Student 3: Low Merit

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One of the many strategic capital expenditure decisions that ABC Eggs have had to make is around how to finance two large scale farms and barns in *[location 1]* and *[location 2]* at a total cost of $60M.

One of the goals behind the building plans was to maintain and grow short-term profitability while ensuring ABC would comply with the government's ruling that by 2022 no more caged eggs would be sold in New Zealand. ABC will have to abolish all caged farms they currently have producing eggs, and replace them with free range and barn-bred egg production. The reason for this is that although demand for cheap eggs (which tend to come from caged chickens) has grown in certain large markets, there has been considerable discussion about the animal abuse associated with caged egg production.

ABC wants to take a proactive approach to moving away from caged egg production as soon as possible. Not only will this mean the company is well prepared for when the new legislation takes effect in 2020. They will be in a better position to promote the company to consumers as ethical and to shareholders as sustainable. The two new plants will create a platform for continued growth, allowing ABC Eggs to create higher profit margins in the short-term and long-term.

There are several financing options for ABC Eggs to gain the $60M required to build the two new plants.

One option is a bank loan which is when money is lent by the bank to a business and is paid off over a certain term. Interest is charged and repayments are fixed so that it is easy for the business to budget to cover their repayments. The bank needs security over a fixed asset of the borrower. If the borrower defaults on payments the asset may be sold by the bank so that the balance of the loan can be recovered. An advantage for ABC Eggs of taking out a bank loan would be that shareholders would 4
retain 100% ownership and decision-making would not be affected. Another advantage is that because ABC Eggs is a large and established company there are many assets to use as security. However, there are also disadvantages of a bank loan. One of these is that because the loan is so large the company will be committed to paying it back for a long time. This creates an ongoing 3
expense against revenue, and having a large liability on the balance sheet for many years. The security needed for a bank loan would need to be of a high enough value to satisfy the bank that they could recover any amount owing, potentially up to $60M. This would be difficult as the current farms are set up for caged farming and the two new farms will take at least a year to be fully established so the value of assets could be hard to estimate. It has been difficult for me to calculate
the interest and repayments that will be payable on a $60M loan as online calculators do not go that 2
far. This is probably because amounts that high are better taken as a mortgage rather than a loan.

Another financing option is an initial public offer, or an IPO. ABC Eggs is a private limited liability 1
company. It was originally a family-owned company but over several years more shareholders have bought shares until now there are approximately 25 shareholders who all know each other. An IPO happens when a company wants to open the shareholding opportunity to members of the public in order to attract much more capital.

There are more disadvantages than advantages of the IPO option. One of the few advantages is that it
would allow current shareholders to exit ABC Eggs. Some shareholders want out. They want their 4
capital back, but the company is not able to buy out their shares. Some shareholders also do not want to be involved in the big reorganisation and growth that will be necessary if ABC is to be ready for when caged egg production stops. With an IPO, current shareholders in ABC Eggs can release their
shares onto the share market for new shareholders to buy. One of the disadvantages of an IPO is the 4
huge cost and time taken to prepare a prospectus and get all the accounting and legal documents

ready for the IPO. There are financing options that are more cost and time efficient. An IPO also results in the founding shareholders losing some control as the IPO is managed from outside the company. 4

The final financing option that was open to ABC was to take on a private equity partner. They have 1 found a possibility, the Australian company DEF Capital. One of the reasons that ABC is interested in DEF is the large amount of capital that DEF could offer towards the $60M. By partnering with DEF ABC Eggs could achieve their goal of establishing at least one of the new farms almost straight away, improving short-term profitability for the company. Another important advantage of partnering with DEF is the ability to create an exit strategy for existing shareholders. By entering into an equity agreement with DEF Capital current shareholders would be able to release a significant amount of their capital, around 75%.

Although there would be a loss of ownership status with the private equity partner option, DEF would 4 share the goal of wanting to grow and diversify the company and to receive high profit returns. This is because DEF was established as an investment company. ABC has eggs as their product, but DEF has money to invest for the highest profit they can get. This could cause a difference in views. For 4 example, ABC might want to minimise or eliminate cruelty to animals, but DEF might just be interested in the cheapest way of doing things.

There are positive and negative consequences to this financing option. One non-financial long-term benefit of having a private equity partner is that building the two new farms will enable more workers to be employed and productivity to be increased. Another non-financial benefit is that more capacity will be available for free-range production so ABC Eggs will not face the consequences of breaking the government regulation to be enforced from 2020. The significant injection of cash from DEF Capital means ABC can buy back the shares of the shareholders who want to exit the company. A financial benefit is that building the two new farms will be possible with the equity partner and this should result in increased revenue and, in the long run, profitability. ABC Eggs will not be committed to the principal 3 and interest repayments that would be necessary over many years if the bank loan (or mortgage) option had been adopted.

Partnering with the equity partner ensures ABC Eggs has long-term viability. I recommend it as the 5 best option for ABC Eggs.