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

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The project begins on page 15.

Incorporating subject areas – Financial Strategy and Risk Management.

This ONE question is compulsory and MUST be attempted

Emmanuel Hire plc

1 Emmanuel Hire plc operates a chain of tools and equipment hire branches throughout England and Wales. In the past ten years it has grown rapidly through a process of acquisition and organic growth and now, with more than 150 branches, is one of the leading tool hire businesses in Europe. The customer base is largely local tradesmen and DIY enthusiasts and the tools and equipment hired range from carpet cleaners through to excavators. However, drills, breakers and concrete mixers are the core revenue producers for the company. The company operates a fleet of delivery vehicles and all branches have vehicles for delivery purposes. The company has high service standards and has acquired a good reputation. As a result, more than 60% of revenue generated comes from repeat business.

The most recent financial statements of the business are set out below.

Draft balance sheet (Emmanuel Hire plc) as at 31 January 2005

	£000	£000	£000
Fixed assets (at written down values)			
Goodwill			4,560
Freehold land and buildings			1,920
Leasehold land and buildings			130
Hire equipment			13,230
Motor vehicles			960
Fixtures and fittings			2,370
			23,170
Current assets			
Stocks		220	
Debtors		10,540	
Cash in hand		4	
		10,764	
Less **Creditors: Amounts due within one year**			
Trade creditors	3,520		
Corporation tax	1,100		
Dividends	1,650	6,270	4,494
			27,664
Less **Creditors: Amounts due after more than one year**			
7% Loan stock (secured on freehold buildings)			1,500
			26,164
Capital and reserves			
£0·50 ordinary shares issued			10,000
Retained profit			16,164
			26,164

Draft profit and loss account (Emmanuel Hire plc) for the year ended 31 January 2005

	£000	£000
Sales		35,730
Cost of sales		7,080
Gross profit		28,650
Less		
Selling and distribution expenses	3,350	
Administration expenses	19,845	23,195
Operating profit		5,455
Finance expenses		105
Net profit before tax		5,350
Corporation tax (25%)		1,337
Net profit after tax		4,013
Dividends		1,337
Retained profit for the year		2,676

Emmanuel Hire plc uses the straight-line method of depreciation and depreciation charges for the year to 31 January 2005 were £3,850,000. The company, which is listed on the London Stock Exchange, has a price earnings (P/E) ratio of 12 times and has a policy of maintaining a dividend cover ratio of 3·0 times.

The hire market is very competitive and there are many small businesses operating within the industry. However, there has been a trend towards consolidation over recent years with many small businesses being either taken over or forced out of business by their larger rivals. Emmanuel Hire plc has acquired five small businesses over the past three years and expects to acquire further businesses in the future in order to increase both market share and geographical coverage. To this end, Emmanuel Hire plc is now in the final stages of negotiation for the purchase of the assets of Hughes Hire Ltd, which operates more than 40 branches in Lanarkshire. The most recent financial statements of this company are as follows:

Draft balance sheet (Hughes Hire Ltd) as at 31 January 2005

	£000	£000	£000
Fixed assets (at written down values)			
Freehold land and buildings			700
Hire equipment			4,280
Motor vehicles			390
Fixtures and fittings			960
			6,330
Current assets			
Stocks		70	
Debtors		3,850	
		3,920	
Less **Creditors: Amounts due within one year**			
Trade creditors	1,280		
Corporation tax	555		
Dividends	1,200	3,035	885
			7,215
Less **Creditors: Amounts due after more than one year**			
5% Loan stock (secured on freehold buildings)			2,200
			5,015

Capital and reserves

£1·00 ordinary shares issued	1,000
Retained profit	4,015
	5,015

Draft profit and loss account (Hughes Hire Ltd) for the year ended 31 January 2005

	£000	£000
Sales		12,810
Cost of sales		2,480
Gross profit		10,330
Less		
Selling and distribution expenses	1,260	
Administration expenses	6,740	8,000
Operating profit		2,330
Finance expenses		110
Net profit before tax		2,220
Corporation tax (25%)		555
Net profit after tax		1,665
Dividends		1,200
Retained profit for the year		465

The company uses the straight-line method of depreciation and depreciation charges for the year to 31 January 2005 were £960,000.

An inspection of the branches of Hughes Hire Ltd by the operations director of Emmanuel Hire plc revealed a lack of investment over recent years. The delivery fleet is in need of replacement, the hire equipment is in poor condition and the quality and presentation of the branches are well below the standards of the prospective new owner. Assuming the acquisition goes ahead, an investment of approximately £4 million will be required to bring the newly-acquired operations up to the required standards. However, no new investment will be made during the first year of operations. The operations director of Emmanuel Hire plc believes that the potential of the branches has not been fully exploited. He estimates that, following acquisition, sales can be increased by 20% per year. Furthermore, selling, distribution and administrative expenses relating to the newly-acquired branches can be reduced by 10% per year through better monitoring and control systems.

