Diploma in Financial Management

PROJECT DB2, INCORPORATING SUBJECT AREAS
– FINANCIAL STRATEGY
– RISK MANAGEMENT

All questions are compulsory and MUST be answered

The project MUST be written in English.

The maximum word count (including appendices and tables but excluding references and bibliography) is 5,000.

The project MUST be TYPED in black ink, one-sided, double-spaced, using a minimum 12-point font size and a 1-inch margin at each side. HANDWRITTEN SUBMISSIONS WILL NOT BE ACCEPTED. The project must be submitted by post, electronic submissions are not acceptable.

The project should be submitted on A4 paper with your student number, project name, date and page number at the top of each page.

A project submission form MUST be completed for each project submitted and attached to the front of the project.

The Association of Chartered Certified Accountants

Module B

Section 1 – Financial Strategy
This ONE question is compulsory and MUST be attempted

1 The Whinchat deal

Scaup plc is an international pharmaceutical company that was once seen as a safe haven for investors when stock markets became volatile. It had a reputation as a well-managed and solid, but rather unexciting, company operating within a strong industrial sector. However, a number of problems has emerged in recent years to damage its reputation. A major problem for the company has been its failure to develop new drugs to replace a generation of successful drugs, the patents of which had either already expired or were about to expire. Where patents had already expired, rival companies had developed competing generic drugs that had seriously damaged the company's sales and profits. To make matters worse, the company had recently launched two new products, amidst much publicity, which had to be swiftly withdrawn when patients taking the drugs complained of side effects. This led to a severe loss of confidence in the management of the company and it became clear that major changes had to be made.

Key figures and ratios relating to Scaup plc for the past five years are set out below:

	Year ended 31 January				
	1999	**2000**	**2001**	**2002**	**2003**
Sales (£m)	542·6	579·9	487·2	456·4	425·3
Operating profits (£m)	42·1	43·5	27·8	24·3	22·8
P/E ratio	15·3	19·2	14·3	9·5	7·8

In order to restore confidence in the future of the company, the majority of members of the Board of Directors was replaced and Anne Pochard was appointed as Chief Executive Officer. The new Board agreed that the pharmaceutical sector had become fiercely competitive in recent years and it doubted whether the company had the resources or expertise to remain a successful player within the industry. The increasing costs associated with developing new drugs, along with downward pressure, exerted by governments, on prices for prescription drugs led the Board to conclude that a change of direction was needed. Hence, it was decided that the company should reposition itself in the related healthcare market where it already had a small presence. For some years, Scaup plc had been selling a range of antiseptics and disinfectants for use in hospitals and nursing homes. The mission of the company was restated as being:

To maximise shareholder value by becoming a leading provider of healthcare products

Whinchat Ltd is a family-owned company that produces a small range of healthcare products. The main products of the company are wound dressings and surgical gloves, which are sold to hospitals, surgeries and nursing homes throughout Europe and which enjoy a reputation for their very high quality. The most recent accounts of the company are set out below:

Balance sheet as at 31 January 2003

	£000	£000	£000
Fixed assets			
Freehold premises at cost		8,470·2	
Less accumulated depreciation		484·6	7,985·6
Plant and equipment at cost		17,854·3	
Less accumulated depreciation		13,906·2	3,948·1
Motor vans at cost		3,718·3	
Less accumulated depreciation		1,428·1	2,290·2
			14,223·9

	£000	£000	£000
Current assets			
Stock	1,346·7		
Trade debtors	1,490·6		
Cash at bank	2,012·9	4,850·2	
***Less* Creditors: Amounts falling due within one year**			
Trade creditors	1,576·4		
Proposed dividend	2,600·0		
Accrued expenses	180·8	4,357·2	493·0
			14,716·9
***Less* Creditors: Amounts falling due beyond one year**			
7% Debentures			7,000·0
			7,716·9
Capital and reserves			
£1 Ordinary shares			2,000·0
Retained profit			5,716·9
			7,716.9

