Diploma in Corporate Finance

Corporate Finance Techniques & Theory

Date of exam	Tuesday 1 December 2015
3 hours	2.00 pm – 5.00 pm
Rubric	Section A – answer **five** questions in this section
	Section B – answer **both** questions in this section

Candidates are reminded that no marks will be awarded for illegible work

Notes to candidates

1. Please insert your candidate number on the cover of your answer book. **Do not insert your name.**
2. Show **all** workings in your answer book.
3. Candidates may attempt the sections in any order. Please indicate clearly in your answer book which questions you are answering.
4. Please insert the numbers of the questions which you have attempted, in the order in which they appear in the answer book, in the box provided on the cover of your answer book.
5. You may use the calculator provided or a model approved by the CISI.
6. You must hand your answer book to an invigilator before you leave the examination hall. **Failure to do so will result in disqualification.**
7. The decision of the exam panel is final and no correspondence will be entered into concerning the grade awarded.
8. Once submitted, the examination scripts become the property of the CISI. They are not returned to candidates.

Please turn over when instructed

SECTION A **TOTAL 50 MARKS**

All companies designated as a plc should be assumed to be UK-based, premium listed companies, unless otherwise indicated.

Answer <u>FIVE</u> questions in this section

1. Peak Finance plc (Peak) is considering raising £100 million in the form of corporate bonds. At a recent board meeting several of the board members were confused about what type of bonds, if any, should be issued. Below is an extract from the minutes of the meeting:

Director one: I have read in the Financial Times that in 2015 there has been a trend for companies to issue debt with ever-longer maturities, even 100 years! Also there has been a record level of perpetual debt issued. Should we consider these alternatives?

Director two: Perpetual debt is the same as issuing preference shares, why not issue those instead?

Director Three: I think that we should issue convertible bonds, aren't they cheaper for us?

Director Four: Actually zero coupon bonds are the cheapest.

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Requirements

(a) Describe the characteristics of the securities listed below:

- Coupon paying bonds.
- Convertible bonds.
- Zero coupon bonds.
- Perpetual debt.
- Preference shares.

(3 marks)

(b) Briefly discuss why a company might wish to issue bonds rather than equity and comment on the statements made by directors two, three and four. (6 marks)

(c) Address the statement made by director one and briefly discuss whether issuing bonds with 100 years to maturity or perpetual debt is likely to be problematic for companies. (1 mark)

2. You have been asked to make a presentation to a group of new recruits in your firm. The presentation is to cover an introduction to the Main Market of the London Stock Exchange (LSE).

Requirements

Prepare notes for your presentation, which should include:

(a) An outline of the three segments of the Main Market of the LSE. (3 marks)

(b) An outline of the relevant regulatory body, its legal status and the sets of relevant rules (Note: you are not required to provide any detailed rules). (3 marks)

(c) An outline of the main requirements for a listing on the LSE main market. (4 marks)

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3. The Board of Lock plc (Lock) is considering a rights issue to finance acquisitions in the next financial year. Some members of the board are concerned about the effect of a rights issue on Lock's earnings per share (EPS) and the share price after the issue.

You have been asked to make a presentation to the Board of Lock showing the effect of rights issues on current and past EPS. To illustrate your presentation use the following information related to a competitor of Lock:

- Bolt plc (Bolt) made a fully subscribed 1 for 3 rights issue on 30 April 2015 at a price of 140p, which was a 20% discount on the closing price before the rights issue. Bolt has a financial year end of 30 September.

- Prior to the rights issue Bolt had 4.7 million shares in issue.

- Earnings after tax for the year ended 30 September 2015 were £1.6 million

- The EPS unadjusted for the rights issue for the year ended 30 September 2014 were 20p.

Requirements

Prepare notes for your presentation that should include:

(a) The theoretical ex-rights price of Bolt's shares immediately after the rights issue. (1 mark)

(b) An example of how a shareholder who holds shares in Bolt and subscribes to the rights issue would theoretically not suffer any loss of value. Assume that the shareholder holds 1,500 shares prior to the rights issue. (3 marks)

(c) Calculate the EPS, allowing for the rights issue, of Bolt for the two years ended 30 September 2014 and 2015. (3 marks)

(d) With respect to the Board's concerns comment on the practical implications of your calculations in (a), (b) and (c) above. (3 marks)

4. Peter Swan is a director of Acquisitive plc (Acquisitive). Acquisitive holds 26% of the 15 million ordinary shares of White plc (White). Peter also holds in his own name 450,000 of the ordinary shares of White. At Peter's 60th birthday celebrations his wife presented him with a surprise present of 150,000 ordinary shares in White which she had purchased six months ago. Peter was delighted with the gift of the shares but was a little uneasy about any regulatory implications.

Requirements

(a) What are the regulatory implications of the gift of 150,000 ordinary shares in White? (4 marks)

(b) Discuss the likely reaction of the regulatory authorities involved.
(4 marks)

(c) Discuss whether it would have made any difference if Peter's wife had purchased call options on the shares of White. (2 marks)

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5. Jack Street (JS) manages Street Capital (Street) which is a hedge fund that he founded several years ago. Street has a 15% holding in Starlight plc (Starlight). Starlight has engaged an investment bank to enter into discussions with certain of its shareholders, including Street, who will be required to sign a non-disclosure agreement prior to discussions commencing. JS has declined to do so but has agreed to participate in the discussions provided he does not receive any inside information. However, during the discussions it is revealed that Starlight is considering an issue of new shares by way of a private placement in order to reduce indebtedness.

Following the discussions Street reduces its holding in Starlight from 15% to 10%. Subsequently Starlight announced the placing to the market, as a result of which its share price fell by 25%. Street had thus avoided substantial losses.

