Example 1

(a) Feasibility and effectiveness of the defence strategies of selling off individual garden centres and enhancing directors' remuneration

Kingtim Co (the Company) is a nationwide chain of garden centres, selling products such as plants, fertilisers, tools and garden furniture. Potential acquirers are looking to diversify their business into the profitable garden centre sector. As long as the Company is a position to protect itself from takeover there are a number of safeguards that could be put in place.

One of these safeguards is to sell individual garden centres. It is believed that disposal of these centre would make Kingtim Co less attractive purchase. In the light that no potential acquirer has approached the Company to buy the whole chain, but there are parties interested in the individual purchase of the garden centres, the measure might be a proper defence strategy. By divestment, the directors will face less stress over the unpredictable future for their wellbeing, and will be able to focus on other parts of the business. Such sale may take some time to be arranged. Also detailed analyses are to prepared whether the garden centre are crucial for the future development, even survival, of the business. If those centres are crucial for the business, and steps for selling the garden centres will only lead to potential bankruptcy.

Another safeguard is enhancing directors' remuneration. Such a defence approach is more common for post-offers stage, while the divestment is more common for pre-acquisition stage. Pay the directors higher remuneration and change their contract so that they receive much higher compensation for loss of office is a probable safeguard that will bring desirable compensation for the directors, established and running the Company for the past 20 years. Due to the fact that the same have been involved in the business since its incorporation, the directors may feel attached to it. Due to this fact paying them a higher compensation may not be in line with their desires. Also under some legislation these increased remunerations, also known as 'golden parachutes' are not permitted. Further analyses are to be made in these regards on whether the executive directors would be satisfied by the compensation, and whether such defence is in line with local regulations. Moreover, regarding the feasibility of the measure, it should be taken under consideration whether there is a potential for the whole company to be purchased, and not just the garden centres, which may bring no effect over the executive directors' positions.

Besides the above stated considerations, it should also be taken in mind the fact that the executive directors hold 25% of the shares of the Company. In the light of a potential take-over they would probably be not in the position to be forced to dispose of their holding (in some legislations the threshold for a forced sale is 10% shareholding in the light that the rest is acquired by a purchaser). Also the control exercised over the Company is to be taken under considerations.

(b)

Report

Prepared by: Financial Consultant

To: Board of directors of Kingtim Co which

Date: 01.01.20X0

Introduction:

Kingtim Co (the Company) is in the position to analyse further development by establishment of chain of outdoor shops. The same would be finance through debt. This report is prepared to estimate the company's cost of capital before the new bonds are issued, the market value and yield to maturity of the new bonds, the revised cost of equity and revised cost of capital if the new bonds are issued, the impact of the chief executive's proposal on forecast after-tax earnings for the coming year, and to list considerations on the impact on Kingtim Co's cost of capital and the reaction of equity and bond holders to the chief executive's proposal.

Company's cost of capital before the new bonds are issued

The company's cost of capital (as per Appendix 1) is 10%.

Market value and yield to maturity of the new bonds

The market value of the new bond is 109.91 (as per Appendix 2), and the yield to maturity is 9.92% (as seen in appendix 2)

Revised cost of equity and revised cost of capital if the new bonds are issued

Revised cost of equity is 9.73% (Appendix 3) and the revised cost of capital is 7.378% (Appendix 3).

Impact on Kingtim Co's cost of capital and the reaction of equity and bond holders to the chief executive's proposal.

Further gearing may be beneficial to the shareholders, as the same will bring tax reliefs and will ultimately boost the company cost of capital. This statement is suggested by M&M. The theory faces limitation that such effect would be achieved in perfect market environment.

As per the calculations in the appendixes and the stated statements in this report, the WACC (weighted average cost of capital) decreases from 10% to 7.38%. This is in line with M&M theory. This decrease will benefit the shareholders.

The issue of new debt may bring, however, some further risk to the current and future debt holders, and to the shareholders, as well.

The increase in risk may be unnecessary to the shareholders, as they may have already diversified their portfolio of investments by taking shares in different companies.

The increased risk is relevant to incapability of the company to repay its interest obligations, and the principal amount upon maturity. This in long term may bring negative effects to the investors willingness to invest into the company and eventually lead to bankruptcy.

