

CERTIFIED PUBLIC ACCOUNTANT

ADVANCED LEVEL 2 EXAMINATIONS

A2.1: STRATEGIC CORPORATE FINANCE

FRIDAY: 4 DECEMBER 2020

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 where necessary.

SECTION A

QUESTION ONE

Intambwe Ltd is a multi-national investment company with its headquarters in the City of Kigali. The company currently has three fully owned subsidiaries operating in different sectors with other multiple investments in pipeline as the company continues to implement its growth strategy; a strategy based on both organic growth and acquisitions and mergers.

The company founder and Chairman; Mr. Karasira Karega Ntambwe has of recent started looking into potential projects that could be internally managed. He has already created an internal project management office responsible for all upcoming projects. The newly created PMO is made of multi-disciplinary experts who are expected to be making the go/no-go decisions on each proposed project.

PROJECT PXP

Project PXP is the first project to be brought to the PMO's attention for analysis. The project originator told the experts that this is nothing like anything else the company has done before; the business model is different and represent lots of opportunities.

Project PXP is expected to last 3 years with an initial investment of Rwf 1,500M. The project sales revenues are estimated at Rwf 1,232M in the first year. Sales in second and third year are projected to grow at 24% and 18% respectively, each growth based on recent sales figures. In contrast, the inflation rate applicable to revenue is expected to remain constant at 5% per year and the above revenue projections are stated before inflation. The Project costs are expected to grow in line with revenue and inflation rate applicable to costs is constant at 3% per year with first year costs standing at Rwf 765M. Interest payments will remain the same throughout the project at Rwf 213M per year.

40% of the required initial investment will be allocated to the purchase of equipment and machinery which will be sold at end of the project at a scrap value of Rwf 55M. A tax allowable depreciation on the equipment and machinery is available on straight line basis with disregard to eventual sales at scrap value. The project's profits will be taxed at 30% and are paid in the same year they are earned.

Working capital funds requirements will be provided at the start of each year and estimated at 25% of expected sales in the same year. At the project closure, the remaining working capital funds will be released.

It is planned that the project will be entirely financed by debts from multiple lenders. The total issue costs related to raising the required project financing is 3% of the gross required funds.

Though the project originator stated the uniqueness of the project and related business model, the council of experts managed to find another business operating in the same industry; Karibu Ltd. The latter is financed by both debt and equity with 30M shares valued at Rwf 1,260 per

share. The value of debt is Rwf 12,000M. Karibu's equity beta is 1.7, the market free risk rate at 3% and the market risk premium at 9%. The tax rate is the same as the proposed project.

UPCOMING PAYMENT

Intambwe Ltd is due to pay one of its major suppliers located in Kenya, a total of Ksh 217M in 6 months' time. The spot exchange rates stand at Rwf 8.8 – Rwf 8.5: Ksh 1. It is expected that by the time of payment, the Ksh would have strengthen by 15% due to the volume of expected transactions between the two Countries. In Kenya, businesses can borrow at 12% while the borrowing rate in Rwanda is slightly higher by 500 basis points. However, the deposit rate in Rwanda is 60% below the Country's lending rate while in Kenya; the same rate is only 450 basis points below the Kenyan's lending rate.

GAKIRE LTD

Gakire Ltd is one of the company subsidiaries of Intambwe Ltd. Mr. Ntambwe was concerned about its financial position, noting that the Group Management should perform a detailed assessment into its finances and revert back to him. The Council of experts has since been accumulating the below information on Gakire Ltd. Gakire Ltd recent published Financial Statements are shown below:

P&L	2019	2018
	Rwf'000,000	Rwf'000,000
Revenue	4,978.0	4,703.0
Cost of sales	(3,409.0)	(3,290.0)
Gross Profit	1,569.0	1,413.0
Admin Expenses	(1,307.0)	(967.0)
Interest	(463.0)	(473.0)
Profit after interest and tax	(201.0)	(27.0)
Balance Sheet	2019	2018
	Rwf'000,000	Rwf'000,000
Assets		
PPE	7,135.0	7,539.0
Land	925.0	970.0
Inventory	1,604.0	915.0
Receivables	369.0	401.0
Cash & Cash equivalents	238.0	632.0
Total assets	10,271.0	10,457.0
Liabilities		
Ordinary Share Capital	6,590.0	6,590.0
Retained Earnings	(2,000.0)	(1,799.0)
Bank debt	5,140.0	5,230.0
Trade payables	446.0	349.0
Other current payables	95.0	87.0
Total Liabilities	10,271.0	10,457.0

The company sells and purchases using both cash and credit. On average, only 9% of sales and 6% of purchases have been cash based for the last 3 years. The industry's credit period is 30 days. 3% of other current assets are included into company receivables.

