Domusco - Unseen material provided on examination day

Read this information before you answer the question

Acquisition of KLT by Domusco

Domusco is experiencing cash flow difficulties, due primarily to the slow selling of houses and offices in the Hadsi development. However, in July 2005 Domusco announced a bid for KLT Construction (KLT), a listed house building company based in Zee, which has house building subsidiary companies in several European countries. KLT is one of the construction companies building over 4,000 housing units in the Hadsi development project.

Peter Kaye was very much in favour of the acquisition of this key competitor and together with Marma Winge, who was keen to see the expansion in his division, persuaded the other Board members to vote in favour of this acquisition.

The three reasons why they considered KLT to be a good acquisition were:

- It would enable Domusco to increase its market share in Zee;
- It would give Domusco access to KLT's European infrastructure, in order for Domusco to be able to expand its European operations into countries in which Domusco has not yet operated;
- It would give Domusco access to KLT's large land bank for future construction projects, mainly in Europe.

Martyn Lite was not in favour of the acquisition of KLT for two reasons. First, the company had insufficient cash for the acquisition, without raising further loans, which he did not want to do. Second, he felt that the company was stretching its management resources at present. However, the Domusco Board agreed to bid to acquire KLT.

KLT's share price, prior to bid announcement in early July 2005, was Z$4·17 per share, which was near to its all time high. Domusco announced an offer equivalent to Z$5·00 per share, valuing KLT at Z$550 million, which was accepted by KLT's shareholders.

Domusco paid Z$400 million in cash and the balance of Z$150 million in shares, resulting in Domusco issuing around 10·85 million new shares for this acquisition, based on Domusco's share price of Z$13·82 per share. In order to finance the cash payment for KLT, Domusco increased its loan finance, as it had insufficient cash generated from operations. Domusco arranged a new 5-year loan of Z$300 million at 9% interest per year, with local bankers in Zee in mid July. This is the only new loan taken on by Domusco so far in 2005.

The synergies from the acquisition are expected to be Z$10 million per year from 2006. However, market analysts did not approve of Domusco's acquisition of KLT, and Domusco's share price fell. By the end of July 2005 it was down from Z$13·82 to Z$12·16, a fall of 12%.

Zee government announcement of interest rate changes

From mid-September 2005, there were a few weeks of exchange rate turbulence in Zee, as well as in several other non-Euro European countries and some Middle East countries.

The Zee government announced a 2% rise in its interest rates on 1 October 2005 in an attempt to protect its exchange rate. The exchange rates between the Zee dollar and the Euro and the US dollar have now changed and after fluctuations over the preceding few weeks appear to have settled down.

On 31 October 2005 the exchange rates were as follows:

	Z$ to US$	Z$ to Euro
Exchange rates on 31 October 2005	3·97	3·12
Exchange rates at 30 June 2005	3·25	2·55
Exchange rates ruling on 30 June 2004 (when Domusco non-Zee dollar loans were signed)	3·18	2·51

Note: Shading indicates information given in the pre-seen material.

When Martyn Lite arranged the new loan of Z$300 million to finance the KLT acquisition he was aware that Domusco's loans would bring Domusco to just within the limits of one of the loan covenants that are attached to the two loans from the ALT and BRG banks taken out for the Hadsi project. This loan covenant states that Domusco's total loans must not exceed 40% of shareholders' equity plus total loans. Shareholders' equity is defined as share capital, share premium and retained earnings.

Domusco had un-audited post tax (pre-dividend) profits of Z$318 million for the first half year to 30 June 2005. Domusco's post tax cost of capital is 10%.

European sports stadium contract

At the June 2005 Domusco Board meeting Peter Kaye announced that Domusco had been awarded the contract to construct a national sports stadium in a European country at a total revenue to Domusco of €180 million (approximately Z$459 million).

