

Gainesboro mt essay



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GAINESBORO MACHINE TOOLS CORPORATION Overview In mid September 2005, Ashley Swenson, the chief financial officer of this large CAD/CAM equipment manufacturer must decide whether to pay out dividends to the firm? Is shareholders or repurchase stock. If Swenson chooses to pay out dividends, she must also decide on the magnitude of the payout. A subsidiary question is whether the firm should embark on a campaign of corporate-image advertising and change its corporate name to reflect its new outlook. The case serves a review of the many practical aspects of the dividend and share buyback decisions, including (1) signaling effects, (2) clientele effects, and (3) finance and investment implications of increasing dividend payout and share repurchase decisions. Critical Issues Below are listed the various issues that Gainesboro is currently facing.

Issues are listed at random and in no order of importance. 1. Investor Relations: 2. Dividend Policy: Gainesboro needs to choose a adequate policy with regards to its dividend policy that does not jeopardize its ability to generate future earnings or affect its relationship with its large dividend reliant shareholder base.

3. Capital Structure: Debt and equity Dividend Policy One of the misconceptions at Gainesboro is the belief that only by paying dividends will the company be able to make a strong public gesture that the company has "turned the corner" and is on track to levels of growth and profitability. Typically, growth companies do not pay dividends as earnings are usually reinvested into the company to foster growth and fund various projects and operating assets. While Gainesboro is not a standard growth company, its management and recent activity would seem to suggest that

the firm is poised to become more innovative, strongly suggesting growth with new products. The case gives three dividend alternatives for Gainesboro which are analyzed on the basis of disadvantages and advantages that would contribute to the intrinsic value of the company.

These are presented below in the order that they appear in the case. Zero ? V dividend payout: As mentioned in the case and by Gainesboro? Is management, having a zero-dividend policy would not significantly hurt the company with regards to its investor relations. In fact, due to recent technological advancements and new product issues, the company could be justified in withholding dividends from shareholders by reinvesting earnings to achieve greater growth and solidify market share. Advantages of following this alternative are as mentioned a positive cash flow, no need to borrow to pay dividends, long-term strategy that focuses on intrinsic value, and the ability to create a platform upon which Gainesboro can operate from in strength. The disadvantages of following this approach is that it deviates away from the company? Is traditional past and can be viewed by investors as signs of financial trouble or inability to generate substantial returns. This can be dangerous as Gainesboro relies upon equity for the majority of financing (78%), and a mass exodus by investors could seriously hinder any growth or future prospects the company does have.

40 percent dividend payout: A 40% dividend is almost the exact reversal of the latter alternative, where the advantages of continuing to payout high streams of cash flow could be taken as a sign of confidence by investors, thus boosting share capital. It would also serve to calm jittery investors, who would run on the slightest change in net earnings or dividend payments. The

disadvantages of paying out such a high ratio are quite obvious, in that currently Gainesboro does not have the adequate capital or free cash flow on hand to pay such a large dividend to its investors. In order to make these high payments, Gainesboro would have to sacrifice certain aspects of its growth and market opportunities, and take on significant amounts of either bank loans or long-term debt to satisfy its shareholders.

Residual ? V dividend payout: This alternative proposes that the Gainesboro only pay out dividends when it has adequate cash flow and has achieved positive NPV in its various projects. The advantages of this option are that it takes into consideration Gainesboro's future growth and market aspirations, but also the concerns of its shareholders. On the other hand, inconsistent dividends may make institutional and retirement oriented investors wary of continued investment in the company, if steady payments cannot be determined. It also may worry value oriented investors who will see dividends paid out as a decrease in intrinsic value of the company, and a short-term solution that is more harmful to the long-term growth of the company. In general, the decision to pay dividends should be looked at in terms of the company structure, and where the company is headed into the future. While the industry may pay a certain percentage of dividends, Gainesboro needs to understand that it is now a different company in terms of strategic competition and is more of a growth company, with its hopes resting on new product development.

Dividend payouts are more characteristic of steady cash flow and ? \$blue-chip?? companies, Gainesboro is no longer guaranteed a steady flow of cash due to innovations and stiff competition, and thus must realize that dividend

payments will only detract from the intrinsic value generated in the future. Also, considerations must be given to the types of investors Gainesboro is accountable to, as the equity provided from this group is 78% and any significant drops could lead to a collapse of operations and management.

Gainesboro Valuation Based on the financials and projected sales and income figures for Gainesboro given in the case, two models were constructed and used to provide a valuation of the company. The models used were the discounted cash flow (based on free cash flows), and the dividend discount model (based on the 40% dividend payout ratio). Other models such as the abnormal earnings growth and residual operating income were calculated, but yielded extremely varying results. This stems from the lack of information given in the case with regards to the company's financials for re-formulation, and the lack of reality in the projections given in the case with the actual current financial structure of Gainesboro.

