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.

Module B

The Association of Chartered Certified Accountants

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

This ONE question is compulsory and MUST be attempted

Centaur Communications plc

1 Centaur Communications plc is a large media business that is listed on the London Stock Exchange. The company runs its operations through two, wholly-owned subsidiaries – Centaur Magazines Ltd and Centaur Radio Ltd. To date, the two subsidiaries have been allowed considerable autonomy, with each being responsible for its own investment and financing decisions. Details of each subsidiary are set out below.

Centaur Magazines Ltd

Centaur Magazines Ltd is the larger of the two subsidiaries. The company owns several famous UK magazine titles, with each occupying a leading position in the particular market served. In recent years, the company has expanded into Europe and now owns leading magazine titles in Spain, Portugal and France. It believes that magazine sales in mainland Europe are likely to grow rapidly in the near future as the Euroland economies come out of recession. The company is committed to having an increasing presence in mainland Europe and, to this end, the following titles are about to be launched:

1. *Tele mois* – a monthly TV listings magazine aimed at the French market;
2. *Nouveau Homme* – a monthly men's magazine also aimed at the French market;
3. *Hasta La Vista, Baby* – a weekly movie magazine aimed at the Spanish market.

The launch of these magazines is in line with the declared strategy of making the company the largest magazine publisher in Europe.

The most recent financial statements of Centaur Magazines Ltd are as follows:

Abridged profit and loss account for the year ended 31 January 2006

	£000
Sales revenue	180,000
Operating profit	37,750
Interest payable	4,000
Net profit before tax	33,750
Corporation tax (20%)	6,750
Net profit after tax	27,000
Dividends proposed and paid	16,200
Retained profit for the year	10,800

Abridged balance sheet as at 31 January 2006

	£000	£000
Fixed assets		
Property, plant and equipment		27,400
Goodwill		45,000
Publishing rights and titles		49,600
		122,000
Current assets		
Stocks	2,500	
Trade debtors	58,500	
Other debtors	980	
Cash	20	
	62,000	
Creditors: Amounts due within one year		
Trade creditors	31,800	
Other creditors	6,200	
Bank overdraft	2,000	
	40,000	
		22,000
		144,000
Creditors: Amounts due beyond one year		
Loan capital		54,000
		90,000
Capital and reserves		
Ordinary shares of £1 each		20,000
Retained profit		70,000
		90,000

The subsidiary is committed to strong growth and sales are set to rise rapidly. A sales forecast for the next five years has been produced by the marketing director of Centaur Magazines Ltd, which is as follows:

Sales forecast for the year ended 31 January

Year	£000
2007	206,000
2008	252,000
2009	312,000
2010	356,000
2011	382,000

The board of directors of Centaur Magazines Ltd is currently reviewing the amount of finance required to sustain its growth strategy. When considering this matter, the following key assumptions were made by the board members:

1. The parent company, Centaur Communications plc, will continue to receive the same percentage of profits in the form of dividends as it currently receives.
2. The current net profit margin (after tax) will be maintained for the foreseeable future.
3. The current debt/equity ratio will be maintained in order to maintain the same level of financial risk.
4. The current sales to capital employed ratio will also be maintained to ensure sufficient resources are available to sustain the level of sales.
5. Finance will be made available by the parent company to cover any shortfall in funds that cannot be covered by additional loan capital.

A plan covering the next five years, which sets out the financing requirements, is to be presented to the board of directors of the parent company, Centaur Communications plc, with a view to obtaining any additional finance that may be required.

Centaur Radio Ltd

Centaur Radio Ltd operates a number of commercial radio stations, all of which were acquired ten years ago when the parent company was seeking to diversify its interests. The main radio stations operated are:

– Yoof-2day – consisting of two analogue stations and ten digital stations with more than two million listeners throughout the UK. It is targeted at 15–24 year olds and plays indie, dance and Hip Hop music.

