

CERTIFIED PUBLIC ACCOUNTANT ADVANCED LEVEL 2 EXAMINATIONS

A2.1: STRATEGIC CORPORATE FINANCE

THURSDAY: 3 DECEMBER 2015

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

Muhabura Limited

Background:

Muhabura Ltd is one of the major players in long distance road haulage within the East African Region. The company was incorporated in January, 2008 in Rwanda. Management of Mahabura Ltd is planning an initial public offer (IPO) on the Rwanda Securities Exchange (RSE) in the next 2 years. The Board of Directors (BOD) has however set some conditions to be met before they can give an approval to management to hire preliminary transaction advisors.

BOD's concerns on general financial performance

At a recent board meeting, management of Muhabura Ltd was put to task to prove that the company was growing faster than the rate of inflation and the rate at which the reporting currency Frw is depreciating against major international currencies. The Board also tasked management to illustrate whether:

- Muhabura Ltd's debt-absorption capacity has not been exhausted by recent borrowings;
- The returns to shareholders were increasing above the inflationary rates; and
- Financing options used by the company provide the optimal shareholder value.

The Managing Director assured the Board requirements that “we strive to bring on board only positive net present value projects that also reflect an internal rate of return (IRR) that is higher than our cost of capital currently at 15%. We always beat competition by bidding low and compensating by high turnover. We also constantly review our financing options and profit retention policy of 45% of profit after tax against our targeted optimal capital structure”.

Muhabura Ltd's financial position and operating results for the year ended 31 March 2015 are reflected below:

Abridged statement of comprehensive income:

	2015	2014
	Frw Million	Frw Million
Revenue	2,443,251	2,223,359
Direct expenses	(2,138,999)	(1,931,849)
Gross Profit	304,252	291,510
Administrative expenses	(119,870)	(120,830)
Other operating expenses	(116,980)	(115,650)
Operating profit	67,402	55,030
Finance Costs	(27,750)	(22,500)
Profit before tax	39,652	32,530
Taxation	(11,301)	(8,946)
Profit after tax	28,351	23,583

Abridged statement of financial position:

	2015	2014
	Frw Million	Frw Million
Non-Current Assets		
Property, plant and equipment	283,960	295,318
Current Assets		
Inventory	18,907	13,907
Accounts receivable	45,800	22,383
Cash and bank balances	8,520	6,352
	73,227	42,642
Total Assets	357,187	337,960
Equity and Liabilities		
Share Capital – Paid up	31,000	31,000
Retained earnings	75,057	62,299
9% Preference shares	36,500	36,500
	142,557	129,799
Non-current Liabilities		
Term Loan	185,000	167,000
Current Liabilities		
Accounts payables	10,850	10,509
Other payables	14,122	21,080
Overdraft	4,658	9,572
	29,630	41,161
Total Equity and Liabilities	357,187	337,960

Evaluation of new projects/contracts:

Muhabura Ltd is negotiating a 4-year contract with Uganda-based Hima Clays Ltd (HCL), a manufacturer of construction materials. The contract provides that Muhabura Ltd shall transport 75% of the goods produced by HCL in return for an 11% commission of the gross value of the goods handled per annum. The obligations of either party are summarized below:

Obligations of Muhabura:

- Provide a dedicated 25-strong fleet of new 30-tonne Iveco trucks, all comprehensively insured throughout the duration of the contract.
- The insurance premium per annum is expected to be 6.0% of the net book value of the trucks and is payable in advance annually. The trucks have a 4-year useful life and are depreciated on a straight-line basis.
- Provide a performance bond to HCL (upon commencement of the contract) worth 10% of projected annual volume of the contract. The *Value-Trade Bank* in Katuna has agreed to provide the bond at a fee of 1.5% per annum – and shall be 100% cash-secured. The cash security would be in form of a fixed deposit in the same bank with an interest rate of 1% per annum.
- To settle the final balance of 50% on the Frw 250,000 commission due to the middleman that connected Muhabura to HCL.

Obligations of Hima:

- Guarantee the production of a minimum of goods worth USD 38 million for the first year. This should grow at a minimum of 10% per annum.

