Section A: All three questions to be attempted

Section A (70 marks in Total)

Question 1

Financial Information relating to Acme PLC, a stock market listed company, is as follows:

	€ mn
Profit after tax	55.0
Ordinary Dividends	30.0
Preference Dividends	4.0

Balance Sheet as at 31st December 2012

	€ mn	€ mn
Non-current Assets		
Land & Buildings		317
Machinery		67
Motor vehicles		20
		403
Current Assets		
Recievables	50	
Inventories	78	
Cash	10	
		138
Total Assets		541
Equity		
Ordinary Shares @ 80 c each	66	
Preference Shares @ €1 each	50	
Retained Earnings	247	
		363
Non-Current Liabilities		
Loan secured on property		127
Current Liabilities		
Payables	23	
Taxation	23.6	
Bank Overdraft	5	
		52
		541

Acme PLC has a cost of equity of 11% and pays tax at an annual rate of 30% per year. The ex-dividend share price of the company is €7.50 per share. Preference shareholders have the right to cash in their preference shares at their discretion.

Financial analysts have forecast that the ordinary dividends of Acme PLC will grow in the future at an expected rate of 5% per year. The forecast for the growth rate of profit after tax (earnings) of the company is 6% per year.

The finance director of Acme PLC believes that taking into account the risks associated with the company's expected earnings growth, an earnings yield of 12% per year could be used for valuation purposes.

The current market value of the the land and buildings is estimated at €380mn. The net realisible value of inventories is €65mn. The net realisible value of the machinery is €50mn. The net realisible value of the motor vehicles is €15mn.

Requirements:

a) Calculate the value of Acme PLC using the following methods:
   i) net asset value method
   ii) dividend growth method
   iii) earnings yield method (both with growth and without growth)
   iv) market capitalisation method

(16 marks)

b) Discuss the weaknesses of using the dividend growth model as a method of company valuation.

(4 marks)

c) With the aid of a diagram explain why to an investor the benefit of diversification decreases as the diversification of the investor increases.

(5 marks)

(25 Marks in Total)

Question 2

Oriental Foods Ltd. owns a chain of asian food shops and a separate asian food distribution business. It is currently reviewing its management of its working capital needs. You have been asked to advise the Finance Director on the following two issues:

a) Oriental Foods Ltd. currently sells 3,000 bottles of soy sauce per month. The average selling price per bottle is €4.00, earning Oriental Foods Ltd. a margin of 30%. The estimated handling and storage cost per bottle is €7.67 per annum.

The current supplier of the soy sauce charges a fixed cost of €60.00 per order and takes 15 days to supply an order.

Oriental Foods Ltd. has received a quote from a new supplier who will charge €150.00 per order for bottles of soy sauce but would give a discount of 12.5% on the purchase price if the order was for 1000 bottles. They are new to the soy sauce distribution business but claim they could deliver orders with a lead time of just 6 days.

Storage costs for the new soy sauce would be €8.25 per bottle due to the higher volume. Oriental Foods Ltd. holds 100 bottles of safety stocks so average inventory levels are based on the order quantity plus the level of safety stocks.

Requirement

i) Find the Economic Order Quantity (EOQ) using the current supplier and calculate the cost of stocking the soy sauce from the existing supplier using this Economic Order Quantity.

(5 Marks)

ii) Calculate the cost of stocking the soy sauce from the new supplier and recommend whether it is financially attractive to switch supplier.

(5 Marks)

b) The board of directors of Oriental Foods Ltd. is concerned at the level of bad debts the company is experiencing and has suggested outsourcing the management of receivables to generate savings. They are considering the use of Invoice Management Ltd. a factoring company has asked you provide advice on this decision. You have been provided with the following information:

- Oriental Foods Ltd. has annual credit sales of €7,000,000 in its asian food distribution division. Currently bad debts are 6% of sales and customers are taking an average credit period of 42 days even though the standard sales contract credit period is 35 days. The industry averages is a credit period of 31 days and 2.5% bad debts.

- Oriental Foods Ltd. spends €80,000 on managing receivables. Invoice Management Ltd., a factor company, would look after the all of the administration of the receivables, all of the credit checking requirements and the collection of debts for an annual fee 4% of credit sales.