Profit and loss account for the year ended 31 January 2003

	£000	£000
Sales		45,924·8
Less Cost of sales		19,853·6
Gross profit		26,071·2
Selling and distribution expenses	12,596·2	
Administration expenses	8,868·6	21,464·8
Operating profit		4,606·4
Finance charges		702·5
Net profit before taxation		3,903·9
Corporation tax		780·8
Net profit after taxation		3,123·1
Proposed dividend		2,600·0
Retained profit		523·1

Francis Whinchat founded the business in 1971 and has been the Chief Executive and Chairman of the company since that date. However, ill health has recently forced him to consider his future and also to consider the future of the company. Although the founder has two children, neither has shown an interest in the business. The idea of allowing non-family members to manage the business was regarded by the Whinchat family as unacceptable and so the various family members, who owned all the issued shares, agreed to sell the company.

When Anne Pochard discovered that Whinchat Ltd was for sale, she expressed an immediate interest in entering into negotiations with the Whinchat family. She believed that this was an outstanding opportunity to acquire a range of high quality products with a strong brand image. It provided an immediate and strong presence in markets that the Board of Directors of Scaup plc had recently identified as being of particular interest.

The Finance Director of Scaup plc, David Shearwater, was the first among the new Board of Directors to express reservations concerning the possible acquisition. Although he acknowledged the possible benefits that might accrue, he argued that Scaup plc had no previous experience in acquiring companies and that the new Board of Directors had not yet developed a clear view as to how the acquisition process should be approached or managed. As a result, there was a risk that the acquisition of Whinchat Ltd would not turn out to be as successful as Anne Pochard was expecting. David also wondered whether investors would be prepared to support the deal given the recent history of Scaup plc. The Board of Directors debated the issue and, by a narrow majority, decided to support Anne's wish to enter into negotiations with the Whinchat family with a view to buying all the shares of the company. However, it was agreed that an independent firm of consultants, Bittern Associates, should be appointed to advise the Board throughout the period of negotiations.

The Finance Department of Scaup plc extracted the following information as at 20 February 2003 relating to healthcare companies from a financial newspaper:

12 month High	Low	Company	Price(p)	+/-	Yld %	P/E
673 1/2	478	Curlew International	622	+ 2	2·3	10·5
780	460	Fieldfare	592 1/2	+ 12 1/2	1·2	11·5
279 1/2	172 1/2	Plover UK	194 1/2	.....	1·2	12·5
182 1/2	117 1/2	Nightingale Healthcare	117 1/2	– 5 1/2	3·3	6·8
266	121 1/2	Turnstone Health Products	202 1/2	+ 3 1/2	2·6	8·3
316	164	Wigeon Group	296 1/2	....	1·8	9·7

The Finance Department also provided the following ratios for each of the companies listed above:

	Market value*/ Book value*	Sales/ Market value*
Curlew International	3·7:1	1·7:1
Fieldfare	2·8:1	1·6:1
Plover UK	3·6:1	1·5:1
Nightingale Healthcare	2·9:1	1·9:1
Turnstone Health Products	3·2:1	2·3:1
Wigeon Group	2·7:1	1·4:1

* These values refer to the ordinary shares of each company

In the early stages of negotiation between the two companies, the following information was provided by Francis Whinchat:

– The market value of the freehold premises of Whinchat Ltd was estimated to be between £32 million and £33 million.
– The sales of Whinchat Ltd are expected to grow at about 2 or 3 per cent each year over the next five years. The market is fairly competitive and there is little prospect of improved growth rate over this period. Thereafter, sales are likely to stabilise.
– Operating profit margins are likely to remain at their historic levels, which are between 10 per cent and 12 per cent for the foreseeable future.
– Replacement costs of fixed assets will be more or less in line with the annual depreciation charge. In addition, however, the company is committed to a major upgrade of plant and equipment costing £1·8 million over the next three years. The cost of this upgrade would be spread evenly over the three-year period.
– Additional working capital over the next five years will be 20 per cent of sales growth.
– An exceptional dividend had been paid during the year to 31 January 2003. In previous years, the dividend paid had varied between £220,000 and £260,000.

