Example 2

(a) Defence strategies

As Kingtim Co is fearful of the takeovers in the sector the company is looking to protect itself from the bid. They revealed two proposals for defence - Selling the key assets "Crown jewels" strategy and "Golden parachutes".

Selling the individual garden centres -This strategy represents selling the major or key assets/business of the company and to not be so attractive to the bidder. It has Pros and Cons:

Pros -

The Amount of money that will be received can be invested in other beneficial projects and earn additional money.

Cons -

The sell off of the assets can lead to loss of competitive position in the market. As per the scenario this is not the case with Kingtim.

Enhancing directors’ remuneration- This represents defence strategy "golden parachutes". The large amount of money will be distributed to the managers as large amounts.

Pros-
The Company will leave the cash balances reduced and this will not be attractive to the bidder.

Cons
Maybe the directors only want to get the money and are not interested anymore for the future of the company.

(b) **Report to board of directors, Kingtim Co:**

Introduction

This report estimates and discusses the impact of the proposed bond issue from the Financial director on the capital structure and on the bond holders value. Also it estimates the impact on the after-tax earnings and discuss the assumptions made in the estimates.

Financial results by proposal:

After issuing the second bond as per the proposal of the finance director the change in the capital structure is marginal and despite the increase in debt due to the tax shield relief the overall structure of the capital is not changed. There is slight decrease by 0.05%.

Please see the Appendixes i - iii.

	Before Bond issue and investment	After Bond issue and Investment
Cost of capital	12.06 %	12.01 %

Non-Financial aspects

The political situation is not stable. There can be a problem in the remittances from the subsidiary.

Assumptions

All the calculations in the appendixes considers that the figures are accurate. The models used consists of lots of variables that can change and the result of the predictions can be different. The revised cost of the debt is based on the required yield based on different bonds and credit spreads as per the BBB rating. As the debt is rising and the industry specifics may the credit agencies consider that the ratings need to be adjusted and debt market value will change. Also the tax rate can change. It will be better to perform sensitivity analysis and simulation models to see the outcomes if there is change in some of the variables.

Debt Holders

Debt holders are likely to happy with new bond issued as the interest of 7.5 % is bigger.

Equity Holders

Equity holders might be happy due the increase in the after tax profit due to the investment in the non-current assets which could impact the dividends positively. There is also increased in the earnings per share could impact the share price positively and capital gains could be realised.

Conclusion

Based this report and taking the into account the almost immaterial in the overall change in the cost of capital, the increased earnings after tax and the assumptions made the proposals made by the finance director should be accepted.

Report compiled by:

Date:

(c) Remuneration issues

If the wages of the employees do not increase there is possibility of the reputation risk for Kingtim co. Also the morale and loyalty will decrease as well. This will increase the cost and decrease the profits.

Professional skills summary

This answer scores a total of 7 marks out of 10 for the professional skills.

Marks summary

Technical	
(a)	4
(b)(i)	3
(b)(ii)	4
(b)(iii)	1
(b)(iv)	5
(c)	2
Professional skills	
Communication	4
Analysis and evaluation	2
Scepticism	1
Commercial acumen	0
Total professional skills	7
Total	26

Appendixes

I) Cost of the capital before the bond issue

Market value of equity	139	m
Market value of debt	0.468	m
Cost of debt	4.10%	
Cost of Equity		
Asset beta	0.9	
Cost of equity using CAPM	12.1	%
WACC	**12.06**	%

ii) Estimate market value of the bond and yield to maturity of the new Bond

Yield to Maturity

Year	Annual Yield %	BBB Rating	Yield to maturity	
1	4	0.56	4.56	0.0456
2	4.3	0.78	5.08	0.0508
3	4.7	1.06	5.76	0.0576
4	5.2	1.35	6.55	0.0655

Market value		
annual interest		4.5
4th year		107.5
		7.5
	103.710886 per 100$	

iii) Revised cost of capital		
Market value of the new debt	0.62	m
Market value of debt	0.468	m
Total debt	1.09	
Premium	8%	
Revised cost of capital	**12.01**	%

There is a slight decrease in the revised WACC

1
1.0456
1.0508
1.0576
1.0655

Boullain marked scripts

Example 1

(a)

As Boullain Co started to sell its products to the US it now faces transaction risk and economic risk. Although economic risk cannot be hedged (due to its nature it depends on macro economic factors or risks) it can be reduced through diversification.