Required:

- A. By showing all relevant calculations that the experts are likely to go through, calculate the Project PXP APV and advise whether the project should be given a “Go” or “NO-GO” stating your reasons. (26 Marks)**
- B. For the upcoming payment, compute the total future payment in Rwf, if:**
- i. No hedging method is used, (2 Marks)**
 - ii. Money Market Hedging is used with disregard to future strengthening of Ksh and considering the required funds will be locally borrowed. (5Marks)**
- C. Using relevant financial ratios, evaluate and comment on Gakire Ltd performance by focusing on its profitability; use of working capital; financial risk and liquidity capabilities. (17 Marks)**

(Total :50 Marks)

SECTION B

QUESTION TWO

The Board of Directors of Kamageshi Investment Company (KIC), through a competitive process, has recently appointed Mrs. Karema Alice as the company's new Chief Executive Officer.

During the Handover ceremony between the outgoing and incoming CEO, the board chairperson congratulated the new CEO and wished her well as she takes on new responsibilities. The board chair further highlighted key priorities for the new CEO which he said included total elimination of the current harsh competition preferably through acquisitions and local or international listing.

The board chair believes it is time for KIC to further expand its horizons and significantly increase shareholders wealth, “it is now or never. We want to see the processes initiated fast so we can start reaping benefits soon”.

The new CEO who felt pressured to start the acquisitions, has already identified Biragoye Company Limited (BC Ltd); one of KIC fierce competitor; as a potential target. Mrs. Alice who is well familiar with the market players says KIC does not have to go through intense assessment/review processes considering her knowledge of potential targets. She estimates that KIC would acquire BC Ltd at a price not exceeding Rwf 96 Billion.

Small extracts of financial statements of both companies are provided below:

	KIC	BC Ltd
P&L	Rwf'000,000	Rwf'000,000
Revenue	29,500	9,455
Cost of sales	(12,850)	(4,119)
Gross Profit	16,650	5,337
Admin Expenses	(8,957)	(2,871)
Interest	(200)	(64)
Tax	(150)	(48)
Profit after interest and tax	7,343	2,354
Balance Sheet	Rwf'000,000	Rwf'000,000
Assets		
PPE	455,003	105,325
Current assets	121,420	28,106
Total assets	576,423	133,431
Liabilities		
Ordinary Share Capital	364,000	84,259
Retained Earnings	52,523	12,158
Non-current liabilities	159,900	37,014
Total Liabilities	576,423	133,431

KIC and BC Ltd both pay dividends at constant rates of 15% and 21% of annual profits respectively. The balances are always transferred to the balance sheet. The per share value of KIC and BC Ltd are the same at 1,000 Rwf and KIC current share price is estimated at Rwf 1,250 per price. BC Ltd price to earnings ratio is 3.3% higher than that of KIC.

Mrs Alice has also started enquiring about the listing processes. She is considering a local or a regional listing.

Required:

(a) Based on BC Ltd earnings and valuation, compute the likely gain or loss on the CEO's proposed purchase price and give at least 2 arguments on whether BC Ltd owners would or would not accept her offer. (10Marks)

(b) Explain to the new CEO, the importance of a legal and financial due diligence during a merger/acquisition. (5Marks)

(c)

- i. Provide the CEO with a list of functioning Stock Exchanges in the Eastern Africa Community. (2 Marks)
- ii. Explain to her the types of capital markets information efficiency and give arguments for and against international capital markets. (5Marks)
- iii. Comment on the need of financial markets integration. (3 Marks)

(Total :25 Marks)

QUESTION THREE

His highness Alhamin Del Muhamed is a wealthy Saudi prince who runs multibillion investments in various regions of the world. Saudi Arabia has of recent established a close political and bilateral relationship with Rwanda. His highness Mr. Alhamin has in the last three months visited different parts of Rwanda and has already expressed interest of investing in the Country. His team of highly educated advisors have identified the Tourism and Energy sectors as areas of interests.

