Diploma in Corporate Finance

Corporate Finance Techniques & Theory

Date of exam	Tuesday 21 June 2016
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, examination scripts become the property of CISI and ICAEW. 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. Blueberry plc (Blueberry) has made an approach in secret to Pear plc (Pear) with a view to Blueberry making a takeover offer for the shares of Pear.

   Pear's share price has recently risen sharply and this has coincided with a rumour about the potential takeover offer. The board of Pear is concerned about the rise in Pear's share price.

   Requirements

   (a) Describe the options available to the board of Pear with regard to the recent sharp rise in the company's share price and the approach from Blueberry. (6 marks)

   (b) Assume that Pear has now received an offer for its ordinary shares from Grape plc (Grape). Describe the options available to Blueberry. (4 marks)

2. Como ltd., (Como) sells climbing and walking equipment in shops located in the major cities of the UK. Como has specialised in selling British products but has recently found a new supplier based in Italy. The CEO of Como is concerned about the foreign exchange rate risk that the company will be exposed to when making payments to its Italian supplier.

Your firm has been asked to make a presentation to the board of Como regarding hedging foreign exchange rate risk (FOREX).

Requirements

Prepare briefing notes for the presentation to the board of Como that should include:

(a) a brief rationale as to whether Como should hedge its FOREX

(4 marks)

(b) an explanation, including calculations, of how a bank would quote Como a three month forward exchange rate, assuming that the spot exchange rates are €/£ 1.2330 – 1.3091 and that interest rates in the UK are 6% and in the Eurozone 4% (3 marks)

(c) the advantages and disadvantages of using forward contracts or over the counter foreign currency options to hedge Como's FOREX

(3 marks)

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3. Northern Chemicals plc (Norchem) manufactures domestic and industrial cleaning products. The domestic cleaning division has grown substantially in recent years and Norchem is considering either selling the division or demerging its activities into two separate companies.

Requirements

Advise Norchem on:

(a) the relative advantages and disadvantages of selling the domestic cleaning division or demerging into two separate companies (4 marks)

(b) how a demerger can be achieved by:

(i) a scheme of arrangement (3 marks)

(ii) liquidation (3 marks)

4. ABC plc (ABC) proposes to enter into a transaction outside of its normal day-to-day activities with an unlisted business having previously done so twice before. The results of some of the class tests for the three similar transactions are as follows:

	April 2015	March 2016	Proposed transaction July 2016
Consideration to market capital	15%	13%	14%
Profits test	6%	7%	5%
Gross assets	7%	9%	8%

Requirements

Advise ABC on:

(a) the implications of the class tests regarding the proposed transaction (7 marks)

(b) the implications for ABC if any of the class tests had come to 100% (3 marks)

5. Martin Stewart is a partner and UK head of the pensions assurance practice of a large firm of financial advisers, and he has been asked by a number of major clients who are listed companies in the UK to hold a seminar on the subject of pension schemes. Martin has asked you to prepare briefing notes for the seminar.

Requirements

Prepare briefing notes for certain specific sections of the seminar which should include:

(a) the differences between a Defined Benefit Scheme and a Defined Contribution Scheme (2 marks)

(b) the role of the trustees in such occupational pension schemes (4 marks)

(c) how asset securitisation can be used to fund pension deficits (4 marks)

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6. Brook plc (Brook) has a market capitalisation of £2 billion. The average gearing ratio (debt/equity) by market value in Brook's market sector is 25%. The total debt that Brook currently has in issue is in the form of bonds with a market value of £200 million. The board of Brook would like to issue sufficient debt capital to bring its gearing ratio up to 25% by market value.

Requirements

(a) Identify the factors that the board of Brook should consider when deciding upon the type of debt instrument to use to raise the additional debt capital. (4 marks)

(b) Assume that Brook issues bonds with a coupon of 4% (paid annually) and redeemable in five years' time at the par value of £100. An analyst has established that Brook could issue these bonds at a yield to maturity of 5%. Calculate the market price of the bonds and how many bond units Brook would have to issue in order to meet its target gearing ratio (you may assume that the value of equity remains constant). (4 marks)

(c) Explain the comparative advantages and disadvantages to Brook of issuing the bonds mentioned in (b) above with a coupon of 5% paid annually rather than 4% paid annually. (2 marks)

7. Boardman ltd., (Boardman) is seeking to raise £500,000 for expansion. Boardman was formed several years ago and has a successful operating history. The directors and shareholders of Boardman are unable to contribute any additional funds themselves and they have asked your firm to give them advice on how the £500,000 can be raised from external sources.