The calculations shown above are made upon a number of assumptions. The same include:

* Bd is assumed to be 0 for all relevant calculations;

* Equity beta of the garden centres is assumed to be the same as the equity beta of the company before the bond issue;

* For revised cost of equity calculations it is assumed that the similar companies are appropriately selected, and that the gearing level is the same as the company in question. Also it is assumed that beta can be reasonably established;

* It is assumed that the return of the newly issued bond is equal to the interest payable each year;

* It assumed that there will be no change in tax legislation for the near future.

Conclusion:
Given the limitations of the assumptions made, and the effect over the stakeholders, it should be further analysed what is the best decision for the company. However, based on the numbers, it is reasonable to undertake the project and further invest, as suggested above.

(c) **Approach taken to employee remuneration by Kingtim Co's Northern region and the issues associated with it.**

Kingtim Co's annual report contains a general commitment to act with social responsibility, in line with society's expectations. This brings some responsibility for the company to act in line with their core principles.

The annual report also commits to paying the staff fairly in accordance with their responsibilities.

A newspaper investigation has revealed revealed that some staff in Kingtim Co's garden centres are paid up to 15% less per hour than the recommended by the Government minimum wage. This issue may not be illegal, however, puts the company into the public eye. Such negative press may reflect the company's future operations. Nowadays, entities are becoming much more concerned regarding the social principle adopted by the companies. This negative press may lead to decline in client base, to decline in investors' interest, and even to staff redundancies.

The fact that the company is not acting in line with its policies and representations bring into question the whole integrity of the management. By questioning the integrity of the management, all the stakeholders may lost faith in the company, especially the current and potential investors and the shareholders.

The managers states that the company had obligations to its shareholders to control staff costs. Lower pay levels are claimed to be necessary to differentiate between staff. This brings agency problem, when the managers might not be seen as acting in the best interest of the shareholders.

The approach taken, however, might be seen as in line with social and shareholders' expectations, if the same is in line with legislation, internal policies, best practises, and is designed to serve the company in long term. As long as lower remuneration is paid to staff working part-time than to those full-time, the same might not be considered as inequal and unethical treatment.

Professional skills summary

This answer scores a total of 11 marks, but as there is a maximum of 10 marks available, this is capped at 10 marks.

Marks summary

Technical	
(a)	5
(b)(i)	4
(b)(ii)	4
(b)(iii)	3
(b)(iv)	6
(c)	5
Professional skills	
Communication	5
Analysis and evaluation	4
Scepticism	0
Commercial acumen	2
Total professional skills	10
Total	37

b i)
Appendix 1

This appendix is prepared to support the report to the Board of Directors

Company’s cost of capital before the new bonds are issued

Shares	25,000,000.00	
Ve	139,000,000.00	
Bonds 6.5%	450,000.00	
Vd	46,800,000.00	
premium	2%	
Kd (after tax)	4.10%	
Be (garden centers)	0.9	*Bd is assumed to be 0; Equity beta of the garden centers is assumed to be the same as the equity beta ot the company before the bond issue*
Rf	4%	
T	25%	
Market risk premium	9%	
Ba (company)	0.718552556	*Ba=Ve((Ve+Vd(1-T))*Be*
E(ri)	0.121	*E(ri) = Rf +Be*MarketRiskPremium*
WACC	0.1008493	*WACC = (Ve/(Ve+Vd)Ke + (Vd/(Ve+Vd)Kd(1-T)*
WACC in %	**10%**	

b ii)
Appendix 2

This appendix is prepared to support the report to the Board of Directors

Market value and yield to maturity of the new bonds

new bond	900000				
interest	7.50%				
redemption	4 years				
premium	8%				
Working for bond value:					
Time	1	2	3	4	
Return	4.56	5.08	5.76	6.55	*Return = Market Spread+Credit Rating*
1+Return	1.0456	1.0508	1.0576	1.0655	
Premium	7.5	7.5	7.5	7.5	
Redemprion				108	
CF	7.5	7.5	7.5	115.5	
CF*(1+r)^-n	7.172915073	6.79237	6.34011	89.6124	
Value	109.9178063				*the sum of discounted CF*
Valuer of all bonds	**98,926,025.65**				
Yiled	**9.92%**				