The price paid for the assets of the company is likely to be £12 million and will be paid in cash. The purchase negotiations concern the assets of Hughes Hire Ltd only. The owners of Hughes Hire Ltd will take responsibility for the payment of any outstanding liabilities before winding up the company. To finance the purchase, Emmanuel Hire plc will make either a 2-for-5 rights issue of ordinary shares or an issue of loan capital at par.

The Board of Directors of Emmanuel Hire plc is due to meet shortly to discuss the proposed acquisition and there are a number of items on the agenda for discussion. One of the more important items concerns the financing of the purchase. If loan stock is used to help finance the bid, the finance director is keen to hedge against interest rate risk. The company has a good credit rating and can raise fixed rate loan capital at 6·5% and floating rate loan capital at LIBOR plus 0·7% from its bank. The company want to use long-term, floating rate finance to help fund the purchase of Hughes Hire Ltd and has been offered a five-year swap arrangement by a bank. The bank has identified Fitzwilliam plc as a counterparty to the agreement. Fitzwilliam plc is a large soft drinks company that can raise fixed interest loan capital at 8·1% and floating rate loan capital at LIBOR plus 1·4% from its bank. The swap bank will arrange the swap agreement and act as guarantor for both parties for an annual total fee of 0·3%. The two companies will pay to, or receive from, the swap bank a fixed amount and will receive, or pay, LIBOR in return. It has been estimated that LIBOR will be 5·8% for the whole of next year.

Recent reports suggest that the tool and equipment hire market will remain unchanged for the foreseeable future. A succession of rises in interest rates over the past two years has led to stagnation in the home improvement market and, as a consequence, the market for tool hire has also stagnated. However, the directors of Emmanuel Hire plc are confident that sales (excluding the acquisition of Hughes Hire Ltd) can be increased next year by entering new markets. The company has begun to forge links with construction companies and is now about to sign a contract with one large construction business that is likely to increase sales by £3 million per year. The gross profit margin from this agreement will be the same as for the business as a whole and there will be no additional selling, distribution or administration costs as a result of the agreement.

The directors are keen to standardise the credit period allowed to credit customers following the takeover of the assets of Hughes Hire Ltd. As a result, they have agreed that customers for both Emmanuel Hire plc and Hughes Hire Ltd, will all be given three months' credit. The only exception to this policy is the construction business, which has negotiated a credit period of four months. Trade creditors are expected to be 40% of total trade debtors at the year end.

Emmanuel plc was created by David Emmanuel in 1992 and he was both chief executive and chairman up until his retirement at the end of January 2005. After his retirement, a new chief executive was appointed and a non-executive chairman was also appointed. David Emmanuel was extremely entrepreneurial and, in the early years, the company benefited from his flair and appetite for risk. However, in more recent years, this entrepreneurial style has become less successful. The company, although still growing, appears to have entered a new, more mature, phase in its development. There have been increasing calls from institutional investors for the company to be managed more strategically and for risk management to feature more strongly in the decisions made by the directors. The finance director has pressed for some years for the business to adopt a risk-based management approach to decision-making but was consistently rebuffed by David Emmanuel. However, the new chief executive is keen to adopt this approach.

Required:

(a) Evaluate the acquisition of Hughes Hire Ltd from the viewpoint of shareholders in Emmanuel Hire plc. (18 marks)

(b) Set out the factors to be considered when deciding between ordinary share capital and loan capital to finance the purchase of Hughes Hire Ltd. (7 marks)

(c) Assuming the purchase of Hughes Hire Ltd is financed by an issue of loan capital:

(i) set out the details of the swap arrangement showing how it can benefit both companies and showing the total interest rate to be paid by Emmanuel Hire plc in the first year.

(ii) suggest an alternative method by which interest rate risk may be managed and compare this with a swap arrangement. (10 marks)

(d) Assuming that the various proposals are undertaken at the beginning of the year to 31 January 2006:

(i) prepare a forecast cash flow statement and a forecast profit and loss account for Emmanuel Hire plc under each of the financing options identified for the year to 31 January 2006;

(ii) calculate the effect on the profitability and gearing of the company under each of the financing options identified for the year to 31 January 2006;

(iii) comment on the findings in (i) and (ii) above. (25 marks)

(e) Set out the main advantages of a risk-based management approach to decision-making and identify the key tasks that should be carried out to implement such a system. (20 marks)

(f) Identify the key *operational* risks that confront Emmanuel Hire plc as a result of the purchase of Hughes Hire Ltd and state how these might be managed. (20 marks)

(100 marks)

Notes.

1. All recommendations must be supported by reasoned arguments.
2. All key workings must be shown and key assumptions must be clearly stated.
3. Workings should be in £000s
4. Ignore inflation.
5. Assume that corporation tax is payable nine months after the year end.

End of Project