Extracts from the most recent financial statements are as follows:

	£	£
NON-CURRENT ASSETS		
Property		2,000,000
Vehicles and equipment		150,000
		2,150,000
CURRENT ASSETS (debtors £90,000; cash £10,000)	100,000	
CURRENT LIABILITIES (Including a bank overdraft of £400,000)	475,000	
NET CURRENT LIABILITIES		(375,000)
LONG-TERM LOANS		(200,000)
NET ASSETS		1,575,000

Requirements

Give advice to the Boardman directors and shareholders, which should include:

(a) whether Boardman needs to restructure its existing financing (2 marks)

(b) an estimate of the total funds that need to be raised (2 marks)

(c) three examples of sources of finance that Boardman could use to raise the total funds required (6 marks)

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SECTION B **TOTAL 50 MARKS**

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

Both questions in this section are based on the same company, Pittards plc (Pittards), 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 22 March 2016

Pittards' share prices during 2015/16:

- **22 March 2016** **70.5p**
- **29 February 2016** **63p**
- **29 January 2016** **76p**
- **31 December 2015** **82p**
- **30 November 2015** **100p**
- **30 October 2015** **92.5p**
- **30 September 2015** **96p**
- **28 August 2015** **132.5p**
- **31 July 2015** **127p**
- **30 June 2015** **135p**

The following article relates to Pittards:

The Guardian – online 23 December 2015:

"Pittards has published its second profit warning in three months after slowing global economic growth and events such as the Paris attacks suppressed demand for the leather manufacturer's products.
The 190-year-old company, based in Yeovil, Somerset, said in a trading update that it expected to make a reasonable profit in the year that ends

next week but that the figure would be materially below forecasts. The company did not give figures for market expectations.

Pittards said in September that demand for its goods had weakened because of slower growth in emerging markets such as Russia and China and wider economic uncertainty. It said then that annual profit would be less than forecast and the trend has continued amid turbulent world events with a further impact on profits.

Pittards employs 220 people in Yeovil and 1,700 in Ethiopia, producing leather mainly for sale to makers of upmarket gloves, bags and similar items. It sells to brands such as Jack Wills and the golfwear maker Footjoy and also supplies the British armed forces and other armies.

Reg Hankey, Pittards' chief executive, said: "If you look at the Russian situation and Chinese demand and, post-Paris, consumers in Europe being more cautious and turbulence in the Middle East, it makes most of the big brands a little bit more cautious and that results in slightly weaker demand for everything."

In the past 10 years, Pittards has started making its own branded goods and the company opened its first shop, in Somerset, this year. But with more than 90% of sales from exports it is exposed to global events and trends.

Pittards' shares fell as much as 9% and were down 8.6% to 85p in late morning trading. They have dropped by more than a third since the company's previous profit warning in September.

UK manufacturers have reported weakening overseas demand for their goods caused by the weaker global economy and the strength of the pound. A CBI survey last month showed that manufacturers expected output to fall in the coming three months as a downturn in China and other export markets hit demand.

Hankey said: "UK manufacturing companies all seem to be saying something similar: that order books have slowed up in the last six months or so and we are no different. But the fundamentals of what we are doing are sound."

He said the pound's recent fall against the dollar would help Pittards because more than 70% of the company's products are invoiced in

dollars. Lower raw material prices are starting to boost margins, the company added.
Hankey said Pittards would tighten up on costs but that jobs were not at risk and the company is recruiting new employees in the UK."

8. Several articles similar to the one above have been published regarding Pittards and the directors of the company are concerned about the threat of a takeover. The company has recently announced its results for the year ended 31 December 2015 and the board would like to hold a meeting with City analysts to discuss these results. At the meeting the directors will present a financial analysis of the company.

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

Requirements

(a) Prepare a financial analysis of Pittards 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 article above, whether the financial health and trends of Pittards might cause analysts to consider recommending that shareholders sell their shares. You must include a conclusion in your discussion. (6 marks)

(c) Explain two actions that the board of Pittards could take to encourage shareholders not to sell their shares in the company.

(4 marks)

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9. Assume now that an informal approach has been made to the board of Pittards regarding a takeover offer for its ordinary shares. The offeror has indicated that it might be willing to offer 90p for each of the ordinary shares of the company with the purchase price being paid for by way of a share exchange.

You work for the financial adviser of Pittards regarding the potential takeover offer. A director in your firm is due to attend a meeting with the board of Pittards and he has asked you to prepare a report on the potential takeover of the client company.

Requirements

Prepare a report that should contain:

(a) an estimate of a range of values for the ordinary shares of Pittards based on:

(i) discounted cash flow using a four year time horizon and assuming a growth rate of 2% thereafter. (Note: The Capital IQ estimates only show figures for 2016 and 2017). An appropriate risk free rate is 1.50% and market risk premium 5%. (11 marks)

(ii) a broad range of multiples (5 marks)

Note: In both parts (i) and (ii) 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 as to whether the potential offer price of 90p is likely to be acceptable. (3 marks)

(c) a discussion of the comparative advantages and disadvantages for the shareholders of Pittards of receiving the purchase consideration by way of:

(i) a share exchange, or

(ii) cash

(4 marks)

(d) Assume that a formal offer for the ordinary shares of Pittards is made and that the board of Pittards wishes to reject the offer. Provide details of any specific Takeover Code rules that apply to defence documents. (2 marks)

End of examination paper