South Tuen Mun Government Secondary School

Ch_3_Sources of Financing

3.14_ Photocopying Shop

a) Explain TWO factors that will affect Vivian's choice. (6 marks)

b) Given that Vivian's shop has high liquidity. Which of the above proposals would you recommend to her? Explain. (5 marks)

c) how can Vivian search for suitable suppliers of photocopying machines? Describe THREE ways.

(6 marks)

d) Besides the above proposals, suggest another financing method for acquiring the new photocopying machines. (1 mark)

3.15_ Supermarket

a) Explain ONE way for the company to segment the Hong Kong market. (3 marks)

b) Evaluate the financing plan proposed by the board of directors. (8 marks)

c) Suggest TWO suitable financing methods other than those proposed by the board of directors. Explain your suggestion. (4 marks)

d) Explain whether the company should use short-term financing or long-term financing to purchase goods from suppliers. (3 marks)

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3.16_ Prosperous Property

a) Why shouldn't Prosperous Property finance the project by issuing commercial paper? (5 marks)

b) Should Prosperous Property finance the project by issuing common stock or 10-year bonds. Give THREE reasons. (7 marks)

c) Describe THREE promotion mix tools that Prosperous Property may use to promote its new property in Chengdu. (6 marks)

3.17_ Video game company

a) Why would Game Raider have less freedom in decision making if it finances the acquisition by issuing common stocks instead of using retained profits? Give TWO reasons. (4 marks)

b) Explain why the freedom in decision making allowed by internal financing may not be a good thing. (3 marks)

c) Why should Game Raider use external financing in addition to internal financing? Explain. (3 marks)

d) Describe THREE marketing strategies that Game Raider, as the market leader of the video game industry, may use. (6 marks)

e) Which strategy does Game Raider use in selecting market segments? Explain briefly. (2 marks)

Case Analysis

3.14 **a** The following factors will affect how Vivian chooses between the two financing methods:

- Control: If Vivian chooses Proposal 2, Sammy will become a stockholder. This would undermine her control over the shop. However, Proposal 1 will not affect her control because a creditor (the bank) does not have voting rights.
- Risk: If Vivian chooses Proposal 1, the shop's interest burden will increase. This will increase the shop's risk of bankruptcy. However, Proposal 2 will not increase the shop's risk as adding a new stockholder will not create any financial burden.
- Cost: Debt financing is generally less costly than equity financing. This is partly because interest expense is tax deductible.In other words, Proposal 1 is less costly than Proposal 2.
- Flexibility: If Vivian chooses Proposal 1, she needs to repay the loan by monthly instalments. Although she may recover her investment within two years, she still needs to make repayments as scheduled until the due date if early repayment is not allowed.

(Any two of the above, 1 mark for the factor, 2 marks for explanation)

b As Vivian's shop has high liquidity, it has a low risk of bankruptcy and it should be able to obtain the bank loan at a low cost. (2 marks)

In this case, Vivian should use debt financing because the advantages of debt financing (i.e., maintaining control and lower cost) outweigh the disadvantages. (2 marks)

Therefore, she should choose Proposal 1. (1 mark)

c Vivian may search for suitable suppliers in the following ways:

- Drawing up a list of potential suppliers by reviewing trade directories (2 marks)
- Searching for supplier information on the Internet (2 marks)
- Seeking recommendations from other photocopying shops or the printing industry association (2 marks)

(Any other reasonable answers)

d Vivian may obtain new photocopying machines by hire purchase. (1 mark)

3.15 **a** The company can segment the Hong Kong market by income level (i.e., demographic segmentation). (1 mark)

This is because consumers with different income levels usually have different shopping preferences. For example, those with a higher income level may put more emphasis on product quality and do not mind paying higher prices, but those with a lower income level may prefer low-priced goods. (2 marks)

b The proposal to pay part of the investment cost by cash in hand is correct. (1 mark)

This is because internal financing will not result in an extra financial burden for the company and does not involve transaction costs. (2 marks)

However, the proposals to finance part of the investment by a one-year bank loan and factoring accounts receivable are problematic. (1 mark)

