | | 350,000 | | | |  | |  | |  | |
|  | |  | | Dividends on Ordinary Shares | | | | |  | | £20,000 | | | | | | |  | | |  | | | £80,000 | | | |  | |  | |  | |
|  | |  | |  | | | | | | | **6·88 times** | | | | | | | **(1)** | | | **4·38 times** | | | | | | | | | **(1)** | |  | |
|  | |  | |  | | | | | | |  | | | | | | |  | | |  | | | | | | | | |  | |  | |
|  | |  | | **Working Notes for (ii)** | | | | | | |  | | | | | | |  | | |  | | | | | | | | |  | |  | |
|  | |  | |  | | | | | | |  | | | | | | |  | | |  | | | | | | | | |  | |  | |
|  | |  | | Preference Dividends | | | | | | | 5% × £250,000 | | | | | | |  | | |  | | | | | | | | |  | |  | |
|  | |  | |  | | | | | | | = £12,500 | | | | | | |  | | |  | | | | | | | | |  | |  | |
|  | |  | |  | | | | | | |  | | | | | | |  | | |  | | | | | | | | |  | |  | |
|  | |  | | Ordinary Share Dividends | | | | | | | 200,000 × 10p | | | | | | |  | | | 1,000,000 × 8p | | | | | | | | |  | |  | |
|  | |  | | Dividend Paid | |  | | | | | = £20,000 | | | | | | |  | | | = £80,000 | | | | | | | | |  | |  | |
|  | |  | |  | | | | | | |  | | | | | | |  | | |  | | | | | | | | |  | |  | |
|  | | (iii) | | **Earnings per Share** | | | | | | |  | | | | | | |  | | |  | | | | | | | | |  | |  | |
|  | |  | | PFY after Tax – Pref Div | | | | | | | 150,000 – 12,500 | | | | | | |  | | |  | | | 350,000 | | | |  | |  | |  | |
|  | |  | | No of Ordinary Shares | | | | |  | | 200,000 | | | | | | |  | | |  | | | 1,000,000 | | | |  | |  | |  | |
|  | |  | |  | | | | | | | **£0·69** | | | | | | | **(1)** | | | **£0·35** | | | | | | | | | **(1)** | |  | |
|  | |  | |  | | | | | | |  | | | | | | |  | | |  | | | | | | | | |  | |  | |
|  | | (iv) | | **Price/Earnings Ratio** | | | | | | |  | | | | | | |  | | |  | | | | | | | | |  | |  | |
|  | |  | | Market Price per Share | | | | | | |  | | | £1·75 | |  | |  | | |  | | £1·50 | | | |  | | |  | |  | |
|  | |  | | Earnings per Share |  | | | | | |  | | | £0·69 | |  | |  | | |  | | £0·35 | | | |  | | |  | |  | |
|  | |  | |  | | | | | | |  | | | **2·54 times** | |  | | **(1)** | | |  | | **4·29 times** | | | |  | | | **(1)** | |  | |
|  | |  | |  | | | | | | |  | | | | | | |  | | |  | | | | | | | | |  | | **8** | |
|  | |  | |  | | | | | | |  | | | | | | |  | | |  | | | | | | | | |  | |  | |
| (b) | | (i) | | Before making a recommendation the following should be considered:   * Dividend yield allows shareholders to compare the return on their investment at current market price, rather than the nominal value of the share **(1)**. Bowlers plc has a slightly better dividend yield than Rounders plc, indicating that they have a better performance than Rounders plc and that the client would receive a greater return **(1)**. * The dividend cover shows that Bowlers plc retains more of its profits in the business in the form of reserves and for reinvestment in the company **(1)**. This may benefit the client in the future with increased share price. However, if the client is looking for income, Rounders plc distributes more of its profits to its shareholders **(1)**. * The earnings per share may be a better indicator to potential investors than either the rate of dividend or the dividend yield **(1)**; however, it can be influenced by the capital gearing of the company. Bowlers plc shows much better earnings per share than Rounders plc. **(1)** | | | | | | | | | | | | | | | | | | | | | | | | | |  | |  | |
|  |  | | * The price/earnings ratio shows how the market price of the share compares with its earnings **(1)**. It would cost Bowlers plc  2·55 times its earnings to buy a share, whereas it would cost Rounders plc 4·29 times its earnings. As share prices might increase, this might be a good time to purchase shares in Bowlers plc. **(1)**  Taking into account the above, I would recommend that the client purchase shares in Bowlers plc. | | | | | | | | | | | | | | | | | | | | | | | | |  | | **8** | |
|  |  | |  | | | | | | |  | | | | | | |  |  | | | | | | | | | |  | |  | |
|  | **(ii)** | | **Equity Gearing Ratio** | | | | | | |  | | | | | | |  |  | | | | | | | | | |  | |  | |
|  |  | | Fixed Interest Equity | | | |  | | |  | | 250,000 | | |  | |  |  | | 500,000 | | | | | |  | |  | |  | |
|  |  | | Ordinary Shares | | | |  | | |  | | 200,000 | | |  | |  |  | | 1,000,000 | | | | | |  | | **(1)** | |  | |
|  |  | |  | | | |  | | |  | | 1·25 | | |  | |  |  | | 0·5 | | | | | |  | |  | |  | |
|  |  | |  | | | |  | | |  | | 1·25:1 | | |  | |  |  | | 0·5:1 | | | | | |  | | **(1)** | | **2** | |
|  |  | |  | | | | | | |  | | | | | | |  |  | | | | | | | | | |  | |  | |
|  | **(iii)** | | Bowlers plc is a more highly geared company **(1)**.In times when profits are high, the client would benefit from purchasing ordinary shares in this company, as they would receive a good share of the profits **(1)**. In times of poor profits, they would receive little or no dividend **(1)**. | | | | | | | | | | | | | | | | | | | | | | | | |  | |  | |
|  |  | |  | | | | | | | **(up to a maximum of 2 marks)** | | | | | | | | | | | | | | | | | **2** | | | | |
|  |  | |  | | | | | | |  | | | | | | |  |  | | | | | | | | | | | | | | |

**Total marks (20)**