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

May 2023 Examination

Strategic Level
FSV – 402 Financial Strategy & Valuation

No. of Pages:08
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

Leisure PLC, a pioneer in Sri Lanka's travel and tourism sector, operates a chain of lavish hotels and resorts around the country. The research unit of Leisure PLC has observed that its investors are gradually attracted to invest in Nature PLC which is the main competitor of Leisure PLC following the going green concept implemented by them. As an immediate action to increase the marketability of shares, Leisure PLC is currently considering splitting the shares in the ratio of 2-for-1 share. The applicable income tax rate for the travel and tourism industry is 40%. The following information is related to the capital structure of Leisure PLC, Nature PLC, and the industry.

	Leisure PLC (Rs. in Mn)	Nature PLC (Rs. in Mn)	Industry
Equity – Ordinary Shares	175	40	60%
Debt – Long-Term bank loan	75 (Interest rate is 14% per annum)	160 (Interest rate is 12.5% per annum)	40%

Extracts of the statement of comprehensive income of Leisure PLC and Nature PLC, for the year ended 31st March 2023, are as follows.

	Leisure PLC (Rs. in Mn)	Nature PLC (Rs. in Mn)
Sales	500	830
Less: Costs of goods sold	150	332
Gross profit	**350**	**498**
Administrative expenses	40	74.7
Selling and distribution expenses	70	149.4
Earnings before interest and tax (EBIT)	**240**	**273.9**

Following the skyrocketing fuel costs, hiking inflation, and LKR depreciation, a financial analyst has forecasted that sales of the travel and tourism industry will decrease by 50% during the next year. Accordingly, the finance manager of Leisure PLC has forecasted a drop in earnings per share (EPS) by 5% next year. The number of shares of each company is as follows.

	Leisure PLC	Nature PLC
No. of shares	1,750,000	400,000

YOU ARE REQUIRED TO:

1.1. **Calculate** the net income of Leisure PLC and Nature PLC for the year ended 31st March 2024 based on the forecast of the financial analyst. (Assume administrative expenses and selling and distribution expenses are fixed)

(06 Marks)

1.2. **Evaluate** the level of business risk and financial risk of Leisure PLC and Nature PLC by calculating the degree of operating leverage (DOL) and degree of financial leverage (DFL).

(06 Marks)

1.3. **Comment** whether the forecasted EPS drop of 5% of Leisure PLC is realistic. Justify your answer.

(03 Marks)

1.4. **Explain** with reasons, why do you recommend the stock split planned by Leisure PLC under the prevailing scenario.

(05 Marks)

1.5. **Evaluate** the impact of bankruptcy costs and agency costs on the optimal capital structure of Leisure PLC and Nature PLC.

(05 Marks)

Part-B

Nutri Pet Foods is a US- based multinational animal food processing company that is planning to establish a food processing factory in the United Kingdom. Nutri Pet Foods has hired you to assess the feasibility of the project. The initial investment of the project is USD 100 Mn and annual revenue, and costs are as follows;

	2024	**2025**	**2026**	**2027**	**2028**
Revenue (GBP Mn)	120	140	155	180	220
Costs (GBP Mn)	30	50	75	105	125
Forward spot rate	1 USD = 0.9 GBP	1 USD = 0.92 GBP	1 USD = 0.96 GBP	1 USD = 0.97 GBP	1 USD = 0.98 GBP

Nutri Pet Foods assumes that the revenue and costs will grow at a constant rate of 5% per year indefinitely after 2028. Nutri Pet Food's required rate of return on investments of this nature is 17% per annum. The government of the United Kingdom is in an ongoing discussion to restructure the international tariff system and to implement a policy that will restrict remitting funds to foreign countries with the intention of promoting reinvestment within the United Kingdom.

YOU ARE REQUIRED TO:

1.6. **Evaluate** the economic exposure and political risks faced by Nutri Pet Foods.

(03 Marks)

1.7. **Distinguish** between the home currency approach and the foreign currency approach used in evaluating an international project.

(02 Marks)

1.8. **Calculate** the net cash flow of the project from 2024 to 2027 in GBP.

(02 Marks)

1.9. **Calculate** the continuing/terminal value of the project at the end of 2028.

(03Marks)

1.10. **Evaluate** the feasibility of the project by calculating the net present value (NPV) based on the home currency approach.

(05 marks)

[Total 40 Marks]

PART – II

Answer any three (03) questions.

QUESTION NO. 02

Auto Crown PLC is a leading vehicle assembler in Sri Lanka that experiences constant sales and growth in profits from the year 2019. They are currently considering a new project 'Eco Car' which imports electric and solar cars. The project is expected to start in the year 2024. The cost of the project Rs.100 Mn is expected to recover in 10 years. Auto Crown PLC is totally equity financing company and therefore, the finance manager has decided to finance the new project using debt capital. Bank of Sri Lanka has agreed to grant a 10-year loan at a fixed rate of 20% per annum. Further, Auto Crown PLC has negotiated with an investment banker to issue 10-year debentures at a 20% annual coupon rate which yields 18% per annum for an investor.

YOU ARE REQUIRED TO:

2.1. **Discuss** how the above investment and financing decisions affect the treasury function of the company.

(05 Marks)

2.2. Identify the life cycle stage of Auto Crown PLC and **evaluate** its decision to finance the 'Eco Car' project.

(05 Marks)

2.3. **Explain** how the investment bankers assist in Auto Crown PLC's debenture offering process.

(05 Marks)

2.4. **Recommend** with reasons to Auto Crown PLC, which source of debt financing would be suitable to finance the 'Eco Car' project assuming that you are the finance manager of Auto Crown PLC.

