
CERTIFIED PUBLIC ACCOUNTANT

ADVANCED LEVEL 2 EXAMINATIONS

A2.1: STRATEGIC CORPORATE FINANCE

THURSDAY: 6 DECEMBER 2018

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 ONE

GIKONGORO TECHNOLOGIES LIMITED

Jean Ngabonziza, commonly referred to as Jean, is the founder and Chief Executive Officer (CEO) of Gikongoro Technologies Limited (GITEL). Jean has received an offer from a Tanzanian-based company, RIZIKI Technologies Ltd (RTL), to buy all of the equity in his company GITEL for RWF 3,800 million. While Jean is delighted to be offered this amount of money for the company, he has no idea as to whether this is a good deal for his company. One aspect of the offer that has caused him some concern is the fact that RWF 1,000 million of the consideration is to be in the form of shares in RTL. Jean has a policy of investing in growth stocks and his company, GITEL, is well-established and develops and sells useful 'Apps'. The shareholding in GITEL as of 31 December, 2017 is summarized below.

Shareholder	% ownership
Jean Ngabonziza	45
Omega Fund (Rwanda)	15
Rwanda Veterans' Pension Fund (Rwanda)	14
East African Diversified Fund	6
Proper Pension Fund (Rwanda)	7
Pool Hedge Fund (Rwanda)	6
Sindi Hedge Fund (Rwanda)	2
Others (composed of small shareholders)	5

As a result of the flotation and in particular the change in ownership, GITEL further modified its corporate governance to better comply with the Rwanda's Code of Corporate Governance. Little has changed with respect to the Board structure over the years since GITEL's initial flotation. The current board structure is outlined in the table below.

Mr. Jean Ngabonziza, 47	Founder/ CEO; staunch supporter of Cyangugu Football Club (CFC)
Mr. Thierry Gatete, 52	Marketing Director. Has been with GITEL since one year before its flotation
Mr. Xavier Tuyishimire, 62	Non-executive chairman; former fund manager and banker. With CEO they are staunch supporters of Cyangugu Football Club (CFC)
Mr. Pierre Irankunda, 47	Non-executive director; entrepreneur and 'App' developer; long-time friend of Jean Ngabonziza.
Mr. Alexis Kanamugire, 57	Founder of Alexis Hair Salons; non-executive director of six companies in Rwanda.
Mr. Peter Hatimana, 45	Small businessman and landlord; owner of Happy People Pub (Happ) in Gisenyi; long-time friend of Jean Ngabonziza
Ms. Lorraine Unineza, 63	Nominee of Omega Fund; former investment banker.
Mr. Claude Hakizimana, 65	Nominee of Prosper Pension Fund and Rwanda veterans' Pension Fund; former fund manager.

Xavier Tuyishimire, the non-executive chairman is quite keen on Jean taking the offer from RTL and argues that Jean has virtually all of his wealth stored in GITEL and is concerned that his wealth is not

as diversified as it should be. Jean argues that he owns RWF 100 million worth of shares in social media platforms' i.e. Link, Q-Zone and Meet-Up and, therefore, has diversified away from GITEL.

Jean is clearly considering the offer from RTL very seriously. However, should Jean and the other shareholders refuse the offer from RTL they will have some issues regarding the corporate governance of GITEL to deal with. At the most recent annual general meeting (AGM) some of the smaller investors, as well as the East African Diversified Fund representatives expressed some concerns with regard to what they perceive as shortcomings in the corporate governance of GITEL. Jean wishes to address the primary issue and asks Diane Mutuzo his business development manager (BDM) if the offer is being made by RTL values GITEL fairly.

In the ensuing conversation, Diane ascertains that the beta of GITEL is 0.97. She further ascertains that the correlation between the return on GITEL' shares and those of RTL is estimated at 0.85. The correlations between the returns on shares in Link, Q-Zone and Meet-Up and the returns on shares in RTL are 0.87, 0.71 and 0.93 respectively. Jean also handed over the following extracts of the most recent financial statements of GITEL to Diane Mutuzo, to enable her carry out a critical analysis of GITEL's business.