If investors hold well-diversified portfolios they reduce unsystematic risk and only face systematic risk. However, introduction of hedging techniques might help further reduce risks of cash flow fluctuations. Investors and shareholders might benefit from it.

If the policy is communicated to the key stakeholders, shareholders will also be able to benefit from it for example debt providers might demand companies who operate abroad make sure they that they have hedging strategies in place. If the company does not have it and it does not communicate the debt providers might increase its compensation for increased risk (interest) or reduce / do not give funding. This would mean Boullain Co will not be able to invest in the new project and this will not increase shareholder wealth.

Due to new operations abroad of the company suppliers of Boullain Co might become worried that the company might not be able to pay and won't give long credit terms, therefore cash operating cycle will become shorter.

Customers might be worried about the situation where prices might increase as Boullain Co would try to compensate for the FX risk , therefore, if they are informed about foreign exchange risk strategies, they will not switch to another supplier.

(b) See spreadsheet for calculations

Comparing these three hedging methods, it is obvious that hedging the exchange risk using future contracts is most effective as it shows the biggest receipts of €16,284,113 while options show the smallest receipts of €16,177,711 due to the huge amount of premium needing to be paid. However Boullain Co should consider its risk preference to determine the final hedging method. Options can be used to hedge the exchange rate with a limit and the downside but no limit to the upside that is to say if the exchange rate moves favourably to Boullain Co, the company can let the option lapse to gain a higher return but the return of using futures is predetermined.

Based on marking to market, the profit and loss of the margin account will be calculated daily and reduce or increase the account balance. If after deducting the loss, the balance is below the maintenance level the broker will ask the investor to pay extra funds to the margin account to keep the balance at a minimum level of maintenance.

Professional skills summary

This answer scores a total of 5 marks out of 5 for the professional skills.

Marks summary

Technical	
Part (a)	5
Part (b)	12
Professional skills	
Analysis and evaluation	3
Scepticism	0
Commercial acumen	2
Total professional skills	5
Total	22

Example 2

(a)

Operating or receiving cash flows from foreign countries gives rise to numerous different risks; economic, translation and political risks.

In the case of Boullain Co, the receipt of $18,600,000 will give rise to an uncertain euro amount as the FX rate is ever changing. This change is caused by numerous factors, such as inflation, interest rate, balance of payments, therefore in order to ascertain a definite value of the receipt hedging must occur.

There are numerous benefits arising from hedging. Hedging reduces the volatility of future foreign cash flows thus if Boullain Co needs additional finance in the form debt this could be acquired at a lower cost of debt. The ability to gain financing would allow the company to invest in more profitable projects thus increasing shareholder wealth.

(b)

The futures market hedge offers the highest receipt of €16,284,113. This scenario assumes that basis risk is zero however this may not be the case. If basis risk is present it may result in a profit or loss on the hedge receipt as it will not equate to the future futures contract price.

The forward market hedge provides the next best hedge and this is followed by the currency option which offers the worst hedge receipt. Although the option provides the worst hedge receipt once exercised if the FX moves in favour to offer a higher receipt at the spot rate this can be taken advantage of.

In terms of which method to prescribe the pros and cons need to be taken into effect, however I would prescribe the futures market hedge.

Professional skills summary

This answer scores a total of 5 marks out of 5 for the professional skills.

Marks summary

Technical	
Part (a)	1
Part (b)	8
Professional skills	
Analysis and evaluation	3
Scepticism	1
Commercial acumen	1
Total professional skills	5
Total	14

Example 3

(a)

The rationale for the policy of hedging Boullain Co's foreign exchange risk is that having a policy would be in line with IFRS and being able to benefit from application of hedging standards.

Additionally, a formal hedging policy would show stakeholders that Boullain has procedures in place for hedging foreign currency risk which would increase shareholder confidence in Boullain Co. This confidence may lead to an increase in Boullain's share price as opposed to it being reduced if no policy were in place as their shareholders may view this as reckless.

A formal hedging policy maybe seen more favourably by Boullain's lenders which may allow for Boullain to benefit from eased debt covenants from its bank as the bank would have more confidence in Boullain's management of foreign currency exchange risk.

(b)

I would recommend forward contracts as these can be tailored to Boullain Co's needs as opposed to entering for fixed amount currency futures or currency options where an inefficiency due to a shortfall or surplus arises.

The currency options have the drawback of having an expensive premium however, the currency options allow Boullain Co to benefit if the exchange rate isn't favourable with the option as it can voluntarily abandon or not take up the option. The trade off to this is the expensive premium.