(05 Marks)

[Total 20 Marks]

QUESTION NO. 03

PART-A

StyleZy PLC is the pioneer in textile manufacturing in Sri Lanka and is currently considering acquiring CottonUs PLC, which is a high-potential company for Rs. 220 Mn by using the available liquid assets of StyleZy PLC. Following is the information related to the two companies before the acquisition.

	StyleZy PLC	CottonUs PLC
Number of shares (Mn)	15	5
Total assets (Rs. in Mn)	390	55
Total liabilities (Rs. in Mn)	65	30
Profit after tax (Rs. in Mn)	780	168
PE ratio (in times)	9	2

After the acquisition, the value of StyleZy PLC is expected to be Rs. 7,200 Mn.

YOU ARE REQUIRED TO:

3.1. Calculate the post-acquisition net asset value (book value) of StyleZy PLC.

(03 Marks)

3.2. Determine the value of synergy from the acquisition of CottonUs PLC.

(05 Marks)

3.3. Evaluate the sources through which StyleZy PLC was able to synergize from the acquisition of CottonUs PLC.

(04 Marks)

PART-B

Star Global is a leading training provider operating in the US and has entered into an agreement to conduct a virtual training programme for the employees of ABC Apparel Industries on the proposed ERP system. ABC Apparel Industries is expecting to pay USD 20,000 in 6 months. Assume current interest rate prevailing in Sri Lanka is 15% per annum and the current spot exchange rate is Rs.360/USD. The 180-day forward rate is Rs.390/USD and the expected exchange rate in 6 months is Rs.375/USD. ABC Apparel Industries is currently considering possible hedging techniques to manage the exchange rate exposure.

YOU ARE REQUIRED TO:

3.4. Discuss the possibility of using futures to hedge the exchange rate exposure.

(02 Marks)

3.5. Calculate current interest rate prevailing in US.

(02 Marks)

3.6. Evaluate the following statement with justifications.

'ABC Apparel Industries is indifferent between covering 60% of the exchange rate exposure through a forward contract and not covering the entire exposure'.

(04 Marks)

[Total 20 Marks]

QUESTION NO. 04

PART-A

Lanka Tea PLC is a renowned tea export company operating in Sri Lanka and extracts of the statement of financial position prepared as at 31st March 2023 are as follows.

	Rs. in Mn
Ordinary Shares	70
Bank Loan (32% per annum)	50

In addition, the following information is also available.

- Nominal/ face value of an ordinary share is Rs.10/- and is currently selling at a price of Rs.28.50 per share.
- Market return is 57% and the current treasury bill rate is 20% per annum.
- Cost of ordinary shares of Lanka Tea PLC is 49%.
- The marginal tax rate of the firm is 40%2

YOU ARE REQUIRED TO:

4.1. **Evaluate** the systematic risk of Lanka Tea PLC.

(03 Marks)

4.2. **Compute** the weighted average cost of capital (WACC) of Lanka Tea PLC.

(03 Marks)

4.3. **Evaluate** the finance manager's decision considering, Lanka Tea PLC plans to raise Rs. 175 Mn to invest in a green tea processing factory by issuing debentures with a coupon rate of 34%. The finance manager of Lanka Tea PLC has assessed the feasibility of the project based on the existing cost of capital of Lanka Tea PLC.

(03 Marks)

4.4. **Evaluate** the new project financing decision of Lanka Tea PLC based on the pecking order theory.

(03 Marks)

PART-B

AB PLC is considering taking over PQ PLC which is a high-potential early-stage company operating in the telecommunication industry. PQ PLC's total net assets as at 31st March 2023 is Rs.4 Mn and earnings for the year ended 31st March 2023 is Rs.1.2 Mn. Net tangible assets of PQ PLC account 60% of total net assets. Even though, the fair return expected on the companies operating in the telecommunication industry is 20%, early-stage companies require an additional return of 12% due to the high risks involved. AB PLC has decided to value PQ PLC by considering goodwill at five years of super profits.

You are required to:

4.5. **Calculate** the value that you would place on PQ PLC assuming you are the finance manager of AB PLC.

(05 Marks)

4.6. **Discuss** the limitations of the super profit method in valuing a company.

(03 Marks)

[Total 20 Marks]

QUESTION NO. 05

Jambo Holdings PLC is a well-diversified group of companies listed on the Colombo Stock Exchange and is currently considering investing Rs.75 Mn in Windy Power Pvt Ltd, a small and medium enterprise (SME) operating in the renewable energy sector. Jambo Holdings PLC has issued new ordinary shares to finance the cost of this project and dividends will not be declared in the next consequent two years. However, dividends for the third year are expected to be Rs. 3.50 after which it will grow rapidly at a rate of 30% per year during years 4 and 5. Then dividends are expected to grow at a constant rate of 10% per annum indefinitely. Jambo Holdings PLC's most recently paid Rs.3/- dividend per share. Ordinary shares of Jambo Holdings PLC are currently selling at Rs.40/- and the required rate of return of Jambo Holdings PLC's investor is 20%. The company is currently having a debt ratio of 40% which is lower than the industry average.

You are required to:

5.1. **Compute** the intrinsic value of a share of Jambo Holdings PLC.

(05 Marks)

5.2. **Explain** why you would invest in ordinary shares of Jambo Holdings PLC, assuming you are a potential investor of it.

(03 Marks)

5.3. 'Jambo Holdings PLC is practicing constant dividend policy'. Do you agree with this statement? **Explain** your answer.

(04 Marks)

5.4. Is it reasonable for Windy Power Pvt Ltd to use Jambo Holdings PLC's required rate of return as their cost of equity? **Justify** your answer.

(04 Marks)

5.5. Critically **evaluate** Jambo Holdings PLC's equity financing decision over debt financing potential.

(04 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=$\frac{C+(F-P)/n}{(C+P)/2}$
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	$V_L = V_{UL} + T_c D$