Peter Kaye had stated that he was surprised that Domusco had been awarded this contract as he had thought that Domusco had been removed from the shortlist some months before. When Peter Kaye discussed the proposed new contract with Richard Sears, Domusco's Head of Construction for Sports Facilities, Richard Sears openly stated that he had made two payments to government representatives in order to win the contract. Peter Kaye was furious that he had not been consulted about making these payments.

Peter Kaye is very concerned that the media will discover these payments. Peter Kaye discussed the matter urgently with Martyn Lite. After investigations Martyn Lite informed Peter Kaye about the following irregularities:

- Two payments, each for €200,000, had been paid eight weeks previously. The requests for both payments had been made and authorised by Richard Sears. Payments of this amount (totalling over Z$1,000,000) were within his limit of authority.

- The payments had been made by bank transfer and after investigation were not paid to the accounts for the government, nor any company involved in the bid, but to the private bank accounts of two advisors to the government.

Martyn Lite agreed to discuss the matter with the Chairman and Chief Executive, Will Umm, as a matter of urgency and requested that Peter Kaye delays the date for contract signing. The government of the European country that is financing the stadium is keen to announce that the contract will be awarded to Domusco and for construction work to commence. Peter Kaye has so far been able to defer contract signing but has been told by the government of the European country which is financing the stadium, that contracts must be signed by end December 2005 at the latest. The government of the European country is frustrated by Domusco's slow progress with this high profile stadium and is threatening that this could affect Domusco's ability to win further government financed contracts in future.

Low sales of houses and office buildings in the Hadsi development

The Domusco plan assumed that 90% of housing units in Hadsi would be sold before construction is completed, with some housing units sold off-plan (where customers purchase a house or apartment based purely on detailed site plans before construction has commenced) and some sold whilst construction work is in progress. Therefore, Domusco planned to be left with only 10% of housing units to be sold when the site is completed.

However, despite the high amount of publicity and marketing work that Domusco and the other construction companies had generated, the sale of housing units was extremely low. Domusco had achieved sales of only 920 housing units by the end of September, which was less than 31% of the first phase of 3,000 housing units that are currently under construction. Domusco does not want to slow down the construction process, although it may need to as the company is experiencing cash flow difficulties due to lack of sales of housing units in Hadsi, as well as elsewhere in Zee.

In addition, KLT is also experiencing low sales of its housing in Zee (both in Hadsi and elsewhere in Zee). However, KLT's housing under construction in other European countries is selling well and is in accordance with plan.

Piers Moore is very disappointed in the level of sales in Hadsi and has requested an additional promotional budget of Z$5 million to try to boost sales. Will Umm is not keen to spend any more on marketing costs, since the Zee Government has still not fulfilled its undertaking to promote the general development in the Hadsi area, on behalf of all of the construction companies.

The Zee government had previously agreed, as part of the sale of land agreement, that it would spend Z$20 million on promotional campaigns about the Hadsi development to encourage companies to relocate to Hadsi. So far it is estimated that the Zee government has spent less than Z$2 million. Will Umm and Tom Micol have raised their concerns to the relevant government minister, who had promised that the government funded marketing campaign would be continued. However, by the end of October 2005, the Zee government had not undertaken any further promotional work of the Hadsi area.

Domusco's construction costs on the Hadsi project are on budget. However, with the low level of sales, Marma Winge is getting worried that the housing units under construction will remain unsold. Furthermore, Domusco has only signed contracts for the sale of two of the twelve office buildings under construction. Therefore, Domusco's construction costs were far outweighing customers' deposits, and the Hadsi development is becoming a drain on Domusco's working capital.

Domusco had acquired the entire Hadsi site and had sold plots of land to five other construction companies. The amount of land that the Domusco Board agreed to develop was around 40% of the entire site, and Domusco still held 9% of the Hadsi land that it wished to sell, valued at Z$102 million. So far this land remains unsold and is in its land bank, reported as inventory in Domusco's balance sheet. However, Domusco's auditors have advised that this land value may need to be written down significantly, to Z$30 million.