- (ii) To undertake the marketing of the merchandise across the region and deliveries to average a distance of 450 kilometers.
- (iii) To withhold and account for an assumed 10% tax on commissions paid to Muhabura to the Uganda Revenue Authority.
- (iv) To ensure commissions are paid consistently within 30 days of delivery.

Other information on the Muhabura-Hima contract:

- (i) The Iveco trucks cost an average of Frw 120 million each; and each will have an annual maintenance cost of Frw 40 million for the first year.
- (ii) The trucks qualify for a 25% writing down allowance on a reducing balance basis;
- (iii) Muhabura Ltd corporation tax rate is 30% and tax is paid 1 year in arrears.
- (iv) The Frw is currently trading at 740/USD. The Frw is projected to depreciate at the existing depreciation rate of 4% per annum.
- (v) Inflation in Rwanda has averaged 6% over the years 1997 to 2015. This rate is projected to continue affecting the maintenance costs.

The potential for a finance lease:

In a related but different matter to be evaluated after clinching of the transportation deal, the *Value-Trade Bank* (VTB) has offered to provide a finance lease facility to Muhabura Ltd for purposes of financing the trucks. The Bank would charge annual premiums of Frw 1.16 million for the fleet. Under this arrangement, VTB has assured Muhabura of a scrap value at the end of the 4 year contract of Frw 12 million per truck. Note that an outright purchase would be financed by a loan at the existing cost of capital.

REQUIRED:

Write a report to the Managing Director:

- a) Analyzing the financial performance of Muhabura (2015, 2014) relative to the concerns of the Board of Directors. **(8 Marks)**
- b) Evaluating the viability of the Muhabura-Hima contract (based on NPV) and recommends a way forward. **(14 Marks)**
- c) Evaluating any three potential risks associated to the contract and how they can be mitigated; and summarizing any key assumptions to be made and monitored if the contract is undertaken. **(10 Marks)**
- d) Evaluating the sensitivity of the Muhabura-Hima contract to the price of trucks. **(5 Marks)**
- e) Evaluating the buy-lease option for trucks assuming the contract is viable and recommends the way forward. **(8 Marks)**
- f) Explaining the relationships between accounting rate of return, internal rate of return and the firm's cost of capital **(5 Marks)**

(Total: 50 Marks)

(Where computations are required, they should preferably be reflected in millions to one decimal place)

SECTION B

Attempt two questions from this section

QUESTION TWO

- (a) Vitooma Energy Authority formerly a public entity supplying power in the country was privatized, to

become Northern Power Ltd (NPL). Apart from political considerations, a major motive for privatizing the entity was to allow access for NPL to private sector finance. Considerable investment was required to enable the company meet more increasing power needs. When it was privatized, it was valued by the merchant bankers at Frw 10 billion. The promoters floated 10million ordinary shares (par value Frw 5000) to raise funds for NPL.

REQUIRED:

Discuss ways in which the objectives of altering ownership of Vitooma Energy Authority into NPL may be altered. **(16 Marks)**

(b) You are the Finance Manager of a company in the leisure industry that has been growing steadily over the last five years. The consumer demand has been buoyant, and your innovative leisure services have been taking an increasing share of the growing market sector. However, the economy has now taken a downturn. Inflation has been on the increase over the past year, while output and consumption have fallen.

The Chief Executive Officer (CEO) is planning a review of the company's strategy and has asked members of the senior management team to submit their proposals on changes that might be made to various aspects of the company strategy and objectives in light of the new economic situation. You have been asked to comment on how the company's financial objectives might change so as to take account of the new economic situation.

REQUIRED:

Draft a report to the CEO in respect of the above issues. **(9 Marks)**

(Total 25 Marks)

QUESTION THREE

Mutuzo Ltd is a company established in Rwanda selling a range of fast moving consumer goods to medium enterprises. The strategy of the company is to accelerate opening store through acquisition and Partnerships in key growing markets such as Southern Sudan. The most recent financial statements for the company are given below;

Mutuzo Ltd statement of financial position as at 31 May 2015

Noncurrent assets [NBV]	Frw '000'	Frw '000'
Intangible assets	102,000	
Machinery	30,000	
Motor vehicles	36,000	
		168,000
Current assets		
Inventory	52,000	
Trade accounts receivable	118,000	170,000
Total assets		338,000
Capital and reserves		
Issued share capital (par value Frw 1)		50,000
Reserves		38,000
Noncurrent liabilities		
10% convertible debenture		40,000
Current liabilities		
Trade accounts payable	176,000	
Corporation tax	12,000	
Short-term –credit	20,000	
Proposed dividend	2000	210,000
Total Capital and Liability		338,000

