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SECTION A

a.

Financial analysis is the evaluation of a company's financial performance and financial condition. Key to such evaluation is the annual report, which is the communication between the management of the company and the owners. The annual report contains financial statements, from which information can be drawn about the company's assets, liabilities, equity, income, and cash flows, among other things (Booth et al. 2014).

The two organisations that will be analysed in this report are: William Hill PLC and Paddy Power Betfair PLC.

William Hill PLC is one of the world's leading gambling companies and one of the most recognisable names on the UK High street, having taken bets in licensed betting offices since 1966. Today they have 2,342 of the 8,500 shops in the market. They offer sports betting on football, horseracing and other sports as well as gaming on machines. Their customers have access to more than a million betting opportunities every week. This includes in-play and pre-match sports betting, and a wide range of gaming products. The UK is William Hill's primary market, generating 82% of Group net value in 2017 and they also generate revenues in other countries via williamhill.com (William Hill PLC annual report 2017).

Paddy Power Betfair PLC is one of the world's leading sports betting and gaming operators, formed from the 2016 merger of Paddy Power PLC and Betfair Group PLC. Today they operate four sports betting and gaming brands; Paddy Power, Betfair, Sportsbet and TVG. They are online-led, mobile-led and sports-led: and their proprietary technology, unique products and innovative marketing all combine to offer a superb experience to their customers. They employ over 7,000 people in sixteen locations across the globe; from Dublin to Los Angeles, and London to Melbourne. They operate over 600 betting shops in the UK and Ireland. They are the largest retail betting operator in Ireland and the fifth largest retail betting operator in the UK (Paddy Power Betfair annual report 2017).

The key ratios in determining the performance of a firm include: Profitability, Efficiency, Liquidity, Investment and Financial Structure.

Investment ratios are: Earnings per share, Dividend per share, Dividend cover and Gearing ratio. Liquidity ratios are Current ratio and Acid test (Quick) ratio. Profitability ratios include Operating profit margin, Gross profit margin, Return on Equity and Return on Capital Employed.

There are four techniques used to evaluate an investment decision: the Payback period method, the Accounting rate of return method, the Net Present Value method, and the Internal rate of return method.

The Payback period is the simplest way of looking at one or more major project ideas. It tells you how long it will take to earn back the money you will spend on a project. The formula of Payback period is cost of project/annual cash inflow. Thus, if a project cost £60,000 and was expected to return £12,000 annually, the Payback period would be £60,000/£12,000 or five years.

The Accounting rate of return method overcomes the deficiencies of the Payback period method in the sense that it considers the earnings of a project over its entire economic life.

The Net Present Value method of a capital Budgeting project is used to indicate the expected impact of the project on the value of the firm. Projects with a positive Net Present Value are expected to increase the value of the firm.

The Internal rate of return of a capital Budgeting project is the discount rate at which the Net Present Value of a project equals zero.

Year	Project A (cost=£160,000) Net cash inflow (£)	Accumulated net cash (£)
1	45,000	45,000

2	45,000	90,000
3	45,000	135,000
4	45,000	180,000
5	45,000	225,000
6	45,000	270,000

a. To determine the Payback period of project A, we use the formula:

Payback=cost of project/annual cash inflow=£160,000/£45,000=3.6 years

Year	Project B (cost=£220,000) Net cash inflow (£)	Accumulated net cash (£)
1	60,000	60,000
2	60,000	120,000
3	60,000	180,000
4	60,000	240,000
5	60,000	300,000
6	60,000	360,000

To determine the Payback period of project B, we use the formula:

Payback=cost of project/annual cash inflow=£220,000/£60,000=3.7 years

The Net Profit Value (NPV) for projects A and B is computed as:

Cash flow	£
Present value of future receipts	x
Present value of future payments	(x)
Initial investment	(x)
Net Present Value (NPV) =	X

To adjust the future cash flows to the Present Value, the following is observed:

