Institute of Certified Management Accountants of Sri Lanka
Incorporated by Parliament Act No.23 of 2009

May 2022 Examination

Strategic Level
FSV – 402 Financial Strategy & Valuation

No. of Pages:11
No. of Questions: 05

Instructions to Candidates

1. Time Allowed : Reading– **15 minutes.**
   Writing - **Three (3) hours.**
2. Total : **100** Marks
3. This paper consists of two Parts.
   Part-1: Question no. 01 (**Compulsory**)
   Part- II: Question no. 02 – 05 (**Select any 03 questions**)
4. Answer only four (04) questions **including** Question No. 01
5. The answers should be in **English** language.
6. Begin each answer on a separate page in the answer booklet.
7. Only non-programmable calculators are permitted to use.

PART – I
Compulsory

QUESTION NO. 01

PART-A

Lanka Operating Leasing & Finance (LOLF) is one of the reputed finance companies in Sri Lanka. The company is headed by a young businessman who hails from a renowned business family. In a move toward diversifying its operations, the company decided to invest in the plantation and tourism sectors - by acquiring loss-making entities at bargain prices. These acquisitions were financed by debentures. Following are the pre- and post-merger extracts of the statement of financial position.

	Pre-acquisition (Rs. million)	Post-acquisition (Rs. million)
Equity	100	100
Debt	10	80

You are required to:

1.1. Do you agree with LOLF's decision to diversify its operations into tourism and plantation sectors? **Justify** your answer with suitable arguments.

(05 Marks)

1.2. **Discuss** the immediate impact of the acquisition and its decision to use debentures to finance the acquisition on the credit ratings of LOLF.

(05 Marks)

1.3. **Advise** on the suitability of using only debentures to finance this acquisition and **explain** how the sources of funds should be selected to mitigate any possible adverse impact.

(05 Marks)

1.4. Critically **evaluate** LOLF's decision to diversify its operations into tourism and plantation sectors.

(05 Marks)

PART-B

The following information relates to Company A and B.

Description	Company A	Company B
Number of shares	200 million	10 million
Profit/loss for the year (Rs.)	600 million	(-10 million)
Price per share (Rs.)	3/-	1/-

Company A is to acquire Company B by issuing one share of Company A for two shares of company B.

You are required to:

1.5. **Explain** why the shares of Company B are being traded at a premium even when the company is making losses.

(05 Marks)

1.6. **Discuss** the applicability of relative valuation methods based on P/E (Price to Earnings) ratio for valuing Company B. Also, **explain** a suitable approach to value company B for acquisition purposes.

(04 Marks)

1.7. On a post-acquisition basis, if the value of company A is Rs.605 million after paying Rs.25 million to the owners of company B, will there be any synergy from the acquisition? If so, **determine** the present value of that synergy.

(05 Marks)

1.8. "Merger is a synonym for Acquisition." Do you agree with this statement? **Explain.**

(02 Marks)

1.9. **Discuss** why post-mergers may fail, even when both organizations are in the same value chain.

(04 Marks)

[Total 40 Marks]

PART - II

Answer any three (03) questions.

QUESTION NO. 02

Part-A.

XYZ PLC is planning on investing in a condominium (a large property complex) called Imperial Court Apartments (ICA) which is located in Kadawatha. It incorporates a splendid collection of apartments. The project will be carried out on a 30-acre site, neighbouring the 4-way lane main road running towards Colombo & several popular expressway entries. ICA has 100 apartments to be rented at a monthly rental of Rs.200,000/- per apartment.

Out of the total investment of Rs.7 billion, Rs.4 billion will be funded by a Foreign Direct Investment (FDI) as equity. The balance will be financed by a commercial loan obtained from a commercial bank in Sri Lanka at 12% interest. According to the BOI (Board of Investment) agreement, XYZ will have to pay taxes at a reduced rate of 15% - for the first five years.

Every year XYZ will incur a fixed cost of Rs.19 million on maintenance and other administrative work in ICA. Additionally, one apartment unit will incur an additional maintenance cost of Rs.120,000/- per annum when occupied. The project requires working capital of Rs.1,500 million and is expected to be recovered at the end of 20 years.

Additional information

Five-year Sri Lankan government treasury bond rate is 13%. The shareholders of XYZ require a risk premium of 5%. Further, the beta value of a share of XYZ PLC is estimated to be 1.5. Additionally, FDI investors require a country risk premium of 2%.

You are required to:

2.1. Estimate the funding requirement of the project which needs to be financed by borrowings.

(03 Marks)

2.2. Determine a discount rate which can be used to appraise the project.

(03 Marks)

2.3. Compute the operating leverage of the project assuming that 50 apartments are to be rented initially and then, it will go up to 70 apartments.

(04 Marks)

Part-B.

