ENG 111 Homework 2

Spring 2021

Mel Bulu-Taciroglu

1. (10 points) AGENCY PROBLEM

After reading the following short article, identify the “principal” and “agent” for each example given in the article.

http://smallbusiness.chron.com/examples-agency-problems-financial-markets-70962.html

(You can also answer the following on your own, NOT for this homework: How could you prevent the agency problem in each case, what kinds of mechanisms would prevent the agency problem?)

ENRON:
Agent: Company's officers including board of directors and chairman (1.25 points)
Principal: Stockholders/owners of Enron (1.25 points)

GOLDMAN SACHS:
Agent: Financial analysts (1.25 points)
Principal: Clients/home owners (1.25 points)

BOEING:
Agent: Boeing executives (1.25 points)
Principal: Boeing employees/stockholders (1.25 points)

WORLDCAM:
Agent: Worldcom executives (1.25 points)
Principal: Stockholders of Worldcom (1.25 points)

2. (30 points) FINANCIAL STATEMENTS

Following are the account entries for BV Company for 2014. BV's corporate tax rate is 4.36%.

a) (20 points) Organize company's 2014 Balance Sheet and Income Statement.

b) (10 points) BV's Net Income grew by 5% and its stock price in the market went up by 3%, both annually, since 2014. BV did not distribute any dividends and did not buyback or sell stocks since 2014. What is BV's 2019 Equity?

Cash 256

Interest 22
Accounts Payable 82
Account Receivables 122
Notes Payable 34
Selling & Administrative Costs 170
Inventory 76
Cost of Goods Sold 340
Fixed Assets 1675
Long Term Debt 345
Revenue 850
Common Stock 375
Acc. Retained Earnings 1293

a) (20 points)

BALANCE SHEET - BIENVENIDO COMPANY - in thousand $			
	2014		**2014**
Cash	256	Accounts Payable	82
Acc Rec.	122	Notes Payable	34
Inventory	76	Total Current Liabilities	116
Total Current Assets	454	Long Term Debt	345
Fixed Assets	1675	Total Liabilities	461
Total Assets	2129	Common Stock	375
		Retained Earnings	1293
		Total Liabilities and Owners' Equity	2129

INCOME STATEMENT - BIENVENIDO COMPANY - in thousand $	
	2014
Revenue	850
Cost of Goods Sold	340
Selling, Administrative Costs	170
EBIT	340
Interest	22
Income Before Taxes	318
Taxes	13.865
Net Income	304.14

Total Assets (5 points)

Total Liabilities&Equity (5 points)

EBIT (5 points)

Net Income (5 points)

b) (10 points)

Equity in 2014 = 1,668

*Equity in 2015 = 1,668 + Net Income in 2015 = 1,668 + Net Income in 2014 * 1.05 = 1,987.35*

*Equity in 2016 = 1,987.35 + Net Income in 2016 = 1,987 + Net Income in 2014 * 1.05^2 = 2,322.66*

*Equity in 2017 = 2,322.66 + Net Income in 2017 = 2,322.66 + Net Income in 2014 * 1.05^3 = 2,674.74*

*Equity in 2018 = 2,674.74 + Net Income in 2018 = 2,674.74 + Net Income in 2014 * 1.05^4 = 3,044.42*

*Equity in 2019 = 3,044.42 + Net Income in 2019 = 3,044.42 + Net Income in 2014 * 1.05^5 = 3,432.59*

The last line is worth 10 points. Student does not have to provide the previous steps.

3. (20 points) Please read the following article that appeared on Wall Street Journal on 1/22/2013 (also posted in pdf) which predates the corporate tax rate reduction in 2017:

http://online.wsj.com/article/SB10001424127887323301104578255663224471212.html?mod=WSJ_hpp_LEFTTopStories

Explain why having access to low cost debt would encourage companies to keep their foreign earned income abroad.

If cost of debt is lower than cost of bringing cash to US which is the tax that had to be paid, then, companies would rather get into debt than paying the tax. (20 points)

Additionally, the cost of debt can be reduced to reduce the tax obligation!

4. (20 points) Please answer the following question after reading the article and finding the numbers for BHC's retained earnings for the last 4 years.

How did the retained earnings change from 2016 to 2019? What is the explanation for this change?