Statement of comprehensive income for the year ended 31 May 2015

	Frw"000"	Frw "000"
Sales		1,320,000
Less Cost of sales:		
Opening stock	44,000	
Add Purchases	852,000	
Less closing stock	(52,000)	844,000
Gross profit		476,000
Less operating expenses:		
Selling and distribution expenses	352000	
Advertizing expenses	(76,000)	
Finance expenses	(14,000)	(442,000)
Pre-tax profit		34,000
Corporation tax at 30%		(10,200)
Net profit after tax		23,800
Declared dividend		(2,000)
Reserves for the year		21,800

Additional information:

Members held an annual general meeting (AGM) where the financial statements for the year ended 31 May 2015 were presented and considered. It was disclosed that the company's Board of Directors had awarded themselves 15% pay rise and that the Chief Executive had just appointed an old colleague to the position of Finance director. The company is currently experiencing severe cash-flow problems. These difficulties threaten the company's reputation for offering high quality services.

Following the Board presentation, the shareholders raised the following issues:

- (1) The company's reported results were very poor.
- (2) The company has a cash crisis and there is a possibility of becoming insolvent and collapsing
- (3) The Directors appointment process is questionable
- (4) Justification of Board's 15% pay rise despite the freezing of the pay of all other employees
- (5) Removal of the company Non-Executive Directors (NEDs) by the company Chairman
- (6) The total amount spent on corporate social responsibility (CSR) could not be determined from the audited accounts.
- (7) The market has rapidly continued to change
- (8) The Board's strategic thinking was stuck in the past not considering any alteration in the company's corporate strategy in light of the above challenges.

In light of the above issues raised by the shareholders, the company's Board responded to the looming crisis by introducing the following measures:

- Removal of NEDs prompted the resignation of the company's Development Manager.
- Ceasing all R&D for the foreseeable future
- Paying no dividends for the next four years.

- Selling part of the business to its management team.
- Recruit a Credit Controller to manage credit.

REQUIRED:

Given the concerns expressed by the shareholders at the AGM, the Managing Director of Mutuzo Ltd has requested you to prepare a report that:

- Explains reasons why Mutuzo Ltd could potentially collapse. **(15 Marks)**
- Compute any three financial ratios for Mutuzo Ltd that would be useful in detecting whether the company was overtrading. Explain the significance of each ratio. **(10 Marks)**

(Total 25 Marks)

QUESTION FOUR

Pacifique Builders Ltd is a firm with interests mainly in property development. It has acquired a subsidized loan to purchase land and raw materials and to pay labour for development purposes. It is considering a project of two design types:

Design 1:	An ordinary two bed-roomed house
Design 2:	An executive four bed-roomed house

The success of the project depends largely on economic conditions, which will influence the demand of new houses. The National housing statistics suggest that the demand for Executive houses is relatively higher when the economy is growing rapidly and it is lowest when the economy is in a depression. However, the demand for ordinary houses is higher when the economy is in a depression.

It appears that there is an inverse relationship between the designs and net cash-flows, from the two products, therefore it is sensible to consider a diversified portfolio.

Additional information:

Returns from Pacifique builders Ltd:

Economic State	Probability	Estimated NPV Frw '000' Per:	
		Executive house	Ordinary house
Excellent	0.2	40,000	40,000
Good	0.3	40,000	60,000
Average	0.4	80,000	40,000
Poor	0.1	80,000	60,000

Pacifique Builders Ltd wants to exploit the returns from the two projects, without over committing itself.

REQUIRED:

- Compute the expected return and project risks **(10 Marks)**
- Determine the expected return of a portfolio which involves 25% of available funds in executive houses and 75% in ordinary houses. **(3 Marks)**
- Portfolio theory application is the most needed theory now in business organizations. Assess the relevancy of this theory in the context of Rwanda business environment and also discuss the possible challenges in its application. **(12 Marks)**

(Total 25 Marks)

End of question paper

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