CERTIFIED PUBLIC ACCOUNTANT ADVANCED

LEVEL 2 EXAMINATIONS

A2.1: STRATEGIC CORPORATE FINANCE

DATE: WEDNESDAY, 01 DECEMBER 2021

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.
7. The question paper should not be taken out of the examination room.

SECTION A

QUESTION ONE

Umwezi Investment Company (UIC) is a holding and an investment firm with a sizeable portfolio of companies that are separately and independently managed. On a quarterly basis, Mrs. Mutoni, a portfolio Manager, together with her team, review pending decisions among the portfolio companies and technically support company management to make final decisions.

AKANOZE LTD

The Board of Directors of Akanoze Ltd has shown its interest to grow through acquisition of other potential companies in the same sector. The Board has already identified Kabore Ltd as a target company to acquire.

While Akanoze Ltd has 30 million shares in issue currently trading at FRW 250 each, Kabore Ltd has only 4.6 million shares in issue and its debts are fair valued at FRW 740 million.

Kabore Ltd is a profitable company that recently made FRW 195million of (Profit Before interest and Tax (PBIT). This was after removing the non-cash expenses which included tax allowable depreciation of FRW 26 million.

Kabore Ltd makes annual cash investments in assets and working capital equivalent to FRW23 million. Kabore Ltd expects that its cash flows will continue to grow at a rate of 5% per year while its cost of capital will remain the same at 13%.

Should Akanoze Ltd succeed in acquiring Kabore Ltd, the combined company's sales will be FRW9,520 million in the first year, with sales expected to grow by 6% annually for the next three years after the first year. Annual pre-tax profit margin on sales will be 17% for the next few years ahead.

It is planned that the combined company will require additional investment of FRW 62 million in the first year and FRW15 for every FRW 100 increase in sales for each of the next three years. The combined company's annual depreciation will be equivalent to the investment required to maintain the company at current operational levels.

After the first four years, the combined company's free cash flows will grow by 3% annually for the foreseeable future while its cost of capital will be 11%. After the acquisition, the capital structure of 30:70 of debt to equity level in market value terms will be maintained.

The applicable annual tax rate is 30% payable in the same year profits are made.

AKEZA LTD

Akeza Ltd is a locally listed company and the below extract of the company Statement of Financial Position (SOFP) has been availed to Mrs. Mutoni and her team.

Balance Sheet	**Year 2020**
Assets	**FRW'000'**
Property Plant and Equipment	600,000
Inventory	56,000
Cash and cash equivalents	132,000
Other current assets	25,100
Total assets	**813,100**
Liabilities	
Share Capital	250,000
Reserves	221,000
7% preference shares	80,050
11% loan notes	99,600
Long term debt	120,800
Trade payables	23,850
Other current payables	17,800
Total equity and liabilities	**813,100**

The team from Akeza Ltd has provided more explanations on the balances in the SOFP. It was noted that the ordinary shares of Akeza Ltd have a par value of FRW 1,000 per share and a current ex-dividend market price of FRW7,200 per share and that a dividend of FRW 850 per share was recently paid. The 7% preference shares on the other hand have a par valueof FRW 500 per share and an ex-dividend market price of FRW 490 per share. The 11% loan notes have a par value of FRW 100,000 per loan note and a market price of FRW134,000 per loan note. Annual interests have also been paid recently and Mrs. Mutoni's team have been told that the loan notes are redeemable in four years' time at a 16% premium to par value.

The team was further told that Akeza Ltd has an equity beta of 1.32 while the applicable risk-free rate of return is 2.8% per year and the equity risk premium is 7.3% per year.

The corporation tax rate applicable is 30% and the long-term debt loan has a variable interest rate.

AKIREZE LTD

The Management of AKIREZE Ltd is considering making an investment by acquiring a building for a special project. The Management team understands it will have to perform an investment appraisal considering potential risks in the project. Mrs. Mutoni has expressed her concerns on the new project and the impact it will have on the planned dividend pay-out. Mrs. Mutoni later found out that Akireze Ltd does not have a dividend policy in place and has recommended its immediate development.