Organisational change

Domusco Office Building subsidiary

At the September 2005 Board meeting the Board considered a proposal to either close down its Office Building subsidiary or to merge it with the Major Construction Projects subsidiary. The Office Building subsidiary is experiencing difficult trading conditions and has recently lost two sales. Both lost sales will receive some level of compensation, but the expected sales revenue, running into millions, will not be achieved.

Additionally there are several office buildings that are behind schedule in construction, with costs higher than forecast, due to poor project management. Will Umm does not want to lose Tan Lee's management skills from the company but also cannot allow this subsidiary to make losses.

Tan Lee defended the track record of his subsidiary and he also stated that he was unwilling to work for Peter Kaye, who Tan Lee considers has mis-managed the Wye motorway project, which has resulted in large losses for Domusco. Tan Lee stated that he considered that Domusco has been stretching its management resources too much and the recent losses of office building sales are merely a temporary setback.

Project planning

A further organisational change that has been raised by Peter Kaye is that the project planning division, headed up by Derek Alder, should oversee all project planning for all of the Domusco group subsidiary companies. At present Derek Alder's team only undertakes project planning and project management for major construction projects. Each of the other two subsidiary companies within the Domusco group is currently responsible for its own project planning and project management work and the professionalism varies between the different Domusco subsidiary companies.

Domusco's share price

With the recent fluctuations in exchange rates, many Zee companies have experienced falls in their share prices. However, since July 2005 Domusco has seen its share price fall from its high of Z$13·82 to just under Z$8·00, due to lack of confidence by the majority of Domusco's institutional investors. They fear that Domusco has taken on too much of the Hadsi project, which to date, has not been successful.

One of Domusco's institutional investors is threatening to sell all of its shares in Domusco, which could lead to a further fall in its share price. This investor is astute enough to realize that Domusco must be starting to suffer an acute shortage of working capital due to the recent low level of sales in Zee. It has asked Tom Micol to take urgent management action to address shareholders' concerns.

By the end of October 2005, Domusco's share price had fallen further to Z$7·50 per share.

Finance Director resigns

The financial press in Zee had been critical of the acquisition of KLT Construction by Domusco. The financial press had stated that Domusco had paid too much for KLT and that the timing of the acquisition was wrong and the media is also concerned about the difficult trading conditions that Domusco is experiencing in Zee. The financial press was also critical of Martyn Lite, as they considered that Domusco did not focus on profitability and was trying to grow too fast.

Following the exchange rate deterioration many of the Zee based construction companies, including Domusco, are experiencing problems due to low demand for housing and office buildings.

The latest forecast profits for the Domusco group (post tax, pre dividend) for the full year 2005 is Z$535 million. This figure takes account of the forecast profits generated by KLT in the second half of 2005 since acquisition, as well as a significant write down of the remaining unsold plot of Hadsi land to Z$30 million. The forecast is based on current contracted sales and forecast sales that are due to be completed by the end of 2005. Therefore much of the forecast for the rest of 2005 is known with a high degree of certainty.

Martyn Lite considered that Domusco should announce a profits warning for 2005. However, he has been over-ruled by other Domusco Board members. Martyn Lite considered that the decision to announce a profits warning is within his functional responsibility. As a result of not being allowed by the Domusco Board to issue a profits warning, he decided to resign. He left Domusco at the end of October 2005.

Domusco cash flow forecast

The latest quarterly rolling cash flow forecast, based on recent sales projections by Tan Lee and Marma Winge, shows negative cash flows for the office building and house building subsidiaries over the next few quarters, based on the assumption of continuing construction work as originally planned, and being able to secure sales later in the construction process.

