FINANCIAL MANAGEMENT

Time allowed – 3 hours
Total marks – 100

[N.B. – The figures in the margin indicate full marks. Questions must be answered in English. Examiner will take account of the quality of language and of the manner in which the answers are presented. Different parts, if any, of the same question must be answered in one place in order of sequence.]

Marks

1. (a) Strategic planning is concerned with the long-term direction of the business and how the business will achieve its objectives. Financial strategy is concerned with the financial aspects of the strategic planning process, so in reality they are part and parcel of the same overall picture. Having decided on its overall direction and objectives a firm must then make more detailed supporting financial decisions over the medium to short term. There are three broad categories of financial decisions which are interlinked.

Explain about these three categories of financial decision and illustrate with an example in each category to demonstrate their interrelationship. 7

(b) An agency relationship occurs when a principal (shareholders) hires an agent (management) to perform some duty. A conflict, known as an "agency problem", arises when there is a conflict of interest between the needs of the principal and the needs of the agent. Explain why the Management might pursue an agenda in following situations which are at odds with the maximisation of shareholder wealth:

i. Takeovers
ii. Time horizon
iii. Risks, and
iv. Debt 8

(c) Nice Shoe Ltd, a footwear manufacturer, has a factory in Chittagong that it rents on a lease due to expire at the end of December 2017. The factory is entirely devoted to making shoes for babies and old persons. The market for these products has been declining and a decision had been taken two years ago not to seek to renew the lease in 2020, but to close down Chittagong factory when the lease expires. At a recent meeting of the company's board of directors the question was raised as to whether it might be more beneficial to close at the end of December 2017, three years earlier than had originally been decided. As a member of the company's finance staff, you have been asked to look into this question.

Sales of Chittagong Factory are projected to be as follows for the next three years.

Year	***Taka*'000**
2018	12,000
2019	8,000
2020	6,000

The marketing director believes that these figures could be increased if an advertising campaign were to be undertaken. Such a campaign would involve cash outlays of Taka 1 million on 31 December in each of 2017, 2018 and 2019. The marketing director acknowledges that the results of the advertising campaign are uncertain, but she believes that there would be at least a 15% increase in sales on the projected figures and the increase could be as high as 25%. To ease assessment, it has been agreed that it is reasonable to assume that the increase will be either 15% with a probability of 30%, or 25% with a probability of 70%. If the advertising were to be undertaken, the expenditure would be available for tax relief in the accounting year in which it would be incurred.

The variable costs of manufacture of Chittagong Factory are estimated at 35% of the selling price. The rent of the factory is Taka 5 million a year, payable on 1 January. The owner of the factory will not agree to an early termination of the lease, but the company has the right to

sublet the factory. The directors are confident of finding a subtenant who would pay Taka 4 million on 1 January in each of the three relevant years.

The plant used in the factory was all bought in January 2014 for Taka 2,000,000. Were the factory to close in 2017, it would be sold in December for Taka 1,000,000, but if it were retained until 2020 it would be sold in December of that year for an estimated Taka 200,000. For the purposes of the present analysis, treat the plant as if it had been excluded from the general pool. *This means that it attracts 25% (reducing balance) tax depreciation in the year of its acquisition and in every subsequent year of its being owned by the company except the last year*. In the last year, the difference between the plant's written down value for tax purposes and its disposal proceeds will either be allowed to the company as an additional tax relief if the disposal proceeds are less than the written down value, or be charged to the company if the disposal proceeds are more than the tax written down value.

Apart from rent and depreciation, fixed costs are estimated to be Taka 1,000,000 each year, including a Taka 300,000 allocation of head office costs. When the factory closes, certain staff would be entitled to redundancy payments. These would total Taka 400,000 if closure were to take place in 2017, but rise to Taka 450,000 if closure were in 2020. In either case the payment would be made on the day of closure and be fully allowable for income tax for the year concerned.

Production of Chittagong Factory gives rise to a working capital requirement of an amount equal to 5% of the sales value. This needs to be in place by the beginning of each year concerned. By the end of the production period all of the working capital will have been released. Closure on either date is not expected to have any effect on any of the company's other activities. It is estimated that the appropriate cost of capital is 8% per annum.

The company's accounting year is to 31 December and the income tax rate of 25% is payable *at the end of the year to which it relates*.