Of the three models presented in this report, the dividend discount model is shown in exhibit 1, the discounted cash flow model is shown in exhibit 2, and the residual earnings model in exhibit 3. Assumptions The following assumptions were made in valuing the intrinsic value of Gainesboro. The marginal tax rate on average is 35%. All dividends have been paid, and there are none outstanding.

Assumed that interest rates charged on average on all debt is approximately 4%. Sales would continue to grow at 15%. That given the existing WACC of 10% and the cost of debt (pre tax) at 4% that the cost of equity for Gainesboro is 12% (see exhibit 4). That the current weighting of debt and equity financing would remain at their current levels of 22% and 78%

respectively. That capital expenditures projected are additions to operating assets and thus affect the company? s ability to generate future returns.

That the projected sales and income figures given in the case accurately reflected the company? s future earnings based on market trends, current R&D, restructuring charges, and changing cost structure. Dividend Discount Model Please refer to exhibit 1 to see the structure of the model. The dividend discount model provides a valuation of Gainesboro based on the future projected dividends the company is expected to pay. These payments are then discounted back to present value using the cost of equity as the discount rate. The cost of equity was used as the discount rate as it accurately reflects the expectations of shareholders with regards to the payment of dividends on their capital invested.

The continuing value in the model was calculated by taking 2010? s projected dividend and multiplying it by 1 plus the dividend growth from 2009 to 2010, and then dividing this figure by the difference between the cost of equity and the dividend growth. Based on the numbers given in the case, the per share value of Gainesboro based on a 40% dividend is \$ 27. 04. This number is slightly lower than the average share price at which Gainesboro? s shares were trading at for 2004 (\$ 29. 15). This would seem to suggest that even with a 40% dividend Gainesboro is still overvalued by approximately \$ 2.

11 per share or roughly \$ 39 million in share capital. This presents a dilemma for Gainesboro, in that only by offering a dividend slightly higher than 40% will it even reach market expectations, and to achieve an increase

in share price it must issue close to 50% of net income as dividends. It should be noted, that should Gainesboro choose not to issue any dividends, the valuation provided by the dividend discount model is no longer valid, as there are no future dividend streams. It should also be considered that this model does not take into account the fact that Gainesboro would have to borrow capital to pay the first six years of dividends forecasted, thus the valuation of \$ 27.

04 can be very misleading. Discounted Cash Flow Model Please refer to exhibit 2 to see the structure of the model. The discounted cash flow model provides a valuation of Gainesboro based on the future projected free cash flows the company is expected to experience. These cash flows are then discounted back to present value using the cost of operations (WACC) as the discount rate.

The cost of operations was used as the discount rate as it is more appropriate with regards to evaluating the intrinsic value of the company, as it accurately reflects the expectations of shareholders and debtors with regards to future earnings. Free cash flows for Gainesboro were determined by the financial data projections given in exhibit 8 of the case, but did not include the dividends that would be paid out to shareholders. If dividends were included than the value per share based on free cash flow would be considerably lower. Based on the numbers given in the case, the per share value of Gainesboro based on the projected cash flows without considering dividends is \$ 24. 62. This number is much lower than the average share price at which Gainesboro's shares were trading at for 2004 (\$ 29.

15), and would suggest that Gainesboro is still overvalued by \$ 4. 53. In fact if dividends are considered into the model, then the value per share drops to \$ 17. 14, which reflects very closely the valuation given by the residual earnings model.

This would certainly suggest that paying dividends on a current sales growth of 15% is draining the company of value, and is weakening its long-term opportunities for strong future earnings. Residual Earnings Model Please refer to exhibit 3 to see the structure of the model. The residual earnings model provides a valuation of Gainesboro based on the difference between actual projected net income and the expected income required by shareholders to meet their opportunity cost in the company. The differences in these amounts are then discounted back to present value using the cost of equity as the discount rate. The cost of equity was used as the discount rate, just like the dividend discount model, as it is more accurately reflects the intrinsic value of the company from the shareholders point of view and their expectations of future earnings.

The continuing value for the residual earnings was determined by taking 2010s projected residual earnings and multiplying it by 1 plus residual earnings growth from 2009 to 2010, and then dividing this figure by the difference between the cost of equity and the residual growth. Based on the projected net operating assets and income figures given in the case (see exhibit 5), the per share value of Gainesboro based on residual earnings is \$ 19. 06. This number is much lower than the average share price at which Gainesboro's shares were trading at for 2004 (\$ 29. 15), and would suggest that Gainesboro is still overvalued.

This model backs up the valuation given by the discounted cash flow if dividends are to be considered and paid.