b iii)
Appendix 3

This appendix is prepared to support the report to the Board of Directors

Revised cost of equity

Ba (similar companies)	0.88	Assumption is made that the similar companies are appropriately selected, and that the gearing level is the same as the company in question. Also it is assumed that beta can be reasonably established.
Be	0.636158003	*Ba=Ve((Ve+Vd1(1-T)+Vd2(1-T))*Be*
Ve	139000000	
Vd1	46800000	
Kd1 (after tax)	0.041	
Vd2	98926025.65	
Kd2	0.075	*It is assumed that the return of the newly issued bond is equal to the interest payable each year.*
E(ri)	**9.73%**	*E(ri) = Rf +Be*MarketRiskPremium*

Revised cost of capital if the new bonds are issued;

Ve+Vd1+Vd2	284,726,025.65	
WACC	**7.38%**	*WACC = (Ve/(Ve+Vd1+Vd2)Ke + (Vd1/(Ve+Vd1+Vd2)Kd1(1-T) + (Vd2/(Ve+Vd1+Vd2)Kd2(1-T)*

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 1

Using forward contracts			
Total receipt	€	16,235,940	
Using futures			
Buy September future contracts			
Total receipts	€	16,284,364	
No of contracts		81.421818	Say 81 contracts
Amount not hedged	$	96,360	
Use forward	€	84,113	
Total receipts	€	16,284,113	
Using options			
Buy call options			
Total receipts	€	16,287,215	
No of contracts		81.436077	Say 81 contracts
Amount not hedged	$	99,600	
Use forward	€	86,941	
Premium paid	€	109,229	
Total receipts	€	16,177,711	

Example 1

a) See spreadsheet

b)

Validity of the chief executive's reasons for adjusting the discount rate used in appraising the project in Canvia are:

Usually the WACC should be used for discounting the cash flows. However a project specific cost of capital can be used if

a) The business risk changes or
b) The company is diversifying into a new sector

In Colvin Co's case, the company is investing in another country which is a developing economy and so the government rules and the financial situation will change from time to time.

Furthermore the inflation in the foreign country is higher than that of the euro zone which can lead to adverse effect on the currency rates.

However the changes in government or the economic conditions are systematic risks, which can't be eliminated and are not business risk.

As a result, for an appropriate cost of capital the firm should decide on a project specific WACC.

Professional skills summary

This answer scores a total of 3 marks out of 5 for the professional skills.

Marks summary

Technical	
Part (a)	9
Part (b)	4
Professional skills	
Analysis and evaluation	3
Scepticism	0
Commercial acumen	0
Total professional skills	3
Total	16

Working 1 TAD

	cost	Depreciation
1	700	175
2	525	175
3	350	175
4	0	350

Working 2 Land value

	cost
1	70
2	91
3	118.3
4	153.79

Working 3 working capital

	0	1	2	3	4
Working capital change	25	2.5	2.8	3	-33.3

Working 4 FX

	0	1	2	3	4
CL per $	9.91	10.48	11.09	11.96	12.89
Transfer price		10.40	10.82	11.03	11.25
Manufacturing cost		2.08	2.16	2.21	2.25
Contribution per unit $		8.32	8.65	8.83	9.00

Calculation of NPV

	Amount in	Amount in ı	Amount in	Amount in	Amount in m
	0	1	2	3	4
Sales units		109,725	121,795	148,590	197,624
Contribution		460	609	997	1,900
Fixed cost		270	292	315	340
TAD		175	175	175	350
PBT		15	142	507	1,210
Tax		-4	-36	-127	-303
PAT		11	107	380	908
TAD		175	175	175	350
Working capital	-25	-3	-3	-3	33
Initial investment					
Land	-75				84
Plant	-700				
Total cash flow in CL	-800	184	279	552	1,375
FX	9.91	10.48	11.09	11.96	12.89
Amounts in $m	-80.73	17.53	25.14	46.19	106.63

Contribution earned		9.13	10.54	13.11	17.79
Tax on contribution		-1.83	-2.11	-2.62	-3.56
Total cashflow	-80.73	24.83	33.57	56.68	120.86
NPV at 16%	68.69				

Based on a positive NPV the project can be undertaken