Present Value = Future cash flows x Discounting factor at the cost of capital

Year	Project A Cash flows	PV factor at 7%	PVS
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0	(160,000)	1.000	(160,000)
1	45,000	0.935	42,075
2	45,000	0.873	39,285
3	45,000	0.816	36,720
4	45,000	0.763	34,335
5	45,000	0.713	32,085
6	45,000+20,000	0.666	43,290
	NPV=		67,790

Therefore NPV for Project A is £67,790

Year	Project B Cash flows	PV factor at 7%	PVS
0	(220,000)	1.000	(220,000)
1	60,000	0.935	56,100
2	60,000	0.873	52,380
3	60,000	0.816	48,960
4	60,000	0.763	45,780
5	60,000	0.713	42,780
6	60,000+10,000	0.666	46,620
	NPV=		72,620

All calculations are displayed in the appendix

b. The Accounting Rate of Return (ARR) for both projects is computed as:

$$\text{ARR} = (\text{Average accounting profit} / \text{Average investment capital}) \times 100$$

Whereby:

Average accounting profit = Total profit for the length of the project / The length of the project

Average investment capital = (Initial capital + scrap or residual value) / 2

Depreciation = (Cost of project – scrap or residual value) / Economic life

For Project A:

$$\text{Depreciation} = (\text{£}160,000 - \text{£}20,000) / 6 = \text{£}140,000 / 6 = \text{£}23,333.33$$

With the available information, we will assume that profits is the remainder after deducting depreciation expense from the net cash inflows.

Year	Net cash(£)	Depreciation(£)	Profit(£)
1	45,000	(23,333)	21,667
2	45,000	(23,333)	21,667
3	45,000	(23,333)	21,667
4	45,000	(23,333)	21,667
5	45,000	(23,333)	21,667
6	45,000	(23,333)	21,667
Total			130,002

Therefore, Average accounting profit = £130,002 / 6 = £21,667

Average capital employed = (Initial cost + scrap or residual value)/2
= (£160,000 + £20,000)/2 = £90,000

Therefore, ARR = (Average accounting profit/Average capital employed)x100 = (£21,667/£90,000)x100 = 24.07%

For Project B:

Depreciation = (£220,000 - £10,000)/6 = £230,000/6 = £35,000

With the available information, we will assume that profits will be the remainder after deducting depreciation expense from the net cash inflows.

Year	Net cash(£)	Depreciation(£)	Profit(£)
1	60,000	35,000	25,000
2	60,000	35,000	25,000
3	60,000	35,000	25,000
4	60,000	35,000	25,000
5	60,000	35,000	25,000
6	60,000	35,000	25,000
Total			150,000

Therefore, Average accounting profit = £150,000/6 = £25,000

Average capital employed = (Initial cost + scrap or residual value)/2 =
(£220,000 + £10,000)/2 = £115,000

Therefore, AAR = (Average accounting profits/Average capital employed)x100 = (£25,000/£115,000)x100 = 21.74%

The Internal Rate of Return(IRR) can be calculated by using an interpolation method as:

$$\text{IRR} = P\% + \left[\frac{p}{p+N} \times (N\% - P\%) \right]$$

Whereby:

P% = interest rate that results into positive NPV

N% = interest rate that results into negative NPV

p= positive NPV

N = negative NPV

For Project A:

The NPV is £67,790 which is positive, and so therefore we need to find a discount rate which will result into negative NPV. If we try to use 20% as a discount rate for this project, NPV will be calculated as:

Year	Cash flows	PV factor at 20%	PVS
0	(160,000)	1.000	(160,000)
1	45,000	0.833	37,485
2	45,000	0.694	31,230
3	45,000	0.579	26,055
4	45,000	0.482	21,690
5	45,000	0.402	18,090
6	45,000+20,000	0.335	21,775
	NPV =		(3,675)

Therefore, $IRR = P\% + [p/(p+N) \times (N\%-P\%)]$

$IRR = 7\% + [67,790/(67,790+3,675) \times (20-7)]$

$= 7\% + [67,790/71,465] \times 13$

$= 7\% + 12.33 = 19.33\%$

And for Project B:

The NPV is £72,620 which is also positive, and therefore we need to find a discount rate which will result into a negative NPV. If we decide to use 17% as a discount rate for this project, NPV will be calculated as:

