



Society of Certified Management Accountants of Sri Lanka

Professional II Stage Pilot paper

Instructions to Candidates

1. Time allowed is **three (3) hours**.
2. Answer **Question-1** in **Section A** which is compulsory and **any three Questions** in **Section B**.
3. The answers should be given in the **English Language**.

<i>Subject</i>	<i>Subject Code</i>
Strategic Financial Management	(SFM)

Section A

Question-1 (40 Marks)

Stationers Ltd is a wholesaler supplier of stationary. In recent months, the company has experienced liquidity problems. The company has an overdraft at the end of December 2006 and the bank has been pressing for a reduction in this overdraft over the next six months. The company is unwilling to raise finance through long-term borrowing. The balance sheet of the business as at 30 December 2006 is as follows:

	Rs. 000	Rs. 000	Rs. 000
Fixed Assets			
Freehold land and premises at cost		1,150	
Less Accumulated depreciation		<u>24</u>	1,326
Fixtures and fittings at cost		1,740	
Less Accumulated depreciation		<u>380</u>	<u>1,360</u>
			2,686
Current Assets			
Stock at cost		1,420	
Debtors		<u>1,200</u>	
		2,620	
Creditors: amounts due within one year			
Trade creditors	1,450		
Bank overdraft	1,260		
Corporate Tax	240		
Dividend	<u>20</u>	<u>(2,970)</u>	<u>(350)</u>
			<u>2,336</u>
Capital and Reserves			
Rs 10/= ordinary shares			2,200
Profit and loss account			<u>136</u>
			<u>2,336</u>

The following projections for the six months ended 30th June 2007 are available considering the business.

1. Sales and purchases for the six months ended 30th June 2007 will be as follows:

	Sales Rs. 000	Purchases Rs. 000
January	1,600	1,600
February	2,200	1,400
March	2,400	1,700
April	1,500	1,100
May	1,800	1,200
June	2,000	1,600

2. 70% of sales are on credit and 30% are cash sales. Credit sales are received in the following months. All purchases are on one month's credit.
3. Wages are Rs. 40,000 for each of the first three months. However, this will increase by 10% as from April 2007. All wages are paid in the month they are incurred.
4. The gross profit percentage on goods sold is 30%.
5. Administration expenses are expected to be Rs. 12,000 in each of the first four months and Rs. 14,000 in subsequent months. These figures include a monthly charges of Rs. 4,000 in respect of depreciation of fixed assets. Administration expenses are paid in the month they are incurred.
6. Selling expenses are expected to be Rs. 8,000 per month except for June 2007 when an advertising campaign costing Rs. 12,000 will be paid for. The advertising campaign will commence at the beginning of July 2007. Selling expenses are paid for in the month they are incurred.
7. The dividend outstanding will be paid in January 2006.
8. The company intends to purchase, and pay for, new fixtures and fittings at the end of April 2007 for Rs. 28,000. These will be delivered in July 2007.

The company's financial specialist suggests the following at the beginning of July 2007, which may help to overcome the problems the company faces.

- To issue 6,000 debentures of Rs.100/- each carrying a coupon rate of 13% payable annually. They will be issued for a period of 4 years and redeemed on maturity, at face value. There is no necessary to issue new shares. But specialist estimated that the Beta of the company's shares is 1.1 and the required rate of return on the market portfolio is 18% while the risk free rate is 6.5%.
- To reduce credit sales to 40% and to delay payment of trade creditors in one month additional.
- To reduce the freehold land by selling one piece of land (1/5) at Rs. 200,000.

You are required to;

- (a) Prepare a cash flow projection for the company for each of the six months to 30 June 2007. **(12 marks)**
- (b) Prepare a projected profit and loss account for the six months to 30 June 2007. **(10 marks)**
- (c) If the company implements specialist's suggestions, discuss and prepare a statement including one month calculations which may include the ways in which the company may reduce the bank overdraft as required by the bank. **(12 marks)**
- (d) Compute Company's cost of debt, cost of equity and weighted average cost of capital (WACC) before and after implementing specialist's suggestions. **(6 marks)**
- (Total 40 marks)**

State any assumptions that you made

End of Section A

Section B

Answer any Three Questions

Question -2 (20 Marks)

- (a) An investment company considering three investments. The first is a bond that is selling in the market at Rs.1,200. The bond has a Rs. 1,000 par value, pays interest at 14%, and is scheduled to mature in 12 years. For bonds of this risk class, company believes that a 12% rate of return should be required.