Moonlight Holdings PLC is a conglomerate with an established presence in Healthcare, Plantations, and Fast-Moving Consumer Goods (FMCG). The Group is now planning on further diversifying its business into Power & Energy. Moonlight requires Rs 200 million next year to invest in a new, mini thermal power plant. Currently, the company's target capital structure is comprised of 35%-debt and 65%-equity. The company's current net income is Rs.160 million and the company has 10 million ordinary shares outstanding. Moonlight strictly follows the residual dividend policy.

You are required to:

2.4. Determine Moonlight's dividend payout ratio.

(03 Marks)

2.5. Compute the dividend payout, if there is a drop in net income to LKR 90 million.

(03 Marks)

2.6. Discuss the disadvantages of strictly following a residual dividend policy in an organization.

(04 Marks)

[Total 20 Marks]

QUESTION NO. 03

Part-A.

ABC PLC is one of the leading conglomerates listed on the Colombo Stock Exchange (CSE), Sri Lanka. Dividends for the past three years (from the oldest to the most recent) are Rs. 5.00, Rs.5.30, Rs.5.75. Further, the earnings retention ratio is 70%, and the Return on Equity (ROE) is 9%.

The current year's dividend is Rs.6/-, and the return required by the equity holders is 12%. The market price of a share of ABC is Rs.100/-.

Assuming that one of your clients has invested Rs.50 million to purchase shares of ABC PLC.

You are required to:

3.1. Determine the dividend growth rate.

(03 Marks)

3.2. Compute the intrinsic value of a share of ABC PLC.

(03 Marks)

3.3. Based on the intrinsic value calculated above, what can you **recommend** for the investors of ABC PLC share.

(02 Marks)

Part-B.

Capital PLC is currently operating at its optimal capital structure. The company is considering a Real Estate Project which requires an investment of Rs.900 million. The following information relating to the capital structure can be obtained.

Source of Capital	**Market Value (Rs.000)**
Equity - Common Shares	1,000,000
Preferred Stock	300,000
Debt	700,000

The Board of directors has decided to finance the new project based on the current weights of the capital structure. Thus, the new project will be financed using common equity, preferred stocks and debt.

The company recently paid a dividend of Rs.6/- per common share and this is expected to grow at a rate of 7%. The current price of common stock is Rs.60/- per share. A dividend of Rs.7/- per share is paid to the preferred stockholders, and the preferred stocks are trading at Rs.40/- per share.

Capital PLC will also obtain a bank loan at an interest rate of 20%. The applicable Corporate Tax Rate is 30%.

You are required to:

3.4. Discuss how the investment of Rs.900 million will be funded by Common Stocks, Preferred Stocks and Debt.

(03 Marks)

3.5. Compute Cost of Equity, Cost of Preferred Stock and after-tax Cost of Debt.

(06 Marks)

3.6. Compute the Weighted Average Cost of Capital (WACC) of the project.

(03 Marks)

[Total 20 Marks]

QUESTION NO. 04

Sarubima is a small property management company. Mr Shehan is the Managing Director of Sarubima. The company is located in Negombo. The company has two vehicles: a car and a van. The current market value of the car is Rs.10 million. Monthly fuel cost of the car is Rs.80,000/-. At present, they get electricity from the Ceylon Electricity Board (CEB), and the average monthly electricity usage is 400 units which costs them Rs.10,000/- (CEB price per unit is Rs.45/-).

Mr. Shehan is planning on purchasing a solar power system to generate electricity instead of having the electricity connection with CEB due to the frequent power interruptions. He believes that it is possible to transfer from CEB to the solar power system on 1st of January 2023. It is estimated that the identified solar power system will generate 700 units of electricity per month, and the system will cost Rs.2,100,000/- with a 5-year warranty.

In order to make sure that the solar power system is optimally utilized, Mr. Shehan is planning on fixing two air conditioners on 1st of January 2023. One machine will cost him Rs.180,000/- which will have a useful life of 5 years with no salvage value. It is estimated that one air conditioner will consume 50 units of electricity per month. Further, once the solar panel system is fixed, Mr.Shehan is planning on selling the car on 1st of January 2023 for Rs.5,000,000/- and buying a second-hand electric car with the same expected life as the previous car at Rs.4,700,000/-. It is estimated that the electric car will consume 200 units of electricity per month. After 5 years, the electric car will be sold at a price of Rs. 400,000/-.

The company has enough savings to invest, so it will create an opportunity cost of 12%. Assume the company is not paying corporate taxes.

You are required to:

4.1. **Compute** the cash inflows and outflows generated by the project for the first 5 years.
(07 Marks)

4.2. **Assess** the feasibility of the project using an appropriate tool assuming the lifetime of the project is 5 years. (Consider annual net cash flows when discounting).
(08 Marks)

4.3. Assuming that the company can issue debentures to finance the above project, **explain** the meaning of the underlined terms given below in relation to debentures,
"5 years listed guaranteed unsecured subordinated redeemable debentures".
(05 Marks)

[Total 20 Marks]

QUESTION NO. 05

Part-A.

