PILOT PAPER – 2023-2027 SYLLABUS

SL4.2 Finance Strategy & Valuation

Strategic Level

No of Pages: 11 No of Questions: 05

Time allowed: 3 Hours and 15 Minutes (Including 15 minutes of reading time).

Total Marks: 100

Exam Structure

This exam is consisting of two parts.

Part-1

- One compulsory essay question.
- 40 marks in total

Part- II:

- Four Essay Questions (Question No 02-05)
- Each 20 marks and 60 marks in total
- Select any 03 questions from part-II

Answer only four (04) questions including question no. 01

Other Instructions

- The answers should be in **English** language.
- Begin each answer on a separate page in the answer booklet.
- Only non-programmable calculators are permitted to use.

Part I Compulsory

QUESTION NO: 01

With the long-term plan of diversification of its business activities, Colby PLC, which is a large conglomerate, is expecting to acquire Aventura PLC, which is a manufacturing company, which is specialized in the manufacturing of industrial chemicals. Several rounds of discussions were held between the board of directors of both companies and the directors decided that the discounted cash flow approach would provide the most realistic results in deciding the value of Aventura PLC shares for the purpose of acquisition.

The following extracts from the financial statements of Aventura PLC are provided to you.

Income Statement As at 31st Dec 2022	
	Rs. Mns
Revenue	3120
Cost of Sales	(1580)
Depreciation and Amortization	(230)
Gross profit	1310
Administration and sales expenses	(340)
EBIT	970
Interest expenses	(370)
Earnings before tax	600
Taxation - 35%	(210)
Net Income after tax	390

Aventura PLC expects that the sales revenue will grow at a rate of 12% for the next 2 years, at 20% for the following 2 years and at 15% for the fifth year. From 2028 onwards, the cash flow growth rate is expected to be constant at a rate of 6% per annum.

Cost of sales as a percentage of sales is expected to be maintained at the existing level for the next 5 years. The administration and sales expenses are expected to grow at a rate of 8% for the next 2 years and from the 3rd year onwards, it will grow at a rate of 3%. Interest expenses and the corporate tax rate of 35% are expected to remain constant for the next 5 years. The top management of Aventura PLC demands Rs. 100 per equity share to agree on the acquisition. The board of Aventura PLC provides the following additional estimates in Rs. Mn for the next 5 years.

Year	Depreciation	Fixed Capital Investments	Working Capital Investments
2023	250	80	30
2024	245	75	30
2025	280	110	35
2026	310	100	22
2027	290	70	26

Further, a Weighted Average Cost of Capital of 16% was estimated for Aventura PLC. Value of non-operating assets and non-equity claims as at 31/12/2022 were Rs.1950 Mn and 3880 Mn respectively. Aventura PLC had 100 Mn equity shares as at 31/12/2022.

YOU ARE REQUIRED TO:

1.1. Recommend Colby PLC whether to acquire Aventura PLC.

(15 Marks)

PART B

One firm can acquire another in several different ways. The main reason for companies to acquire another company is the synergy generated by the acquisition. Synergy can be measured as the value of the combined firm less the value of two firms as separate entities. A merger is said to be friendly when the managers of the target company support it. A merger is said to be hostile when the target company managers do not support it. In a scenario of a hostile takeover, the target company will resist the takeover and in return, they will practice several takeover-defending tactics to stop the takeover.

You are required to:

1.2. **Explain** the basic forms of acquisitions.

(02 Marks)

1.3. **Explain** the sources of synergy providing examples to each.

(04 Marks)

1.4. **Discuss** the defending tactics, which can be undertaken by the target company.

(04 Marks)

PART C

Sirimewan is a newly appointed financial manager of the CNT PLC. His immediate superior the Chief Financial Officer (CFO) informs that the company is contemplating investing in common stocks and bonds. The following information is available for Sirimewan at his disposal.

Common Shares of CCC PLC

CCC PLC has declared a common share dividend of Rs.5/- per share for the year 2022. The company is currently expanding at a rapid rate. Therefore, its earnings and dividends are anticipated to grow at a rate of 15% p.a. for the next two years and 12% p.a. for the following two years. Thereafter, the company's earnings and dividends are expected to deplete at a constant rate of 4% p.a. forever. The required rate of return is 14% per annum. The current market price of a share is Rs.40/-.

Corporate Bonds of Demco PLC

Demco PLC's pays coupon semiannually at a rate of 8% per annum for their 20-year bonds. The bonds are redeemable at par for Rs.1,000/-. The yield required by for this based on the ratings given by the credit rating agency is 15% compounded semiannually. The current price of Demco bond is Rs.515/-.