The team has gathered a lot of information about sectors and companies located in Rwanda. Two of the identified energy related companies are Ruhura Hydropower Project (RHP) in the South and Bwiza Solar Company (BSC) in the Eastern part of the country. The team is considering purchase of equity stakes in each of the two companies. Gathered information shows that ordinary shares in RHP and BSC have 1.3 and 0.8 of betas respectively. Investors in RHP expect a rate of return of 12% while the expected market return is 10%.

During their discussions, one of the team members; Ms. Asma Dalia highlighted the need to invest in multiple investments at once as a way of reducing risk and ensuring adequate future return especially in this period of Covid19 Pandemic.

The team further argued whether they should use the Arbitrage Pricing Theory (APT) or Capital Asset Pricing Model (CAPM) for future computations of required returns.

Required:

- (a) Identify and explain the investment management theory Ms. Asma is referring to. Show its relevance in the team's investment decisions?** (3 Marks)
- (b) Join the team's conversations by comparing APT and CAPM. Give limitations of each of the two methods.** (8 Marks)
- (c) Compute the required rate of return from BSC ordinary shares** (4 Marks)
- (d) As the team continues to learn about the country, provide answers to their queries below:**
 - i. Who is the regulator of the financial sector in Rwanda?** (1/2 Mark)
 - ii. Who is the regulator of capital markets in Rwanda?** (1/2 Mark)
- e) In the wake of the Covid19 Pandemic, the team has learned of a recent Government of Rwanda intervention through a national economic recovery plan and economic recovery Fund. Inform the team of the content of the Economic Recovery Plan and Fund by answering the below queries:**
 - i. The main aim of the Economic Recovery Plan.** (1 Mark)
 - ii. List the 5 priorities of Government of Rwanda under COVID19 Economic Recovery Plan.** (5 Marks)
 - iii. Period to be covered by the GoR Covid19 Economic Recovery Plan.** (1 Mark)
 - iv. The GoR has further established a Covid19 Economic Recovery Fund (ERF). How much is the initial total funds under ERF and what institution is in charge of managing the fund.** (2 Marks)

(Total :25 Marks)

QUESTION FOUR

Muhabura Processing Company Limited (MPC Ltd) is a small but fast-growing manufacturing company with ambitions to become a leader in the industry and in the region. The company has recently launched an e-commerce platform which has significantly increased the sales orders from across the globe. Suddenly, there is a need to expand the company's operations and processing capacity. The company owners who are unfamiliar with modern financing methods have asked you; a recently hired consultant to advise on various issues including potential sources of finance, capital structure optimisation, dividend policies, etc.

Required:

- (a) Inform and explain to the company owners of at least 3 sources of long term finance for their fast growing business (6 Marks)
- (b) The owners have been told by some of their friends that debt is cheaper than equity. Explain by giving at least 3 reasons why debt is a cheaper financing method than equity financing. (6 Marks)
- (c) The company owners have expressed their desire to start paying dividends in excess of yearly benefits. Explain how this will be done and the risks associated with this dividend policy. (6 Marks)
- (d) MPC Ltd eventually decided to issue loan notes and below are the resulting summary financial statements:

P&L	Rwf'000
Revenue	725,350
Cost of sales	(532,850)
Gross Profit	192,500
Admin Expenses	(91,000)
Interest	(25,000)
Tax	(15,000)
Profit after interest and tax	61,500
Balance Sheet	Rwf'000
Assets	
PPE	3,500,020
Receivables	231,000
Inventory	135,000
Cash	568,000
Total assets	4,434,020

Liabilities	
Ordinary Share Capital	2,800,000
Retained Earnings	404,020
Loan notes	1,230,000
Total Liabilities	4,434,020

You are requested to explain and compute MPC Ltd.'s operational gearing and financial gearing using market values. (4 Marks)

e) As MPC Ltd plans to expand beyond borders, explain to the owners at least three importance of effective working capital management to avoid corporate failure.

(3 Marks)

(Total :25 Marks)