Diploma in Financial Management

Module B

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 table of contents, 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

Section 1 – incorporating subject areas – Financial Strategy and Risk Management.

Burrator plc

Burrator plc was founded in 1996 by four academics from the University of Oxbridge and was floated on the London Stock Exchange in 2000. The company uses biochemistry and biotechnology to develop new treatments and dressings for severe wounds such as leg ulcers, burns and scars. Despite a promising start, the company experienced financial difficulties in 2002. Large losses, caused by high research and development costs, and a weak product pipeline led to a share price collapse. For a while it seemed that the company would go into liquidation, however, it was eventually taken over in 2003 and became a wholly-owned subsidiary of a large pharmaceutical company – Kes Pharmaceuticals plc.

Abridged versions of the group financial statements of Kes Pharmaceuticals plc (including Burrator plc) and the separate financial statements of Burrator plc for the most recent year are shown below.

Income statements for the year ended 30 June 2006

	Group results (incl. Burrator plc)	Burrator plc results
	£m	£m
Revenue	2,835	26
Cost of sales	(695)	(9)
Selling, general and administration expenses	(1,373)	(5)
Research and development expenses	(185)	(5)
Operating profit	582	7
Interest charges	(42)	–
Profit (loss) before taxation	540	7
Corporation tax (20%)	(108)	(1)
Profit (loss) attributable to shareholders	432	6

Balance sheets as at 30 June 2006

	Group financial position (incl. Burrator plc)		Burrator plc financial position	
	£m	£m	£m	£m
Non-current assets		1,470		20
Current assets	1,345		12	
Less Current liabilities	810		5	
Net current assets		535		7
Total assets less current liabilities		2,005		27
Less Non-current liabilities		620		–
		1,385		27
Equity				
£1 Ordinary shares		500		10
Retained profit		885		17
		1,385		27

Soon after the takeover, it became apparent that a mistake had been made as Burrator plc did not fit comfortably with the overall aims and objectives of the parent company. The directors of Kes Pharmaceuticals plc had failed to appreciate fully the nature of Burrator plc's business and the problems and issues that it posed. In January 2006 it was therefore decided that Burrator plc should be demerged soon after the end of the financial year to 30 June 2006. To prepare for this event, a new board of directors was appointed for Burrator plc and financial guarantees were made to ensure that the company could survive as a separate entity for a reasonable period. To ensure long-term survival, it was agreed that the newly-demerged company should immediately seek a listing on the Alternative Investment Market (AIM) in order to raise the profile of the company and attract investor interest. Shareholders in Kes Pharmaceuticals plc will own all of the shares of the demerged company and an appropriate number of shares in Burrator plc will be allocated to each shareholder.

A public announcement of the demerger will soon take place and this is expected to be welcomed by major institutional shareholders of Kes Pharmaceuticals plc. In the past, they have expressed doubts as to whether the acquisition of Burrator plc would enhance shareholder value and saw the acquisition as a distraction from the core business of the parent company. The finance director of Kes Pharmaceuticals plc therefore believes that the market will view the demerger as a signal that the parent company is returning to its core business activities and he expects a 5% increase in the P/E ratio, based on the pre-demerger group earnings of Kes Pharmaceuticals plc, once the announcement takes place. The current P/E ratio of the company is 10 times.

The advanced wound management sector, within which Burrator plc operates, is still in the early stages of development. The total global market size is approximately £800 million per year as at 30 June 2006 and it is expected to grow at a rate of between 8 and 10% each year up to, and including, 2013, as an ageing population drives demand. Thereafter, the market is expected to stabilise at the level achieved by the end of 2013. The main customers are Accident and Emergency and Surgical departments of hospitals in the UK and USA, which account for around 60% of the total market size. The concentration of demand in these countries is mainly due to the fact that other countries impose tight regulatory requirements for advanced wound management treatments and/or governments are not prepared to pay for such treatments.