The FCA is now investigating Street and JS regarding the sale of the 5% holding in Starlight. JS has asserted that Starlight had not conveyed inside information to him because he had only participated in discussions about a potential private placement, and that he had not signed the non-disclosure agreement.

Requirements

(a) Define market abuse including reference to its legal status and list the seven types of behavior that give rise to it. (6 marks)

(b) Discuss whether JS and Street are guilty of any offences relating to the above scenario. (4 marks)

6. Armstrong Bikes Ltd., (AB) is a family company with a value of approximately £5 million. The company imports and sells two brands of road and mountain bikes and operates from leased properties in the north of England. The family members of AB own 90% of the ordinary shares and the current non-family management team owns the remaining 10%. The family members are active in the business but they are planning their exit, in full or in part, from the business and they are considering the following alternatives:

(i) Sell their shares to the current management team.

(ii) Find a third party to buy their shares.

(iii) AB buys the family members' shares in the form of a share buy-back.

Requirements

(a) Discuss the advantages and disadvantages of the three alternatives above. (6 marks)

(b) Recommend to the family members of AB the most practical way for them to exit from AB highlighting any specific problems associated with this type of private company. You are not limited to the three alternatives above. (4 marks)

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7. Black, Scholes and Merton published their option pricing model in 1973. As a result, the use of options increased rapidly. A knowledge of the use of options and their pricing characteristics is essential for those working in finance.

Requirements

(a) Describe the five inputs into the Black-Scholes option pricing model and discuss how and why an increase in each will affect the value of call options. (6 marks)

(b) Describe four uses of options in corporate finance. (4 marks)

SECTION B **TOTAL 50 MARKS**

Answer <u>BOTH</u> questions in this section

Both questions in this section are based on the same company, UK Mail Group plc (UK Mail), but each question is to be treated separately. For both questions, you are provided with an information booklet, which contains financial information on the company.

Assume that the current date is 31 August 2015

Sample share prices during 2015:

- **31 March 475p**
- **30 April 514p**
- **31 May 512p**
- **30 June 523p**
- **31 July 510p**
- **7 August 455p**
- **31 August 375p**

The following articles relate to UK Mail:

The Telegraph 7 August 2015:

"UK Mail has issued a profits warning after a move to a new fully-automated parcel processing facility caused more disruption than expected and the unit was overwhelmed by an influx of bulky oversized mail that had to be handled by hand, resulting in lower volumes and higher operating costs.

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The independent postal services provider said that a larger proportion of parcels than expected had proved "incompatible" with its state-of-the-art automated sorting equipment at the brand new facility in Coventry. That resulted in higher operating costs and means that the financial benefits the group had expected from the new facility won't be felt for some time.

UK Mail has 52 regional depots across the country, but the Coventry facility is the only one that is fully decked out for automation.

"Parcels were either too big or the wrong size or shape," a spokesman explained. "Around 20pc of the group's parcel volumes are incompatible for the new machinery, but we were expecting these volumes to be spread across the network - we were only expecting to handle 5pc at the Coventry hub, when in fact, a much larger proportion of volumes coming in have been what they call 'incompatible freight'."

He added that the operational hiccup was "really hitting the efficiency of the business", and that it might look at raising prices for larger, irregular shaped parcels that take more manpower and floor space.

And while parcel volumes were running some 4pc ahead in the first four months of the year, the move to the new Coventry unit had also "caused a greater level of customer churn and loss of volume than anticipated".

"It is now clear that the near-term challenges and their impact on the current year's performance are more significant than anticipated," the group announced in a statement on Friday morning, adding that it was making a plan on how to "better manage" the flow of parcels by hand."

8. After the release of the profits warning the Board of UK Mail is arranging a meeting with analysts and shareholders. During the meeting the board will present a financial analysis of the company.

You work for the firm that is giving advice to the board of UK Mail and you have been asked to prepare a financial analysis. You have also been asked to give your thoughts on certain other matters that will be discussed at the meeting of the UK Mail shareholders.

Requirements

(a) Prepare a financial analysis of UK Mail and discuss its financial health and trends. Where possible you should refer to the comparable company information. You must include a conclusion in your discussion. (15 marks)

(b) Discuss, making reference to the newspaper article above, whether the financial health and trends of UK Mail might cause shareholders to consider selling their shares. You must include a conclusion in your discussion. (6 marks)

(c) Suggest and discuss two actions that the board of UK Mail could take to encourage the shareholders not to sell their shares in the company. (4 marks)

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9. Some members of the Board and senior management team (together known as “The Team”) of UK Mail are concerned about the current trends in their share price and they are concerned about the possibility of another company launching a takeover bid. As a takeover defence The Team would like to investigate taking the company private.
You work for the firm that is giving advice to The Team and you have been asked to prepare briefing notes for a partner who is going to make a presentation to them.

Requirements

Prepare briefing notes that should contain:

(a) An estimate of a range of values for the ordinary shares of UK Mail based on:

(i) Discounted cash flow using a four year time horizon and assuming a growth rate of 2% thereafter. An appropriate risk free rate is 1.40% and market risk premium 5%. (10 marks)

(ii) A broad range of multiples. (5 marks)

(Note: In both valuations you should state the reasonableness of the assumptions that you make and state your reservations and further information requirements)

(b) A recommendation with supporting evidence of an offer price and a brief description of how the finance might be raised for The Team to launch a bid for the ordinary shares of UK Mail. (4 marks)

(c) A brief description of the advantages and disadvantages of The Team making the offer by way of:

(i) A takeover offer

(ii) A scheme of arrangement (4 marks)

(d) Details of any particular Takeover Code rules that apply to The Team. (2 marks)

End of examination paper