Financial Management
Module 14
November 2009

Section A: All three questions to be attempted.
Section B: Two of the following three questions to be attempted

Question 1

Paul and Tony Reid are the owners of LHW Ltd., publishers of “Luxury Homes of the World”. As with similar pushers they are currently experiencing difficult market conditions. Paul wishes to sell his share of the business to Tony to pursue other interests. Paul feels their business has a “long term value” not captured by current market values. Paul and Tony wish to have their business “property valued” so a “fair” buyout price can be agreed.

LHW Ltd: Balance Sheet as at 31 December 2008

Fixed Assets	€ Million	€ Million
Land and Buildings		2.5
Plant and Machinery		4.5
Fixtures and Fittings		1.5
Motor Vehicles		0.5
		9.0
Current Assets		
Stocks	1.1	
Debtors	2.5	
Cash	0.2	
Prepayments	0.1	
	3.9	
Creditors: amount payable within one year		
Creditors	2.4	
Taxation	1.5	
Bank Overdraft	0.1	
	4.0	
Net current assets		-0.1
Total Assets less current liabilities		8.9
Creditors: amount payable after one year		
10% Debentures 2014		-5.0
Deferred Taxation		-1.3
		2.6
Financed By:		
Ordinary shares of 10 cent		1.0
Share Premium		1.0
Retained profits		0.6
		2.6

Net profit after tax and interest payments but before dividends was €250,000 and the annual dividend was €100,000 in the year ended December 31st 2008.

Covenants in the debentures require that a change in ownership of LWH would result in the redeeming of its debentures. They must be redeemed at "fair market value" based on the yield on comparable bonds, which is currently 8% p.a. The semi-annual coupon has just been paid with 10 more due before the bond would mature in 2014.

Paul and Tony estimate that 20% of LWH's debtors are likely to be irrecoverable but feel that current market conditions will improve and that over the next three years earnings should increase by 5% per annum.

Independent valuations state that the current realisable values of the company's fixed assets are:

Land and Buildings	2.0
Plant and Machinery	4.0
Fixtures and Fittings	1.2
Motor Vehicles	0.35
	7.55

For a firm similar to LHW Ltd with similar growth expectations but which is quoted on the stock exchange, the Price Earnings ratio was 14 times and its gross dividend yield was 10%.

Required:

(a) Given the above information, estimate the value per share of LHW Ltd. using:

(i) the net asset (liquidation) basis
(ii) the P/E basis
(iii) the dividend yield basis (assume with no growth) and
(iv) the dividend yield basis (assume with growth)

[13 Marks]

(b) Discuss the relative merits of each approach and what you feel is the appropriate valuation in this instance, using your estimates obtained in part (a) above.

[7 Marks]

(c) Explain the differences between standard deviation and beta and when each is an appropriate measure of risk in a portfolio. **[5 Marks]**

Total Marks 25

Question 2

Allegro Motor Vehicles Plc. (AMV) is evaluating a proposal to acquire another car manufacturer Green Speed Ltd. (GSL), a company new to the car manufacturing business. Their new range of energy efficient cars, when incorporated into AMV's existing range, will enable AMV to offer a fuller range of cars to dealers. AMV analysts have projected income statement for GLS, along with estimates of GSL's accounts payable balances and asset requirements for the next five years. These projections appear in the income statements that follow. These statements are calculated assuming that GSL remains an independent, unconnected company.

AWN Income Statements (€m's for years ended December 31)

	2010	2011	2012	2013	2014
Sales	110.00	154.00	200.20	240.24	264.26
- Cost of goods sold	77.00	104.80	140.14	168.17	184.98
Gross Profit	33.00	46.20	60.06	72.07	79.28
- Operating expenses	22.00	30.80	40.04	48.05	52.85
- Depreciation	15.00	17.50	20.00	22.25	23.98
Pre-tax income	-4.00	-2.10	0.02	1.77	2.45

AWN Assets and Accounts Payable (€m's for years ended December 31)

	2009	2010	2011	2012	2013	2014
Accounts payable	5.00	7.50	10.50	13.65	16.38	18.02
Cash	6.00	6.00	6.50	6.50	7.00	7.00
Accounts receivable	4.00	6.00	8.40	10.92	13.10	14.41
Inventory	15.00	22.50	31.50	40.95	49.14	54.05
Total Current assets	25.00	34.50	46.40	58.37	69.24	75.47
Plant and Equipment						
Gross	40.00	50.00	60.00	69.00	75.90	79.70
Net	30.00	40.00	47.50	54.00	58.65	60.72

Note: The 2009 figures represented the established balances which would be on GSL's balance sheet when AMV would take over on December 31st 2009.

If AMV acquires GSL, its analysts believe that the following adjustments must be made:

1. AMV's larger international distribution network will enable GSL to increase sales of its cars by 10 percent above current projections (for example, if acquired, GSL will sell €121 million, rather than €110 million, in 2010). This will occur without extra marketing on AMV's behalf as GSL dealers will simply extend AMV's range of cars with its existing customers.

2. AMV's current cash reserves are more than sufficient for the combined company, so GSL's existing cash balances will be reduced to €0.

3. AMV also enjoys a higher credit raring than GSL, so after the acquisition, GSL will obtain credit from suppliers on more favourable terms. Specifically, GSL's accounts payable balance will be 15 percent higher each year than the level of current forecast.

4. Over the four years, synergies and economics of scale will gradually increase as GSL becomes embedded into AMV. GSL gross profit on its sales will increase from its current 30 percent in 2009 by two percent per annum to 40 percent in 2014. Similarly its operating expenses as a percentage of sales will fall from the current 20 percent by three percent per annum to 5 percent in 2014.