Although currency futures would work in this scenario, they are usually only for large and fixed amount and would be unable to be tailored for Boullain's needs. Additionally the currency in which futures are available are often limited and Boullain may not always be able to access these.

If the settlement price is less than Boullain's exercise price, Boullain will not need to meet the mark to market requirement to put in additional cash.

Professional skills summary

This answer scores a total of 1 mark out of 5 for the professional skills.

Marks summary

Technical	
Part (a)	2
Part (b)	4
Professional skills	
Analysis and evaluation	0
Scepticism	0
Commercial acumen	1
Total professional skills	1
Total	7

Script 2

Forward market

Six month forward	16,235,940	€

Currency futures

Buy September contracts

No of contracts	81.4218175	
Round to	81	contracts
Shortfall	-96360	$
Use forward market	84,113	
Basis	0.00094639	
Outcome	16,200,000	
Shortfall	84,113	
	16,284,113	

Currency options

September call options

No of contracts	81.4360771		
Round to	81	contracts	
Shortfall as above	84,113		
Premium	109,229		1.147974

Option outcome	€	
Net outcome		16,200,000
Shortfall		84,113
Premium		-109,229
		16,174,883

Example 2

(a) See spreadsheet for calculations

The NPV comes out as -21.6 million euros. Given the negative outcome, this project should not be accepted. A key driver of this was the differing inflation rate, with Canvia consistently at 10% driving a divergent exchange rate. This means that the amount of money received by Colvin reduced.

By including a risk premium the DF would increase from 13% to 16%. This would return a lower NPV.

(b)

Due to the uncertainty in the Canvia market, it may be prudent to introduce a risk premium.

Whilst it is true that Canvia is developing and appears economically less stable, it has got 10% inflation. This shows strong growth in the market and given that it is expected to stay at 10%, it shows some stability.

The country risk index does provide a sound reasoning for a risk premium, as it shows the likelihood of adverse results in that market.

Professional skills summary

This answer scores a total of 5 marks out of 5 for the professional skills.

Marks summary

Technical	
Part (a)	8
Part (b)	1
Professional skills	
Analysis and evaluation	4
Scepticism	0
Commercial acumen	1
Total professional skills	5
Total	14

	T0	T1	T2	T3	T4
Contribution (W4)		422.1	502.2	671.0	956.3
Fixed costs		-270	-291.6	-314.9	-340.1
Tax allowable dep'n (W1)		-175	-131.2	-98.4	295.3
Taxable Profit		**-22.9**	**79.4**	**257.7**	**911.5**
Tax (W2)		0	-14.1	-64.4	-227.9
Land and buildings (w3)	-75				214.2
Investment in plant	-700				
FCF	**-775.0**	**-22.9**	**65.3**	**193.3**	**897.8**
DF (13%)	1	0.855	0.783	0.693	0.613
PV	**-775.0**	**-19.6**	**51.2**	**133.9**	**550.4**
Exchange Rate 1Euro: xCl (W5)	9.91	10.48	11.09	11.96	12.89
PV (Euros M)	-78.2	-1.9	4.6	11.2	42.7
NPV	**-21.6**				

As the NPV is 0, I would not accept this project. One of the main drivers for this is the exchange rate, as Canvia has got a much higher rate of inflation that the eurozone.

NPV at stable exchange rate.	-78.20	-1.98	5.16	13.51	55.54

W1 - Tax allowable dep'n

	CLm
Opening (T1)	700
TAD	-175
CF (T2)	**525**
TAD	-131.25
CF (T3)	393.75
TAD	-98.43
CF (T4)	295.313
Written off	0
Balancing figure	-295.313

W2 - Tax

Year 1 loss 22.9m carried forward.

Year 2 taxed on 79.4-22.9 = 56.5m

W3 - Land

Year		Value	Additional value to previous year
	0	75	
	1	97.5	22.5
	2	126.8	29.3
	3	164.8	38
	4	214.2	49.4

W4 - Contribution

Of the contribution 10euro relates to component manufactured in Eurozone.

	1	2	3	4
Sales volume	109725	121795	148590	197624
Pre tax contribution (m)	419.4	500.2	671.3	961.2
Remove component (10euros = 9	408.5	488.1	656.6	941.6
Revised cost of component	13.6	14.1	14.4	14.7
Add back component	422.1	502.2	671.0	956.3

W5 - Exchange Rates

Using purcahsing power parity

Year	Exchange Rate
0	9.91
1	10.48
2	11.09
3	11.96
4	12.89