

ICAEW / CISI Diploma in Corporate Finance

December 2015

CHIEF EXAMINER'S REPORT CORPORATE FINANCE TECHNIQUES & THEORY

INTRODUCTION

22 candidates sat the exam and the overall standard was reasonable, with a pass rate of 73%. 7 candidates were awarded a merit and 2 candidates were awarded a distinction.

The standard in both sections of the paper was mixed and the examiner would like to emphasise that it is necessary for candidates to demonstrate a broad knowledge of corporate finance topics. There were a number of scripts where the handwriting was very hard to read, and candidates should be aware that illegible scripts will not be marked.

Section A:

Turning to the individual questions:

1. 17 attempts with an average mark of 7.1 out of 10 marks. Answers to all parts of this question were reasonable.

(a) In relation to the debt instruments, candidates should have mentioned coupon payments; redemption, cash or conversion; nominal values; market values; risk; and year to date (YTD). They should have made a distinction between debt instruments and preference shares.

For debt instruments, 0.5 marks per point made up to a maximum of 2 marks. For distinction and characteristics of preference shares, 1 mark.

(b) In relation to debt versus equity, candidates should have mentioned: tax relief on coupon payments, control issues, gearing and risk.

Director two: The main difference is that the coupon payable on a bond is allowable for tax purposes whereas the dividend for a preference share is not. However the coupon payment cannot, normally, be delayed whereas a preference dividend can be. Directors three and four: The coupon on a convertible bond might be cheaper than a non-convertible bond since the ability to convert is valuable. Zero coupon bonds are the cheapest in terms of there not being any cash flow impact during the life of the bond, however to compensate for this they will have to be issued at a deep discount. This means that more bond units will have to be issued and this could cause problems on redemption.

3 marks for debt versus equity and 3 marks for addressing the directors' statements.

(c) Issuing bonds with 100 years to maturity or perpetual debt in the current, low-

interest, market may be attractive; however, the coupon may be slightly higher than redeemable debt. Taking account of inflation, investors in the bonds are likely to be losing money on their capital. Perpetual very long dated debt blurs the line between debt and equity and can be problematic in assessing financial risk. The major advantages are that the debt will never need to be refinanced and projecting interest expense is not a problem.

0.5 marks per point, max 1.

2. 15 attempts with an average mark of 6.1 out of 10 marks. Responses to all parts of the question were mixed with some very poor answers. In part (a) very few candidates mentioned The High Growth Segment and, instead, many mentioned the Alternative Investment Market (AIM).

In part (b) few candidates mentioned the UK Financial Services and Markets Act 2000 (FSMA).

(a) Candidates should have provided an outline of the Premium, the Standard and the High Growth Segments.

1 mark each.

(b) The Financial Conduct Authority (FCA) is the regulatory body acting in its capacity as the UK's competent authority for the purposes of Part VI of the FSMA. The FSMA sets and administers the criteria governing admission to the Official List. The name given to the FCA when acting in its capacity as the competent authority is the UK Listing Authority (UKLA). The relevant rules are the Listing Rules, Prospectus Rules and Disclosure and Transparency Rules.

1 mark for FCA and UKLA, 1 mark for FSMA and 1 mark for relevant rules.

(c) Candidates should have included for example:

- An application made to both the UKLA and the London Stock Exchange (LSE)
- A prospectus is required and must be approved by the UKLA
- Must comply with the UKLA's Listing Rules and the LSE's admission and disclosure standards
- Part VI of FSMA
- There must be a free float of shares of at least 25% for Premium and Standard and 10% for High Growth
- At the time of admission to listing there must be at least 25% of each class of shares in the hands of the public in one or more European Economic Area (EEA) States
- The minimum size is an aggregate value of shares of £700,000
- Must have published or filed historical financial information which covers at least three years

0.5 marks each, maximum 4.

3. 8 attempts with an average mark of 5.1 out of 10 marks. Answers to part (a) were reasonable. However, answers to parts (b) and (c) were poor with many computational errors. In part (b) few candidates mentioned the likely reaction of the markets to the rights issue.

(a) The theoretical ex-rights price (TERP) =

Pre-discount share price = 175p(140/0.8).