The last investment is a common stock (Rs.25 par value) that recently paid a Rs.3 dividend. The firm's earnings per share have increased from Rs 4 to Rs. 8 in 10 years, which also reflects the expected growth in dividends per share for the indefinite future. The stock is selling for Rs. 25, and you think a reasonable required rate of return for the stock is 20 percent.

Which investment would you recommend the company to accept? Show your calculations based on value of each security. **(12 marks)**

- (b) A banking firm is arranging a loan scheme for Small and Medium scale Entrepreneurs. This scheme indicates that money could be supplied at 14% compound interest for four years when any project proposal was approved by the management. The loan is repayable in four equal annual installments payable at the end of each year.

If the bank approved Rs. 2,000,000 at the beginning of 2007, estimate annual amount of interests and the amount of loan principles that would be received in each of four years. **(8 marks)**

(Total 20 marks)

Question-3 (20 Marks)

Alpha Investment plc is proposing to invest in capital markets in two overseas countries, Peaceland and Freeland. Peaceland has recently changed their monetary policies and imposed some restrictions on the movements of funds between Peaceland and other countries. However, the government of Peaceland expects and encourages foreign investments in the country and is prepared to relax investment rules and regulations. The second investment will be in Freeland, where there are no restrictions on the movement of foreign exchange or capital.

	Sri Lanka	Freeland	Peaceland	World Markets
Average Treasury bill rate (%)	9.0	7.0	10.0	7.0
Long term borrowing rate (%)	12.5	8.5	12.5	7.0
Market return (%)	12.0	9.0	13.0	12.0
Equity beta	1.2	1.0	1.5	1.0
Corporate tax rate (%)	35.0	25.0	30.0	25.0
Pre-tax cost of debt (%)	9.5	6.5	10.0	5.0

World markets include the markets with no significant funds transferring barriers. Alpha's capital structure, if the two investments are undertaken, is expected to be 60% equity, 40% debt by book values, and 40% equity, 40% debt by market values. The debt would be borrowed in the relevant local capital market at local market rates.

You are required to:

- (1) Calculate and discuss what discount rates should be used in the evaluation of the investment in other countries. **(5 marks)**
 - (2) Briefly explain the opportunities and benefits available in Peaceland and Freeland. **(5 marks)**
 - (3) Briefly explain what possible inaccuracies of the estimates could be expected when calculating above discount rates. **(5 marks)**
 - (4) What type of other factors could you observe when investing in other countries? **(5 marks)**
- (Total 20 marks)**

Question-4(20 Marks)

- (a) Damian Villa Company expects with some degree of certainty to generate the following net income and to have the following capital expenditures during the next five years (in thousand of Rupees):

Year	Net Income	Capital Expenditure
1	2,000	1,000
2	1,500	1,500
3	2,500	2,000
4	2,300	1,500
5	1,800	2,000

The company currently has 1 million shares of common stock outstanding and pays annual dividends of Rs. 1 per share. Company financial policies include:

- Maintaining dividend payout ratio of 50%
- Maintaining 60% equity financing and 40% debt financing when the company invests in long-term assets

You are required to:

Estimate the amounts of external financing through equity and debt that will be necessary in each year while maintaining current financing policies. **(8 marks)**

- (b) Apple Computer Company has estimated the cost of debt and equity for various proportions of debt in its capital structure.

Proportion of debt Debt/ (Debt+Equity)	After-tax cost of debt K_d - %	Cost of equity K_e - %
0.0	0.0	12.0
0.1	5.7	12.1
0.2	5.9	12.5
0.3	6.1	13.0
0.4	6.5	13.9
0.5	7.1	15.0
0.6	8.5	17.0

- i. Determine the company's optimal capital structure. *(3 marks)*
- ii. If the company's current capital structure consists of 30% debt, how much higher its weighted cost of capital than at the optimal capital structure? *(2 marks)*

(c) Instruments Company has estimated the cost of debt and equity for various proportions of debt in its capital structure.

