ICAEW / CISI Diploma in Corporate Finance

June 2016

CHIEF EXAMINER'S REPORT
CORPORATE FINANCE TECHNIQUES & THEORY

INTRODUCTION

Twenty-one candidates sat the exam and the overall standard was reasonable with a pass rate of 67%. Five candidates were awarded a merit and three 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 that candidates are prepared to demonstrate a broad knowledge of corporate finance topics. There were a number of scripts where the writing 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. Nine attempts with an average mark of 4.3 marks out of 10 marks. Answers to both parts of this question were poor. A number of candidates gave very general answers with no, or very little, reference to the Code. Those who did not mention the Code at all received no marks.

Candidates should have provided:

(a) A description of the 'put up or shut up' rules in the Code and how they apply to Pear.
3 marks for description including rules; 3 marks for application to the scenario.

(b) The options for Blueberry to have the put up or shut up deadline extended or do nothing.
2 marks for rules; 2 marks for application to the scenario.

2. Eight attempts with an average mark of 6.4 marks out of 10 marks. Answers to all parts of this question were reasonable with some unusual approaches to part (b), which were acceptable.

Candidates should have:

a) Mentioned for example: planning; attitude to risk; effect of adverse movements in exchange rates; hedging v not hedging.
1 mark for each valid point.

(b) Mentioned that the bank will use interest rate parity to calculate the forward rate and provided calculations of the forward rate as follows:

Mid spot rate = €/£ 1.27105 ((1.2330 + 1.3091)/2)

The three month forward rate is =
€/£ 1.2648 (1.27105 x ((1 + 0.04/4)/(1 + 0.06/4)))
This mid rate will be adjusted for the bid-offer spread.

1 mark for mention of interest rate parity; 2 marks for calculations.

(c) Mentioned for example: fixed rate for a forward contract; the upside potential of options while protecting downside risk; option premiums.
1 mark for each valid point.

3. Twenty-one attempts with an average mark of 8.2 marks out of 10 marks. Answers to both parts of this question were good.

Candidates should have:

(a) Mentioned for example: benefits: focus on central strategy; elimination of cross-subsidies; capital market factors; defence against takeover; motivation of management; cultural differences; increase in market value. Problems: internal reorganisation; tax; size of the independent companies; use of central services; employee issues.
0.5 marks per point – maximum 4 marks.

(b) Mentioned for example:

(i) Conducted under the Companies Act 2006; court approval; shareholders must approve a special resolution requiring 75% majority in value of the shareholders voting; creditors must approve.
Each point – 1 mark.
(ii) Arises under the Insolvency Act 1986: parent put into voluntary liquidation; assets distributed to two new companies; assets paid for by shares given to the shareholders of the liquidated parent; creditors paid or debts reassigned to the new company; employee contracts reassigned.
Each point – 1 mark – maximum 3 marks.

4. Eighteen attempts with an average mark of 5.7 marks out of 10 marks. Answers to both parts of this question were reasonable. However, a number of candidates did not consider the rules relating to aggregation.

Candidates should have:

(a) Mentioned that the April 2015 transaction should not be included when considering the July 2016 transaction. Explained the rules relating to aggregating transactions and the implications for the July 2016 transaction. Concluded that July 2016 would be aggregated with March 2016; consideration to market value is more than 25% and so it is a class 1 transaction.

3 marks for the aggregation rules and 4 marks for calculations and implications.

(c) Described the rules relating to reverse takeovers – 2 marks; application to the scenario – 1 mark.

5. Eighteen attempts with an average mark of 8.8 marks out of 10 marks. Answers to all parts of this question were good.

Candidates should have:

(a) Described that: in defined benefit schemes the employer takes the risk and guarantees a pension based on final salary levels; in defined contribution schemes the employee takes the risk and the pension depends on investment performance and annuity rates available on retirement or cash settlement.
1 mark for each.

(b) Mentioned for example: proper operation of the scheme; funding levels; recovery plans; communication of information; contributions being paid as expected; investment of pension monies.
1 mark for each valid point.

(c) Mentioned for example: an explanation of securitisation; special purpose vehicles; control of the SPV; cost; credit risk; protection.
1 mark for each valid point.

6. Eleven attempts with an average mark of 7 marks out of 10 marks. Answers to all parts of this question were reasonable.

Candidates should have:

(a) Mentioned for example: coupon-paying bonds; zero coupon bonds; convertible bonds; fixed-rate bonds; floating-rate bonds.
1 mark per relevant factor mentioned.

(b) Calculated the market price of the bonds and the number of bond units to be issued as follows:

Market price: £95.67 (4 x 4.329 + 100/1.05^5)

To bring the debt equity ratio up to 25% the company will have to issue bonds where the proceeds equal £300 million (£2 billion x 25% − £200 million). Since the bond price is less than £100 the number of bond units to be issued is:

(£300 million/0.9567)/£100 = 3,135,779.

2 marks for the bond price; 2 marks for the number of bond units to be issued.

(c) Mentioned, for example, that if the coupon is raised to 5% from 4% the bonds will be issued at par. This will result in fewer bond units being issued but a higher interest payment each year. If the coupon is kept at 4% there will be a lower interest cost each year but a higher lump sum payment on redemption of the bonds. Mentioned that Brook should consider the cash flow implications.
0.5 marks for each relevant point – maximum 2 marks.

7. Seventeen attempts with an average mark of 6.5 marks out of 10 marks. Answers to all parts of this question were reasonable.

Candidates should have:

a) Mentioned that since Boardman has net current liabilities and a large bank overdraft it should restructure its financing.
1 mark for each relevant point made.

(b) Provided computations similar to the following:
Assuming a current ratio of 2:1, Boardman needs to raise £425,000 for working capital and £500,000 for expansion – a total of £925,000.
1 mark for total; 1 mark for working capital.
Reasonable assumptions regarding the current ratio were acceptable.

(c) Provided appropriate sources of finance for Boardman.
2 marks for each.

8. Twenty-one attempts with an average mark of 16.1 marks out of 25 marks. Answers to all parts of this question were reasonable.

Candidates should have:

a) Provided a financial analysis.
10 marks for analysis; 5 marks for conclusions.

(b) Provided a discussion with a conclusion in which they made reference to the newspaper article and mentioned trends and estimates.
2 marks for reference to the newspaper article; 2 marks for trends and estimates; 2 marks for conclusion.

(c) Provided sensible suggestions of actions that the board of Pittard could take.
2 marks each.

9. Twenty-one attempts with an average mark of 14.8 marks out of 25 marks. Answers to all parts of this question were reasonable.

Candidates should have:

(a) (i) In their DCF valuation, included: adjustments for CAPEX; working capital; depreciation: a computation of WACC: stated assumptions and limitations.
Computations – 7 marks; assumptions and limitations – 4 marks.

(ii) In their multiples valuation, included: consideration of the comparability of the comparable companies; justification for their choice of multiples.
Computations – 3 marks; justification of multiples – 2 marks.

(b) Made a supported recommendation making reference to the current share price and the range of values.
1 mark for decision; 2 marks for support.

(c) Mentioned for example: uncertainty of the offer price with a share exchange v cash; replacing an investment v cash; taxation; risk; control.
1 mark for each relevant point made.

(d) Stated the rules relating to defence documents and provided a brief timetable.
1 mark for rules; 1 mark for the timetable.