To date, Burrator plc has failed to develop a strong pipeline of new treatments and dressings and the failure rate for new products has been higher than in many comparable biotechnology companies. Furthermore, two of the most successful treatments developed by the company came to the end of their useful lives during the year to 30 June 2006 and thereafter only two remaining treatments seem certain of generating revenues. These are:

Derova – a transparent dressing that can be easily removed. This polyurethane-based product requires less frequent dressing changes than conventional wound dressings and hastens the healing process by ensuring that essential proteins produced by the body are not absorbed by the dressing.

Polova – a temporary covering for burns. This tissue-engineered product acts as a skin substitute, providing protection for the wound and reducing pain.

It is estimated that each product has four years' life remaining and the share of the total market that each are expected to achieve over this period are set out below.

	Share of total market size for years ended 30 June			
	2007	2008	2009	2010
Product				
Derova	2·0%	1·5%	1·0%	0·5%
Polova	3·2%	2·4%	1·0%	0·4%

In the advance wound management sector, high levels of scientific and technological expertise are the critical success factors. Hence, strong links with leading universities are essential. Although the company was founded by academics, links with universities have been fairly weak. However, considerable effort has been invested in strengthening these links and Burrator plc has recently signed agreements with two leading universities, resulting in three new products in the development pipeline. These are:

AN 113 – an impregnated dressing. This product, which contains an amorphous hydrogel, loosens damaged tissue and helps to moisten wounds in order to encourage healing.

AN 144 – a plaster with a special polymembrane. This plaster contains cell tissues from the patients own skin thereby accelerating the healing process and avoiding rejection by the host.

AN175 – a moistening dressing for chronic wounds. This dressing relies on super-absorbent technology to ensure that sufficient moisture is retained to promote healing but excess moisture produced by the body is absorbed.

If the above treatments receive regulatory approval, the following estimates have been made concerning the market share of each product over their ten-year life.

Expected market share for the year ended 30 June

	2007	2008	2009	2010	2011	2012	2013 – 2017
Product							
AN113	–	1·5%	1·8%	2·0%	2·0%	2·5%	2·5%
AN144	–	0·2%	1·2%	2·4%	3·0%	3·6%	3·6%
AN175	–	0·1%	1·0%	1·8%	2·2%	2·4%	2·4%

Burrator plc does not have a sales and marketing division that is capable of dealing with the demands of a global market. Thus Burrator plc, which had not been taken over when the two existing treatments were first developed, had signed a licensing agreement with a large pharmaceutical company for the marketing and distribution of the treatments. This agreement gave Burrator plc a royalty of 30% of the sales proceeds from each treatment. It is quite common for biotechnology companies operating in the sector to do this and the company will shortly sign licensing agreements with another large pharmaceutical company relating to the treatments that are currently being developed. These will provide a royalty on future sales of each treatment, the amount of which will depend on the particular stage of development that has been reached.

A treatment must successfully complete three phases of clinical trials in order to obtain regulatory approval and, when negotiating licensing agreements, the more developed the treatment, the higher the royalty that can be expected. The trial phase reached and expected royalty for each treatment are as follows:

1. *AN113* is undergoing Phase I trials (which is the earliest point at which trials can be carried out on humans). Royalty payments will be 20% of sales, with a 100% contribution towards all future development costs.
2. *AN144* is undergoing Phase II trials. Royalty payments will be 40% of sales with a 100% contribution to all future development costs.
3 *AN175* is undergoing Phase III trials. Royalty payments will be 60% of sales with 100% contribution towards any remaining development costs.

The estimated total development costs for each product up to the launch are as follows:

	Total development costs up to launch
Product	
AN113	£2·6m
AN144	£2·2m
AN175	£1·4m

Industry data show that the chances of a treatment, at a particular trial phase, successfully completing all trial phases and receiving regulatory approval are as follows:

1. For treatments undergoing Phase I trials – 10%
2. For treatments undergoings Phase II trials – 30%
3. For treatments undergoing Phase III trials – 70%

If each treatment successfully completes the three phases of clinical trials, they will all be ready to launch at some point during the year to 30 June 2008.

