Final Level

Management Accounting – Financial Strategy

13 FLFS

25 May 2004

Tuesday afternoon

INSTRUCTIONS TO CANDIDATES

Read this page before you look at the questions

You are allowed three hours to answer this question paper.
Answer the ONE question in Section A. Answer TWO questions ONLY from Section B.
Maths Tables and Formulae are provided which can be downloaded separately from the CIMA website.

SECTION A – 50 MARKS

READ THE SCENARIO AND ANSWER THE QUESTION

Question One

Background

The Hi-clean Group is a UK-based unlisted company that imports, assembles and distributes laundry and cleaning equipment for hotels and restaurants and for public sector departments, such as hospitals, prisons and the armed forces. The company was formed in 1985 with £24 million start-up capital in ordinary shares of £1. No other capital has been raised since then, except from the venture capital company explained below.

The company has seen growth in turnover and post-tax profits of around 20% each year over the past three years in all sectors of its customer base, although sales to the public sector now account for a much higher proportion of the total than five years ago: 38% in 2004 compared with 18% in 2000.

Details on major shareholder

A venture capital company owns 20% of the company's shares, bought three years ago for £25 million. The venture capital company also provided a £25 million loan with equity warrants attached. The loan carries a variable rate of interest, LIBOR + 3%, and is repayable in 2006. The warrants allow for the venture capital company to buy 1 share at 400 pence for every £10 of debt at the time the loan is repaid. This shareholder is looking to exit from its investment in Hi-clean in two to three years time. Unless Hi-clean has obtained a share listing by then, the venture capital company has indicated it is unlikely to exercise its warrants. The venture capital company's usual required return is an average of 50% per annum (dividends plus capital gain as percentage of initial investment) over a five-year investment period.

Although the venture capital company has a seat on the Hi-clean Group board, it has taken a very "hands-off" approach and had little involvement in the company's direction or management.

Forecast results for the year to 31 December 2004

The accounts department has produced the following full-year forecasts for 2004.

Results by sector:

	Public sector	*Hotels and restaurants*	*Total*
	£ million	*£ million*	*£ million*
Turnover	83·60	136·40	220·00
Direct costs	45·98	68·20	114·18
Gross profit margin	37·62	68·20	105·82
Fixed overheads *	26·53	43·29	69·82
Operating profit	11·09	24·91	36·00

* Fixed overheads are apportioned to operating sectors on the basis of turnover.

Summary group profit and loss account:

	£ million
Operating profit	36·00
Interest payable	1·75
Profit before taxation	34·25
Taxation	6·17
Profit after tax	28·08
Ordinary dividends	8·43

Summary group balance sheet:	*£ million*
Fixed assets (net book value)	124·00
Net current assets	48·00
Loan capital	25·00
Assets less liabilities	147·00
Capital and reserves	
Called up share capital (Ordinary shares of £1)	30·00
(Authorised share capital £35 million)	
Share premium account	18·00
Profit and loss account	99·00
Shareholders' funds	147·00

Future funding and request for study

Hi-clean's directors have, for some time, been considering a public listing for the company's shares to raise new finance and provide an exit route for the venture capital company. Assume you are the Financial Manager with Hi-clean. The directors have asked you for a study that includes a forecast of the company's financial situation at 31 December 2005. You have spent the last month obtaining the following information from a variety of sources.

Growth in turnover and profits:

You expect growth to continue but not at the high levels seen over the past few years. A complication is that a general election will take place shortly and the outcome will have an effect on Hi-clean's business. If Party A wins, it has promised more money for some public sector departments, which may increase Hi-clean's sales to its public sector customers. However, this increased spending would be paid for by an increase in certain taxes that would adversely impact on some of Hi-clean's private customers. If Party B wins, spending on public services will also increase, but not necessarily in areas serviced by Hi-clean. Opinion polls suggest Party A has a 60% chance of winning and Party B 40%.

Based on your informed opinion about prospects for the economy and the industry, you forecast the following range of turnovers and probabilities for 2005, by sector, depending on which party wins the election.

		Public sector		*Hotels and restaurants*
If Party A wins:	Turnover £ *million*	102·00	112·00	123·00
	Probabilities	0·55	0·45	1
If Party B wins:	Turnover £ *million*	95·00	110·00	143·00
	Probabilities	0·50	0·50	1

Other information/assumptions:

- Corporate tax will be payable at the current percentage level of 18% owing to availability of capital allowances. No capital expenditure is planned for 2005.
- Gross profit margin percentage by sector is expected to remain unchanged irrespective of the election outcome.
- Fixed costs are expected to rise to £71·8 million.
- LIBOR is currently 4%. It is expected to fall to 3% in 2005.
- Average P/E ratio and cost of equity capital for listed companies in this industry are currently 11 and 9% respectively. It is difficult to forecast how P/E ratios will move over the next 12 months but market professionals are expecting an upturn in the market generally, so anything between 12 and 15 is not unreasonable.
- The dividend payout ratio has been constant at 30% since 2001.