A summary of the latest quarterly rolling cash flow forecast, which is considered to be a realistic and achievable forecast, for the next four quarters is as follows:

Post tax net cash movements *Inflow/ (outflow)*	*Quarter 4 2005 (October – December) Z$ million*	*Quarter 1 2006 (January – March) Z$ million*	*Quarter 2 2006 (April – June) Z$ million*	*Quarter 3 2006 (July – September) Z$ million*
Major construction projects	+190	+220	+180	+50
Office building	(550)	(240)	+170	+110
House building (including KLT)	(750)	(970)	(50)	+230
Loan interest (post tax)	(40)	(40)	(40)	(40)
Total post tax cash flows	(1,150)	(1,030)	+260	+350

Other information relevant to the above forecast cash flows is:

1. The final payment to the Zee government for the Hadsi land, totaling Z$415 million is due to be paid in December 2005 (Quarter 4) and is NOT included in the above cash flows.

2. The Domusco group had a cash balance of Z$124 million at the end of September 2005.

3. The Domusco Board has not yet decided what level of dividend should be paid for 2005. Dividends are normally paid in the second quarter of each year.

Appointment of a consultant

The Domusco Board held an emergency meeting at the beginning of November 2005, after Martyn Lite had left Domusco. It was agreed that a consultant would be appointed to advise the Board on the many issues currently facing Domusco.

End of unseen material

Maths tables and formulae are on pages 27 to 30

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MATHS TABLES AND FORMULAE

Present value table

Present value of 1.00 unit of currency, that is $(1 + r)^{-n}$ where r = interest rate; n = number of periods until payment or receipt.

Periods	Interest rates (r)									
(n)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621
6	0.942	0.888	0.837	0.790	0.746	0705	0.666	0.630	0.596	0.564
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149

Periods	Interest rates (r)									
(n)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	0.812	0.797	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694
3	0.731	0.712	0.693	0.675	0.658	0.641	0.624	0.609	0.593	0.579
4	0.659	0.636	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482
5	0.593	0.567	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402
6	0.535	0.507	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335
7	0.482	0.452	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279
8	0.434	0.404	0.376	0.351	0.327	0.305	0.285	0.266	0.249	0.233
9	0.391	0.361	0.333	0.308	0.284	0.263	0.243	0.225	0.209	0.194
10	0.352	0.322	0.295	0.270	0.247	0.227	0.208	0.191	0.176	0.162
11	0.317	0.287	0.261	0.237	0.215	0.195	0.178	0.162	0.148	0.135
12	0.286	0.257	0.231	0.208	0.187	0.168	0.152	0.137	0.124	0.112
13	0.258	0.229	0.204	0.182	0.163	0.145	0.130	0.116	0.104	0.093
14	0.232	0.205	0.181	0.160	0.141	0.125	0.111	0.099	0.088	0.078
15	0.209	0.183	0.160	0.140	0.123	0.108	0.095	0.084	0.079	0.065
16	0.188	0.163	0.141	0.123	0.107	0.093	0.081	0.071	0.062	0.054
17	0.170	0.146	0.125	0.108	0.093	0.080	0.069	0.060	0.052	0.045
18	0.153	0.130	0.111	0.095	0.081	0.069	0.059	0.051	0.044	0.038
19	0.138	0.116	0.098	0.083	0.070	0.060	0.051	0.043	0.037	0.031
20	0.124	0.104	0.087	0.073	0.061	0.051	0.043	0.037	0.031	0.026

Cumulative present value of 1.00 unit of currency per annum, Receivable or Payable at the end of each year for n years $\left[\frac{1-(1+r)^{-n}}{r}\right]$

Periods	Interest rates (r)									
(n)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103
14	13.004	12.106	11.296	10.563	9.899	9.295	8.745	8.244	7.786	7.367
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.559	8.061	7.606
16	14.718	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824
17	15.562	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022
18	16.398	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201
19	17.226	15.679	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365
20	18.046	16.351	14.878	13.590	12.462	11.470	10.594	9.818	9.129	8.514