Burrator plc outsources the manufacture of the treatments and dressing to traditional textile-dressings' manufacturers, specialist pharmaceutical companies and specialist chemical companies. Following the re-negotiation of contracts with suppliers and the reduction in administrative costs, the future total costs incurred by the company (excluding development costs) are estimated to be 45% of the expected value of the royalty payments received during each year. The company has no financial commitments beyond the year ended 30 June 2017.

In preparation for the AIM listing, the new board of directors of Burrator plc has been giving consideration to corporate governance issues. The board is convinced that good corporate governance will instill confidence among investors in the company and this may, in turn, lower the cost of capital. As part of its review of corporate governance procedures, it has decided to introduce an annual appraisal for each board member and has also decided to appoint two non-executive directors as the board currently has none. The board is clear as to the criteria that should be applied when appraising executive directors but has yet to decide what criteria should be applied to non-executive directors. It has therefore decided to seek advice on this issue.

Recently, the board of directors of Burrator plc identified a similar company that is currently listed on AIM. Kilmar plc operates within the advanced wound management sector and has been listed on AIM for the past three years. The abridged financial statements of the company for the year ended 30 June 2006 are shown below.

Income statement for the year ended 30 June 2006

	£m
Revenue	46
Cost of sales	(15)
General and administration expenses	(10)
Research and development expenses	(11)
Operating profit	10
Interest charges	(1)
Profit before taxation	9
Corporation tax (20%)	(2)
Profit (loss) attributable to shareholders	7

Balance sheet as at 30 June 2006

	£m	£m
Non-current assets		29
Current assets	28	
Less Current liabilities	15	
Net current assets		13
Total assets less current liabilities		42
Less Non-current liabilities (Loan capital)		15
		27
Equity		
£1 Ordinary shares		10
Retained profit (loss)		17
		27

The ordinary shares of Kilmar plc have a current market value of £5·40 per share and the equity beta is 1·7. Returns to the market are 10·5% and the risk-free rate is 3·2%. The loan capital is irredeemable and currently trading at £120 per £100 nominal value. The corporation tax rate is 20%.

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Required:

(a) Evaluate the proposal for the demerger of Burrator plc. In carrying out this evaluation you should:

(i) Provide an estimate of the average cost of capital for Burrator plc. (10 marks)

(ii) Suggest a value for each share in Burrator plc that could be used as a basis for the company's flotation on AIM, assuming that global demand for advanced wound dressings is:

(1) at the lower end of expectations;

(2) at the higher end of expectations. (27 marks)

(iii) Derive a value for each share in Burrator plc using an alternative valuation method to that used in (ii) above in order to test the validity and reliability of your earlier valuations and comment on your findings. (8 marks)

(iv) Recommend an appropriate allocation of shares in Burrator plc to the shareholders of Kes Pharmaceuticals plc and, using the most conservative share value derived from your answers to (ii) and (iii) above, assess the likely effect of the proposed demerger on the wealth of an institutional shareholder holding 100,000 shares in Kes Pharmaceuticals plc. (11 marks)

(56 marks)

(b) Prepare a briefing paper for the board of directors of Burrator plc setting out the criteria that may be used in the annual appraisal of a non-executive director. (16 marks)

(c) Prepare a report for the board of directors of Burrator plc which identifies and assesses the key risks faced by the company after the demerger and which explains how these risks may be managed. (28 marks)

Notes:

In answering the case study questions:

1. All key workings must be shown and key assumptions must be clearly stated.
2. The estimate derived in (a)(i) should be to the nearest percent.
3. Workings in (a)(ii) and (a)(iii) should be in £ millions and to one decimal place.
3. Ignore inflation.
4. Assume that corporation tax is paid in the year to which it relates.

(100 marks)

End of Project