ICAEW / CISI Diploma in Corporate Finance

June 2015

CHIEF EXAMINER'S REPORT
CORPORATE FINANCE TECHNIQUES & THEORY

INTRODUCTION

Twenty candidates sat the exam and the overall standard was good with a pass rate of 70%, 4 candidates were awarded a merit and 2 candidates were awarded a distinction.

The Examiner noted that section B questions were generally well answered and students were providing an adequate number of reservations and assumptions. Section A questions were less well answered and, in particular, question five was attempted by only three candidates. The question was based on a practice statement which is available on the Takeover Panel website. It should be noted by candidates that the syllabus specifically states that practice statements are examinable. The examiner would again like to warn future candidates to be prepared for questions from any area of the syllabus.

Turning to the individual questions:

1. 15 attempts with an average mark of 4.6 out of 10 marks. Section (a) was reasonably well answered, however a number of candidates thought that acquiring 53% of a target company's shares triggered a mandatory offer. Section (b) (i) was well answered however (b) (ii) was not well answered.

   (a) (i)3%. Must notify the target company within two business days.
   1 mark.

   (ii) 10%. Can block a squeeze out by another bidder. But a scheme of arrangement may be used.
   1 mark for squeeze out. 1 mark for scheme of arrangement.
   (Note: Mention of Rule 11 = 1 mark)

   (iii) 30% A rule 9 offer is required. 1 mark.

   (iv) 53%. Power to appoint or remove directors. Also the offer can be declared unconditional as to acceptances. However in recommended offers the acceptance level for is likely to be much higher.
   1 mark for powers. 1 for unconditional as to acceptances.

(f) 75%.The required majority of voting shares needed to approve a special resolution and/or to approve a scheme of arrangement.
1 mark for special resolution. 1 mark for scheme of arrangement.

(b) (i) Where a bidder, or any person acting in concert with it, acquires an interest in shares in the target company during the three months prior to the offer period the bid price must not be less than the highest price paid by the bidder, or person acting in concert with it, during that period. 1 mark.
(ii) The offer price must be not less than the highest price paid by the bidder for share in the 12 months prior to the offer period :

- where a compulsory bid is required
- where the bidder, or any person acting in concert with it, have acquired an interest in shares in the target for cash during the preceding 12 months which carry 10% or more of the target company voting rights.

1 mark for each.

2. 8 attempts with an average mark of 3.9 out of 10 marks. Both sections of this question were not well answered which is a little surprising. Many candidates completely ignored the scenario of the question.

(a) The CEO is incorrect because: Rules in the Companies Act 2006 that came into effect from 1 October 2009 state that, subject to some exceptions, a public company is prohibited from giving financial assistance for the purpose of the acquisition of its shares or those of a parent company. This extends to a private company in that it is prohibited from giving financial assistance for the purpose of the acquisition of shares of a public parent company. Since 1 October 2008, a private company may give financial assistance for the purchase of shares in itself or another private company. Lion is a public company and its private subsidiaries will not be able to give financial assistance for the purchase of its shares.
1 for public companies andfor private subsidiaries of a public company; 1 for private to private; 1 for application to the scenario.

(b) It is likely that the bank will want to regulate the conduct of the offer and to restrict King's ability to declare the offer unconditional unless the 90% acceptance level has been reached.
King's bankers will most likely want to secure the loans on the assets of Lion and its subsidiaries and this would breach the financial assistance rules. Therefore the security cannot be taken until after the offer has been declared unconditional and the target can be re-registered as a private company.
A typical approach might be:

(i). On the announcement of a firm intention to bid, King's bankers will take out a charge over its assets including any shares acquired in Lion.

(ii). When the offer is declared unconditional in all respects (at a 90% level), Lion can grant charges to King's bank to secure any new working capital advances made by King's bank to Lion.

(iii). Once Lion has been re-registered as a private company further charges can be granted by Lion and its subsidiaries for King to secure the loans.

Re-registration as a private company requires the passing of a special resolution of a Lion's shareholders. Shareholders numbering 50 or more or holding not less than 5 per cent. of the issued share capital or of any class of shares, who do not consent to or vote in favour of the resolution - for example, Lion's shareholders who have not yet accepted the offer (even though it has become unconditional) - can apply to the court to have any re-registration resolution cancelled. Shareholders who do not object within a 28 day period become barred from objecting thereafter. The re-registration process is likely to be postponed until after this 28 day period unless acceptances of the offer have exceeded 95 per cent. and there are fewer than 50 non-assenting shareholders.