Requirements:

(i) Determine, on the basis of net present value (NPV), whether the advertising should be undertaken, assuming that closure is delayed until 2020. 10

(ii) Taking account of your conclusion from (i) determine, on the basis of NPV, whether the company should close the factory in 2017 or in 2020. 15

2. You have been approached for financial advice by the management of a client, Epic Cables Ltd, a manufacturing company. Epic Cables was established in 1990 and formed the platform for growth. The following information relates to the proposed financing scheme for a management buy-out of Epic Cables.

	%	Taka'000
Share capital held by Management	40	100
Institutions	60	150
		250
10% redeemable cumulative preference shares		
(redeemable in ten years' time and all sold to institutions)		1,200
		1,450
Clearing bank		
Loans		700
Overdraft facilities (currently 12% per annum)		700
		2,850

Loans are repayable over the next five years in equal annual instalments. They are secured on various specific assets, including properties. Interest is 12% per annum.

Epic Cables is at present part of a much larger organisation, which considers this segment to be no longer compatible with its main line of business. This is despite the fact that Epic Cables has been experiencing growth in revenue in excess of 10% per annum.

The assets to be acquired have a book value of Taka 2,250,000, but the agreed price was Taka 2,500,000.

Requirements:

(a) What is the difference between:
(i) a management 'buy-in' and a management 'buy-out'?
(ii) a 'sell-off' and a 'spin-off'? 4

(b) Outline briefly the major advantages and disadvantages of a management buy-out. 4

(c) Write a report to the buy-out team of Epic Cables Ltd appraising the financing scheme. Your report should include, *inter alia*, the cash flow implications of the proposed scheme. 9

(d) What problems are likely to be encountered in assembling a financing package in a management buy-out of a service company, as opposed to a manufacturing company? 3

3. (a) The net income of S Ltd. is Tk.85,000. The company has 25,000 outstanding shares and a 100% payout policy. The expected value of the firm one year from now is Tk.1,725,000. The appropriate discount rate for S Ltd. is 12% and the dividend tax rate is zero.

i. What is the current value of the firm assuming the current dividend has not yet been paid? 2

ii. What is the ex-dividend price of S Ltd.'s stock if the board follows its current policy? 3

iii. At the dividend declaration meeting, several board members claimed that the dividend is too meager and is probably depressing S Ltd.'s price. They proposed that S Ltd. sell enough new shares to finance a Tk.4.60 dividend.

a. Comment on the claim that the low dividend is depressing the stock price. Support your argument with calculations. 2

b. If the proposal is adopted, at what price will the new shares sell? How many will be sold? 3

(b) B Industries Ltd. has decided to borrow money by issuing perpetual bonds of Taka 1,000 each with a coupon rate of 7%, payable annually. The one year interest rate is 7%. Next year, there is a 35% probability that interest rates will increase to 9%, and there is a 65% probability that they will fall to 6%. What will the market value of these bonds be if they are non-callable? 5

4. (a) "Financing overseas subsidiaries depends on four key factors" – State those factors briefly. What are the considerations while choosing a country for investment? What measures need to be taken to prevent the exploitation of the country by Multi National Corporation (MNC)? 7

(b) You are currently acting in the treasurer capacity for a large UK business to manage its surplus funds. For the last few years the UK and world economic outlooks have been quite positive and the business has benefited from a major investment in equities and holds a portfolio worth £30m.

Recently, however, these positive signs have reduced and there is now the fear of some market volatility or even a short downturn or market correction over the next three months. The long-term prospects for equities are still positive however and so you do not wish to divest the share portfolio. However you do wish to protect against a downturn over the next three months.

The current level of the FTSE 100 index is 6000 and a three-month FTSE 100 index futures contract is currently quoted at 6020.

Options are also available on the FTSE 100 index with a strike price of 6000 and maturity of three months.

A call option has a premium of 150 points and a put option has a premium of 130 points.

Requirements:

(i) Describe how you could use the FTSE 100 index future to hedge any portfolio losses arising over the next 3 months and illustrate the outcome if the index either falls to 5800 or rises to 6200. 9

(ii) Describe how options may be used to hedge exposure to any market correction and illustrate the outcome if the index either falls to 5800 or rises to 6200. 9