ICAEW / CISI Diploma in Corporate Finance

December 2014

CHIEF EXAMINER'S REPORT
CORPORATE FINANCE TECHNIQUES & THEORY

INTRODUCTION

Twenty nine candidates sat the exam and the overall standard was good with a pass rate of 72%. Eight candidates were awarded a merit and four candidates were awarded a distinction.

In both Sections A and B the better candidates demonstrated a high standard across the corporate finance topics examined and there was no evidence of undue time pressure. Again the Examiner noted that: whilst for the better candidates there was a marked improvement in the core skills of discounted cash flow and financial analysis, weaker candidates were still making some very basic errors; when asked to give advice and reach conclusions weaker candidates were lacking; some candidates answered certain questions generically and did not refer to the scenario of the question; the handwriting of a number of scripts was very hard to read. It should also be noted that the examiner is looking for competence across both sections of the paper and that weaker candidates were not gaining respectable marks in section B. Whilst there is no requirement to pass each section of the paper, it is a dangerous strategy for candidates to not ensure that they are competent in the section B topics. The examiner also noted that question 3 was only attempted by one candidate and would 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 5.5 out of 10 marks. In section (a) some candidates demonstrated that they were not up to date with the recent Code changes. Part (b) was well answered. Part (c) was not well answered, with some candidates not making any distinction between an MBO team and an external offeror.

    (a) The fact that the central management of Lightspeed is in Austria does not exclude the company from being within the scope of the Code.
    2 for the Code rules; 1 for the chairman being incorrect.

(b) The code includes a number of exceptions from the requirement to obtain reports on profit forecasts from independent accountants and financial advisers.
The exceptions are for:

- A profit forecast made before any approach for a possible offer Publication of an "ordinary course profit forecast" during an offer period – but only if the other party consents and after consultation with the Takeover Panel
- A forecast for a period ending more than 15 months from the date on which the forecast is made – but if such a forecast is repeated in an offer document, a forecast for the current financial year and any intervening financial years up to 15 months must be prepared and reported on
- A profit forecast that only states a maximum figure for the likely level of profits for a particular period (with the agreement of the Takeover Panel).

In Lightspeed's case an approach has been made and the exceptions do not apply.
3 for the Code exceptions; 1 for Lightspeed's situation; 1 for the company secretary being incorrect.

(c) Where the offer is a management buy-out the exceptions do not apply and reporting will be required.
2 marks.

2. 29 attempts with an average mark of 8.6 out of 10 marks. Both sections were well answered.

   a) Candidates should have briefly described: Insider dealing; Improper disclosure; Misuse of information; Manipulating transactions; Manipulating devices; Dissemination; Distortion or misleading behavior.
   1 mark for each.

   (b) The secretary is guilty of improper disclosure, if her partner buys call options on Oakwood shares they are both likely to be guilty of insider dealing.

   1 for improper disclosure; 2 for the situation if the partner buys call options.

3. 26 attempts with an average mark of 7.8 out of 10 marks. Both sections were well answered.

   (a) A currency swap will enable Dragon to raise funds in one currency and to convert these funds into another currency, an exchange rate will be agreed

between the counterparties. The currency swap can be transacted directly with another company or through an intermediary such as a bank. There will be an obligation to make interest payments in the foreign currency throughout the duration of the currency swap. The funds will be swapped back at the end of the swap at the initial exchange rate, hence a currency swap can be considered to be a long-term forward contract. Currency swaps can be combined with interest rate swaps to convert fixed rate borrowing to floating or vice versa.
1 mark for each point mentioned, max 4.

(b) Advantages include: flexibility; cost; avoiding foreign exchange market uncertainties; access to finance; financial restructuring; conversion of debt type; liquidity improvement.
Disadvantages include: counterparty risk; market risk; sovereign risk; fees.
1 mark for each advantage1 mark for each disadvantage.

4. 19 attempts with and average mark of 7 out of 10 marks. All sections were well answered.
(a) The EVA of the Volkswagen Group is as follows:

31 December 2012 = 10,904 – (65,749 x 0.078) = €5,776 million.
31 December 2013 = 10,536 – (72,749 x 0.083) = €4,498 million.

Candidates should have mentioned that the above calculations are carried out using operating profits. EVA calculations should use economic profit.

1 mark for calculations; 1 mark for reservation.

(b) EVA is an economic profit and is after charging an implied cost for the use of capital. Volkswagen is producing positive EVAs it is therefore in vesting in projects with a positive NPV, this will increase the wealth of its shareholders.
3 marks for a suitable explanation.

(c) Problems include: no standard way of calculating economic profit; computation of the cost of capital; use of the CAPM; identifying the market risk premium; time period; calculation of invested capital.
1 mark for each point, max 5.

5. 1 attempt with a mark of 3 out of 10 marks. Not well answered.