Following the initial negotiations, the Directors of Scaup plc decided that, in the event of a price being agreed for the shares in Whinchat Ltd:

– The total after-tax savings in operating expenses from merging the sales and distribution channels of each company would be between £100,000 – £120,000 per year. These figures are not included in the operating profit margin estimates mentioned above.
– The shares in Whinchat Ltd will be paid for in cash, which would be raised by a rights issue of ordinary shares.

Scaup plc has an estimated cost of capital of 8 per cent. It has 10 million ordinary shares in issue and the current market value of a share is £10·64.

Assume a corporation tax rate of 20 per cent on operating profits (payable in the current year) and a lower rate of income tax on dividends of 10 per cent.

Required:
Assume that you are a consultant with Bittern Associates.
You are required to write a report for the Board of Directors of Scaup plc that:

(a) suggests with reasons:

(i) a reserve price per share in Whinchat Ltd that is appropriate for the Whinchat family;

(ii) a reserve price per share in Whinchat Ltd that is appropriate for the shareholders of Scaup plc

for use in negotiations concerning the acquisition of the ordinary shares in Whinchat Ltd. (25 marks)

(b) sets out recommendations for a systematic approach to the identification, evaluation and management of future company acquisitions. (15 marks)

(c) sets out recommendations concerning:

(i) the number of rights shares that should be issued;

(ii) the price at which each rights share should be issued to finance the deal; and

(iii) the likely value of an ordinary share in Scaup plc following the rights issue.

In answering part (c), you should assume that shareholders in Scaup plc have been made aware of the impending purchase of Whinchat Ltd and that the agreed price to acquire the shares in Whinchat Ltd is the reserve price identified in your answer to (a)(ii) above. (10 marks)

When answering parts (a) and (c), you should clearly state any assumptions and reasoning that you have made and you should show key workings. Possible options available should be examined and any suggestions or decisions that are made must be supported by appropriate arguments.

(50 marks)

Section 2 – Risk Management
This ONE question is compulsory and MUST be attempted

2 Jodson plc

Jodson plc (Jodson) is an old established firm which was, for a long period, very successful. However, due to a lack of strategic planning and poor product development it had, starting around the mid 1980s, several years of large losses. Jodson's high level of gearing made it difficult for it to service its debt capital during this loss making period and it was thought likely that Jodson would be forced into liquidation unless drastic action was taken to enable the company to survive. In 1989 this resulted in a change in both the management team and in the firm's strategic objectives.

The new management team almost immediately sold some of those divisions which were not efficiently using their assets and used the funds to repay a significant proportion of the outstanding debt – this reduced the gearing ratio to the level of 40% debt and 60% equity.

The management team then turned it's attention to implementing the changed strategic objectives to focus more on customer satisfaction and product development whilst also introducing more financial reporting and control systems, together with a more formalised strategic planning function. This has, over the last ten years, turned Jodson into a well managed and profitable firm. For the last eight years the firm has been increasingly profitable and, by retaining these profits, Jodson has been able to pursue a policy of steady, internally financed, expansion.

Shares in Jodson plc continue to be traded on the stock market. The current share price is 75 pence per share and the equity beta is fairly stable at 1·20. Last year's Earnings Per Share figure was 8 pence and this is currently expected to grow by around 12% per year. Current gearing is, at market values, 15% debt 85% equity.

Current market parameters are

Risk Free interest rate (r_f) 6%

Expected Return on the Market ($\bar{r}_m$) 11%

As a consequence of the policy of retaining all profits to finance the strategy of expansion Jodson has not paid any dividends since its original period of losses over 15 years ago. As the firm is now soundly managed, is currently profitable and expects that future profits will rise, consideration is being given to the question of whether it would be desirable to commence paying dividends to shareholders. When this was recently discussed by some of the firm's Directors at an unofficial meeting there were very mixed views on the desirability of recommencing dividend payments. The views can be broadly summarised as follows:

The Managing Director. 'Our competitors all pay dividends and as we can now afford them we, too, ought to reward our shareholders with a dividend. There has been some press comment indicating that we ought to start paying dividends again – the consensus is that we should start at about two pence per share. I think we should start paying dividends as this will increase our share price. I suggest that we please the market by paying more than the level suggested by the press as the share price will rise with higher dividends. I suggest we start paying a dividend of 3p or 4p per share from next year. In future years the dividend should normally be a stable proportion of our earnings – I think the financial analysts call it a stable dividend cover.'