Teleco is a Sri Lankan- based telecommunication service provider which provides creative and cost-effective communication solutions to several local and global Fast Moving Consumer Goods (FMCG) companies. The following information has been given for Teleco for the year ended 31st December 2021.

The company's operating cash flow for the next year will be Rs.2,200,000/-. The company has also forecasted a capital expenditure of Rs.1,600,000/- for the next financial year.

You are required to:

5.1. **Distinguish** between operating profit & operating cash flow and **recommend** the better measure of operating performance out of those two for valuation purposes.
(03 Marks)

5.2. **Compute** the operating cash flow that can be disbursed to the capital providers.
(02 Marks)

5.3. **Explain** the alternative uses of the operating cash flow calculated in question 5.2.
(05 Marks)

<u>Part-B.</u>

Equator is a tour operator headquartered in Sri Lanka. They have tourist hotels in Maldives and Thailand in addition to Sri Lanka. Due to the prevailing unrest in the Sri Lankan economy, the company cannot find enough foreign currency for the required capital infusions for its international subsidiaries. However, Equator can still manage this situation as its Maldivian and Thailand operations generate some foreign exchange. The company wants to invest USD 5 million in Thailand after one year.

You are required to:

5.4. **Explain** a tool using which Equator can mitigate the foreign currency exchange rate risk with regard to its investment of USD 5 million.

(04 Marks)

5.5. Assume that the company has decided to hedge its USD revenue risk with a currency forward contract. The current exchange rate is LKR 350/USD. Further, the interest rates in the US and Sri Lanka are 3% and 13%, respectively**. Compute** the one-year forward exchange rate applicable for the forward contract.

(03 Marks)

5.6. If you were the company's financial manager, what would you prefer to have? A floating exchange rate or a fixed exchange rate? **Justify** your answer.

(03 Marks)

[Total 20 Marks]

-End of the Question Paper-

Formula Sheet

Formular 01	V=EV/ECITDA
Formular 02	V=EV/EBIT
Formular 03	$ROE = \frac{NI}{BVE}$
Formular 04	$FV_t = C \times (1+r)^n$
Formular 05	$PV_t = \frac{C_n}{(1+r)^n}$
Formular 06	$PV_t = \sum_{n=0}^{N} \frac{C_n}{(1+r_n)^n}$
Formular 07	$FV_t = PV \times (1+r)^n$
Formular 08	$PV_t = \frac{C}{r}\left(1 - \frac{1}{(1+r)^N}\right)$
Formular 09	$PV_t = \frac{C}{r-g}$
Formular 10	$PI = \frac{NPV}{RC}$
Formular 11	$P = \frac{FV}{(1+YTM_n)^n}$
Formular 12	Yield Rate=<u>C+(F-P)/n</u> (C+P)/2
Formular 13	NOPLAT= Business Operating Income x (1 – tax rate) *FCF* = NOPAT – change in IC
Formular 14	$P = \frac{Div_1}{1+r_E} + \frac{Div_2}{(1+r_E)^2} + \cdots + \frac{Div_N}{(1+r_E)^N} + \frac{P_N}{(1+r_E)^N}$
Formular 15	$P = \sum_{n=1}^{\infty} \frac{Div_n}{(1+r_E)^n}$
Formular 16	$P_0 = \frac{Div_1}{r_E - g}$
Formular 17	$g = RR \times RONI$

Formular 18	$P_N = \frac{Div_{N+1}}{r_E - g}$
Formular 19	$FCF = EBIT \times (1 - \tau_C) + D - CD - \Delta NWC$
Formular 20	$V_0 = \frac{FCF_1}{1 + r_{WACC}} + \frac{FCF_2}{(1 + r_{WACC})^2} + \cdots + \frac{FCF_N}{(1 + r_{WACC})^N} + \frac{V_N}{(1 + r_{WACC})^N}$
Formular 21	$P/E = \frac{P_0}{EPS_1} = \frac{Div_1/EPS_1}{r_E - g} = \frac{DPR}{r_E - g}$
Formular 22	$\frac{V_0}{EBITDA_1} = \frac{FCF_1/EBITDA_1}{r_{wacc} - g_{FCF}}$
Formular 23	$R_E = R_U + \frac{D}{E}(R_U - R_D)$
Formular 24	$w = \frac{E}{E+D} r_e + \frac{D}{E+D} r_d (1 - T_m)$
Formular 25	$TV = \frac{FCF_N (1+g)}{(w-g)}$
Formular 26	$V_L = V_{UL} + T_c D$