**XP Homeware** sells fridges, freezers, washing machines, dishwashers, beds, furniture (indoor and outdoor) etc. The owner Bert wants to purchase a truck costing $100,000 to make deliveries to customers. Currently customers have to organise for the delivery of their purchases themselves. All of XP Homeware’s competition have the home delivery option. The quality of service offered by XP Homeware has seen the business win local business awards in each of the last three years.

Bert has two options to finance the purchase of the $100 000 truck.

**Option One**

Sell enough shares to raise $100 000 from the shares he personally has in PGG Wrightson Ltd

**Option Two**

Get a business loan from the bank for $100 000

Loan from the bank would be a 5 year loan

* Interest only loan would cost $609 per month and the total interest cost would be $36,500
* Table loan (interest and principal) would cost $1,995 per month and the total interest cost would be $19, 659

**Additional information**

* Current cash income is $950,000 per year
* Current cash payments are $925,000 per year
* Cash income after purchase of the truck $1,200,000
* Cash payments after purchase of truck
* Financed by shares: $1, 150,000
* Financed by loan (interest only): $1,157,400
* Financed by loan (interest and principal): $1,174,000
* Bert’s shares in PGG Wrightson are expected to earn a dividend $8, 000 per year over the next 5 years. If Bert was to sell his shares in 5 years he believes he will get a capital gain/ appreciation of $30 000.
* Bert will need to sell half of his shares in PGG Wrightson to raise the $100 000 needed for the truck and to pay the share brokers fee of $ 1500. Selling the shares will halve the dividend and the capital gain.
* Equity in the business is currently 53%
* Using the shares to finance the truck will see equity increase to 56%
* Using a $100 000 loan to finance the truck will see equity decrease to 50%

**Question**

Justify how XP Homeware should finance the truck purchase.

**Forecast of XP Homeware**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Yearly** | **Original** | **Sell shares** | **Loan – interest only** | **Loan – interest and principal** |
| Cash income | 950 000 | 1 200 000 | 1 200 000 | 1 200 000 |
| Cash payments | 925 000 | 1 150 000 | 1 157 400 | 1 174 000 |
| Cash surplus per year | 25 000 | 50 000 | 42 600 | 26 000 |
|  |  |  |  |  |
| **5 Years**  |  |  |  |  |
| Cash surplus | 125 000 | 250 000 | 213 000 | 130 000 |
| Dividends | 40 000 | 20 000 | 40 000 | 40 000 |
| Share appreciation | 30 000 | 15 000 | 30 000 | 30 000 |
| Loan repayment |  |  | 100 000 |  |
|  | **195 000** | **285 000** | **183 000** | **200 000** |

**Get the truck**

XP Homeware should purchase the truck because the forecast income of the business and the cash surplus each year will both increase to be more than the original situation. Originally $950 000 income and $25 000 cash surplus and after the truck purchase income is forecast to be $1 200 000 and the smallest surplus from the financing options is $26 000.

**Financing the Truck**

**Shares**

The selling of half of the shares will give Bert the $100, 000 he needs to buy the truck plus the $1 500 to pay his share broker. Any of the options of finance should increase the income to the forecast $1 200 000 but this option has the lowest increase in cash payments. This means if the income doesn’t reach the forecast amount, this option will still have the biggest cash surplus per year and overall.

This financing option will only see cash payments increase to $1 150 000 because of the extra costs associated with running the truck. These would include registration, maintenance, drivers wages, road user charges, diesel paid for each year. This financing method would not put extra pressure on monthly cash flow as there is no cost associated with it. All three methods of finance are all going to incur the $225 000 of extra payments associated with running the truck. Bert **will not** have to look at cutting costs elsewhere because of financing the cost of the truck with his shares.

This method of finance would also have the highest forecast cash surplus over the first 5 years with a total of $250 000. Bert can also earn $20 000 from dividends over the five years from the remaining shares he has in PGG Wrightson. If the share price appreciates he is likely to earn $15 000 from this. This means it is estimated that Bert will be $285 000 better off overall when he combines the cash surplus with what he can earn from the remaining shares. Obviously the downside to this option is that Bert will miss-out on $20 000 of dividend that he is likely to receive from his shares. He would also miss-out on $15 000 from an appreciation in the shares if this was to happen. However, he could use the cash surpluses he is forecast to get to buy more shares each year in PGG Wrightson’s. This would increase the dividends he could earn and he may even get the shares at a cheaper price.