Periods	Interest rates (r)									
(n)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327
12	6.492	6.194	5.918	5.660	5.421	5.197	4.988	7.793	4.611	4.439
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675
16	7.379	6.974	6.604	6.265	5.954	5.668	5.405	5.162	4.938	4.730
17	7.549	7.120	6.729	6.373	6.047	5.749	5.475	5.222	4.990	4.775
18	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.273	5.033	4.812
19	7.839	7.366	6.938	6.550	6.198	5.877	5.584	5.316	5.070	4.843
20	7.963	7.469	7.025	6.623	6.259	5.929	5.628	5.353	5.101	4.870

FORMULAE

Valuation Models

(i) Irredeemable preference share, paying a constant annual dividend, *d*, in perpetuity, where P_0 is the ex-div value:

$$P_0 = \frac{d}{k_{\text{pref}}}$$

(ii) Ordinary (Equity) share, paying a constant annual dividend, *d*, in perpetuity, where P_0 is the ex-div value:

$$P_0 = \frac{d}{k_{\text{e}}}$$

(iii) Ordinary (Equity) share, paying an annual dividend, *d*, growing in perpetuity at a constant rate, *g*, where P_0 is the ex-div value:

$$P_0 = \frac{d_1}{k_{\text{e}} - g} \text{ or } P_0 = \frac{d_0[1+g]}{k_{\text{e}} - g}$$

(iv) Irredeemable (Undated) debt, paying annual after tax interest, *i* (1-*t*), in perpetuity, where P_0 is the ex-interest value:

$$P_0 = \frac{i[1-t]}{k_{d\text{net}}}$$

or, without tax:

$$P_0 = \frac{i}{k_d}$$

(v) Future value of *S*, of a sum *X*, invested for *n* periods, compounded at *r*% interest:

$$S = X[1+r]^n$$

(vi) Present value of £1 payable or receivable in *n* years, discounted at *r*% per annum:

$$PV = \frac{1}{[1+r]^n}$$

(vii) Present value of an annuity of £1 per annum, receivable or payable for *n* years, commencing in one year, discounted at *r*% per annum:

$$PV = \frac{1}{r}\left[1 - \frac{1}{[1+r]^n}\right]$$

(viii) Present value of £1 per annum, payable or receivable in perpetuity, commencing in one year, discounted at *r*% per annum:

$$PV = \frac{1}{r}$$

(ix) Present value of £1 per annum, receivable or payable, commencing in one year, growing in perpetuity at a constant rate of *g*% per annum, discounted at *r*% per annum:

$$PV = \frac{1}{r - g}$$

Cost of Capital

(i) Cost of irredeemable preference capital, paying an annual dividend, d, in perpetuity, and having a current ex-div price P_0:

$$k_{pref} = \frac{d}{P_0}$$

(ii) Cost of irredeemable debt capital, paying annual net interest, i (1 – t), and having a current ex-interest price P_0:

$$k_{d\text{net}} = \frac{i[1 - t]}{P_0}$$

(iii) Cost of ordinary (equity) share capital, paying an annual dividend, d, in perpetuity, and having a current ex-div price P_0:

$$k_e = \frac{d}{P_0}$$

(iv) Cost of ordinary (equity) share capital, having a current ex-div price, P_0, having just paid a dividend, d_0, with the dividend growing in perpetuity by a constant g% per annum:

$$k_e = \frac{d_1}{P_0} + g \quad \text{or } k_e = \frac{d_0[1 + g]}{P_0} + g$$

(v) Cost of ordinary (equity) share capital, using the CAPM:

$$k_e = R_f + [R_m - R_f]ß$$

(vi) Weighted average cost of capital, k_0:

$$k_0 = k_e\left[\frac{V_E}{V_E + V_D}\right] + k_d\left[\frac{V_D}{V_E + V_D}\right]$$

P10 – Test of Professional Competence in Management Accounting

November 2005

Thursday Afternoon Session