Question

Background

Nissi Co is an engineering company which is involved in projects around the world. It has been growing steadily for several years and has maintained a stable dividend growth policy for a number of years now. The board of directors (BoD) is considering bidding for a large project which requires a substantial investment of $40 million. It can be assumed that the date today is 1 March 20X6.

The BoD is proposing that Nissi Co should not raise the finance for the project through additional debt or equity. Instead, it proposes that the required finance is obtained from a combination of funds received from the sale of its equity investment in a European company and from cash flows generated from its normal business activity in the coming two years. As a result, Nissi Co's current capital structure of 80 million $1 equity shares and $70 million 5% bonds is not expected to change in the foreseeable future.

Expected income and cash flow commitments prior to undertaking the large project for the year to the end of February 20X7

Nissi Co's sales revenue is forecast to grow by 8% next year from its current level of $300 million, and the operating profit margin on this is expected to be 15%. It is expected that Nissi Co will have the following capital investment requirements for the coming year, before the impact of the large project is considered:

1. A $0·10 investment in working capital for every $1 increase in sales revenue;
2. An investment equivalent to the amount of depreciation to keep its non-current asset base at the present productive capacity. The current depreciation charge already included in the operating profit margin is 25% of the non-current assets of $50 million;
3. A $0·20 investment in additional non-current assets for every $1 increase in sales revenue;
4. $8 million additional investment in other small projects.

In addition to the above sales revenue and profits, Nissi Co has one overseas subsidiary – Accents Co, from which it receives dividends of 80% on profits. Accents Co produces a specialist tool which it sells locally for $60 each. It is expected that it will produce and sell 400,000 units of this specialist tool next year. Each tool will incur variable costs of $36 per unit and total annual fixed costs of $4 million to produce and sell.

Nissi Co pays corporation tax at 25% and Accents Co pays corporation tax at 20%. In addition to this, a withholding tax of 8% is deducted from any dividends remitted from Accents Co. A bi-lateral tax treaty exists between the countries where Nissi Co is based and where Accents Co is based. Therefore corporation tax is payable on profits made by subsidiary companies, but full credit is given for corporation tax already paid. It can be assumed that receipts from Accents Co are in $ equivalent amounts and exchange rate fluctuations on these can be ignored.

Required

Estimate Nissi Co's dividend capacity as at 28 February 20X7 **10 marks**

Answer

NISSI CO

Expected dividend capacity prior to large project Investment

	$'000
Operating profit (15% (1.08 x $300m))	48, 600
Les interest (5% of $70m)	(3,500)
Less taxation (25% x ($48.6m - 3.5m))	(11,275)
Less investment in working capital ($0.10 (0.08 $300m))	(2,400)
Less investment in additional non-current assets ($0.20 x (0.08 x $300m))	(4,800)
Les investment in projects	(8,000)
Cash flows from domestic operations	18,625
Cash flows from Accents Co's dividend remittances (see working 1)	3,297
Additional tax payable on Accents Co's profits (5% x $5.6m)	(280)
Dividend capacity	21,642

Working 1

Dividend remittances expected from Accents Co

	$'000
Total contribution $24 x 400,000 units	9,600
Less fixed costs	(4,000)
Less taxation (20% x $5.6m)	(1,120)
Profit after tax	4,480
Remitted to Nissi Co (80% x $4.48m x 92%)	3,297