THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

Final Examinations Winter 2005

December 07, 2005

BUSINESS FINANCE DECISIONS

(MARKS 100)
(3 hours)

Q.1 Saleem & Company Limited (SCL) is a UK based importer of clock mechanisms from Switzerland. The Company has contracted to purchase 3,000 mechanisms at a unit price of eighteen (18) Swiss francs. Three months credit is allowed before payment is due.

SCL currently has no surplus cash, but can borrow on short term basis @ 2% above the bank's base rate or invest on short term basis @ 2% below bank's base rate in either the United Kingdom or Switzerland.

The prevailing foreign exchange rates are as follows:

	Swiss Francs / Pound Sterling
Spot	2.97-2.99
1 month forward	2.50-1.50 premium
3 months forward	4.50-3.50 premium
Current Bank Base Rates	
Switzerland	6% per year
United Kingdom	10% per year

Required:

(a) Explain four policies that an importer may adopt with respect to its foreign exchange exposure. Suggest which policy SCL should adopt in the above case. Assume that interest rates will not change during the next three months. **(10)**

(b) If the Swiss supplier were to offer 2.5% discount on the purchase price for payment within 1 month, evaluate whether you would alter your recommendation in (a) above. **(04)**

Q.2 Ashraf Limited (AL) manufactures men's shoes that it sells through its own chain of retail stores. The firm is considering adding a line of women's shoes. Management considers the project a new venture because there are substantial differences in marketing and manufacturing processes between men's and women's footwear.

The project will involve setting up a manufacturing facility as well as expanding or modifying the retail stores to deal in two products. The stores are leased, so modification will involve leasing larger spaces, installing new leasehold improvements, and writing off some old leasehold improvements.

The expected costs are summarized as follows:

	Rs.
New manufacturing unit	750,000
Land	480,000
Building	630,000
New leasehold improvements	200,000

Manufacturing unit and leasehold improvements are to be depreciated in 5 years without salvage value. Life of building is estimated at 30 years. Existing leasehold improvements with remaining life of 3 years having book value of Rs.90,000 are to be written off immediately.

Other relevant costs are as under:

	Rs.
Net new lease expense per annum	40,000
Cost of hiring and training new people	150,000
Initial advertising and promotion	200,000
Advertising and promotion per annum	50,000
Sales salaries per annum	900,000
Additional corporate overheads per annum	60,000

The unit sales forecast is as follows:

Year	**Units in '000'**	**Average Price (Per unit)**
1	30	Rs. 65
2	40	Rs. 68
3	50	Rs. 70
4 and onward	60	Rs. 75

Direct cost excluding depreciation is 40% of sales

- Sales are to retail customers who usually pay through credit cards. It takes about 10 days to actually receive cash. Inventories are estimated to be approximately the cost of two months sales.
- Payables are estimated as one quarter of inventories.
- Incremental cash required is equal to 2% of revenues.
- Accruals are insignificant.
- Working capital estimates are based on the current year's revenue and cost levels.
- Management expects a few of the company's current male customers to be lost, because they would not want to shop in a store that doesn't exclusively sell men's shoes. The gross margin impact of these lost sales is estimated to be Rs. 60,000 per year.
- The company has already purchased designs for certain styles of women's shoes for Rs. 60,000.
- AL's cost of capital is 10%. Its marginal tax rate is 35%, and taxes are paid in the same accounting year.

Required:

(a) Calculate the project's payback period, NPV, IRR, and PI, and recommend, whether the company should accept the idea, assuming that the project has a net of tax realization value of Rs.5,000,000 at the end of 6th year. **(18)**

(b) If you are told that the men's shoe industry is very stable being served by the same manufacturers year after year. However, firms enter and leave the women's shoe business regularly.

- Would this information change your decision in (a) above? Explain very briefly.