P.T.O.

- Invoice Management Ltd. has guaranteed that bad debts would be reduced to the industry average.

- The factor would also provide 90% of the invoiced amounts in advance but at an interest rate of 16%. The remaining amount would be received by Oriental Foods Ltd. after 35 days. Oriental Foods Ltd. currently pays 10% on its overdraft facility.

Requirement

Advise on whether Invoice Management Ltd. should be used to manage receivables and supply working capital finance to Oriental Foods Ltd.

(10 Marks)

c) What factors should managers consider when determining a company's collection policy?

(5 Marks)

Note: please use the following notation (or, if you use an alternative, please explain all components clearly):

The Economic Order Quantity, Q* = $\sqrt{\dfrac{2SD}{IV}}$

Annual Ordering Costs = SD / Q
Annual Holding costs = IVQ / 2

Where:	S	= Forecast annual usage
	D	= Ordering cost per order
	I	= Annual inventory holding charge as a proportion of V
	V	= Cost per unit in stock

(25 Marks in Total)

Question 3

HibOil Ltd. has forecast that in October 2013, five months' time, it will receive €3,000,000 (Euro, which is its unit of account) from a Dublin based retailer. However it will have to pay \$2m (US dollar) to an American supplier.

The following exchange rates are available to HibOil Ltd.:

\$/€ Spot	1.3100 – 1.3110
5 months forward.	0.0100 – 0.0050 premium.

The following annual saving and borrowing rates are available to HibOil Ltd.:

Euro up to 6 months	3.0% - 5.5%
Dollar up to 6 months	2.5% - 5.0%

The managing director of HibOil Ltd. wishes to hedge any foreign exchange risk using only either a forward market hedge or a money market hedge. He is against using currency options or currency futures as he has heard that these derivative instruments are very risky and he wishes to "avoid risk not take it on!"

Required:

a) Outline the costs, advantages and disadvantages of both a forward market hedge and a money market hedge. In your answer show all relevant calculations relating to the two alternative types of currency hedge methods assuming (i) you could fund the dollar amount required out of current funds or (ii) you have currently no spare funds and will use the expected euro receipts to fund the dollar amount required.

(12.5 marks)

Note: To find the Future Value of a one off payment made today:

$$FV = PV(1 + r)^n$$

And hence:

To find the Present Value of a one off payment to be paid / received in time n:

$$PV = FV / (1 + r)^n$$

b) Briefly discuss three of the following four types of risk and explain how these three risks can be alleviated in a multinational corporation:

i) Transactions risk
ii) Translation risk
iii) Economic risk and
iv) Political risk. **(7.5 marks)**

(20 marks in total)

Section B: two (2) of the following three (3) questions to be attempted

Section B (30 marks in Total)

Question 4

Explain with the aid of diagrams if and/or how the proportion of debt and equity in a firm, i.e. its capital structure, affects its WACC. **(15 Marks)**

Question 5

a) Discuss the differences, advantages and disadvantages between payback and NPV. **(5 Marks)**

b) Discuss the differences, advantages and disadvantages between IRR and ARR. **(5 Marks)**

c) Rank the four above investment appraisal methods and explain your choice. **(5 Marks)**

(15 Marks in Total)

Question 6

a) If, as some say, dividends are irrelevant, why do analysts fret over dividend changes? In your answer choose a recent example of a company that changed its dividend policy and / or engaged in share repurchasing. Discuss the reasons for the change and comment on the effects the policy had on the company's share price. **(15 Marks)**

<u>OR</u>

b) Answer all parts below:

i) In dividend policy, what is meant by the "information content effect", (also known as the "signalling hypothesis")?

ii) In dividend policy, what is meant by the "clientele effect"?

iii) What is meant by a "residual dividend policy" and what are the advantages and disadvantages of such a policy?

iv) Why might a firm engage in a "share repurchase" and what are the advantages and disadvantages of doing so?

v) Compare and contrast a stock dividend and a stock split.

(5 x 3 marks = 15 Marks in total)