Year	Cash flows	PV factor at 17%	PVS
0	(220,000)	1.000	(220,000)
1	60,000	0.855	51,300
2	60,000	0.731	43,860
3	60,000	0.624	37,440

4	60,000	0.534	32,040
5	60,000	0.456	27,360
6	60,000+10,000	0.390	27,300
	NPV =		(700)

Therefore, $IRR = P\% + [P/(P+N) \times (N\% - P\%)]$

$IRR = 7\% + [72,620/(72,620 + 700) \times (17-7)]$

$= 7\% + [72,620/73,320] \times 10$

$= 7\% + 9.9 = 16.9\%$

c.

From the results provided above, Project A has a Payback period of 3.6 years whilst Project B has a Payback period of 3.7 years. An investment with the shortest Payback period will be undertaken in priority with that with longer Payback period. Therefore, with the Payback investment technique, Project A should be adopted.

The Net Present Value (NPV) tells us how much a project contributes to shareholder wealth- the larger the NPV, the more value the project adds (Houston, 2012). From the figures above, it is evident that Project B carries

a larger NPV (£72,620) than Project A (£67,790), and hence Project B should be adopted based on NPV figures.

The Accounting Rate of Return (ARR) considers the earnings of a project over its entire economic life. It is compared with the cut off rate of a project. The cut off rate is usually the cost of capital, and if the ARR is equal or higher than the cut off rate of return, the project is accepted. From the figures above, the ARR values for both projects A and B (24.07% and 21.74% respectively) are higher than the company's target cost of capital (7%). However, Project A will be adopted it gives the highest ARR of 24.07%.

d.

The Payback rule states that a project should be accepted if its payback period is less than some specified cut-off period (Brealey et al, 2011). This investment technique is very simple and straightforward. A particular cut-off date, say two years, is selected. All investment projects that have Payback periods of two years or less are accepted, and all of those that pay off in more than two years are rejected. Some of the advantages of using this investment method are: it's very simple to understand and easy to calculate, especially if the future cash flows have already been calculated. It can also be argued that the Payback technique is less risky since it prefers short- term investment than long- term. And it also uses cash, and not accounting profit. One major drawback of this method is the fact that it ignores the time value of money. It also ignores cash flows beyond the acceptable Payback period by saying nothing about the project as a whole. It also ignores the size and timing of cash flows.

The Net Present Value (NPV) investment technique can be described as the present value of cash inflows minus present value of cash outflows. Using this investment method, a project is accepted if the NPV is positive. For mutually exclusive projects, the project with the highest positive NPV is generally adopted. One of the main advantages of the NPV is that it takes

account of the time value of money. This technique is generally regarded by most as the 'gold standard' investment criterion as it is the only criterion necessarily consistent with maximising the value of the firm. It takes account of all relevant cash flows over the life of the project. It uses cash flow and not accounting profit. It also takes account of conventional and non- conventional cash flows, as well as changes in the discount rate during the project. Having said that, no technique is faultless and so therefore the NPV is fraught with few hiccups as well. Accepting will projects with a positive NPV can only be achieved in a perfect capital market. And also there is no guarantee that the cost of capital will remain the same throughout the life of the project. The cash flows of the project may be difficult to estimate, also.

e.

Investment appraisal is not all about financial factors. There are non-financial factors that play significant role in making any meaningful investment decision. Most of those non- financial factors act as backbone that will either make or break the investment if taken. Before an investment decision is taken, a company needs to first familiarise itself with existing government policies and regulations for avoiding the risk of contravening government regulations. Environmental factors should also be considered when making investment decisions. Will the project be environmentally friendly? Will it promote the company's corporate social responsibility in society? Staff motivation is another relevant issue in making investment decisions. Staff morale should be improved, making it easier to recruit and retain employees. The company must also endeavour to make their customers satisfied. General trend must also be considered before making an investment in a project to see if there is potential in the proposed project. Also, the action of competitors must also be considered

before making investment decisions. This will enable the company to have some form of competitive advantage over its rivals.

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