Corporate Bonds of GNT PLC

GNT PLC's pays coupon semiannually at a rate of 12% per annum for their 40-year bonds. The bonds are redeemable at par for Rs.1,000/-. The yield required by for this based on the ratings given by the credit rating agency is 17% compounded semiannually. The current price of a GNT bond is Rs.650/-.

Preferred stocks of Lego PLC

Lego PLC issues preference shares with a maturity of 40 years. The face value of a stock is Rs. 100 and the stated dividend rate is 11% per annum. Based on the analysis done on the stock the required rate of returns is decided to be 15% per annum. The current price of a Lego preferred stock is Rs.78/-.

YOU ARE REQUIRED TO:

1.5. **Discuss** the possible reasons for Sirimewan to require different rates for different financial assets.

(04 Marks)

1.6. **Recommend** Sirimewan on selecting the financial assets.

(08 Marks)

1.7. **Advise** Sirimewan on selecting a bond if he is reluctant to invest in an asset which more susceptible to yield rate changes.

(03 Marks)

[Total 40 Marks]

Part II – Answer any 03 questions.

QUESTION NO. 02

PART A

Contribution of multinational companies to the world economy is huge. Some MNCs have been operating in foreign countries for such a long time and established their names in the market to such an extent that some laymen may perceive them as their domestic firms.

YOU ARE REQUIRED TO:

2.1. **Discuss** whether the objective of financial management of a multinational company (MNC) is different from a domestic firm.

(04 Marks)

PART B

Carlos Demarco is the financial analyst of Dento Inc., a US based manufacturing company. The company has completed a deal with Rico Corporation – a UK firm - for a sale of equipment's worth £ 2,000,000. The transaction was finalized in June and the payment is due in September i.e., three months from the sale. Dento Inc. has a payment to make worth £ 500,000 at the end of September to another customer who has sold goods to them. The current spot exchange rate is $1.76/£ and Carlos expects the spot exchange rate to be $1.78/£ when the payment fall due after three months. However, he thinks that given the fluctuations in the exchange rates in the market, it is better to think of strategies that can be used to hedge the exchange rate risk. He has collected the following information from the market. Currently, the cost of funds of Dento Inc is 11.50%.

Forward Market

Three-month forward rate: $ 1.75/£

Money Market

Type of Rate	USA	UK
Investment Rate	5.5% p.a.	7.5% p.a.
Borrowing Rate	7.5% p.a.	9.5% p.a.

OTC Options Market (Delivery in September)

Type	Value £	Premium	Strike Price
1 (Nearly -at-the-money)	1.5 Mn	1.4%	$ 1.74
2 (Out-of-money)	1.5 Mn	1.1%	$ 1.70

YOU ARE REQUIRED TO:

2.2. **Recommend** the best strategy to follow for Dento Inc. based on the above information.

(10 Marks)

2.3. **Compute** the minimum spot rate that should prevail before options market hedge becomes more beneficial than forward market hedge.

(02 Marks)

<u>PART C</u>

Perera is interested in purchasing a Volvo for his personal use. He has two options, to buy the vehicle in USA or buy it from Sweden. The price of a Volvo is US $ 50,000 in USA and SEK 100,000 in Sweden. The current exchange rate is $0.50/SEK and the SEK exchange rate appreciates to $0.60/SEK.

YOU ARE REQUIRED TO:

2.4. **Calculate** the price of a Volvo in the US market immediately after the exchange rate depreciation for no arbitrage opportunity to prevail.

(02 Marks)

2.5. **Calculate** the degree of exchange rate pass through if the price increases to US $ 52,500.

(01 Mark)

2.6. **Discuss** the possible reasons for the degree of exchange rate pass through in the US market.

(01 Mark)

[Total 20 Marks]

QUESTION NO. 03

Libro PLC is contemplating a new project, which requires Rs.500 Mn. The current capital structure is as follows.

Equity	50% (Rs. 2000 Mn including retained earnings)
Preferred Stock	30% (Rs. 1200 Mn)
Debt	20% (Rs. 800 Mn)

The total asset value of Libro PLC is Rs.4,000 Mn. The common stocks are currently traded at Rs. 100 and the dividends recently paid is Rs.15/-. The firm has entered to the maturity stage of the and therefore they expect the dividend payment to remain unchanged for a long period of time. A Rs.2,000/- bond pays semiannual coupons at 9.50% and is redeemable at par on 25 years from today. The current market price of a Libro bond is Rs.1,130.

The perpetual preferred stocks of Libro with a face value of Rs.100 pays dividend at a rate of 10% and are currently traded at Rs.78/-. Currently, the firm has retained earnings worth Rs. 200 Mn. The floatation cost is estimated to be 2% for common stocks, 2% for preferred stocks, and 3% for bonds. The company has unused funds worth Rs.300 Mn raised from bond issues and retained earnings is available as cash. The corporate tax rate faced by the company is 35%. The company plans to finance the new project ensuring the capital structure of the new project is 50% of equity, 30% of preferred stocks and 20% debt.

