CERTIFIED PUBLIC ACCOUNTANT

ADVANCED LEVEL 2 EXAMINATIONS

A2.1: STRATEGIC CORPORATE FINANCE

THURSDAY: 4 DECEMBER 2014

INSTRUCTIONS:

1. **Time Allowed: 3 hours 45 minutes** (15 minutes reading and 3 hours 30 minutes writing).
2. This examination has two sections; A & B.
3. Section A has one Compulsory Question while section B has three optional questions to choose any two.
4. In summary attempt three questions.
5. Marks allocated to each question are shown at the end of the question.
6. Show all your workings

SECTION A

Compulsory question

QUESTION ONE

Background

M/S Bwite General Commerce Ltd (BGC) is a listed company incorporated in the Republic of Rwanda in the year 2004. The company directly employs close to 500 workers, managing a wide range of business with a network of manufacturing, packaging, importation, retailing, and wholesale distribution channels. This business structure was a result of aggressive diversification and expansion since the company's establishment; with top management arguing that they wanted to create a BGC that was 'too diversified to fail'. Every time the then managing director (MD) met the shareholders, she would consistently remind them that she had built an empire that 'can withstand any kind of political, economic, social and technological upheavals, risks and uncertainties'.

Market analysts have, however, always been concerned that BGC's diversification programmes were not adding value, suggesting that they needed to focus on fewer of their current business lines. They had expressed doubt that such a business and investments structure would be sustainable, especially with the increasing competition as the East African Community (EAC) takes a firmer shape.

BGC has recently appointed a new MD, with a briefing to 'turnaround the fortunes of the giant company' within the next three years. Focus has been placed on increasing the annual growth rate, which stakeholders are concerned has stagnated for too long at about 5% pa. At his first meeting with the board of directors, the new MD presented various proposed changes and initiatives, ranging from divesture to a whole new set of investments and corporate social responsibility initiatives. Some of the proposed changes, investments, divestures and initiatives are summarized in the following scenarios.

Extracts from the annual financial statements of BGC

Statement of Profit or Loss and Other Comprehensive Income for the year to 30 September 2014:

	2014 Frw 'Million'	**2013 Frw 'Million'**
Turnover	10,618	9,480
Cost of sales	(5,868)	(4,556)
Gross profit	4,750	4,924
Operating expenses	(3,360)	(3,450)
Profit before interest and tax	1,390	1,474
Interest Expense	(247)	(142)
Profit before tax	1,143	1,332
Taxation	(360)	(390)
Profit after tax	783	942
Dividends	(300)	(380)
Retained profit	483	562

Statement of Financial Position as at 30 September 2014	2014 Frw 'Million'	2013 Frw 'Million'
Non-current assets	4,350	4,100
Current assets:		
Inventory	2,660	2,500
Accounts receivable & investments	2,993	2,950
Cash	780	700
	6,433	**6,150**

Current liabilities:		
Trade payables	1,620	1,570
Dividends payable	300	380
Bank overdraft	450	370
	2,370	2,320
Net current assets	4,063	3,830
Total assets less current liabilities	8,413	7,930
10% irredeemable debentures	(2,200)	(2,200)
	6,213	**5,730**
Capital and reserves:		
Ordinary shares, par value 500	1,000	1,000
Accumulated profits	5,213	4,730
	6,213	**5,730**

BGC pays interest on its overdraft at an annual rate of 6%.

Proposed investment in a new product range

The new MD has proposed an investment of Frw 1 billion into a new high-end product range and has forecast the following financial information:

Year	1	2	3	4
Sales volume (units)	70,000	90,000	100,000	75,000
Selling price (Frw /unit)	40,000	45,000	51,000	51,000
Variable costs (Frw /unit)	30,000	28,000	27,000	27,000
Incremental cash				
Fixed costs (Frw '000'/ year)	500,000	500,000	500,000	500,000

Additional information on the new investment:

a. The above cost forecasts have been prepared on the basis of current prices and no account has been taken of inflation of 4% per annum on variable costs and 3% per annum on fixed costs.
b. Working capital investment accounts for 20% of the proposed initial investment and machinery accounts for 80%. Working capital requirements will be constant until year 3 when the required working capital will be 10% of that year's sales.
c. BGC uses a four-year evaluation period for capital investment purposes, but sales of the product are expected to continue even after the lapse of the four years, so working capital will remain in the business.
d. The company (BGC) pays tax on profits in the year in which the liability arises at an annual rate of 30% and claims capital allowances on machinery on a 25% reducing balance basis. No balancing allowance will arise in year 4.
e. Average data on companies similar to BGC:
   Interest cover: 6 times
   Long-term debt / equity (book value basis): 50%
   Long-term debt / equity (market value basis): 25%

- The company's ordinary shares are currently trading on the stock market at Frw 2,535 per share. The dividend paid by the company has increased at a constant rate of 5% per annum in recent years and, regardless of the new management initiatives, it is safer to assume that the company will continue to grow at this rate into the foreseeable future.

- It has been suggested that the proposed Frw 1 billion investments could be financed by a new issue of corporate bonds with coupon rate of 12% per annum, redeemable after 4 years. The finance manager has, however, asserted that "this is not the right timing to issue a corporate bond". The past and current information about the company is not favourable, much as the Rwandan capital and money markets may not be that efficient. The truth is that we have many fundamental and technical analysts amidst our young financial markets.

- The existing debentures of the company are trading at Frw 93 per Frw 100 nominal and it is expected that the bond issue would be at the same price, with interest payments being made semi annually.

