

Professional Level – Options Module

# Advanced Financial Management

Tuesday 6 December 2011

**Time allowed**

Reading and planning: 15 minutes

Writing: 3 hours

This paper is divided into two sections:

Section A – BOTH questions are compulsory and MUST be attempted

Section B – TWO questions ONLY to be attempted

**Formulae and tables are on pages 8–12.**

**Do NOT open this paper until instructed by the supervisor.**

**During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.**

**This question paper must not be removed from the examination hall.**

The Association of Chartered Certified Accountants

P4  
Paper

**ACCA**

**Section A – BOTH questions are compulsory and MUST be attempted**

- 1 Tramont Co is a listed company based in the USA and manufactures electronic devices. One of its devices, the *X-IT*, is produced exclusively for the American market. Tramont Co is considering ceasing the production of the *X-IT* gradually over a period of four years because it needs the manufacturing facilities used to make the *X-IT* for other products.

The government of Gamala, a country based in south-east Asia, is keen to develop its manufacturing industry and has offered Tramont Co first rights to produce the *X-IT* in Gamala and sell it to the USA market for a period of four years. At the end of the four-year period, the full production rights will be sold to a government-backed company for Gamalan Rupiahs (GR) 450 million after tax (this amount is not subject to inflationary increases). Tramont Co has to decide whether to continue production of the *X-IT* in the USA for the next four years or to move the production to Gamala immediately.

Currently each *X-IT* unit sold makes a unit contribution of \$20. This unit contribution is not expected to be subject to any inflationary increase in the next four years. Next year's production and sales estimated at 40,000 units will fall by 20% each year for the following three years. It is anticipated that after four years the production of the *X-IT* will stop. It is expected that the financial impact of the gradual closure over the four years will be cost neutral (the revenue from sale of assets will equal the closure costs). If production is stopped immediately, the excess assets would be sold for \$2.3 million and the costs of closure, including redundancy costs of excess labour, would be \$1.7 million.

The following information relates to the production of the *X-IT* moving to Gamala.

The Gamalan project will require an initial investment of GR 230 million, to pay for the cost of land and buildings (GR 150 million) and machinery (GR 80 million). The cost of machinery is tax allowable and will be depreciated on a straight-line basis over the next four years, at the end of which it will have a negligible value.

Tramont Co will also need GR 40 million for working capital immediately. It is expected that the working capital requirement will increase in line with the annual inflation rate in Gamala. When the project is sold, the working capital will not form part of the sale price and will be released back to Tramont Co.

Production and sales of the device are expected to be 12,000 units in the first year, rising to 22,000 units, 47,000 units and 60,000 units in the next three years respectively.

The following revenues and costs apply to the first year of operation:

- Each unit will be sold for \$70;
- The variable cost per unit comprising of locally sourced materials and labour will be GR 1,350, and;
- In addition to the variable cost above, each unit will require a component bought from Tramont Co for \$7, on which Tramont Co makes \$4 contribution per unit;
- Total fixed costs for the first year will be GR 30 million.

The costs are expected to increase by their countries' respective rates of inflation, but the selling price will remain fixed at \$70 per unit for the four-year period.

The annual corporation tax rate in Gamala is 20% and Tramont Co currently pays corporation tax at a rate of 30% per year. Both countries' corporation taxes are payable in the year that the tax liability arises. A bi-lateral tax treaty exists between the USA and Gamala, which permits offset of overseas tax against any USA tax liability on overseas earnings. The USA and Gamalan tax authorities allow losses to be carried forward and written off against future profits for taxation purposes.

Tramont Co has decided to finance the project by borrowing the funds required in Gamala. The commercial borrowing rate is 13% but the Gamalan government has offered Tramont Co a 6% subsidised loan for the entire amount of the initial funds required. The Gamalan government has agreed that it will not ask for the loan to be repaid as long as Tramont Co fulfils its contract to undertake the project for the four years. Tramont Co can borrow dollar funds at an interest rate of 5%.

Tramont Co's financing consists of 25 million shares currently trading at \$2.40 each and \$40 million 7% bonds trading at \$1,428 per \$1,000. Tramont Co's quoted beta is 1.17. The current risk free rate of return is estimated at 3% and the market risk premium is 6%. Due to the nature of the project, it is estimated that the beta applicable to the project if it is all-equity financed will be 0.4 more than the current all-equity financed beta of Tramont Co. If the Gamalan project is undertaken, the cost of capital applicable to the cash flows in the USA is expected to be 7%.