TERP = 166/25p $((175.5 \times 3 + 140 \times 1)/4)$

1 mark.

(b) Wealth before the rights issue = £2,625 (1,500 x 175p)

The bonus element in the rights issue = 1.0526 (175/166.25)

The bonus shares = 78.9 $((1,500 \times 1.0526) - 1,500)$

The value of original shares and bonus shares = £2,625 (1,578.9 x 166.25p)

Full price shares cost £700 $((500 - 78.9) \times 166.25p)$

Total wealth after the rights issue = £3,325 (2,000 x 166.25)

Proof: (original wealth + cost of shares) (£2,625 + £700)

1 mark bonus element, 1 mark full price and 1 mark wealth after.

(c) Earnings Per Share (EPS) 2015 Timing 1/10-30/04 = 7 months 1/05-30/9 = 5 months.

Weighted number of shares:

1/10-30/04 = 2.8859m $(4.7 \times 1.0526 \times 7/12)$

1/05-30/9 = 2.6113m $((4.7 + 4.7 \times 1/3) \times 5/12)$

Total weighted number of shares 5.4972m (2.889 + 2.6113)

EPS = 29p (£1.6m/5.4972m)

EPS 2014 original 20p. Adjusted of comparison with 2015 = 19p $(20 \times 1/1.0526)$

2 marks for 2015 and 1 mark for 2014.

(d) The board should not be concerned since the wealth of shareholders will remain the same provided that they take up, or sell, their rights. The EPS and therefore the Price-To-Earnings (P/E) ratio should reflect the rights issue. However, this is based on a TERP, the market reaction to the rights issue might mean that the share price is below or above the TERP.

1 mark shareholders wealth, 1 mark based on TERP and 1 mark market reaction.

4. 12 attempts with an average mark of 5.4 out of 10 marks. Responses to parts (a) and (b) were mixed with some reasonable answers. However, a worrying number of candidates thought that call options would only be counted if exercised.

(a) The shares registered in Peter's name now total 450,000, which is 3% of White's ordinary shares. Peter and Acquisitive now hold 29% of the shares in White and this would not trigger a Rule 9 offer. The gift of 150,000 shares is covered by Note 12 of Rule 9.1 and this takes the total holding of Peter and Acquisitive to 30%, triggering a Rule 9 offer.

1 mark for Rule 9, 1 mark for Peter and Acquisitive jointly holding shares, 1 mark for the rule relating to gifts and 1 mark for a conclusion.

(b) The panel must be consulted (Note 12 to Rule 9.1) and there might have to be a mandatory offer for the shares of White, the price to be paid subject to Notes 2 and 3 to Rule 9.5. However, it could be argued that Rule 9 had been breached by an inadvertent mistake (Note 4 on dispensations from Rule 9). In this case the panel would normally require the percentage of shares to be reduced within a limited time period to below 30%.

1 mark mandatory offer, 1 mark price to be paid, 1 mark inadvertent mistake and 1 mark reduce the holding.

(c) Call options are covered in the definition of interests in securities and a Rule 9 situation would still be triggered if Peter's wife had purchased call options.

1 mark for definitions and 1 mark for conclusion.

5. 21 attempts with a mark of 8.3 out of 10 marks. Well answered.

(a) Market abuse is a civil offence under s118 of FSMA which provides a regime for enforcing the criminal prohibitions on insider dealing and market manipulation. The UK market abuse rules implement the EU Market Abuse Directive. Market abuse is behavior, which occurs in relation to:

- qualifying investments admitted to trading on a prescribed market
- qualifying investments in respect of which a request for admission to trading on a prescribed market has been made
- related investments of a qualifying investment.

Market abuse falls within one or more of the offences of market abuse: Insider Dealing, Improper Disclosure, Misuse of Information, Manipulating Transactions, Manipulating Devices, Dissemination, Misleading Behaviour and Distortion.

2 marks for statutory backing, 1 mark for definition and 0.5 marks for each offence. Max 6 marks.