Statement of financial position as at 31 December, 2017

	RWF 'Million'	RWF 'Million'
Non-current assets:		
Land & buildings		900
Plant & machinery		740
Motor vehicles		160
Acquired goodwill		<u>200</u>
		2,000
Current assets:		
Inventories	1,040	
Receivables	760	
Short-term investments	180	
Cash	<u>120</u>	
	<u>2100</u>	
Current liabilities:		
Payables	520	
Taxation	<u>380</u>	
	<u>900</u>	
Net current assets		<u>1200</u>
Total assets less current liabilities		3,200
Non-current liabilities:		
Bank loan	520	
Deferred taxation	<u>200</u>	<u>720</u>
		<u>2,480</u>

	RWF 'Million'	RWF 'Million'
Equity:		
Ordinary shares RWF 250 per share		600
Reserves		<u>1520</u>
		2,120
5% preference shares RWF 250 per share		<u>360</u>
		<u>2,480</u>

Additional information:

1. During the year just ended, GITEL's profit before tax amounted to RWF 600 million. The current price-earnings (P/E) ratio of GITEL's shares is 6. The land and buildings are estimated to have a market value of about RWF 2,400 million while plant and machinery estimate is RWF 640 million. An estimated 15% of the receivables are considered doubtful, but no provision has yet been made. A quarter of the value of inventories represents old, unusable materials with a scrap value equal to about 20% of the book value. Goodwill represents the value of patents and copyrights. The fair value of other assets is the same as their book value.
2. GITEL Board Chairman recently disclosed that the company developed a strategic business plan, which is expected to increase the company's before tax earnings by RWF 180 million in the year ending 31 December, 2018.
3. Some of GITEL's major shareholders are not confident about the future and would like to sell the business as a going concern. The minimum price they would consider would be a fair value of the shares, plus a 10% premium. GITEL's chief finance officer (CFO) believes the best way to find the fair value of the company is to estimate potential value on the basis of either net assets or earnings, using GITEL's existing P/E ratio.

You have been hired as a financial consultant to advise on the various concerns raised between GITEL and RTL.

REQUIRED:

Prepare a report to the key stakeholders in the case:

- (a) Critically evaluating the offer of RWF 3,800 million from RTL for GITEL as a whole.
(18 Marks)
- (b) Discussing the likely rationale behind RTL offering RWF 1,000 million of the consideration for GITEL in the form of shares in RTL.
(4 Marks)
- (c) Analyzing the various types of foreign exchange risk to which the purchase of GITEL will expose RTL to.
(3 Marks)
- (d) Appraising Jean's strategy for reducing risk by investing in growth stocks in the ICT industry, which are well known to him.
(5 Marks)
- (e) Advising on Jean's position that investing in Link, Q-Zone and Meet-Up has enabled him to diversify his wealth away from GITEL.
(5 Marks)

- (f) Discussing the factors that GITEL shareholders may consider before deciding whether to accept or reject the offer from RTL.

(6 Marks)

- (g) Evaluating the corporate governance of GITEL as outlined in the case, discussing the additional information required to carry out a full assessment of the standard of GITEL's corporate governance.

(9 Marks)

(Total 50 Marks)

SECTION B (CHOOSE ANY TWO QUESTIONS)

QUESTION TWO

Ngoro Ltd gained a stock exchange listing ten years ago. At the time of the listing, members of the family who founded the company owned 75% of the shares, but now they only hold just over 50%. The number of shares in issue has remained unchanged since Ngoro Ltd was listed. Ngoro Ltd's directors have continued the policy of paying a constant dividend per share, each year, which the company had before it was listed. However, investors who are not family members have become increasingly critical of this policy, saying that there is no clear rationale for it. They would prefer to see steady dividend growth, reflecting the increase in profitability of Ngoro Ltd since its listing. The finance director of Ngoro Ltd provided its Board with details of Ngoro Ltd's dividends and investment expenditure, compared with two other similar-sized companies in the same sector, i.e. Huye Ltd and Gitarama Ltd. Each company has a 31 December year end.