The spot exchange rate between the dollar and the Gamalan Rupiah is GR 55 per \$1. The annual inflation rates are currently 3% in the USA and 9% in Gamala. It can be assumed that these inflation rates will not change for the foreseeable future. All net cash flows arising from the project will be remitted back to Tramont Co at the end of each year.

There are two main political parties in Gamala: the Gamala Liberal (GL) Party and the Gamala Republican (GR) Party. Gamala is currently governed by the GL Party but general elections are due to be held soon. If the GR Party wins the election, it promises to increase taxes of international companies operating in Gamala and review any commercial benefits given to these businesses by the previous government.

**Required:**

**Prepare a report for the Board of Directors of Tramont Co that**

- (i) **Evaluates whether or not Tramont Co should undertake the project to produce the X-IT in Gamala and cease its production in the USA immediately. In the evaluation, include all relevant calculations in the form of a financial assessment and explain any assumptions made;**

Note: it is suggested that the financial assessment should be based on present value of the operating cash flows from the Gamalan project, discounted by an appropriate all-equity rate, and adjusted by the present value of all other relevant cash flows. (27 marks)

- (ii) **Discusses the potential change in government and other business factors that Tramont Co should consider before making a final decision.** (8 marks)

Professional marks will be awarded in question 1 for the format, structure and presentation of the answer.

(4 marks)

**(39 marks)**

- 2 Alecto Co, a large listed company based in Europe, is expecting to borrow €22,000,000 in four months' time on 1 May 2012. It expects to make a full repayment of the borrowed amount nine months from now. Currently there is some uncertainty in the markets, with higher than normal rates of inflation, but an expectation that the inflation level may soon come down. This has led some economists to predict a rise in interest rates and others suggesting an unchanged outlook or maybe even a small fall in interest rates over the next six months.

Although Alecto Co is of the opinion that it is equally likely that interest rates could increase or fall by 0.5% in four months, it wishes to protect itself from interest rate fluctuations by using derivatives. The company can borrow at LIBOR plus 80 basis points and LIBOR is currently 3.3%. The company is considering using interest rate futures, options on interest rate futures or interest rate collars as possible hedging choices.

The following information and quotes from an appropriate exchange are provided on Euro futures and options. Margin requirements may be ignored.

Three month Euro futures, €1,000,000 contract, tick size 0.01% and tick value €25

March 96.27

June 96.16

September 95.90

Options on three month Euro futures, €1,000,000 contract, tick size 0.01% and tick value €25. Option premiums are in annual %.

	Calls		Strike	Puts		
March	June	September		March	June	September
0.279	0.391	0.446	96.00	0.006	0.163	0.276
0.012	0.090	0.263	96.50	0.196	0.581	0.754

It can be assumed that settlement for both the futures and options contracts is at the end of the month. It can also be assumed that basis diminishes to zero at contract maturity at a constant rate and that time intervals can be counted in months.

**Required:**

- (a) Briefly discuss the main advantage and disadvantage of hedging interest rate risk using an interest rate collar instead of options. (4 marks)
- (b) Based on the three hedging choices Alecto Co is considering and assuming that the company does not face any basis risk, recommend a hedging strategy for the €22,000,000 loan. Support your recommendation with appropriate comments and relevant calculations in €. (17 marks)
- (c) Explain what is meant by basis risk and how it would affect the recommendation made in part (b) above. (4 marks)

**(25 marks)**

**Section B – TWO questions ONLY to be attempted**

- 3** Levante Co has identified a new project for which it will need to increase its long-term borrowings from \$250 million to \$400 million. This amount will cover a significant proportion of the total cost of the project and the rest of the funds will come from cash held by the company.

The current \$250 million borrowing is in the form of a 4% bond which is trading at \$98.71 per \$100 and is due to be redeemed at par in three years. The issued bond has a credit rating of AA. The new borrowing will also be raised in the form of a traded bond with a par value of \$100 per unit. It is anticipated that the new project will generate sufficient cash flows to be able to redeem the new bond at \$100 par value per unit in five years. It can be assumed that coupons on both bonds are paid annually.

Both bonds would be ranked equally for payment in the event of default and the directors expect that as a result of the new issue, the credit rating for both bonds will fall to A. The directors are considering the following two alternative options when issuing the new bond:

- (i) Issue the new bond at a fixed coupon of 5% but at a premium or discount, whichever is appropriate to ensure full take up of the bond; or
- (ii) Issue the new bond at a coupon rate where the issue price of the new bond will be \$100 per unit and equal to its par value.