YOU ARE REQUIRED TO:

3.1. **Compute** the weighted average cost of capital (WACC) for Libro PLC before accepting the new project.

(05 Marks)

3.2. **Compute** the breakpoints in the capital structure based on the available funds from each source of capital.

(01 Mark)

3.3. **Compute** the marginal cost of capital (MCC) for Libro PLC if the company accepts the new project.

(02 Marks)

3.4. **Discuss** the implication of MCC on investment decisions.

(02 Marks)

3.5. **Compute** the overall WACC for Libro PLC if the company accepts the new project.

(05 Marks)

3.6. **Discuss** the impact of capital structure on the value of the business and the irrelevance of the capital structure using the theories in capital structure.

(05 Marks)

[Total 20 Marks]

QUESTION NO. 04

MLC PLC is in the FMCG industry and has been in the industry for a longtime. The business is well established and do not have profitable investment opportunities at their disposal. The CFO thinks that the shareholders deserve a high payout and proposes the board of directors (BOD) to declare a dividend of Rs.10 per share, which is 50% of earnings per share. However, the Chairman is in the view that the company should look for new investment opportunity; may be acquire a smaller company with promising growth potential. Further, he claims that the acquisition shall be made using debt capital instead using equity capital. CFO however does not agree with the chairman claiming that the shareholders will not be happy with lower dividend payments since most of the investors are above 60 years old. He has collected this information from the research conducted by the market research section of the company.

YOU ARE REQUIRED TO:

4.1. **Discuss** the elements of financial strategy in the above scenario.

(05 Marks)

4.2. **Discuss** the arguments of both CFO and Chairman of MLC PLC using your knowledge on corporate finance.

(15 Marks)

[Total 20 Marks]

QUESTION NO. 05

<u>PART A</u>

According to the statement of financial position prepared based on the market value, a company has Rs.40 Mn rupees earmarked for a project. The total asset value excluding that Rs.40 Mn of the business is Rs.360 Mn. Currently, the company has no debt, and the total equity value is 400 Mn. Neither the equity value of the firm nor the asset values currently reflect the net present value (NPV) of the investment. The management has decided to make a Rs.40 Mn dividend payment to the shareholders and finance that by issuing shares since the cash in hand is earmarked for the investment. It is expected that the borrowing policy and the investment policy to remain unaltered after the new decision to pay dividends. This company has 40 Mn shares outstanding before the new share issue. The NPV of the project is estimated to be Rs. 80 Mn and the company is able to issue new shares at fair price.

YOU ARE REQUIRED TO:

5.1. **Calculate** the value of an old share before and after the dividend payment.

(02 Marks)

5.2. **Calculate** the number of shares this company must issue.

(02 Marks)

5.3. **Calculate** the value of a share after the dividend payment, if this company gives up the project.

(02 Marks)

5.4. **Discuss** the applicability of the views of “Rightists” and the “Radical Left” on payout policy to the above scenario.

(04 Marks)

5.5. **Discuss** whether the “Trade-off theory” in the discourse of capital structure is applicable to the scenario presented above.

(04 Marks)

PART B

Meltra PLC has merged with Nentra PLC issuing their shares at the prevailing market price. After the acquisition, it is revealed that the EPS of Meltra increased from Rs.4 to Rs.5. Mr. Joel Nixon, CEO of Meltra PLC attempts to convince the shareholders that the merger was extremely beneficial given the earnings per share has increased by nearly 25% after the merger.

Mr. Joel is the CEO of another company, Tiens PLC, of which the market value is Rs.405 Mn. Tiens PLC is considering merging with Biens PLC, which is valued at Rs.100 Mn based on the market price of shares. Merging the two would allow cost savings with a present value of Rs.60 Mn. Biens PLC is to be bought for Rs.140 Mn. However, the newly appointed financial analyst claim that Biens PLC’s share price is already increased by Rs.28 with the anticipation of the merger. The number of shares outstanding for Biens PLC is Rs.0.5 Mn and the market price per share is Rs.200/-.

YOU ARE REQUIRED TO:

5.6. **Discuss** the claim of Mr. Joel regarding the first merger using your knowledge on mergers.

(02 Marks)

5.7. **Evaluate** the decision to merge Tiens PLC and Biens PLC, if the shares of Biens is not overpriced.

(02 Marks)

5.8. **Evaluate** the decision to merge Tiens PLC and Biens PLC if the claim of the financial analyst of Tiens is true.

(02 Marks)

[Total 20 Marks]

-End of the Question Paper-