5. AMV's more efficient receivables and inventory management systems will allow GSL to increase its sales as previously described without making investments in receivables and inventory beyond those already reflected in the financial projection.

6. AMV will maintain the fixed asset increases currently projected through 2014 which given its greater operating efficiency will be enough to allow for extra 10 percent increase in sales volume per annum.

7. Both companies face a tax rate of 12.5 percent. Taxes are paid in the year that the income is earned. Any losses incurred by GSL once taken over by AMV can be used to offset profits made by AMV in that year.

Requirements:

(a) Recalculate GSL's cash flows from 2010 to 2014, supposing that AMV acquires GSL, making all the changes previously described in items 1 to 7. State any assumptions you make. **[14 Marks]**

(b) Assume that after 2014 GSL's cash flows will decrease at a steady 5 percent per year as their range of models become obsolescent. Calculate in 2009 the present value of all cash flows from 2010 forward for AMV from GSL and hence the maximum price AMV would pay for GSL? You may assume a discount rate of 13 percent. **[4 Marks]**

(c) **"**Given that financial institutions paid spectacular bonuses to their executives and yet their shareholders wealth destroyed, it is clear that all the recent changes in corporate governance in relation to executive remuneration have been for naught!**"** Discuss the recent changes in corporate governance in relation to executive remuneration and comment on the above statement. **[7 Marks]**

Total marks 25

Question 3

The Irish Organic Dairy Co Ltd, (IODC), has had difficulties and dropping margins in its main export market, Hong Kong, due to the appreciation of the Euro. However it is just about to export 1,000 units of organic yogurt to Hong Kong at a price of HK$3,000 per unit this year.

The proposed sale of organic yogurt is on credit and payment is expected on the 31st of February, (3 months' time). IODC has no spare cash to finance the credit period and its overdraft account is fully drawn. For short-term funds in Euro the company can borrow at 2% above, or can deposit ar 0.5% below, the Euro base rate of 1%. For short-term funds in Hong Kong dollars it can borrow at 2.5% above, or can deposit at 1.5% below the Hong Kong dollar base rate of 5.5%.

New to exporting, the new Finance Director of Irish Organic Dairy Co Ltd is wary of both the possibility of non-payment and adverse currency movements. To protect the company against non- payment he has taken out short-term export credit insurance. He is however unsure as to how best to protect the company from adverse currency movements. He is considering covering the currency risk through the forward foreign exchange market or the money market.

Assume exchange rates for Hong Kong doller/Euro are as below:

Spot	HK$ 10.6585	€ 10.6955	
1 Month forward	HK$ 315	€ 1356	Discount
3 months forward	HK$ 650	€ 2421	Discount

The Finance Director has heard of other companies, which have suffered horrendous losses due to speculating in foreign exchange market. He has ruled out getting involved with currency options or futures and it's temped to **"**to do nothing and simply wait and see what the rate will be in the next three months time**"**.

Required:

(a) Advise the Export Director whether the forward market, the money Markey or simply wait and see the approach would offer the best combination of cost and risk. Support your recommendations by appropriate calculations where possible. State the main limitations/risks of each of these three strategies and any assumptions you make. **[9 Marks]**

(b) Assume that when the organic yogurt arrives in Hong Kong it is discovered that the refrigeration units have failed and the organic yogurts are gone off. In addition they have become a biohazard and must be correctly disposed off. The buyer in Hong Kong is not obliged to pay either for the yogurt or the disposal of them. Luckily the consignment was insured and the policy will pay the manufacturing, shipping and disposal costs of €200,000 on the 31st of February. With hindsight which of the three approaches outlined in part (a) above would have offered the best combination of cost and risk. **[3 Marks]**

(c) Discuss different types of internal hedging techniques available to avoid foreign exchange in a multinational corporation. **[8 Marks]**

Total Marks 20

Question 4

Write short notes on three of the following six topics:

(i). The strategic issues that arise from pursuing growth through organic growth.
(ii). The strategic issues that arise from pursuing growth through mergers and acquisitions.
(iii). The advantages to achieving growth by conglomerate diversification.
(iv). The disadvantages to achieving growth by conglomerate diversification.
(v). Describe the two basic types of leases available and explain the advantages and disadvantages of leasing.
(vi). Describe the main features of and explain what are the main attractions to the investor and the issuer of convertible bonds.

[3 x 5 Marks]

Total Marks 15

Question 5

"Asset Resolution Corporation (ARC) is being set up ... to buy property loans from the banks in Ireland that are not part of the NAMA scheme. … (They would) pay market prices for anything they bought, but added that, ultimately, the market price was simple. It is whatever someone is willing to pay for it**"** Sunday Business Post, October 25th 2009.

Discuss the statement in the context of:

(a) A principal-agent perspective of the relationship between (i) those that borrowed money and (ii) those that lent money causing the boom and bust in the value of property in Irish and International markets. **[5 marks]**

(b) The Efficient market Hypothesis (EMH) and the boom and bust in the value of property. **[5 Marks]**

(c) Corporate social responsibly (CSR) and reckless lending by Irish financial institutions. **[5 Marks]**

Total marks 15

Question 6

(a) Briefly discuss the reasons for and outline general techniques that could be used by companies to assess the consequences of their financial forecasts being inaccurate due to uncertainty about the future? **[7 Marks]**

(b) Explain when firms should discount projects using cost of equity. When should they use the WACC instead? When should they use neither? **[8 Marks]**

Total Marks 15