Proportion of debt Debt/ (Debt+Equity)	K_d	K_e with financial Distress costs - (%)	K_e with financial Distress Costs and agency Costs - %
0.0	0.0	12.00	12.00
0.1	5.8	12.05	12.05
0.2	5.9	12.10	12.20
0.3	6.0	12.20	12.60
0.4	6.2	12.40	13.40
0.5	6.7	12.80	14.80
0.6	8.0	15.00	18.00

Based on these data, determine the company's optimal capital structure

- i. with financial distress costs and
- ii. with financial distress and agency costs.

(4 marks)

(d) If the company's actual capital structure consists of 50% debt, how much higher its weighted cost of capital at this capital structure than at the optimal value with financial distress and agency costs?

(3 marks)

(Total 20 marks)

Question-5 (20 Marks)

- (a) ABC Co. Ltd. paid a dividend of Rs. 3/- per share last year. The company's EPS is Rs.12/- and its market multiplier is 1.5. According to the Graham-Dodd model, what will be the company's current share price? Also calculate the share price if the dividend per share is increased to Rs. 4/- while the EPS remains the same. *(6 marks)*
- (b) In recent year Malaka Limited had a net operating income of Rs. 2,700,000. It employs Rs. 3,600,000 debt carrying 10% interest charges. The overall capitalization rate applicable to Malaka is 15%.

What is the required return on equity?

(6 marks)

(c) Some managers, if asked what the main objective of their business is, may simply state 'To survive!' What do you think of this as a primary objective?

(8 marks)
(Total 20 marks)

Question-6 (20 Marks)

Dawn Raider Plc has just offered 1 of its shares for 2 shares in Sleepy plc, a company in the same industry as itself. Extracts from the accounts of each company for the year ended 31 December 2006, appear below:

	Dawn Raider Rs m	Sleepy Rs m
Profits and loss accounts		
Sales	150	360
Profit after tax	18	16
Dividends	4	14
 Balance sheet data		
Fixed Assets	150	304
Net current assets (note 1)	<u>48</u>	<u>182</u>
	198	486
Less loans	<u>80</u>	<u>40</u>
	<u>118</u>	<u>446</u>
Share capital (note 2)	50	100
Reserves	<u>68</u>	<u>346</u>
	<u>118</u>	<u>446</u>

Notes:

	Dawn Raider	Sleepy
1 Includes Cash/(overdrafts)	(Rs 60m)	Rs 60m
2 Shares	Rs 25.00	Rs 50.00

Stock market data for each company is as follows:

Dawn Raider	31/12/2004	31/12/2005	31/12/2006
Share price	120	144	198
Earnings per share	5.30	6.90	9.00
Dividends per share	2.00	2.00	2.00
 Sleepy			
Share price	45	43	72
Earnings per share	8.40	7.40	8.00
Dividends per share	8.00	7.00	7.00

If the takeover succeeds, Dawn Raider plans to continue Sleepy's marketing and distribution channels with its own, with an after-tax savings of Rs. 1 million per annum. In addition it expects to be able to increase Sleepy's profits after tax by at least Rs. 5 million per annum by better management. Dawn Raider's own profits after tax are expected to be Rs. 23 million (excluding the Rs 1 million saving already mentioned), in the year ended 31 December 2007.

One of the shareholders of Sleepy has written to its chairman arguing that the bid should not be accepted. The following is an extract from his letter: "The bid considerably undervalues Sleepy since it is below Sleepy's net assets per share. Furthermore, if Dawn Raider continues its existing

policy of paying only Rs 2 per share as a dividend, Sleepy's shareholders will be considerably worse off."

You are required to calculate:

- (a) The total value of the bid and the bid premium **(3 marks)**
- (b) Sleepy's net assets per share at 31 December 2006 **(3 marks)**
- (c) The dividends the holder of 100 shares in Sleepy would receive in the year before and the year after the takeover **(3 marks)**
- (d) The earnings per share for Dawn Raider in the year after the takeover. **(3 marks)**
- (e) The share price of Dawn Raider after the takeover assuming that it maintains its existing price/earnings ratio **(3 marks)**
- (f) Briefly explain the followings:
 - i. Spin-off
 - ii. Partial sell-off
 - iii. Leverage Buyout (LBO)

(5 marks)

(Total 20 marks)

End of Section B

End of question paper