Required:

(a) For 2005, calculate forecasts of the following:

(i) turnover, gross margin and operating profits by customer sector;

(ii) a profit and loss account and earnings per share for the Hi-clean Group.

Assume a full-year effect for all the changes forecast for 2005. Provide comments to accompany your forecasts that explain any significant changes between 2004 and 2005.

(10 marks)

(b) As Financial Manager, write a report to the directors of Hi-clean Group. In your report you should:

(i) Calculate a range of potential values as at the end of 2005 for the entire Group and for the venture capital company's shareholding. Base your calculations on the information you have available and assume the Group remains a private, unlisted company. Accompany your calculations with a brief discussion of each valuation method.

(ii) Comment on the reasons for potential differences between the value of the entire company and the value of the venture capital company's shares (that is, why the value of the venture capital company's shares might not be strictly proportionate).

(18 marks)

(c) Based on your forecasts, estimate whether the venture capital company will achieve its target return on investment in Hi-clean and identify exit strategies that might be available to the investor in 2006. Evaluate how the venture capital company's situation might affect Hi-clean's future financial strategy.

(10 marks)

(d) Identify the main risks and opportunities facing the company and advise on methods of managing the risks.

(12 marks)

(Total = 50 marks)

SECTION B – 50 MARKS
ANSWER TWO QUESTIONS ONLY

Question Two

VID Inc is a US-based company, which was established 15 years ago. It makes and distributes videos, both for the general market and to customer specifications. Its common stock (shares) have been listed on a US stock exchange for the past 8 years. However, there are relatively few stockholders and the stock is not traded in large volumes. The founders of the company no longer participate in its management but own around 10% of the stock in issue.

VID Inc borrowed US$ 65 million to purchase new premises three years ago, which have recently been valued at US$ 85 million. The company is now considering diversifying into mainstream film production, which will require raising US$ 50 million for additional fixed and working capital. This new business will involve joint ventures with UK partners and much of the filming will be done in the UK or Spain. The new investment is not expected to have a significant effect on profits for at least 18 months.

The three methods being considered for raising capital are:

(i) New equity in the UK, subject to US stockholders' approval;

(ii) Long-term fixed rate US$ debt;

(iii) Floating rate sterling-denominated Eurobonds.

Summary financial statistics for the last financial year for VID Inc are as below.

	US$ millions
Turnover	175·00
Operating profit	45·00
Post-tax profits	31·36
Fixed assets (book value)	95·00
Net current assets	58·00
Long-term loans:	
8% redeemable 2030	65·00
Common stock (in units of US$ 1)	25·00
Retained earnings	63·00
Share price (US$):	
High for year	28·56
Low for year	18·50
As at today (25 May 2004)	22·58

Current annual fixed interest rates for secured long term borrowing are as follows:

US$ 6% UK £ 7% European common currency area € 5%

Floating rate sterling Eurobond notes are available at the bank base rate +0·5%. Tax will continue to be payable at 20% per annum.

Required:

Assume you are a financial adviser to VID Inc. Evaluate the three methods of finance being considered at the present time and advise the directors of VID Inc. Support your advice with any calculations you consider appropriate. Assume, for the purposes of this evaluation, that the P/E ratio of the company will rise to 20 if equity finance is used, or 19 if fixed or floating rate debt is issued. Make only other simplifying assumptions you think necessary and appropriate.

(Total = 25 marks)

Notes: Up to 10 marks are available for calculations. A report structure is not required for this question.

Question Three

SK Consortium is an international PR and marketing agency. Its shares are listed on an international stock exchange. The company is based in London, but has offices throughout Europe, the Far East and India. Many members of staff are recruited locally. They are supplemented by members of staff based in corporate headquarters in London, but who work worldwide.

SK Consortium generally invoices in the customer's currency. For many years it followed a policy of not hedging currency risks, and has generally profited from this. The Finance Director, who was widely credited with successfully managing the treasury function, has retired. However, the "no hedging" policy was not without its critics among major investors and financial analysts.

The SK Consortium Board is now concerned about currency volatility and the potential effect on its market value and wishes to evaluate different hedging mechanisms. The recently-appointed new Finance Director has suggested using either currency futures or forward contracts. She proposes to demonstrate to the directors how futures and forward contracts would have worked if a forthcoming transaction had been hedged. The details are as follows:

Receipt of US$ 875,000 is due on 1 June 2004. The company has known since the end of February 2004 that this receipt is to be expected.