Required:

(a) You are Mrs Mutoni and you are required to compute the value of equity of Akanoze Ltd and of Kabore Ltd before the acquisition, and of the combined company after the acquisition. **Based on the equity value created after acquisition, advise whether the acquisition is worthwhile.** (25 Marks)

(b) Assuming you are a member of Mrs. Mutoni's team. Assuming the % cost of loan notes is the same as the one on long term debts; **compute the after-tax weighted average cost of capital of AKEZA Ltd on a market value basis.** (17 Marks)

(c) Explain to the Akizere Ltd Management Team the following methods which take into account risk and uncertainty while making investment appraisal

i. **Simulation.** (2 Marks)

ii. **Risk-adjusted discount rates**. (2 Marks)

(d) Explain to Akireze Ltd Management team, four practical considerations which the team must take into account in setting its dividend policy. (4 Marks)

(Total: 50 Marks)

SECTION B

QUESTION TWO

You are a consultant at Komera Ltd; a consultancy firm based in the newly created Kigali Financial Hub, in Rwanda. One of your clients; Maisha Ltd, is based in Nairobi, Kenya and has requested your opinion on an upcoming transaction.

In two months' time, Maisha Ltd expects to receive a payment of Ksh 450,000,000 on 30 June 2021 and plans to invest the received funds locally until 31 December 2021.

The National Bank of Kenya (NBK) base rate is currently 3.5% and Maisha can invest with local banks at NBK base rate plus 50 basis points. Due to fluctuations in markets, the company predicts that between now and 30 June 2021, the NBK base rate could fall by 0.8% or rise by 0.9%.

Maisha Ltd is looking for an appropriate hedging strategy for the Ksh 450,000,000 investment and is considering the use of Forward rate agreements (FRAs).

One of the local banks in Kenya has offered to Maisha Ltd the following FRA rates:

- 3-9: 4.8%
- 2-8: 4.5%

You have also been briefed about the ongoing discussions at the Board level where the Directors of Maisha Ltd are discussing the importance of foreign financial intermediaries in financial markets integration. The Directors have further indicated their plans to obtain a credit rating to Maisha Ltd, a move they believe will support the company in its quest to raise significant capital for planned investments.

Required:

a) In your capacity as a consultant, **compute the expected net return and effective annual rate of return, if Maisha Ltd invests the Ksh 450,000,000 using the appropriate offered FRA rate, in both cases where the interest rates rise by 0.9% or fall by 0.8%.** (10 Marks)

b) **(b)** Foreign Financial Intermediaries play a major role in financial markets integration. **Explain five reasons why global financial systems need integrated financial markets.** (7.5 Marks)

c) **Discuss five factors that Credit Rating Agencies will consider while assessing and attributing a credit score to Maisha Ltd.** (7.5 Marks)

(Total: 25 Marks)

QUESTION THREE

The shareholders of Kamugina Company Limited (KCL) are concerned with the future of the company in light of new developments in the sector and across the operating market. They have requested you to analyse the past performance of the company in order to assess its readiness vis a vis the growing changes in the sector.

The management of KCL has provided you with the following recent financial information about the company.

Statement of Profit or Loss - KCL

	31 Dec 2020 FRW'000	**31 Dec 2019 FRW'000**
Sales revenue	6,689,030	6,560,500
Cost of sales	(4,325,920)	(4,135,890)
Gross profit	2,363,110	2,424,610
Admin costs	(687,590)	(679,520)
Operating profit	1,675,520	1,745,090
Finance costs	(361,000)	(375,000)
Profit before tax	1,314,520	1,370,090
Taxation	(394,356)	(411,027)
Profit after tax	**920,164**	**959,063**
Dividends	(235,000)	(256,890)