- Suppose you know of a company that makes only women's shoes and its beta is 2.0. Also assume that treasury bills are paying 6% and an average stock investment earns 10%, what rate might be more appropriate than the cost of capital for the analysis of this problem? **(04)**

Q.3 Prodco Ltd is contemplating a bid for the share capital of Nordik Ltd. The following statistics are available:

	Prodco Ltd	**Nordik Ltd**
Number of shares	14 million	45 million
Share price	Rs. 8.40	Rs. 1.66
Latest equity earnings	Rs. 11,850,000	Rs. 9,337,500

Prodco Ltd's plan is to reduce the scale of Nordik Ltd's operations by selling off a division which accounts for Rs. 1,500,000 of Nordik Ltd's latest earnings, as indicated above. The estimated selling price for the division is Rs. 10.2 million.

Earnings in Nordik Ltd's remaining operations could be increased by an estimated 20% on a permanent basis by the introduction of better management and financial controls.

Prodco Ltd does not anticipate any alteration to Nordik Ltd's price / earnings multiple as a result of these improvements in earnings.

To avoid duplication, some of Prodco Ltd's own property could be disposed of at an estimated price of Rs16 million. Redundancy costs are estimated at Rs. 4.5 million.

Required:

(a) Calculate the effect on the current share price of each company, all other things being equal, of a two for nine share offer by Prodco Ltd. **(08)**

(b) Assume now that Prodco Ltd, instead of making a two for nine share exchange offer, wishes to offer an exchange which would give Nordik Ltd shareholders a 10% gain on the existing value of their shares. Calculate what share exchange would achieve this effect, assuming the same synergy forecasts as before. **(06)**

Q.4 Your company is in the process of making some investment decisions. In this respect, you are performing an analysis of some companies, one of which is EatFree Ltd (EFL). It is a new franchise of international bakery products, and is expected to be successful as a whole in the medium to long term. Following are some of the collected historic and projected data:

	2001-02	**2002-03**	**2003-04**	**2004-05**	**2005-06 Estimated**
	----------------- Rupees in million -----------------				
Revenues	9,155	10,424	11,718	11,606	12,070
Operating expenditure	8,556	9,764	10,946	10,750	11,017
Interest expense	151	147	133	340	310
Profit before tax	448	513	639	516	743
Taxation	181	188	229	209	297
Profit after tax	267	325	410	307	446

	------------------------ **Rupees** ----------------------				
Average share price	32	46	44	52	
Dividend per share	0.48	0.58	0.69	0.81	0.90
	--------------------- **Number in million**---------------				
No. of shares (Avg.)	223.3	223.3	226.8	230	230

Some historic and projected information about the assets and funding is as follows:

	2001-02	**2002-03**	**2003-04**	**2004-05**	**2005-06 Estimated**
	---------------- **Rupees in million** ----------------				
Non-current assets	2,765	3,075	4,061	4,334	4,510
Current assets	1,427	1,937	2,462	3,302	3,500
Total assets	4,192	5,012	6,523	7,636	8,010
Current liabilities	1,143	1,544	2,120	1,820	2,122
Long Term Floating Rate Loan (Currently at 9% pa)	1,633	1,893	2,488	3,524	3,475
Equity	1,416	1,575	1,915	2,292	2,413
Total liabilities and equity	4,192	5,012	6,523	7,636	8,010

Some additional information has been accumulated by you from the company's budget for the year 2005-06. The estimated amount of depreciation is Rs 429 million, Rs 37 million more than the year 2004-05. The company is exposed to 40% rate of tax on accounting profit.

Market has a risk premium of 6% with government bonds yielding 7%. Beta value of the equity of EFL is 1.3.

Required:

(a) Using the information provided, calculate the cost of capital for the company that is appropriate to discount the free cash-flows available to the company. **(06)**

(b) Define the term 'Free Cash Flows to the Company' and compute the Free Cash Flows available to EFL for 2005-06. **(04)**

(c) In addition to the free cash-flow estimates by you in (b) above, the estimates for the cash flows for 2006-07 and 2007-08 is Rs 420 million and Rs 500 million respectively. Thereafter, free cash-flows to the company have been estimated to grow indefinitely at the rate of 7% p.a. Using only the information provided so far, calculate the estimated value of the Company as at June 30, 2005. **(04)**

(d) Estimate the value of EFL's shares and state whether or not EFL's shares are over-valued or under-valued based on your analysis of Company's value as in (c). **(03)**

(e) Compute the 'Free Cash Flows to Equity Holders' of EFL for the year 2005-06. **(02)**

(f) The value of EFL's share on the basis of 'Free Cash Flows to Equity Holders' has been computed to be Rs 12.70. Calculate the constant growth rate assumed in the computation of the share price of Rs 12.70. **(04)**

Q.5 Noble Limited is in the process of deciding the optimal cycle for the replacement of one of its major machines. It is the company policy not to replace any investment above Rs 2 million before the completion of four operating periods.