– Wrinkly Rock – consisting of six analogue and five digital stations with more than four million listeners in South East of England, South West England, Wales and Scotland. It is targeted at 35–54 year olds and plays hits from rock and pop legends of the 1960s, 1970s and 1980s.

– Radio Ga-Ga – consisting of four analogue and eight digital stations with more than one million listeners in Southern England and Wales. It is targeted at those in the 50+ age range and plays easy-listening music.

The most recent financial statements of Centaur Radio Ltd are as follows:

Abridged profit and loss account for the year ended 31 January 2006

	£000
Sales revenue	75,000
Operating profit	7,500
Interest payable	–
Net profit before tax	7,500
Corporation tax	–
Net profit after tax	7,500
Dividends proposed and paid	4,500
Retained profits for the year	3,000

Abridged balance sheet as at 31 January 2006

	£000	£000
Fixed assets		
Property, plant and equipment		8,500
Goodwill		65,000
		73,500
Current assets		
Debtors	12,500	
Cash	500	
	13,000	
Creditors: Amounts due within one year		
Trade creditors	18,900	
Other creditors	3,600	
	22,500	(9,500)
		64,000
Capital and reserves		
£1 Ordinary shares		20,000
Retained profit		44,000
		64,000

Although the commercial radio stations are now making profits, the board of directors of the parent company, Centaur Communications plc, has been dissatisfied with their performance. None of the radio stations enjoy a leading position in the particular markets served and it seems that a considerable investment of time and resources would be required to improve their market position.

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The board of directors of Centaur Radio Ltd has been asked by the parent company to come up with a five-year plan that will establish each radio station as a leading player in the market served. In response, the marketing director of Centaur Radio Ltd believes that, if sufficient resources were made available, the following sales could be achieved:

Sales forecast for the year ended 31 January

Year	£000
2007	80,000
2008	87,000
2009	98,000
2010	107,000
2011	116,000

To achieve these sales, the following additional investment would be required:

Additional investment requirements

	Additional fixed assets	Additional working capital
Year ended 31 January	£000	£000
2007	12,700	5,300
2008	12,800	5,500
2009	13,700	5,200
2010	5,200	5,100
2011	2,500	4,420

The additional investments in fixed assets will be written off over a ten-year period using the straight-line method of depreciation. Depreciation charges are currently £830,000 a year, and have totalled the same amount for each of the past ten years. The additional depreciation resulting from the additional investments could be offset by savings elsewhere and so net profit margins are not likely to be affected.

When drawing up the plans for presentation to the board of the parent company, the directors of Centaur Radio Ltd will use a slightly different method of establishing its future annual cash flows and financing needs than that used by Centaur Magazines Ltd. It will also use the following key assumptions:

1. The parent company, Centaur Communications plc, will continue to receive the same percentage of profits in the form of dividends as it currently receives.
2. The current operating profit margin will be maintained for the foreseeable future.
3. As a result of heavy tax losses in earlier years, no taxation will be paid by the company during the five-year period.

Although the board of directors of Centaur Communications plc will consider the plans to be presented by the board of Centaur Radio Ltd, it is by no means certain that they will be accepted. Committing funds to both the future growth of magazine sales and to the future growth of the commercial radio stations will place a considerable strain on resources. Furthermore, the commitment to the radio subsidiary is wavering. Some members of the board of Centaur Communications plc argue that the magazine business has far better long-term prospects and that the radio stations are really a distraction from its core operations.

Astrid Ltd

The board of Centaur Communications plc has recently been approached by Astrid Ltd, a venture capital business. During lengthy discussions, the venture capitalist offered to pay 12 times the current operating profits to acquire Centaur Radio Ltd. This unexpected offer brought the discussion concerning the future of the radio business to a head. However, a final decision on the future of the subsidiary was deferred until the board had the opportunity to consider the five-year plan being drawn up by the directors of Centaur Radio Ltd.

