

Professional Level – Options Module

Advanced Financial Management

Thursday 9 June 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 Pursuit Co, a listed company which manufactures electronic components, is interested in acquiring Fodder Co, an unlisted company involved in the development of sophisticated but high risk electronic products. The owners of Fodder Co are a consortium of private equity investors who have been looking for a suitable buyer for their company for some time. Pursuit Co estimates that a payment of the equity value plus a 25% premium would be sufficient to secure the purchase of Fodder Co. Pursuit Co would also pay off any outstanding debt that Fodder Co owed. Pursuit Co wishes to acquire Fodder Co using a combination of debt finance and its cash reserves of \$20 million, such that the capital structure of the combined company remains at Pursuit Co's current capital structure level.

Information on Pursuit Co and Fodder Co**Pursuit Co**

Pursuit Co has a market debt to equity ratio of 50:50 and an equity beta of 1.18. Currently Pursuit Co has a total firm value (market value of debt and equity combined) of \$140 million.

Fodder Co, Income Statement Extracts

Year Ended	31 May 2011	31 May 2010	31 May 2009	31 May 2008
All amounts are in \$'000				
Sales revenue	16,146	15,229	14,491	13,559
Operating profit (after operating costs and tax allowable depreciation)	5,169	5,074	4,243	4,530
Net interest costs	489	473	462	458
Profit before tax	4,680	4,601	3,781	4,072
Taxation (28%)	1,310	1,288	1,059	1,140
After tax profit	3,370	3,313	2,722	2,932
Dividends	123	115	108	101
Retained earnings	3,247	3,198	2,614	2,831

Fodder Co has a market debt to equity ratio of 10:90 and an estimated equity beta of 1.53. It can be assumed that its tax allowable depreciation is equivalent to the amount of investment needed to maintain current operational levels. However, Fodder Co will require an additional investment in assets of 22c per \$1 increase in sales revenue, for the next four years. It is anticipated that Fodder Co will pay interest at 9% on its future borrowings.

For the next four years, Fodder Co's sales revenue will grow at the same average rate as the previous years. After the forecasted four-year period, the growth rate of its free cash flows will be half the initial forecast sales revenue growth rate for the foreseeable future.

Information about the combined company

Following the acquisition, it is expected that the combined company's sales revenue will be \$51,952,000 in the first year, and its profit margin on sales will be 30% for the foreseeable future. After the first year the growth rate in sales revenue will be 5.8% per year for the following three years. Following the acquisition, it is expected that the combined company will pay annual interest at 6.4% on future borrowings.

The combined company will require additional investment in assets of \$513,000 in the first year and then 18c per \$1 increase in sales revenue for the next three years. It is anticipated that after the forecasted four-year period, its free cash flow growth rate will be half the sales revenue growth rate.

It can be assumed that the asset beta of the combined company is the weighted average of the individual companies' asset betas, weighted in proportion of the individual companies' market value.

Other information

The current annual government base rate is 4.5% and the market risk premium is estimated at 6% per year. The relevant annual tax rate applicable to all the companies is 28%.

SGF Co's interest in Pursuit Co

There have been rumours of a potential bid by SGF Co to acquire Pursuit Co. Some financial press reports have suggested that this is because Pursuit Co's share price has fallen recently. SGF Co is in a similar line of business as Pursuit Co and until a couple of years ago, SGF Co was the smaller company. However, a successful performance has resulted in its share price rising, and SGF Co is now the larger company.

The rumours of SGF Co's interest have raised doubts about Pursuit Co's ability to acquire Fodder Co. Although SGF Co has made no formal bid yet, Pursuit Co's board is keen to reduce the possibility of such a bid. The Chief Financial Officer has suggested that the most effective way to reduce the possibility of a takeover would be to distribute the \$20 million in its cash reserves to its shareholders in the form of a special dividend. Fodder Co would then be purchased using debt finance. He conceded that this would increase Pursuit Co's gearing level but suggested it may increase the company's share price and make Pursuit Co less appealing to SGF Co.

