THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

Final Examinations Summer 2006

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BUSINESS FINANCE DECISIONS

(MARKS 100)
(3 hours)

Q.1 NiceOne Traders are a large multinational trading company with operations spread in various cities around the world. The Finance Director of the company wants to implement a hedging policy within the company that would prescribe use of foreign currency futures as a hedge instrument. In order to test this policy, the Finance Director has instructed his Chicago Office to hedge the following foreign currency transactions carried out on April 16, 200X:

Export	€697,500	Receivable on May 19, 200X
Import	£790,800	Payable on July 31, 200X

After the year end on 30 September 200X, the finance director wants to evaluate the impact of the decision.

Spot rates on the relevant dates were as under:

As on April 16	$1.3924/€ - $1.3927/€	$1.9271/£ - $1.9275/£
As on May 19	$1.3891/€ - $1.3895/€	-
As on July 31	-	$1.9335/£ - $1.9339/£

Futures' rates on the relevant dates were as under:

	Maturing on	**Rates on April 16**	**Rates on May 19**	**Rates on July 31**
Euro Futures	Jun. 30	$1.3875/€ - $1.3880/€	$1.3846/€ - $1.3848/€	-
	Sep. 30	$1.3887/€ - $1.3890/€	$1.3857/€ - $1.3860/€	-
Sterling Futures	Jun. 30	$1.9327/£- $1.9331/£	-	-
	Sep. 30	$1.9352/£ - $1.9355/£	-	$1.9411/£ - $1.9416/£

Market lot in future market for each currency is 100,000.

Required:

(a) Compute the gain / loss on above transactions:

 (i) if these were carried out without hedging. **(03)**

 (ii) after hedging. **(09)**

(b) Compute the effective foreign exchange rate applicable to the hedged transaction. **(03)**

Q.2 BestOne Limited is exploring the opportunities to expand. One opportunity being considered is that of buying a recently built manufacturing plant which has not yet started operations. The cost and NPV of the project is estimated as Rs. 20 million and Rs. 1.4 million respectively.

Rs. 8 million has been arranged in the form of debt financing at KIBOR + 4%. The premium on this loan is considered to be in line with the market estimation of BestOne's risk profile. Bank will charge an arrangement fee of 2.5% for this loan.

Shares are to be issued for the remaining amount at par value of Rs 10. The issue cost is estimated to be 7% of the amount issued.

Market is semi-strong form efficient and the directors only disclose information about debt and equity amounts to be raised (not issue costs) and NPV of the project. Current market price is Rs. 12.5 per share and the numbers of shares outstanding are 3.5 million.

Required:
Compute the theoretical post issuance market price of each share of BestOne Limited. **(09)**

Q.3 Following information has been extracted by you regarding some companies listed on the Karachi Stock Exchange:

Company Name	Expected Equity Returns (Rs. / share)	Present Market Price (Rs. / share)	Standard deviation of 'return % on equity'	Covariance with market return%
A Limited	3.25	18.00	6.3	32
B Limited	18.60	212.00	4.8	19
C Limited	0.80	4.50	4.7	24
D Limited	4.15	20.00	6.9	43

Market return has been estimated to be on average around 14.5% per annum (adjusted for the dividend exclusion thereof) with a variance of 25%, whereas the risk free rate is around 6% per annum.

Required:
(a) Estimate and interpret the 'Alpha Values' for each of the given companies. **(06)**
(b) How will the analysis carried out in (a) above help you in deciding about investing in the stock market? **(07)**

Q.4 GoodOne Limited, a manufacturer of cement blocks, has had a consistent profit stream for many years. Accordingly, controlling and minority equity holders both prefer stable and high dividend payout policy that ranges between 90-95% of the earning.

The construction industry is showing an upward trend currently and demand of construction material is expected to increase consistently in next 3-5 years period.

In line with the industry trend, the company is considering to acquire manufacturing facilities to produce ceramic tiles and other similar items as part of its medium term expansion strategy.

Investment opportunity presently available to the company are as under:

Project coded as	Expected upfront investment for the project Rs. '000'	IRR of the project taking into account after tax cash-flows for the life of the project
P	10,000	12.0%
Q	12,000	11.5%
R	12,200	11.0%
S	12,500	10.5%
T	10,500	10.0%

GoodOne has an existing and target debt to equity ratio of 0.75 to 1. Debt is available at 8% per annum (after tax). The cost of its equity at the targeted gearing level is 12.5% per annum, funded either from retained earnings or equity issue.

This year GoodOne has after tax earning of Rs. 25 million wherefrom the dividend will be paid. Prior years' balance of retained earning is Rs. 8.5 million.