(b) This is based on a real case (Einhorn and Punch Taverns) the following is from an analysis of that case:

The FSA rejected Einhorn's assertion that Punch had not conveyed inside information because the discussion had been at a "conceptual level." The FSA concluded "reasonable investors are expected to interpret comments made to them in an appropriate manner, which may sometimes mean understanding more than the precise words spoken, or interpreting certain comments in light of the context." The FSA acknowledged that there was no single statement of inside information made during the conference call and that some interpretation was required to find that inside information had been imparted. However, the FSA found that the clear interpretation of the comments taken as a whole disclosed inside information because Punch management had "disclosed to Mr. Einhorn the purpose and anticipated size and

timing of the issuance"[9] .

Refusing to sign a non-disclosure agreement and communicating the desire to avoid receiving inside information does not mean that information received is generally available or is public information. Investors must make their own, independent determination regarding whether they have been provided inside information or material, nonpublic information. This determination may require analyzing the totality of many bits of information, understanding the nature of the communications, and consulting with counsel. For that matter, investors may wish to assess whether a company has complied with any agreement to provide a cleansing press release[11] or, in the United States, a current report on a Form 8-K, which is common in many private placement transactions (Source: Jones Day).

I expected candidates to produce a similar, but shorter, interpretation.

1 mark for insider trading and misuse of information, 1 mark for it not being relevant that Street had not signed the non-disclosure agreement and 2 marks for the conclusion.

6. 18 attempts with an average mark of 7.4 out of 10 marks. There were good answers to part (a); however, responses to part (b) were often poor.

(a) All sensible comments were given marks; however, candidates should have mentioned: (i) the ability of the management team to raise the finance and continue to run the business; (ii) finding the buyer at the right price is difficult for small companies; and (iii) restrictions on the amount of shares that can be bought back. 2 marks for each alternative.

(b) There are two main problems that any buyer will be concerned about, those being the ability of the current staff to run the business and the continuity of the supply chain. The actual method of exiting the business is likely to be either a management buyout (MBO) or a friendly buyer.

2 marks for such matters as staff and supply chain and 2 marks for a reasonable recommendation.

7. 18 attempts with an average mark of 6.5 out of 10 marks. Answers to part (a) were mixed with some good responses. However, few candidates achieved more than two marks for part (b).

(a) Candidates should have described: the price of the underlying, the exercise price, time, volatility and the risk free rate. With the exception of the exercise price, the effect of an increase in these inputs will mean that the option value will rise. If the exercise price is increased, the option value will fall. In their explanation of why the option price is affected by an increase in the five inputs into the Black-Scholes option pricing model, candidates should refer to risk and probabilities.

2.5 marks for inputs and 3.5 for effect and explanation.

(b) Options that candidates might have mentioned included protective put options,

foreign exchange rate and interest rate options, real options, conversion rights, ordinary shares and warrants.
1 mark for each.

Section B:

8. 22 attempts with an average mark of 15.1 out of 25 marks. Part (a) was well answered by better candidates, however there were also some very poor responses. Part (b) was not well answered with few candidates making reference to the newspaper article. Part (c) tended to be a brain dump of ideas with little reference to the question scenario.

(a) 10 marks for analysis and 5 marks for conclusions.

(b) 2 mark for reference to the newspaper article, 2 marks for trends and estimates and 2 marks for conclusions.

(c) Sensible suggestions will be given marks. 2 marks each.

9. 21 attempts with an average mark of 12.5 out of 25 marks. Responses to parts (a) and (b) were mixed with some poor answers, however good candidates scored highly. Responses to parts (b) and (c) were poor with few candidates relating their answers to the question scenario.

(a)(i) In their discounted cash flow (DCF) valuation, candidates should have included adjustments for capital expenditure (CAPEX), working capital and depreciation: a computation of the weighted average cost of capital (WACC) and assumptions and limitations.

Computations – 6 marks and assumptions and limitations – 4.

(ii) In their multiples valuation, candidates should have included consideration of the comparability of the comparable companies and justification for their choice of multiples.

Computations – 3 and justification of multiples 2 marks.

(b) The offer price must be supported by reference to the current share price and the range of values. Candidates should have mentioned the use of specialist institutions to raise the finance.

2 marks for the offer price and 2 marks for finance.

(c) 2 marks for each.

(d) Candidates should have mentioned Note 4 to Rule 25.1 regarding directors

involved in the MBO team and Rule 3.1 regarding independent advice.