Required:

Prepare a report to the Board of Directors of Pursuit Co that

- (i) Evaluates whether the acquisition of Fodder Co would be beneficial to Pursuit Co and its shareholders. The free cash flow to firm method should be used to estimate the values of Fodder Co and the combined company assuming that the combined company's capital structure stays the same as that of Pursuit Co's current capital structure. Include all relevant calculations;** (16 marks)
- (ii) Discusses the limitations of the estimated valuations in part (i) above;** (4 marks)
- (iii) Estimates the amount of debt finance needed, in addition to the cash reserves, to acquire Fodder Co and concludes whether Pursuit Co's current capital structure can be maintained;** (3 marks)
- (iv) Explains the implications of a change in the capital structure of the combined company, to the valuation method used in part (i) and how the issue can be resolved;** (4 marks)
- (v) Assesses whether the Chief Financial Officer's recommendation would provide a suitable defence against a bid from SGF Co and would be a viable option for Pursuit Co.** (5 marks)

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

(4 marks)

(36 marks)

- 2 Casasophia Co, based in a European country that uses the Euro (€), constructs and maintains advanced energy efficient commercial properties around the world. It has just completed a major project in the USA and is due to receive the final payment of US\$20 million in four months.

Casasophia Co is planning to commence a major construction and maintenance project in Mazabia, a small African country, in six months' time. This government-owned project is expected to last for three years during which time Casasophia Co will complete the construction of state-of-the-art energy efficient properties and provide training to a local Mazabian company in maintaining the properties. The carbon-neutral status of the building project has attracted some grant funding from the European Union and these funds will be provided to the Mazabian government in Mazabian Shillings (MShs).

Casasophia Co intends to finance the project using the US\$20 million it is due to receive and borrow the rest through a € loan. It is intended that the US\$ receipts will be converted into € and invested in short-dated treasury bills until they are required. These funds plus the loan will be converted into MShs on the date required, at the spot rate at that time.

Mazabia's government requires Casasophia Co to deposit the MShs2.64 billion it needs for the project, with Mazabia's central bank, at the commencement of the project. In return, Casasophia Co will receive a fixed sum of MShs1.5 billion after tax, at the end of each year for a period of three years. Neither of these amounts is subject to inflationary increases. The relevant risk adjusted discount rate for the project is assumed to be 12%.

Financial Information

Exchange Rates available to Casasophia

	Per €1	Per €1
Spot	US\$1.3585–US\$1.3618	MShs116–MShs128
4-month forward	US\$1.3588–US\$1.3623	Not available

Currency Futures (Contract size €125,000, Quotation: US\$ per €1)

2-month expiry	1.3633
5-month expiry	1.3698

Currency Options (Contract size €125,000, Exercise price quotation: US\$ per €1, cents per Euro)

Exercise price	Calls		Puts	
	2-month expiry	5-month expiry	2-month expiry	5-month expiry
1.36	2.35	2.80	2.47	2.98
1.38	1.88	2.23	4.23	4.64

Casasophia Co Local Government Base Rate	2.20%
Mazabia Government Base Rate	10.80%
Yield on short-dated Euro Treasury Bills (assume 360-day year)	1.80%

Mazabia's current annual inflation rate is 9.7% and is expected to remain at this level for the next six months. However, after that, there is considerable uncertainty about the future and the annual level of inflation could be anywhere between 5% and 15% for the next few years. The country where Casasophia Co is based is expected to have a stable level of inflation at 1.2% per year for the foreseeable future. A local bank in Mazabia has offered Casasophia Co the opportunity to swap the annual income of MShs1.5 billion receivable in each of the next three years for Euros, at the estimated annual MShs/€ forward rates based on the current government base rates.

Required:

- (a) Advise Casasophia Co on, and recommend, an appropriate hedging strategy for the US\$ income it is due to receive in four months. Include all relevant calculations. (15 marks)
- (b) Provide a reasoned estimate of the additional amount of loan finance Casasophia Co needs to obtain to undertake the project in Mazabia in six months. (5 marks)
- (c) Given that Casasophia Co agrees to the local bank's offer of the swap, calculate the net present value of the project, in six months' time, in €. Discuss whether the swap would be beneficial to Casasophia Co. (10 marks)
- (30 marks)**

Section B – TWO questions ONLY to be attempted

- 3 GNT Co is considering an investment in one of two corporate bonds. Both bonds have a par value of \$1,000 and pay coupon interest on an annual basis. The market price of the first bond is \$1,079.68. Its coupon rate is 6% and it is due to be redeemed at par in five years. The second bond is about to be issued with a coupon rate of 4% and will also be redeemable at par in five years. Both bonds are expected to have the same gross redemption yields (yields to maturity).