Director of Strategy and Planning. 'At present we have more good, profitable, positive NPV expansion projects available to us than we can undertake. We simply do not have sufficient money to finance all our investment opportunities – this looks likely to be the position for the foreseeable future. Any money paid out to shareholders as dividends will reduce the amount available for us to invest. This will mean that we will have to reject even more good projects as we will have even less money available for investment and so future expansion will not be as rapid as it could be. These projects available to us give a good rate of return and so it is in our shareholders' interests for us to invest their money at good rates on their behalf and exploit these opportunities. Therefore we should not pay dividends until we have no further good investment opportunities. If we pay dividends now we will reduce shareholder wealth and the share price will fall.'

Financial Director. 'The finance department has already looked into this matter. Our analysis indicates that if we pay dividends and keep to a stable long term dividend cover, future growth of dividends will keep pace with the growth of earnings. We have concluded that introducing a policy of paying a proportion of earnings as dividends will reduce funds available for investment and this will impact on future growth – both of earnings and dividends. Our calculations of future sustainable earnings growth at different dividend levels are:

Dividend per share (Pence)	Future Sustainable Growth (Percentage Growth per year)
5	3·50
4	5·30
3	7·50
2	9·30
1	10·75
0	12·00

We therefore agree with the Director of Strategy and Planning that paying dividends will stop us exploiting all profitable opportunities and so we, too, suggest that dividends should not be paid.'

Non Executive Director. 'Currently our equity beta is 1·20. This reflects the market perceptions of our risk. If we start paying dividends then our beta is likely to change. My calculations are

Dividend per share (Pence)	Equity Beta
5	1·04
4	1·06
3	1·10
2	1·13
1	1·19
0	1·20

This needs to be taken into consideration.'

The Chairman. 'There is no reason why paying a dividend should change the equity beta – so I think we can ignore that as a possibility. In my opinion dividends are irrelevant to share value – and there is quite a lot of theory and some empirical evidence to support my view. Hence I do not think that there will be any impact on the share price whether or not we pay dividends. I also feel that the reintroduction of dividends is not the most urgent issue I need to consider. Remuneration of Directors is much more pressing. I am told that it is good practice to have a remuneration committee and am wondering what exactly such a committee would do and what benefits it would bring. I am also considering the introduction of some sort of formalised performance based incentive scheme for remunerating the Board of Directors. This would be based either on profits or on share price performance – I find that each of these has merits and deficiencies and so I am currently undecided between these two approaches. To enable us to go forward I think we need two separate reports – one on dividends and one on remuneration – in order to provide us with information and a reasoned, well thought out, recommendation for each of these topics. This will enable us to consider these matters properly and, at the next meeting of the Board of Directors, we can make an informed decision on our policy regarding both executive remuneration and dividends. In both cases the interests of our shareholders is of the greatest importance, therefore I want these matters analysed with shareholder well-being as the top priority.'

Required:

Produce the two separate reports required by the Chairman. The reports should clearly make a recommendation concerning future policy on each of the issues.

(a) The report on dividends should:

(i) explain the theoretical importance of dividends to share valuation and comment on the validity of the views expressed concerning the impact of dividends on share price; (10 marks)

(ii) discuss the major issues to be considered in deciding on dividend policy; and (10 marks)

(iii) briefly consider whether dividend levels are likely to impact on the level of equity beta and determine the likely impact of the various dividend levels on share price if:

(1) dividend levels have no impact on equity beta as suggested by the Chairman; and

(2) dividend levels have an impact on equity beta as suggested by the Non Executive Director. (15 marks)

(b) The report on remuneration should:

(i) clearly indicate the purpose, scope and advantages of a Remuneration Committee; and (5 marks)

(ii) explain the advantages of an incentive scheme for the Board of Directors and the particular merits and problems associated with a scheme based on profits and one based on share price performance. (10 marks)

(50 marks)

End of Project