The offer made by Astrid Ltd was based on its own background research and on information provided by the directors of Centaur Communications plc during their discussions. The venture capitalist believes that it would be possible to work the existing assets of Centaur Radio Ltd harder and, as a result, much more modest levels of investment would be needed than those planned by the directors of the company. Nevertheless, it was believed that sales growth could still be achieved with the introduction of a more able and committed management team. The following sales forecast was produced by Astrid Ltd for the radio subsidiary.

Sales forecast for the year ended 31 January

Year	£000
2007	78,000
2008	82,000
2009	88,000
2010	95,000
2011	104,000

To achieve these sales, Astrid Ltd believes that the following additional investment would be required:

Additional investment requirements

Year ended 31 January	Additional fixed assets £000	Additional working capital £000
2007	3,800	1,000
2008	4,300	800
2009	5,600	200
2010	3,400	400
2011	3,400	100

The additional investments in fixed assets will be written off over a ten-year period using the straight-line method of depreciation. Astrid Ltd also believes that it would be possible to maintain the existing operating profit margin as additional depreciation charges would be offset by cost savings elsewhere.

The offer by Astrid Ltd was made subject to appropriate due diligence investigations. Assuming these are satisfactory, the venture capitalist proposes to invest £48·6 million in order to acquire 90% of the ordinary share capital. A team of managers, appointed from outside Centaur Radio Ltd, will be expected to invest £5·4 million to acquire the remaining 10% of the ordinary shares. The remaining funds are expected to be raised by Centaur Radio Ltd using a bank loan with an annual rate of interest of 6%. However, the financing arrangement just described may be altered if necessary. If the buyout proposal is accepted, Centaur Radio Ltd will be kept as a private limited company for five years, after which time it will be turned into a public company and floated, either on the Alternative Investment Market (AIM) or on the main market of the London Stock Exchange. Similar radio companies command a price/earnings ratio of around 14 times and it is believed that Centaur Radio Ltd would eventually be floated at this figure. When the company is floated, Astrid Ltd will realise the investment by selling its shares.

During the period leading up to the flotation, no dividends will be paid and all available cash generated by the company will be used to repay the outstanding loan. Any loan amounts still outstanding at flotation will be paid off by Astrid Ltd and the management team from the proceeds of the sale of their shares. Astrid Ltd has a cost of capital of 21% and uses the internal rate of return (IRR) method to assess investment opportunities.

The accumulated tax losses will be available for Astrid Ltd and will be sufficient to ensure there will be no tax liability on the projected profits.

Required:

(a) Based on the assumptions mentioned by the directors of each company, calculate the annual financing requirements for each of next five years, for:

(i) Centaur Magazines Ltd; and

(ii) Centaur Radio Ltd. (24 marks)

(b) Comment on the assumptions of the respective directors and upon the results of the calculations in (a) above and state, with reasons, which of the approaches used to establish the financing requirements for each company you would recommend. (10 marks)

(c) Identify and discuss the issues that the board of directors of Centaur Communications plc should consider before making a final decision concerning the divestment of Centaur Radio Ltd. (10 marks)

(d) Prepare a report for Astrid Ltd, which:

(i) evaluates the viability of the proposed investment in Centaur Radio Ltd using IRR; and

(ii) demonstrates how the IRR of the proposed investment might be improved without changing the underlying assumptions (made by Astrid Ltd) regarding sales, operating profits, the acquisition or disposal price of the company. (28 marks)

(e) Assuming the bid for Centaur Radio Ltd is accepted, identify and discuss:

(i) the information that Astrid Ltd may gather when carrying out a due diligence investigation on Centaur Radio Ltd; and

(ii) the factors that may be taken into account when deciding between AIM and the main market of the London Stock Exchange for the eventual flotation of Centaur Radio Ltd. (28 marks)

Notes:
In answering the case study questions:
1. All key workings must be shown and key assumptions must be clearly stated.
2. Calculations should be to the nearest £000.
3. Ignore inflation.

(100 marks)

End of Project