The bank will also be happy with this financing method as it will increase his equity in XP Homeware to 56%. This would mean that if Bert wants to borrow in the future that the bank would look favourably at lending to the business as Bert is financing 56% of his businesses assets personally.

**Loan - interest only**

This option generates the second highest surplus each year of $42 600. It is lower than the share option because the total cash payments are higher as there is an interest cost of $609 per month which increases total cash payments by $7,400 each year. The extra $609 per month will put pressure on cash flow in the months where cash income is lower e.g. winter months where customers aren’t out shopping as much. There could also be more pressure in months where cash payments are higher e.g. months where GST must be paid to the IRD or where XP Homeware has stocked up on appliances or furniture for the new season. This will be stressful for Bert as he will be worried about paying his suppliers on time as he won’t want to be charged penalty costs for late payment or have the businesses credit rating negatively affected.

To make savings in months where he feels cash flow pressure he may reduce the number of staff working in the store at certain times of the day. This may affect his business as customers may feel they aren’t getting the service they deserve and thus they shop elsewhere. It will also place pressure on the staff that are working at times when the store is busy. Staff that don’t work as many hours will feel the pressure of a reduced income as they are paid just above minimum wage. This means they are unlikely to have savings or are able to save any of their pay, as it is needed to pay for the necessities or they may have difficulty even paying for their necessities. This added pressure could see them seeking employment with other retailers that guarantee then enough hours of work each week.

Using an interest only loan will lower the equity Bert has in XP Homeware to 50%. This is getting near a level where his bank will feel the risk of lending to XP Homeware in the future is getting high, especially as any future lending can potentially lower it further. However with a projected cash surplus each year of $42,600 Bert can increase the equity in XP Homeware by not drawing all of it out of the business each year i.e. by keeping some of it in the business he is basically investing in the business.

This method will generate the lowest estimated cash surplus -$183,000 for Bert over five years when including the $70,000 he could earn in dividends and from the possible capital gain from selling his shares. This is less than what it is estimated Bert can earn if he didn’t buy the truck -$195,000. This option has the lowest surplus because Bert incurs a higher interest cost across the life of the loan- $36,500 compared to $19,659 from the interest and principal option. There is also the added pressure of having to pay the $100 000 back to the bank at the end of the loan. Bert will need to make sure that he is putting cash aside each month / year so that he will have $100,000 cash available to pay back the loan.

**Loan – interest and principal**

This method of financing the truck earns the lowest estimated cash surplus each year $26,000. It is also only $1,000 more than not buying the truck. The payments on this option are the highest each year and this is because of the financing cost of the loan includes interest and principal, which total $1,995 per month compared to $609 for the interest only option. This option will put even more pressure on the cash flow in the months indicated in the interest only explanation above e.g. winter, months when GST is paid etc. Thus there will be more stress related to paying suppliers and on staffing levels.

Overall it is estimated that in 5 years the cash surplus from having the truck will only be $5,000 more than not buying it. This is not a high return for such an investment. This method of finance also has the highest risk of it not improving on the performance of XP Homeware over the next 5 years, as the estimated costs/ payments of running the truck only need to increase $1,000 each year for it not to be a situation that improves the cash surplus above $125,000. A smaller increase in cash income generated by the truck offering home deliveries will also see this option not improving the cash surplus above $125,000.

**Justification**

The benefits of using the shares to finance the truck purchase are greater than the either of the debt finance options and there are less costs involved. The selling of the shares will provide Bert with the highest forecast cash surplus $250,000 before adding dividend and capital gain possibilities. This means this method of financing has the smallest risk of the decision to buy the truck not being successful. This is because a combined effect of cash income and cash payments falling and increasing respectively reducing the forecast cash surplus by $20,000 a year will still make it a decision that generates a higher cash surplus than not buying the truck.

The financing by shares decision puts less pressure on cash flow than the debt finance options do as there are no interest and principal payments to be made each month with the only extra payments being those associated with running the truck. Bert won’t need to reduce staffing or cut back on payments and he doesn’t have the pressure of having to repay a loan. The forecast cash surplus from this option will also provide Bert with an opportunity to buy more shares in PGG Wrightson to replace the shares that he sold to finance the truck purchase.