First, the finance manager estimates that it will take about three years to get the investment back. In other words, the company may be unable to earn enough profit to repay the one-year loan, and thus it may have to refinance the loan in one year. However, the refinancing opportunities and the cost of financing (e.g., interest rate) are uncertain after one year. This proposal is quite risky. (2 marks)

Second, most supermarket customers pay by cash and the amount of accounts receivable that supermarkets hold is insignificant. It is doubtful whether the company could raise enough funds by factoring accounts receivable. (2 marks)

c The company may finance a significant proportion of the investment by issuing common stock or obtaining a long-term bank loan (e.g., with maturity of three years). (2 marks)

Both are long-term financing methods which are suitable for long-term investment projects. These can provide a stable source of capital to the company and the need for refinancing can be avoided. (2 marks)

d The company should use short-term financing. (1 mark)

This is because short-term financing is more flexible and less costly than long-term financing. The company can sell the goods and use the cash receipts to settle the short-term debt. (2 marks)

3.16 **a** The company should not finance the project by issuing commercial paper because commercial paper is a short-term source of financing. (1 mark)

The maturity of commercial paper is shorter than one year. However, the complex will not be finished and ready for sale in five years. This means if the company issues commercial paper, it must refinance many times over the next few years.

(2 marks)

This is very risky because the future market condition is highly uncertain. If the company fails to refinance its debt or the interest rate increases sharply when the commercial paper is due, it may face great financial difficulties. (2 marks)

b The company should finance the project by issuing common stock. (1 mark)

The reasons are as follows:

- As Prosperous Property is small and new to investors, investors may not be willing to buy its bonds. (2 marks)
- Since the company does not have a good credit rating, it has to offer a high interest rate to attract investors to buy its bonds. Thus, its cost of financing with bonds will be high.

  (2 marks)
- Stock investors are more willing to take risks and invest in small and new companies like Prosperous Property. They, especially long-term investors, will accept zero dividends for a few years. This is because they believe that the Chengdu project will be profitable and the company's prospects are good.

  (2 marks)

c Promotion mix tools that Prosperous Property may use to promote its new property in Chengdu include:

- Advertising: Prosperous Property may hire an advertising agency to develop TV commercials as well as newspaper advertising or magazine advertisements to promote its new property.
- Sales promotion: Prosperous Property may give away free furniture to customers who have purchased its new property.
- Personal selling: Prosperous Property may use its own sales force or property agents to deliver a face-to-face presentation about the new property to potential consumers to arouse interest in the property.
- Direct marketing: Prosperous Property may make use of its customer database to contact potential customers about the new property by phone, mail, email or the Internet.

(Any three of the above, 2 marks for each point)

3.17 **a** Game Raider would have less freedom in decision making if it finances the acquisition by issuing common stocks instead of using retained profits because:

- If Game Raider issues stocks on the stock exchange, it needs to disclose its purpose for raising capital to investors. As a result, the company has to evaluate the acquisition project carefully before raising capital from the stock market. (2 marks)
- If Game Raider issues common stocks, the number of common stockholders will increase. As common stockholders have voting rights in important decisions made by the company, they may affect its decision making. (2 marks)

b When using internal financing, managers can use the funds without stockholders' approval. (1 mark)
As a result, they may be less careful in evaluating investment projects and may waste the money on unprofitable projects. (2 marks)

c Game Raider needs a huge amount of funds to acquire Unlimited Play. (1 mark)
As the capital raised by internal financing is limited, it is unlikely that Game Raider has enough funds to acquire Unlimited Play by using internal financing alone. (2 marks)

Therefore, Game Raider should use a combination of internal and external financing for the acquisition project.

d Three marketing strategies that Game Raider may use include:

- Expanding the total market to increase the number of its customers (2 marks)
- Increasing its market share in the video game market (2 marks)
- Protecting its current market share (2 marks)

e Game Raider uses the differentiated marketing strategy. (1 mark)
This is because it selects multiple market segments (i.e., video games and mobile games) as its target markets. (1 mark)