BHC's Retained Earnings were around negative $ 5 billion in 2016. Continued losses brought down RE to negative $7.5 billion. (20 points)

Please note that, when a company makes positive Net Income and decides to keep some or all of it within the company, that amount will be added to Accumulated Retained Earnings and Equity will go up. On the other hand, when a company makes a loss, the addition to retained earnings will be negative. The company does not have the option of not registering this effect on its balance sheet. Negative Net Income means reduced Accumulated Retained Earnings. Period. At extreme cases, as in BHC's case, the Accumulated Retained Earnings go into negative territory. Then, the continued loss that is coming from Income Statement has to be funded either by issuing stock or by increasing debt. Since the BHC stock price is very low in the market, issuing new stock will not bring in much, the only option is to get into debt which BHC has been consistently doing that, in tern, drags the Income Statement into even more negative territory due to high interest payments.

Bausch Health Companies: Debt, Cash And Goodwill

Mar. 30, 2020 12:37 PM ET

Michael A. Gayed, CFA

Summary

Bausch Health Companies’ balance sheet is loaded with intangible assets and debt. Its interest expense cannibalizes its operating income year after year.

The stock’s value is now at 5% of what it used to be in 2015.

I am neutral on the stock, but if a couple of events occur, then the company can turn the corner.

"It's easy to complain that pharmaceutical companies place profits over people and apparently care more about hair loss than TB. However, many in the pharmaceutical industry would be glad for the opportunity to reorient their research toward medicines that are truly needed, provided only that such research is financially sustainable." - Thomas Pogge

Bausch Health Companies (BHC) is high on goodwill and intangible assets on the asset side and debt on the liabilities side. The company may own valuable brands, but that’s done zilch for its investors. BHC’s slide has been swift and steep, and it occurred because of regulatory change in drug prices. It took 5 long years (2010–15) for the stock to rise from $15 to $264 and just 18 months to reclaim its 2010 lows. It is still available at those low 2016 levels.

Image Source: Seeking Alpha

Despite BHC’s valuable product portfolio and business verticals, I am neutral on it and here are the reasons why.

Goodwill & Intangible Assets

BHC has $23.3 billion of Goodwill and Intangible Assets on its books. It owns $1.74 billion (net) fixed assets and its long-term debt is a massive $24.66 billion.

Long-Term Assets		
Gross Property, Plant & Equipment	3,378.0	3,378.0
Accumulated Depreciation	(1,641.0)	(1,641.0)
Net Property, Plant & Equipment	**1,737.0**	**1,737.0**
Long-Term Investments	-	-
Goodwill	13,126.0	13,126.0
Other Intangibles	10,201.0	10,201.0
Deferred Tax Assets	1,690.0	1,690.0
Other Long-Term Assets	140.0	140.0
Total Assets	**33,863.0**	**33,863.0**

Image Source: Seeking Alpha

The implications are clear – that BHC has borrowed long term to fund its acquisitions, valued its buys at a certain price, and booked the premiums as intangible assets. The result is a balance sheet that is more or less intrinsic, something that investors can see but not feel. The company amortizes its intangible assets every year, but their book value is so humongous that it will take many years for a complete write-off.

Debt Woes & Cash Flows

BHC is overloaded with $24.66 billion long-term debt on which it pays an annual interest of $1.61 billion, which averages to a 6.49% rate. Actually, this huge liability can turn out to be an opportunity if BHC is successful in either renegotiating or restructuring its debt to a much lower rate. The company has responded to the rapidly evolving COVID-19 disruption by shelving its plan to raise $3.25 billion debt intended to refinance the existing debt and waiting for a more opportunistic moment.

Extinguishing debt should be one of the company’s primary goals. In 2019, BHC earned an operating income of $1.33 billion, paid $1.61 billion as interest expense, and ended up with a loss of $1.78 billion from continuing operations. Assuming the same level of operating income from 2020 onwards, BHC needs to reduce its interest burden by at least 25% to start generating shareholder-friendly numbers.