2 for 90% acceptances and for mention of financial assistance applied to the scenario; 3 for typical approach; 2 for resolution issues.

3. 20 attempts with an average mark of 9.1 out of 10 marks. All sections were well answered.

(a) Indicative timetable below, variations were acceptable.

Time before listing	Stages
24 weeks	Appoint advisors Planning Consult FCA Commence long form report
8 to 12 weeks	Draft documents prepared Drafts submitted to FCA Public relations campaign starts
1 to 6 weeks	Draft prospectus Verification Formal submission of documents to FCA
Final week	Approval of documents by FCA Completion meeting Underwriting agreement signed Investment presentations Allocation list open and basis of allocation is announced Formal application for listing Listing granted Dealing commences

1 for timetable; 0.5 for each box, reasonable list will get marks.

(b) Candidates should have given a description of each method and the state the relative advantages, which include:

The advantages of a placing over an offer for sale:

- Cost; the placing method is cheaper than an offer for sale since it involves selling the shares to a limited number of investors rther than having to undertake a widespread general marketing and advertising campaign

- Targeting of investors: The placing gives the company the opportunity to target an appropriate investor base and to select its shareholders more carefully.

- Speed: The placing may be carried out much more quickly than a public offering.

The advantages of an intermediaries offer over an offer for sale and a placing:

- Cost: cheaper for the issuer than an offer for sale.

- Investors: Gives more opportunity for the public to participate than with a placing.

- Speed: Quicker than an offer for sale.

The advantage of an offer for sale over a placing and an intermediaries offer is that there will be a wider shareholder base.

2 for description; 4 for advantages.

(c) Given the specialist nature of Orion's business it is likely that a placing would be the most appropriate method of bringing it to listing since it will be possible to target more specialist investors.
1 mark. No support 0 mark.

4. 15 attempts with and average mark of 3.2 out of 10 marks. The examiner was surprised that in section (a) many candidates did not know how to calculate the yield to maturity of the bonds, this question has been asked many times before and should be an easy and routine calculation. In section (b) few candidates were able to discuss the implications of issuing at par or at a premium on par. Section (c) was reasonably answered.

(a) The yield to maturity can be approximated as follows:
(6-(10/7)/((100+110)/2)= 4.35%
Full marks also given for linear interpolation.
2 marks.

(b) The bonds would be issued at par if the coupon is equal to the yield to maturity of 4.35%. The take up of the issue with a lower coupon and issue price will depend on the investors' requirements for income or capital.
For Caspian if the bonds are issued at £110 this will only require 909,090 bond units to be issued, annual interest payments of £5,454,450 (909,090 x £100 x 6%) and a capital payment of £90,909,000 in seven years.
If the bonds are issued at £100 this will require 1,000,000 bond units to be issued, annual interest payments of £4,350,000 (1,000,000 x £100 x 4.35%) and a capital payment of £100,000,000 in seven years.
The decision will depend on the cash flow requirements of Caspian.
Note: This assumes that the YTM will be the same for bonds with different coupons.
1 for issuing at YTM; 1 for take up;1 each for the cash flow effects; 1 for the conclusion.

(c) A prospectus will have to be issued by Caspian typical contents include:

- Summary
- Risk factors
- Information about the bonds
- How to apply for the bonds
- Taxation
- A description of Caspian
- Selected financial information
- Subscription and sale
- References to information
- Legal information

1 for prospectus; 2 for contents.

5. 3 attempts with a mark of 3.7 out of 10 marks. Well answered by one of the candidates.

(a) Since Grizdale's announcement was made after the third party offer, in accordane with note 2 (a) to rule 2.8 Grizdale will not be able to make an approach unless (i) the third party offer has been withdrawn or has lapsed; and (ii) in the period following the making of the statement and prior to the third party offer being withdrawn or lapsing, neither the person who made the statement nor any person acting in concert with that person has acquired an interest in any shares of the offeree company.

1 mark for application; 2 for rules.

(b) Since there has been an offer after Grizdale made its announcement, in accordance with note 2 (b) to rule 2.8 where a third party announces a firm intention to make an offer for Track the restrictions will not apply. Grizdale can make an approach to Track.
1 mark.

(c) This will be regarded under note (d) to rule 2.8 as a material change in circumstances and Grizdale will be able to make an approach.
1 for material; 1 for conclusion.