Statement of financial position – KCL

	31 Dec 2020 FRW'000	**31 Dec 2019 FRW'000**
Non-current assets	11,371,351	11,257,637
Cash and cash equivalents	251,000	248,490
Other current assets	696,800	689,832
Total non-current and current assets	**12,319,151**	**12,195,959**
Ordinary shares (FRW1,000)	8,000,000	8,000,000
Reserves	1,123,654	421,481
Non-current liabilities	2,100,530	2,058,519
Current liabilities	1,094,967	1,715,959
Total equity and liabilities	**12,319,151**	**12,195,959**

The shareholders have further noted that KCL might have an agency problem and that the current management might need motivation to avoid potential corporate governance failure which is likely to aggravate the financial and operational situation of KCL.

Required:

a) **Based on relevant calculations of ratios and trends, evaluate the performance of KCL over the last two years. Consider current ratio under liquidity ratios; debt to equity ratio, gearing and interest cover under gearing ratios; earnings per share, dividend per share and dividend cover under investment (dividend) ratios.** (16 Marks)

b) The KCL Shareholders are worried of a potential corporate failure. **State four signs which will lead to corporate failure at KCL if no immediate actions are taken to improve the current financial and operational situation at KCL.** (4 Marks)

c) Business Managers are increasingly becoming indispensable in the daily management of businesses and the achievement of shareholders' objectives. **Identify and describe five approaches used to encourage business leaders to achieve shareholders' objectives.** (5 Marks)

(Total: 25 Marks)

QUESTION FOUR

Mr. Muremure is the CEO of Karekare Company Ltd (KCL). He has called a meeting with the Head of Finance and his team to discuss and make decisions on three outstanding issues.

The first issue relates to a new equipment to be acquired by KCL. The equipment has a useful life of three years with a purchase cost of FRW 240 Million. If purchased, the machine will be acquired on a loan at a cost of 15% per year and will incur annual maintenance costs FRW 13 Million payable at year end. At the end of three years, the equipment residual value is estimated at FRW 65 Million. Alternatively, the equipment could be leased at an annual cost of FRW82 Million paid in advance.

The second issue to be discussed during the meeting concerns the factoring services that KCL is considering using.

KCL has annual revenue of FRW 2.4 billion and all sales are on a 30 days' credit. The company's average trade receivables are currently FRW 790 Million and bad debts stand at 6% of credit sales. The company has faced increased cash shortage, reaching its overdraft limit, requiring the top management's intervention and the need to use a factoring company for better receivables management. The latter has provided KCL with two choices to choose from.

With choice No.1, the factor will administer KCL's invoicing, revenue accounting and receivables collection on a full recourse basis. Under this option, the receivables collection period will remain 30 days and the factor will charge 2% of credit sales per year. The expected annual savings in administration costs are FRW 130 Million.

Under choice No.2, the factor will provide the same services but on non-recourse basis. The receivables collection period and annual administration savings will remain unchanged, but the service fee will be increased by 36% compared to choice No.1. KCL will be provided with an advance of 75% of credit sales when invoices are raised at an interest rate of 13% per year.

The third and final issue on the agenda relates to the planned corporate social responsibility (CSR) activities. The company Head of Finance is reluctant to the idea of conducting this year's CSR activities arguing that they are not revenue generating and therefore the company should not spend on them in the first place. The company CEO, on the other hand, is very keen to conduct these activities and see them as an opportunity for future business and company's high standing in the society.

Required:

a) **Evaluate whether KCL should lease or use the loan to purchase the equipment.** (10 Marks)

b) Knowing that KCL pays interest on its overdraft at a rate of 9% per year and that the company operates for 360 days per year, **compute the costs and benefits of choice No.1 and choice No.2 and advise on the preferred choice**. (9 Marks)

c) **State three arguments in favour and three against CSR Activities**. (6 Marks)

(Total: 25 Marks)

End of question paper