GNT Co considers duration of the bond to be a key factor when making decisions on which bond to invest.

Required:

(a) **Estimate the Macaulay duration of the two bonds GNT Co is considering for investment.** (9 marks)

(b) **Discuss how useful duration is as a measure of the sensitivity of a bond price to changes in interest rates.** (8 marks)

(17 marks)

- 4 MesmerMagic Co (MMC) is considering whether to undertake the development of a new computer game based on an adventure film due to be released in 22 months. It is expected that the game will be available to buy two months after the film's release, by which time it will be possible to judge the popularity of the film with a high degree of certainty. However, at present, there is considerable uncertainty about whether the film, and therefore the game, is likely to be successful. Although MMC would pay for the exclusive rights to develop and sell the game now, the directors are of the opinion that they should delay the decision to produce and market the game until the film has been released and the game is available for sale.

MMC has forecast the following end of year cash flows for the four-year sales period of the game.

Year	1	2	3	4
Cash flows (\$ million)	25	18	10	5

MMC will spend \$7 million at the start of each of the next two years to develop the game, the gaming platform, and to pay for the exclusive rights to develop and sell the game. Following this, the company will require \$35 million for production, distribution and marketing costs at the start of the four-year sales period of the game.

It can be assumed that all the costs and revenues include inflation. The relevant cost of capital for this project is 11% and the risk free rate is 3.5%. MMC has estimated the likely volatility of the cash flows at a standard deviation of 30%.

Required:

(a) **Estimate the financial impact of the directors' decision to delay the production and marketing of the game. The Black-Scholes Option Pricing model may be used, where appropriate. All relevant calculations should be shown.** (12 marks)

(b) **Briefly discuss the implications of the answer obtained in part (a) above.** (5 marks)

(17 marks)

5 Mezza Co is a large food manufacturing and wholesale company. It imports fruit and vegetables from countries in South America, Africa and Asia, and packages them in steel cans, plastic tubs and as frozen foods, for sale to supermarkets around Europe. Its suppliers range from individual farmers to Government run cooperatives, and farms run by its own subsidiary companies. In the past, Mezza Co has been very successful in its activities, and has an excellent corporate image with its customers, suppliers and employees. Indeed Mezza Co prides itself on how it has supported local farming communities around the world and has consistently highlighted these activities in its annual reports.

However, in spite of buoyant stock markets over the last couple of years, Mezza Co's share price has remained static. It is thought that this is because there is little scope for future growth in its products. As a result the company's directors are considering diversifying into new areas. One possibility is to commercialise a product developed by a recently acquired subsidiary company. The subsidiary company is engaged in researching solutions to carbon emissions and global warming, and has developed a high carbon absorbing variety of plant that can be grown in warm, shallow sea water. The plant would then be harvested into carbon-neutral bio-fuel. This fuel, if widely used, is expected to lower carbon production levels.

Currently there is a lot of interest among the world's governments in finding solutions to climate change. Mezza Co's directors feel that this venture could enhance its reputation and result in a rise in its share price. They believe that the company's expertise would be ideally suited to commercialising the product. On a personal level, they feel that the venture's success would enhance their generous remuneration package which includes share options. It is hoped that the resulting increase in the share price would enable the options to be exercised in the future.

Mezza Co has identified the coast of Maienar, a small country in Asia, as an ideal location, as it has a large area of warm, shallow waters. Mezza Co has been operating in Maienar for many years and as a result, has a well developed infrastructure to enable it to plant, monitor and harvest the crop. Mezza Co's directors have strong ties with senior government officials in Maienar and the country's politicians are keen to develop new industries, especially ones with a long-term future.

The area identified by Mezza Co is a rich fishing ground for local fishermen, who have been fishing there for many generations. However, the fishermen are poor and have little political influence. The general perception is that the fishermen contribute little to Maienar's economic development. The coastal area, although naturally beautiful, has not been well developed for tourism. It is thought that the high carbon absorbing plant, if grown on a commercial scale, may have a negative impact on fish stocks and other wildlife in the area. The resulting decline in fish stocks may make it impossible for the fishermen to continue with their traditional way of life.

Required:

Discuss the key issues that the directors of Mezza Co should consider when making the decision about whether or not to commercialise the new product, and suggest how these issues may be mitigated or resolved.

(17 marks)