Answers to Exam Questions

Topic: Sources of Finance

Case Study: Blondie Ltd

1. *Analyse the possible drawbacks to the company of going ahead with the expansion. (9 marks)*

Possible arguments include:

1. Expansion may cause cash flow problems e.g. overtrading
2. It is risky as they are targeting a new market segment
3. It is a competitive market with established rivals that have more experience
4. It is unclear if it is actually feasible as it may not be able to be funded
5. The company may be better increasing profitability in its current operations
6. The marketing investment is risky as it needs to occur prior to proof that it is driving demand
7. The investment in additional stock is risky as forecasts may be too high, a lower than forecasted demand would lead to an overstock position and a worsened working capital
8. The founder is optimistic which may mean they are too aggressive and bold in their forecasts

2. *In your option, how should the expansion be funded? Justify your views. (16 marks)*

Possible arguments include:

1. More share capital could be raised through selling shares. This has the benefit of not incurring interest and only paying dividends when the company is in profit. However, the shareholders are possibly disgruntled as they have received no dividends from the previous year. Consequently, shareholders may not wish to agree to the issuing of more shares and new, prospective investors may not be as interested, meaning the share price would be low.

2. A bank loan might well be secured however, the company already has a large bank loan so may find getting more funding this way difficult particularly given the company is not profitable.

Other solutions could include:

1. Due to the high receivables figure, use of '*debt factoring*' might well be an option; however, not all the £5m would be retrieved (perhaps closer to 90% e.g. £4m). The company should review its payment terms and also any overdue receivables in order to see if cash could be made available more readily through these collections.

2. Negotiating better payment terms to improve working capital. Payables of just £0.5m on cost of sales of £5m implies shorter payment terms with its suppliers than with its customers.

3. Use of '*Inventory financing*' to fund stock purchases, with the stock serving as collateral for the debt, although this could be expensive given the riskiness to the lender.

4. Use of overdrafts to bridge short-term working capital gaps, but this would not be suitable for the marketing investment due to the duration of the funding requirement.

Evaluation:

Option 1 depends on whether banks are willing to lend more money and the current interest rates.

Option 2 depends on whether the shareholders would be willing to invest further themselves and/or allow sale of more shares.

The feasibility of other options depends on:

1. whether all fixed assets are in use – could any be sold?
2. The percentage cut taken by the debt factoring company
3. The suppliers' willingness to alter terms e.g. is Blondie Ltd an important customer?
4. Does Blondie Ltd have a good track record of repaying its payables on time?
5. The cost and terms of the different financing options
6. The level of certainty that the 'advertising and promotional spend' will indeed drive up demand (perhaps more research should be done first on the likely sales projections and the associated capital requirements)