

Gemlo Co is a company listed on a large stock market. Extracts from its current statement of financial position are as follows:

	\$m	\$m
Equity		
Ordinary shares (\$1 nominal)	15	
Reserves	153	
		<hr/>
		168
Non-current liabilities		
6% Irredeemable loan notes	10	
7% Loan notes	12	
		<hr/>
		22
		<hr/>
		190
		<hr/>

Gemlo Co is planning an expansion of existing business operations costing \$10 million in the near future and is assessing its current financial position as part of preparing a business case in support of seeking new finance.

The business expansion is expected to increase the profit before interest and tax of Gemlo Co by 20% in the first year.

The planned business expansion by Gemlo Co has already been announced to the stock market. Information on the expected increase in profit before interest and tax has not yet been announced and the company has not decided on how the expansion is to be financed.

The ordinary shares of the company are currently trading at \$3.75 per share on an ex dividend basis. The irredeemable loan notes have a cost of debt of 7%.

The 7% loan notes have a cost of debt of 6% and will be redeemed at a 5% premium to nominal value after seven years. The interest cover of Gemlo Co is 6 times.

Companies operating in the same business sector as Gemlo Co have an average debt/equity ratio of 40% on a market value basis and an average interest cover of 9 times.

**Required:**

**(a) Calculate the debt/equity ratio of Gemlo Co based on market values and comment on your findings. (4 marks)**