(a) The Listing Rules define a controlling shareholder to be any person who, individually of together with any of their associates and concert parties, exercises or controls 30% or more of the shares capable of being voted at a company's general meeting. Andrew Price controls 32% of the shares of ABC and a controlling shareholder agreement will have to be put in place.
1 mark for definition; 1 mark for an agreement being necessary.

(b) The undertakings are:

- to have an arms' length relationship with the company and only transact with it on an arms' length basis;
- not to take any action to prevent the company from complying with the Listing Rules;
- not to propose any shareholder resolution aimed at circumventing the proper application of the Listing Rules.

1 mark for each.

(c) There is a continuing obligation which requires a premium listed company to notify the FCA without delay if it no longer complies with the independence provisions set out in the controlling shareholder agreement, or if it becomes aware that the controlling shareholder is not complying with the independence provisions in that agreement. There are sanctions and enhanced oversight measures where the company or controlling shareholder are not in compliance with independence provisions.
2 marks for continuing obligation; 1 mark for mention of sanctions and oversight measures.

6. 24 attempts with an average mark of 6 out of 10 marks. Part (a) was well answered. Part (b) was not well answered with weaker students suggesting inappropriate alternatives.

(a) A common misconception about private equity is that it can only be used where a business owner seeks a complete exit from a business. However it can be used where the business owner seeks to sell a stake and continue to have some involvement in the business. Some of the scenarios where private equity can assist include:

- Differing ambitions for founders/shareholders. Allowing some founders/shareholders to buy out other co-founders/angels and continuing to run the business.
- De-risking. For many business owners their entire wealth is tied up in the business that they have founded. This enables founders to release some cash by selling a minority stake.
- Stepping back. Some founders want to take a step back from the day to day running of their business, private equity can help them release some of their wealth and also share in the future value creation of the business. This can be achieved by backing existing management to buy part of a founder's stake and/or to helping founders find teams who can take over form them.

1 mark for introduction; 1 mark each for sensible suggestions.

(b) 2 marks for each sensible alternative. For example candidates could have mentioned and expanded on: Loans in various forms; Sale and leaseback of assets; Depending on the company’s size a listing or being quoted on AIM; Selling shares to third parties.

7. 29 attempts with an average mark of 7 out of 10 marks. All parts of the question were well answered. However in part (c) weaker candidates only mentioned the highest price paid in the last three months and did not mention the twelve month period.

(a) A person/entity may make a takeover offer on a voluntary basis and purchase shares in the market. If the holding in the target reaches 30% or more this will trigger Rule 9 of the Code and the offer will become mandatory.
1 mark for the voluntary purchase of shares; 1 mark for the Rule 9 trigger.

(b) The offer must contain an acceptance condition that the offeror holds more than 50% of the target, however in a voluntary offer the offeror may specify a higher percentage. In a voluntary offer a typical acceptance condition would state that the offer is conditional upon the offer acquitting 90% or more of the shares to which the offer relates (or such lesser percentage as the offeror sees fit, minimum 50%). In a mandatory offer there is not an option to have an acceptance level in excess of 50%.
1 mark for voluntary offers; 1 mark for mandatory offers.

(c) Generally, the offer price must be at least the highest price paid by the offeror or any concert party for the target company shares during the three months prior to the offer period, or any period between the start of the offer period and the announcement of a firm intention to make an offer. For mandatory bids, and where shares carrying 10% or more of the voting rights in the target have been purchased for cash by the offeror or any person acting in concert with it, the period is twelve months.
1 mark for each time period.

(d) If after a mandatory bid has been made (but before it closes for acceptance), the offeror or any concert party acquires a further interest in the target company’s shares above the offer price, the offeror must increase the consideration under the offer.
1 mark.

(e) Candidates may have referred to the detail in the code and/or practice statement 27.
3 marks for a reasonable summary.

8. 28 attempts with an average mark of 16.9 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). Part (c) was well answered.

(a) Candidates' analysis should have covered: profitability; margins; asset turnover; short and long term liquidity; growth. Students should have given a supported conclusion as to the financial health and trends.
Analysis – 10; Conclusions 5.

(b) Candidates should have discussed the financial health and trends in the context of shareholders considering selling or holding their shares in Majestic.
2 marks for considerations; 2 marks for conclusions.
(c) Discussion of the growth prospect, future cash flows, current gearing etc., Also relevant were likely exit routes.
2 marks for each.

9. 28 attempts with an average mark of 13.71 out of 25 marks. Part (a) (i) was well answered with most students making reasonable attempts at the computations and stating assumptions and limitations. Part (a) (ii) the computations were reasonable but some students let themselves down by not stating assumptions and limitations. Parts (b) and (c) were well answered.

(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) Marks only awarded for a supported recommendation.
2 marks for support; 1 mark for recommendation.

(c) Some of the strategies that Majestic could have adopted included: a profit forecast; special dividend; share repurchase; press campaign; road show.
2 marks for each sensible suggestion, max 6.