Value of new machine of equivalent capacity and similar specifications is Rs 2.5 million. Estimates about incurrence of maintenance costs and disposal values of the machinery are as follows:

Age of machinery	**Maintenance Cost incurred during the year (Rs.)**	**Estimated selling price at the end of the year (Rs.000)**
1 year	100,000	2,000
2 year	150,000	1,700
3 year	225,000	1,350
4 year	320,000	1,200
5 year	450,000	900

Initial depreciation is available at 50% and the rate of normal depreciation is 20% p.a. on the written down value.

Taxation rate applicable to Noble Limited is 35%, with tax being paid one year in arrears. This rate is expected to remain the same with sufficient taxable profits to absorb maintenance costs and depreciation etc.

Required:

Assuming that Nobel Limited uses a Discount Rate of 10% p.a. for evaluation of such machine related projects and using Equivalent Annual Cost method, determine whether the replacement cycle followed by the company should be of four years or five years? **(12)**

Q.6 Bayleaf Pharmacy is a private limited company operating a chain of natural herbal products stores located in major cities of Pakistan.

The directors of Bayleaf have come to know that Naturale (Pvt.) Ltd., a company engaged in similar business is for sale. The Naturale is owned by Dr. Naushad who now wants to go back into clinical practice instead of managing the day to day hassles of running a business, provided he gets a good price.

Naturale has eleven stores operating throughout the country. Seven of them are owned by the company, whereas the rest are on annual lease. The total assets are approximately 30% of the total assets of Bayleaf Ltd.

The directors of Bayleaf are considering to acquire Naturale, as this will give rise to economies of scale as well as greater geographical expansion (Naturale stores are located in diverse locations which are of great interest to Bayleaf). However, the directors have no experience of such deals and they ask you for help.

The Senior Director is sharing the above information with you as he has written the following e-mail:

"I have absolutely no experience of buying companies. Mr. Naushad initially sent me audited financial statements showing the following gross figures:

	Rs. in million
Fixed assets	36
Current assets	15
Current liabilities	6.0
Long term bank loans	3.0
Current year's net after tax profit	4.3

Issued capital (Number of Shares: 3.5 million)

Looking at the above figures we thought that Mr. Naushad may be willing to take around Rs.42 million as price of his business. But recently, after meeting with his financial advisor he sent me following information, though relevant, but very confusing to me.

		My Comments
Estimated goodwill	Rs.10 M	*Goodwill exists but I have no idea of value.*
Market value of existing fixed assets	Rs. 43 M	*No idea*
Irrecoverable current assets	Rs. 1 M	*No comments*
Average share price of similar listed companies	Rs. 8.1 / share	*Agreed*
Average EPS of similar listed companies	Rs.0.9 / share	*Agreed*
Company has the ability to maintain its current profitability level and can pay annual dividend of Rs.0.95 per share.		*Agreed*

I feel that if we start a similar business from the scratch with assets of similar age and conditions then, in addition to the cost of assets our startup cost would not be less than Rs.12 million. Further, Bayleaf's return on the combined equity is around 20%. Our idea for incremental future net of tax cash flows from acquisition of Naturale is Rs. 15 million for a maximum period of 10 years.

I am going to meet him next week for the said purpose I request you to please prepare something meaningful for me to assess the valuation of business. Regards, Arthur"

Required:

Draft a reply suggesting any five business valuation methods that Bayleaf could use showing necessary calculations alongwith brief comments on each of the method proposed. **(15)**

(THE END)