Key financial and operating data for the year ended 31 December

	2014	2015	2016	2017
	RWF 'million'	RWF 'million'	RWF 'million'	RWF 'million'
Earnings:				
Ngoro Ltd	150	160	190	195
Huye Ltd	190	(20)	220	240
Gitarama Ltd	150	175	235	265
Dividends paid:				
Ngoro Ltd	70	70	70	70
Huye Ltd	79.8	30	92.4	100.8
Gitarama Ltd	70	35	80	85
New capital expenditure:				
Ngoro Ltd	40	60	50	45
Huye Ltd	60	30	85	60
Gitarama Ltd	75	130	150	170

REQUIRED:

- (a) Evaluate the dividend policies which the three companies appear to have adopted.
(20 Marks)
 - (b) Discuss the relevancy of Modigliani–Miller dividend irrelevancy theory in Rwanda's context.
(5 Marks)
- (Total 25 Marks)**

QUESTION THREE

Recently Rwanda resumed the search for petroleum deposits in Lake Kivu to join the other countries in the region that are already looking forward to oil production. Rwanda's Natural Resources Ministry says that the search is still on and there are high chances of finding petroleum in the country, much as the exploration is projected to take some time. Under the Rwandan law governing petroleum exploration and production activities, an exploration license is valid for three years while a production investor is given a license valid for up to 25 years. The amount of petroleum in the Lake Kivu belt is not known so far but it is believed that all the Great Lakes region states share the same base for the petroleum deposits and once exploitation starts in any of the countries, it is compulsive for another to follow suit. Reviere Ventures Ltd (RVL), an oil company, is considering constructing an offshore drilling rig in the Lake Kivu region to extract oil reserves once exploration is complete and successful.

The following information was obtained for this venture that is expected to have a drilling life of eight years.

No.	Particulars	RWF	Timing
1.	Initial outlay (well-drilling rig)	682,500,000,000	
2.	Residual value of the well-drilling rig*	131,250,000,000	Year 10
3.	Mid-life reconstruction of well-drilling rig	140,000,000,000	Year 5
4.	Decommissioning costs of well-drilling rig	26,250,000,000	Year 9
5.	Decommissioning costs of well-drilling rig	43,750,000,000	Year 10
6.	Selling price per barrel of oil	52,500	
7.	Production costs per barrel of oil	21,875	

8. The cost of capital is 10%.

* = The structures will be sold in year 10

Additional information:

Year	1	2	3	4	5	6	7	8
Barrels of oil per day	14,000	18,000	20,000	22,000	10,000	18,000	14,000	6,000
Rig mobilization costs per year (RWF 'million')	12,250	21,000	22,750	26,250	10,500	19,250	12,250	7,000
Miscellaneous costs per year (RWF 'million')	8,750	10,500	10,500	12,250	7,000	10,500	8,750	3,500
Assume 365 days in a year.								

REQUIRED:

- Using the accounting rate of return and payback period methods, evaluate the financial acceptability of the investment in oil production and comment on the investment duration.
(21 Marks)
- Discuss the possible legal risks of investing in a project like oil exploration which Riviere Ventures Ltd may be concerned about and how these risks may be mitigated.

(4 Marks)

(Total 25 Marks)

QUESTION FOUR

Barely twenty four years since Rwanda experienced one of the most unfortunate political instabilities in the world, it is ranked 46th in the world, for ease of doing business according to the World Bank, and this may seem flattering. Furthermore, the rush with which international lenders financed its Energy Utility's first solar public-private partnership (PPP) demonstrates that this ranking is not empty academic meditation. Within just 12 months of an agreement being reached between the state Energy Utility and private developer GigaWatt Global, an approximately USD 24 million, 8.5 MW solar plant was financed, constructed and connected to the national electricity grid.

REQUIRED:

- (a) Evaluate the public private partnership (PPP) arrangement in the context of project finance.
(18 Marks)
 - (b) Advise other global companies seeking to enter win-win PPPs with African countries.
(7 Marks)
- (Total 25 Marks)**