(d) This will not be regarded under note (d) to rule 2.8 as a material change in cuircumstances and Grizdale will not be able to make an approach.
1 for not material; 1 for conclusion.

(e) If a single confidential approach is made and is rejected by the board of the offeree company. Girzdale will not normally be permitted to make any further approach to the board of Track for the remainder of the restricted period under Rule 2.8, in accordance with the restriction in Rule 2.8(e). Only the board of T
rack is be permitted to initiate any further contact between the parties during the remainder of the restricted period.
Grizdale will not normally be allowed to make a second approach.
1 for the rule; 1 for conclusion.

6. 19 attempts with an average mark of 6.1 out of 10 marks. Both parts of the question were well answered. However it was a little surprising that in section (a) some candidates did not provide any calculations to support their response.

(a) The hotel purchase is a major undertaking for Northern and at the spot rate will be approximately £1.5 million. Northern is also running a substantial overdraft and has net current liabilities. Since Northern is a private company it would be necessary to ensure that, in achieving a profit before tax of £200,000, all the charges in the profit and loss account are realistic and set at commercial levels.

The company requires has net current liabilities and needs an injection of long-term funds. For example if the overdraft was repaid and by taking out a long term loan this would give a current ratio of 1.4 :1 (110:80). However long term loans would increase to £2.750 million increasing the book value gearing to 81% (2.750/3.380) from 67% (2.250m/3.380m)

Assuming that the purchase of the hotel in Asturias is financed by additional borrowing this would increase the gearing to:
87% ((1.5m+2.750m)/(3.380m+1.5m)).
The borrowings would represent 57% ((1.5m + 2.750m)/(1.5m + 6m))of the property value.
This is a high level of gearing and it would be appropriate for Northern to seek additional long-term finance in the form of share capital.

Candidates should then have considered two appropriate sources of additional finance.

3 for analysis including some computations; 2 each for the sources of finance.

(b) Students should have mentioned for example: Country risk, low in this case; Foreign exchange rate risk in relation to the purchase in three months time compared to the spot rate and regarding the remittance of cash flows back to the UK for ongoing transactions.
1 for country risk; 1 for the purchase; 1 for ongoing transactions.

7. 14 attempts with an average mark of 6.7 out of 10 marks. All sections were well answered by the majority of candidates.

(a) A significant transaction is one that is outside the ordinary course of the listed company's business. It is assessed as being outside the ordinary course of business by regard to its size and incidence.
It is important because it is likely to be a transaction which may change a security holder's economic interest in the company's assets or liabilities.
1 for definition; 1 for why it is important.

(b) The transfer of the subsidiary to Newco should be classified by Apple as a disposal and applying the profits, gross assets and consideration to market captialisation tests will assess its classification.
1 for disposal; 1 for tests.

(c) Separately Apple should classify the acquisition of its share in Newco. If this interest is not going to be consolidated into Apple's accounts, the only tests applicable will be the gross assets and the consideration to market capitalisation tests.
1 for acquisition; 1 for tests.

(d) 0.5 marks given to each item mentioned, max 3; 1 mark for class 1 comment.

8. 19 attempts with an average mark of 17.1 out of 25 marks. Part (a) was well answered, however part (b) was less well answered with some candidates not referring to the analysis in part (a) and/or the newspaper articles.

(a) 10 marks for the analysis including; 5 marks for conclusions.

(b) 2 marks for reference to newspaper articles; 2 marks for inclusion of the estimates report; 6 marks for supported conclusions on the two options.

9. 19 attempts with an average mark of 17 out of 25 marks. Part (a) (i) and (ii) were well answered with most students making reasonable attempts at the computations and stating assumptions and limitations. Stating assumptions and limitations. Part (b) was answered.

(a) (a) (i) In their DCF valuation candidates should have included: adjustments for CAPEX; working capital; depreciation: a computation of WACC: assumptions and limitations.
Computations – 6; assumptions and limitations – 4.

(ii) In their multiples valuation candidates should have included: consideration of the comparability of the comparable companies; Justification for their choice of multiples.
Computations – 4; justification of multiples 2.

(b) (i) Any reasonable pre-approach defence was awarded marks. e.g. Investor road shows; profit forecast; newspaper articles. 2 marks for each.

(ii) Candidates should have mentioned, for example: taking independent advice; recommended offers v hostile offers; defence documents; white knights.
4 for strategies; 2 for code rules.