Required:
You, being the CFO of the company, have been asked by the Board of Directors to prepare a memorandum suggesting the amount that can be declared as dividend for the current year keeping in view the opportunity of growth in the industry. **(12)**

Q.5 PoliteOne Limited, presently engaged in manufacturing of fancy tents, is considering investing in a manufacturing facility for long life tents to be used as shelter for victims of natural disasters all over the world. The project will change the company's balance sheet footing significantly. Other relevant details of the project are as under:

(i) Total investment is expected to be Rs. 35 million.
(ii) Directors have decided to meet funding requirements through a debt of Rs.15 million and remainder by a fresh equity issue.
(iii) Debt is available at a subsidized rate of 12% per annum for this particular project.
(iv) Operations will start from year one. Project's life is expected to be infinite.
(v) Corporate tax is chargeable at the rate of 30%.
(vi) Debt equity ratio of the industry is around 35:65 with 15% cost of debt before tax adjustment and 18% cost of equity. Company's existing WACC is 21%.
(vii) The new project is expected to give revenue of Rs. 17.5 million in Year- 1 with a growth of 50% per annum till Year - 3. Revenue is expected to stabilize at Rs. 60 million from Year – 4.
(viii) Margin in the industry is around 35%. Fixed costs of the company are Rs. 1.5 million per annum for the first year rising by 5% annually and stabilizing from year-4.
(ix) It is assumed that costs are paid at the end of year. Revenue collection follows a pattern of 15% in the year earned and remaining in the next year.
(x) Life of assets is taken as 4 years for tax purposes.

Required:
Should the company invest in this project? Support your answer with relevant workings. **(18)**

Q.6 SimpleOne Limited is a manufacturer of bottles for industrial users. The company is using a two-year old label printing machine having a book value of Rs. 450,000 and remaining useful life of 5 years. The machine has no significant market value due to some in-house alterations made to make it compatible with the company's main plant. Presently, it can be sold for Rs. 35,000 only.

Company's production manager suggested that existing machine may be replaced with a new state-of-the-art printing machine which is fully compatible with the company's existing plant.

The cost of new machine is Rs. 950,000 and has an expected useful life of 5 years with a salvage value of Rs. 200,000.

The replacement will save fixed costs (excluding depreciation) amounting to Rs. 35,000 per annum and consumables of Rs.12 per carton of bottles produced. With the installation of new machine annual sales/production is expected to be 3,150 cartons, 5% more than the sale/production that can be achieved with the old machine. Existing margin on each carton is Rs. 938.

One of the company's directors, Mr. CareFull, is your friend and has requested you to jot down some meaningful points for discussion during the forthcoming meeting called for making a final decision on the proposal.

Required:
Prepare a brief for Mr. CareFull:
(i) Containing your recommendation based on the available information, and
(ii) Identify any information which may affect your recommendation in (i) above.

Support your answer with relevant workings. **(14)**

Q.7 SuperOne Limited follows an 'acquisition' model for expansion, that is, it acquires existing businesses for expansion.

SuperOne is negotiating with the management of a targeted company, WeakOne Limited. Following is some relevant information:

(i) Summarized balance sheet of the acquiree is as under:

Net Asset	**Rs. in million**
Fixed assets	10.00
Other non-current assets	11.70
Current assets	25.00
Non-current liabilities	(11.25)
Current liabilities	(16.00)
Total	**19.45**
Represented by	
Paid up capital (2.5 million shares)	25.00
Accumulated loss	(5.55)
Total	**19.45**

(ii) Fixed assets include properties with a carrying value of Rs. 1.7 million and a market value of Rs. 3.2 million.
(iii) Restructuring cost amounting to Rs. Rs. 2.2 million would be incurred which would result in annual cost savings of Rs. 1.2 million.
(iv) Transaction cost to be borne by SuperOne is estimated at Rs. 1.5 million.
(v) WeakOne's assessed tax losses are Rs. 6.0 million in aggregate, which will be adjustable in three subsequent years equally against the project of the acquirer.
(vi) Tax rate applicable on SuperOne is 30%.
(vii) The consideration for transaction has been agreed to be settled through the issuance of marketable debt instruments having a face value of Rs. 5,000 carrying 16% return payable annually.

(viii) Above instrument will be redeemed at the end of the third year.
(ix) Yield on debt instruments of a similar nature in the market is 12.5% per annum and no significant variation is expected during the next three years.
(x) While deciding the swap ratio all the benefits of merger including expected restructuring benefits will be shared by both companies equally.
(xi) Weighted average cost of capital of the merged company is 17.5%.

Required:
Advise SuperOne about the total number of debt instruments to be issued to the shareholders of WeakOne Limited, and the value of goodwill to be incorporated in its balance sheet. **(14)**

Q. 8 CreativeOne Limited has to settle a liability of Rs. 388.50 million payable at the end of third year. It bought Rs. 300 million of 9 percent 3-year non-callable government treasury bonds for the purpose. Return was payable annually and company was expecting that it will always have the opportunity to reinvest the inflows at 9 percent. On the same assumption company was confident to settle the liability in full at the end of third year without injecting further funds. However, at the end of first half of first year the interest rate declined to 8.5% and further decline is also possible.

The company's CFO, in order to redress the situation, suggests:

(i) Floating of zero coupon bonds (discounted bonds) to general public backed by cash inflows of above stated investment, and
(ii) Investment for a period of two and a half years in Government's zero coupon bonds presently offering 8.00% per annum yield.

Individual investors are expected to invest in such risk free issue of the company if following rates are offered:

06 months	6.00%
12 months	6.25%
18 months	6.50%
24 months	6.75%
30 months	7.00%
36 months	7.25%

Issue cost is estimated as 1% of the face value.

Required:
You are required to compute the following (for simplicity you may take fractional face values of bonds, if necessary):

(a) Face value, maturity period and sale price (based on semi-annual compounding) of bonds to be issued to the public by CreativeOne Limited. **(02)**
(b) Future value of zero coupon bonds purchased by CreativeOne Limited against the liability of Rs. 388.50 million. **(03)**

(THE END)