The following extracts are provided on the current government bond yield curve and yield spreads for the sector in which Levante Co operates:

**Current Government Bond Yield Curve**

Years	1	2	3	4	5
	3.2%	3.7%	4.2%	4.8%	5.0%

**Yield spreads (in basis points)**

Bond Rating	1 year	2 years	3 years	4 years	5 years
AAA	5	9	14	19	25
AA	16	22	30	40	47
A	65	76	87	100	112
BBB	102	121	142	167	193

**Required:**

- (a) Calculate the expected percentage fall in the market value of the existing bond if Levante Co's bond credit rating falls from AA to A.** (3 marks)
- (b) Advise the directors on the financial implications of choosing each of the two options when issuing the new bond. Support the advice with appropriate calculations.** (7 marks)
- (c) Among the criteria used by credit agencies for establishing a company's credit rating are the following: industry risk, earnings protection, financial flexibility and evaluation of the company's management.**

**Briefly explain each criterion and suggest factors that could be used to assess it.** (8 marks)

**(18 marks)**

- 4 Proteus Co, a large listed company, has a number of subsidiaries in different industries but its main line of business is developing surveillance systems and intruder alarms. It has decided to sell a number of companies that it considers are peripheral to its core activities. One of these subsidiary companies is Tyche Co, a company involved in managing the congestion monitoring and charging systems that have been developed by Proteus Co. Tyche Co is a profitable business and it is anticipated that its revenues and costs will continue to increase at their current rate of 8% per year for the foreseeable future.

Tyche Co's managers and some employees want to buy the company through a leveraged management buy-out. An independent assessment estimates Tyche Co's market value at \$81 million if Proteus Co agrees to cancel its current loan to Tyche Co. The managers and employees involved in the buy-out will invest \$12 million for 75% of the equity in the company, with another \$4 million coming from a venture capitalist for the remaining 25% equity.

Palaemon Bank has agreed to lend the balance of the required funds in the form of a 9% loan. The interest is payable at the end of the year, on the loan amount outstanding at the start of each year. A covenant on the loan states that the following debt-equity ratios should not be exceeded at the end of each year for the next five years:

Year	1	2	3	4	5
Debt / Equity (%)	350%	250%	200%	150%	125%

Shown below is an extract of the latest annual income statement for Tyche Co:

	\$'000
Sales Revenue	60,000
Materials and consumables	12,000
Labour costs	22,000
Other costs	4,000
Allocated overhead charge payable to Proteus Co	14,000
Interest paid	2,000
Taxable Profit	6,000
Taxation	1,500
Retained Earnings	4,500

As part of the management buy-out agreement, it is expected that Proteus Co will provide management services costing \$12 million for the first year of the management buy-out, increasing by 8% per year thereafter.

The current tax rate is 25% on profits and it is expected that 25% of the after-tax profits will be payable as dividends every year. The remaining profits will be allocated to reserves. It is expected that Tyche Co will repay \$3 million of the outstanding loan at the end of each of the next five years from the cash flows generated from its business activity.

**Required:**

- (a) Briefly discuss the possible benefits to Proteus Co of disposing Tyche Co through a management buy-out. (4 marks)
- (b) Calculate whether the debt-equity covenant imposed by Palaemon Bank on Tyche Co will be breached over the five-year period. (9 marks)
- (c) Discuss briefly the implications of the results obtained in part (b) and outline two possible actions Tyche Co may take if the covenant is in danger of being breached. (5 marks)

**(18 marks)**

- 5 The Chairman and the Chief Executive Officer (CEO) of Kengai Co are discussing whether or not the company should adopt a triple bottom line (TBL) reporting system in order to demonstrate Kengai Co's level of sustainable development. Kengai Co's competitors are increasingly adopting TBL reporting and the Chairman feels that it would be beneficial to follow suit. The CEO, on the other hand, feels that pursuing TBL reporting would be expensive and is not necessary.

**Required:**

- (a) Explain what TBL reporting involves and how it would help demonstrate Kengai Co's sustainable development. Support your explanation by including examples of proxies that can be used to indicate the impact of the factors that would be included in a TBL report. (8 marks)
- (b) Discuss how producing a TBL report may help Kengai Co's management focus on improving the financial position of the company. Illustrate the discussion with examples where appropriate. (10 marks)

**(18 marks)**