Homework Assignment 2

Please note that only question 3 will be graded. **Your group should hand in only one answer for question 3.** However, questions 1-2 will be helpful to do last question. I strongly encourage you to solve all the questions.

1) Swing and Pool is a small publicly traded firm. Below you will find their pro-forma profit and loss statement for the next five years. The numbers in the table are year-end figures reported in thousands of dollars. The firm is already profitable. In addition to their profit and loss statement, I have also provided estimates of their capital expenditure and net working capital levels for the next five years. For Swing and Pool net working capital is the firm's accounts receivables plus their inventory minus their accounts payable. At the end of 1995, Swing and Pool had $2800 in net working capital. Swing and Pool faces a 34% tax rate and the firm carries no debt.

A) If the equity discount rate is 15%, what is the value of Swing and Pools equity? Ignore all cash flows in the year 2001 and beyond. This question will be easier to answer if you use a spreadsheet.

Profit/Loss statement	1996	1997	1998	1999	2000
Sales revenue	12,000	14,400	16,800	19,400	21,000
Cost of goods sold	8,800	10,100	10,400	11,100	10,900
Gross profit	3,200	4,300	6,400	8,300	10,100
Selling expense	600	600	600	650	650
Gen and admin expense	150	150	200	200	200
Depreciation	300	325	350	375	400
Net profit before tax	2,150	3,225	5,250	7,075	8,850
Net working capital	3,000	3,300	3,600	3,900	4,200
Capital expenditure	300	340	370	390	450

B) If there are 1.2 million shares outstanding, based on your answer to A) what should the price of a share of Swing and Pool be?

C) Swing and Pool stock is currently selling for $34.89 per share, or over four times our answer in B). The problem with our valuation thus far is we are ignoring cashflows that occur after the year 2000. A majority of the market value of equity is based on cashflows in the years 2001 and beyond. We can justify the price of $34.89 per share by assuming that cashflows continue after the year 2000 and that they grow at a constant rate. Show

that if the stock market is assuming that cashflows will continue to grow at 6 percent per year, the stock price should be $34.89 per share.

2) Partial income statements and balance sheets for Nike, Inc. are given below. The tables below are available in Excel format on the course web page. Assume that the price per share is $50 and there are 297 million shares outstanding.
Assuming that all financing needs are met by issuing debt (bank loan), fill in the missing blanks. You should assume that interest expense for a given year equals the interest rate of 8% multiplied by the average of the beginning and ending debt outstanding. Be sure to include existing debt in your interest expense calculation (e.g. notes payable, long-term debt).

Consolidated Income Statement (in thousands)

	1997	**1998 (est.)**	**1999 (est.)**
Sales	9,186,539	12,401,828	16,742,467
Cost of goods sold	5,364,955	7,441,097	10,045,480
Payroll, occupancy, and other expenses	2,303,704	3,100,457	4,185,617
Depreciation and amortization	138,038	197,848	235,215
General and administrative charges	0	0	0
Non-recurring charge	0	0	0
Income from operations	1,379,842	1,662,426	2,276,155
Other expenses	32,277	43,574	58,825
Interest expense (r*Avg. Debt Outstanding)	52,343		
Taxable income	1,295,222		
Income taxes	499,400	620,822	848,687
Net income	795,822		
Retained earnings – beginning	2,290,213		
Less shareholder distributions	112,372	115,743	119,215
Retained earnings – ending	2,973,663		
Additional paid-in capital	0	0	0

Consolidated Balance Sheet (in thousands)

Assets			
Cash and equivalents	445,421	601,318	811,780
Accounts receivable	1,754,137	2,378,433	3,210,884
Inventories	1,338,640	1,855,178	2,504,490
Prepaid expenses	157,058	212,028	286,238
Refundable income taxes	0	0	0
Deferred income taxes	135,663	0	0
Total current assets	3,830,919	5,046,957	6,813,392
Plant, property and equipment (net)	922,369	1,096,576	1,196,210
Other assets:			
Intangible assets	464,191	626,658	845,988
Deferred income taxes	143,728	0	0
Total other assets	607,919	626,658	845,988
Total assets	5,361,207	6,770,190	8,855,589
Liabilities and Shareholders' Equity			
Current liabilities:			
Accounts payable	687,121	958,169	1,293,528
Accrued expenses	570,504	770,180	1,039,744
Current maturities of long-term debt	2,216	2,216	2,216
Notes payable	553,153	553,153	553,153
Income taxes payable	53,923	53,923	53,923
Total current liabilities	1,866,917	2,337,641	2,942,563
Bank loan (PLUG)	0		
Long-term debt less current maturities	296,020	296,020	296,020
Convertible subordinated notes	0	0	0
Deferred income taxes	42,132	42,132	42,132
Total liabilities	2,205,069		
Paid-in capital	182,475	182,475	182,475
Retained earnings	2,973,663		
Total stockholders' equity	3,156,138		
Total liabilities and stockholders' equity	5,361,207		

3) This problem asks you to estimate the financing needs and cash flows for a publicly traded company that I will select after the quarter begin. I will provide you with a spreadsheet of historical financial statements. Information to assess the company's future growth opportunities is available from numerous sources. For example, annual reports are available in the library both in hard copy and on CD ROM (Compact Disclosure Database). Securities and Exchange Commission filings, including 10K's, 10Q's, and proxy statements can be downloaded from the SEC's website (http://www.sec.gov/edaux/formlynx.htm).

   You will hand in pro-forma balance sheets and income statements, as well as estimated free cashflows to the firm, to equity holders and to debt holders. The following items should be included in your analysis:

   1. A brief description of the firm's primary line of business and a qualitative assessment of the firm's competitive position and future growth opportunities.
   2. Pro-forma income statements and balance sheets for the next 7 years.
   3. Free cash flows (direct and alternate method) for the last available historical data and the next 7 years (estimates). Specifically, you should provide numbers (and calculations) for:
      a. Total free cash flow of the firm
      b. Free cashflows to equity holders
      c. Free cashflows to debt holders
   4. An assessment of the sensitivity of your results to the underlying assumptions.