	Dec 2019	TTM
Selling General & Admin Expenses		2,554.0
R&D Expenses		471.0
Other Operating Expense/(Income)		(5.0)
Total Operating Expenses		4,917.0
Operating Income		**1,334.0**
Earnings from Continuing Operations		
Interest Expense		(1,612.0)
Interest And Investment Income		12.0
Net Interest Expenses		(1,600.0)
Currency Exchange Gains (Loss)		8.0
Other Non Operating Income (Expenses)		-
EBT, Excl. Unusual Items		(258.0)
EBT, Incl. Unusual Items		(1,837.0)
Income Tax Expense		(54.0)
Earnings From Continuing Operations		**(1,783.0)**

Image Source: Seeking Alpha

Debt is also hurting BHC's cash flows. In 2019, BHC generated $1.5 billion in operating cash, invested $419 million, and issued $1.44 billion debt. As of Dec 31, 2020, BHC had $3.244 billion cash on hand that included proceeds of $2.5 billion from an offering of unsecured notes in Dec 2019.

Debt is frying BHC's balance sheet and interest is cannibalizing its operating income. The company should proactively reduce its debt, in my opinion.

Summing Up Prospects in 2020

BHC will reduce its investment intensity in 2020 and focus on its underinvested businesses like GI, Bausch & Lomb Surgical and Optho Rx. It also plans to invest $300 million in assets in 2020. The company's 2020 guidance has provided $50 million towards the coronavirus impact. Per its guidance, this year should be largely uneventful for the company because the same old story is likely to play out.

So, how can an investor value BHC? The company does not own a brand with massive value such as Pepsi or Nike – and, therefore, putting a price on its brands needs professional assessment, and that isn't available at the moment. The only number available is its market capitalization, which is a meager $5.44 billion. No investor will venture near the stock after comparing its market cap with intangibles and debt – it just doesn't make the cut.

Nevertheless, there is a glimmer of hope, though my rating is neutral.

Existing and new investors can track the following events:

a) Any aggressive moves by the company to sell its brands or verticals at a market-friendly valuation.

b) Debt restructuring in this period of falling interest rates and negative yields. If the company can end up saving 2% on its interest expense, it could make a huge difference.

Either one of these factors is a bull trigger. Watch out for such developments and consider entering the stock if that happens.

5. (20 points) The Balance sheet for a company for last year and this year as well as the Income Statement for this year are given below. How much dividends are paid to stock holders this year? Calculate the Cash Flow from Assets, Cash Flow to/from Creditors and Cash Flow to/from Stock Holders.

Income Statement This Year

Sales	728,000
Cost of Goods Sold	421,000
Gross Profit	307,000
S,G&A Expenses	127,600
Depreciation	18,000
Other Income	3,000
Income Before Taxes	164,400
Taxes	44,890
Net Income	119,510

Balance Sheet

	This Year	**Last Year**
Assets		
Cash	101,500	54,000
Accounts Receivable	80,000	61,000
Inventory	73,800	101,500
Prepaid Expenses	5,400	7,400
Total Current Assets	260,700	223,900
Equipment	134,000	125,000
Accumulated Depreciation	(32,000)	(14,000)
Total Assets	*362,700*	*334,900*
Liabilities and Equity		
Accounts Payable	35,000	45,000
Accrued Expenses	11,400	22,800
Total Current Liabilities	46,400	67,800
Long Term Debt	40,000	70,000
Total Liabilities	86,400	137,800
Equity		
Common Stock, $5 par value	240,000	170,000
Accumulated Retained Earnings	36,300	27,100
Total Liabilities and Equity	*362,700*	*334,900*

Dividends Paid This Year:

Net Income - (Change in Retained Earnings) = 119,510-(36,300-27,100) = 119,510 - 9,200 = 110,310

(5 points)

Cash Flow From Assets = Operating Cash Flow (OCF) - Change in NWC - Change in Fixed Assets

OCF = 164,400-44,890+18,000 = 137,420 (5 points)

Change in NWC = (260,700-46,400)-(223,900-67,800) = 58,200

Change in Fixed Assets = 134,000-125,000 = 9,000

Cash Flow From Assets = 137,420 - 58,200 - 9,000 = 70,220 (5 points)

Cash Flow to/from Creditors = Interest - (Ending Debt - Beginning Debt) = 0 - (40,000-70,000) (2.5 points)

Cash Flow to/from Stock Holders = Dividends - (Stocks Sold - Stocks Purchased) = 110,310 - (240,000-170,000) = 40,310 (2.5 points)

If the student found different numbers for C(B) or C(S) by using the formula C(A) = C(B)+C(S), DO NOT take off any points as the Balance Sheet and Income Statement that are pulled from an actual company's SEC filing has some inconsistent numbers as is usually the case when companies have 90 days to update and finalize their numbers.