

Capital structure, management of working capital and investment appraisal



This report focuses on three Important areas of financial management namely Capital structure, Management of Working Capital and Investment appraisal. While the first two parts of the report analysis Apple's activities, the last part of the report is related to the given scenario. The first part of the report evaluates Apple's capital structure. After determining the company's capital structure, the report will evaluate different financing options for the company's capital investments. The analysis involves the cost of debt and equity. The aim is to justify the financing decision for a long term. The second part of the report evaluates the performance of Apple's working capital management practices. This part relies on the ratio analysis. Current Ratio, Debtors, Creditors and Inventory days will be calculated over a three years period. The data is gathered from the YahooFinance. In order to make the analysis more meaningful there will be a benchmarking with a main competitor. The last part of the report conducts NPV analysis to find out the best investment option for the given scenario. The project with the highest NPV is likely to be most beneficial for the company.

Subsequently conclusions will be drawn. Reason for Choosing Apple for this study I have a personal interest in this company as it is seen the most successful company in the world at the moment. I will be able to learn from the best practice. Capital Structure and Financing Decision A firm's optimal capital structure is the mix of debt and equity that minimizes the weight cost of capital of the firm. When the cost of capital is minimized, the total value of firm's shares are maximized. As a result the minimum cost capital structure is called as the optimum capital structure. (Moyer et al. 012) According to Moles et al. (2011) managers decide on the optimum capital structure based <https://assignbuster.com/capital-structure-management-of-working-capital-and-investment-appraisal/>

on the trade-offs between the benefits and costs of debt. The fact that there are a number of different benefits and costs associated with the use of debt financing suggests that managers will balance these different options. Moles et al. (2012) explains that debt can be cheaper as debt is less risky than the equity. In addition, there is a tax advantage with debt financing as interest expenses are generally tax deductible. Another world, the company pays less tax if they use debt financing.

However, a company can go into liquidation if it cannot payback its debts of interest obligations. According to Apple's financial statements on Yahoo Finance (2012) over the last three years period (2009, 2010 and 2011) the company did not have any long term debt as well as short term debt. While the company's retained earnings increased from \$23.4 billion in 2009 to \$37 billion in 2010 and this figure reached to \$63 billion in 2011, the company financed its projects through retained profits. The company was able to do this because it had large profits. Apple's net profits were \$8.1 billion, \$14 billion and \$25.9 billion in 2009, 2010 and 2011 respectively. According to the Apple's Annual and \$1.3 billion in 2011, 2010 and 2009 respectively.

Currently the company is using equity option to finance its capital expenditure. According to BBC (2012) this year the company announced \$2.65 per share quarterly dividends. This is the first dividend payment since 1995. As the company does not pay regular dividends, it is not meaningful to calculate the company's cost of equity using the dividend valuation model. However, the market prices of Apple shares increased almost 22% in 2011.

Therefore, it can be said that Apple's cost of equity is quite high. In

conclusion, currently Apple finances its capital projects through equity
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financing. With a possible debt financing the company is likely to reduce its cost of capital. This could be a good idea if the company's profit figures start to decline. According to the financial statements of the company Apple did not have any short term or long term loans between 2009 and 2011.

Analysis of working capital management Working capital management concerns with organizing a company's short term sources to sustain ongoing activities mobile funds and optimism liquidity.

It further dropped to 1.61 in 2011. The company's figures can be compared with the Blackberry manufacturer RIM. RIM's current ratios are higher than Apple's in 2010 and 2011. RIM 2011 2010 2009 current Ratio 2.08 2.06 2.39 The main reason for the decline in Apple's current ratio is decline in debtor and from 2010 to 2011. In the same period, the inventor days decline from 9.3 days to 4.4 days. This indicates that the efficiency of the company's working capital management as they were able to receive the money from debtors faster and to keep fewer inventories.

The company also was able to keep creditors days high with 135.5 days. Consequently the company's current ratio declined dramatically in recent years. However, this decline should be seen as a positive development as the company has been leaner in recent years. Therefore, the figures above indicate the company's working management practices are successful.

Investment Appraisal with NAP method Net present value (NAP) of a project is the sum of the present values of all its cash flows, both outflows and inflows. The rate used to discount the cash flows must be consistent with the project's risk.

Another word, if the project risky then higher discount rates should be used when appraising the investment options. The same company might use different discount rates for its different projects depending on a riskiness of the project. (Graham and Smart, 2011) According to Graham and Smart (2011) the companies can invest in any projects if the NPV figure is positive as any positive figure will increase the value of the company. The table below demonstrates the NPV calculations for an investment option. Delta Printing is considering buying machinery and there are three different purchase options.

The machines can be used for a six-year period. After six years Machine A and B can be sold with a scrap value. Initial cost of each option are as follows; £1m for Machine A, £2m for Machine B and £3m for Machine C. According to the initial cost figures the Project C is the best option as it requires less investment. However, there will be no scrap value for Machine C. With the original figures, it is difficult to make a decision. In this case, NPV method can simplify the investment decisions. The cash inflows are discounted with the company's cost of capital of 15%.