Market information at 1 March 2004

Exchange rates		**US$ futures**			
US$/£		**US$/£, contract size £62,500**			
			Price	*Initial margin*	*UK interest rate (% per annum)*
Spot	1·6132				
One month forward	1·6100	March	1·6022	£1,000	3·38
Three months forward	1·6038	June	1·5950	£1,500	3·41

Required:

(a) Despite its success, the "no hedging" policy was criticised. Discuss the basis for such criticism among investors and analysts and explain why and to what extent this policy, if continued, might affect the market value of the company's shares.

(8 marks)

(b) *(i)* Assume it is now 1 June 2004. The spot rate US$/£ is 1·6080 and the June 2004 currency futures rate is 1·6085. Calculate the net receipts in sterling that would have been expected on 1 March and today (1 June) under the two alternative hedging methods and comment on which would have been the most financially advantageous. Assume the profit (or variation) margin would be settled on the maturity or disposal of the futures contract.

(ii) Discuss the main features of these two hedging instruments and comment on their suitability for a company such as SK Consortium.

(17 marks)

Notes: *Marks are distributed roughly equally between the two sections of requirement (b).*
A report structure is not required for this question.

(Total = 25 marks)

Question Four

TMc is a large cosmetic and toiletries retail organisation based in a country within the European common currency zone. Its current turnover is approximately €1·4 billion and it has an asset base of €750 million.

The company is evaluating opening up to 10 new retail outlets in a country in Asia, to be financed by its existing cash or other highly liquid assets. It proposes to operate these new retail outlets itself for the first two years of operation. After that time, and subject to satisfactory commercial and financial performance, each outlet will be offered as a franchise to either the outlet manager/employees or to a third party.

Forecast nominal cash flows for the first two years of operation for a single outlet are as follows:

	Year 0	*Year 1*	*Year 2*
	Asian $ million	*Asian $ million*	*Asian $ million*
Initial investment	-15		
Pre-tax operating cash flows		4·5	5·5

Exchange rate information is as follows:

Spot rate as at today € / Asian $	0·65

Forecast inflation rates (% per annum):

European common currency area	1·50
Asian country	3·50

Estimated cash flows beyond year 2 depend on the type of operation. If the company continues to operate the outlet, it assumes zero growth per year on year 2's post-tax *Euro* operating cash flows until the end of year 10. Cash flows beyond year 10 are ignored. If the outlet is franchised, there will be a one-off taxable payment by the franchisee at the beginning of year 3 of Asian $500,000 plus an annual payment in perpetuity of Asian $3·2 million (both figures in today's money), commencing at the end of year 3.

Additional information

- Corporate taxes in the Asian country are 30% per annum, payable or refundable the year in which the liability to tax arises. In the European country, they are 35% payable or refundable the following year. Double taxation agreements are in force between the two countries. Both countries allow 100% writing-down allowance for investments of this type.
- TMc uses 9% as the discount rate in its investment appraisals.
- All operating cash flows may be assumed to occur at the end of each year. The initial capital investment will be made at the beginning of year 1 and written off over 5 years.
- TMc evaluates international investments by converting the foreign currency cash flows to €s and applying its domestic cost of capital.

Required:

Evaluate the proposed investment and recommend whether it should proceed. You should include in your evaluation some discussion of the risks that might be associated with the two alternative methods of operation being considered after year 2 and advise on how these risks might be managed.

(Total = 25 marks)

Notes: Up to 10 marks are available for calculations.
A report structure is not required for this question.

Question Five

A regional police force has the following corporate objectives:

- to reduce crime and disorder;
- to promote community safety;
- to contribute to delivering justice and maintaining public confidence in the law.

The force aims to achieve these objectives by continuously improving its resources management to meet the needs of its stakeholders. It has no stated financial objective other than to stay within its funding limits.

The force is mainly public-funded but, like other regional forces, it has some commercial operations, for example policing football matches when the football clubs pay a fee to the police force for its officers working overtime. The police force uses this money to supplement the funding it receives from the government. The national government is proposing to privatise (that is, sell off) these commercial operations and has already been in preliminary discussions with an international security company. This company's stated financial objectives are:

- to increase earnings per share year on year by 5% per annum; and
- to achieve a 20% per annum return on capital employed.

Arguments put forward by government in favour of privatisation focus on the conflict of objectives between mainstream operations and commercial activities, and savings to the taxpayer. However, the proposals have met with strong opposition from most of the force's stakeholders.

Required:

(a) Discuss the reasons for the differences in the objectives of the two types of organisation given above. Use the scenario details given above to assist your answer wherever possible.

(12 marks)

(b) Discuss the influence the commercial operations might currently have on the police force's ability to meet its stated objectives. Include in your discussion an evaluation of the possible effects on mainstream services and the various stakeholder groups if the commercial operations were to be privatised.

(13 marks)

(Total = 25 marks)

End of paper