Proposed restructuring of a cash generating unit (CGU)

BGC has a cash generating unit (BGC Lending) – which initially offered hire purchase services to BGC customers wishing to buy some of the company's expensive and durable products. BGC Lending has grown steadily and now offers hire purchase facilities to customers of other retailers. For the year that has just ended, the subsidiary contributed Frw 145 million of the total after tax profits of BGC.

BGC is now considering a demerger and a separate stock exchange listing for this CGU. The financial advisers of BGC have suggested that BGC - Lending Department should be floated as Ubumwe Finance Limited (UFL) with a share capital of 400,000 ordinary shares of Frw 500 per share. It has been suggested that the shareholders of BGC should receive one share in UFL for every 5 shares held.

The financial advisers expect that the P/E ratio of the newly-listed company will be somewhere between 6.5 and 12 times because of the prospects of financial services sector in the bigger EAC economy. The P/E ratio of BGC is expected to reduce by 20% as a result of the demerger.
Ignore taxation in this transaction.

The dividend policy and shareholder value drivers

The new MD has picked on dividend policy as one of the things to be fixed, stating that 'dividend policy has been viewed as relatively unimportant. It has, therefore, not been used to send the right message to the market. This is one factor that has suppressed BGC's price-earnings ratio'. The chairman of the board of directors has argued, however, that as long as there is sustained growth of earnings, what gets paid as dividend remains secondary to shareholder value. The chairman added, 'I have studied Rappaport's value drivers, and none of them relates to dividend policy. The MD should as much as possible tell us his strategies to influence the real value drivers but not focus on signaling'.

Some of the non-executive directors have also expressed concern that the new MD seems to focus on image rather that what will generate value. They are also concerned that when new managers are assigned tight targets, they tend to act unconventionally in regard to corporate governance. This may spell doom for the company, much as they are aware that many internal and external forces would usually influence executive directors to keep fair focus on overall company objectives.

Key information concerning the dividend payments for the past five years is as follows:

Year	Profits after tax	Ordinary dividends
	Frw 'million'	Frw 'million'
2010	870	235
2011	890	220
2012	924	210
2013	942	380
2014	783	300

Management of foreign exchange risks

The MD has criticized the financial controller (FC) for not doing enough to mitigate foreign exchange risks facing the company. He thinks this has increased the company's economic and translation exposures. Whereas BGC has various international trading partners, and the previous management had argued that since there were receipts and payments in the respective currencies of the main trading partners, gains and losses were eventually cancelling out, there was no need to waste time entering into complicated risk-management mechanisms. This

was further supported by the lack of complicated instruments for the management of foreign exchange risks in less developed countries such as Rwanda.
Currently, BGC has bought goods from a Mynamar supplier worth Myanmar Kyats (MMK) 12,000,000 payable in 3 months. For such contracts, the financial controller has always undertaken some hedging, either in form of forward exchange contracts, money market lending or making lead payments.

The following information is available from the Central Bank of Rwanda:

	Myanmar Kyat (MMK)		Rwanda Francs	
	Deposit rate	Borrowing rate	Deposit rate	Borrowing rate
1 month	7%	10.25%	10.75%	14.00%
3 months	7%	10.75%	11.00%	14.25%

MMK/ Frw exchange rate (MMK= Frw 1)	
Spot	1.8625 -1.8635
1 month forward	0.60c- 0.58c pm
3 months forward	1.80c-1.75c pm

The FC is yet to evaluate and recommend the approach she will use on this particular transaction.

Prepare a report to the board of directors of BCG that:

(a) Explains the difficulties that may be encountered in determining the cost of capital for a private limited company. **(6 Marks)**

(b) Explains the concept of market efficiency in relation to the listing of BGC, and the would-be impact of technical and fundamental analysis on valuation of BGC. **(11 Marks)**

(c) Evaluates the viability of the proposed Frw 1 billion investment using BGC's current average cost of capital before the bond issue. **(13 Marks)**

(d) Explains the concept of 'yield to maturity' and compute the yield to maturity on the proposed bond issue. **(7 Marks)**

(e) Evaluates the effect of the new bond issue on:

(i) Interest cover.
(ii) Gearing.
(iii) Share price.

(9 Marks)

(f) Discusses the factors that influence the price-earnings ratio of a company. **(4 Marks)**

(Total 50 Marks)

SECTION B

Attempt two questions from this section

QUESTION TWO

(a) Distinguish between a divestment and a demerger. **(4 Marks)**

(b) Discuss any three advantages and disadvantages of a demerger for the shareholders of a company. **(12 Marks)**

(c) Compute the likely effect of the demerger on the wealth of a shareholder holding 5,000 ordinary shares in BGC, assuming that the P/E ratio of UFL will be at the:
  (i) Lower end and;
  (ii) Higher end of the PER expectations and comment on your findings. **(9 Marks)**

(Total 25 Marks)

QUESTION THREE

Prepare a memo to the BGC board of directors that:

(a) Describes the dividend policy followed by the firm over the past five years. **(5 Marks)**

(b) Evaluates the views expressed by the new MD and the chairman and discusses the key points to be taken into account when establishing an appropriate dividend policy for the company. **(10 Marks)**

(c) Explains how any five value drivers (according to Rappaport) impact on corporate value. **(10 Marks)**

(Total 25 Marks)

QUESTION FOUR

(a) Explain the terms 'economic exposure' and 'translation exposure' and discuss three actions a company can employ to hedge against economic exposure. **(10 Marks)**

(b) Evaluate the cheapest method of managing foreign exchange risk among the alternatives available to the BGC. (Ignore commission costs) **(12 Marks)**

(c) Explain the common challenges of currency hedging to corporate finance managers in less developed countries. **(3 Marks)**

(Total 25 Marks)

End of question paper

BLANK PAGE

BLANK PAGE