CIMA F3 - Financial Strategy

1. CORRECT TEXT
A venture capitalist invests in a company by means of buying:
· 9 million shares for $2 a share and
· 8% bonds with a nominal value of $2 million, repayable at par in 3 years' time.
The venture capitalist expects a return on the equity portion of the investment of at least 20% a year on a compound basis over the first 3 years of the investment.
The company has 10 million shares in issue.
What is the minimum total equity value for the company in 3 years' time required to satisify the venture capitalist's expected return?
Give your answer to the nearest $ million.

A. 34, 35, 34000000, 35000000.

Answer(s): A

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2. CORRECT TEXT
A listed company is planning to raise $21.6 million to finance a new project with a positive net present value of $5 million. The finance is to be raised via a rights issue at a 10% discount to the current share price. There are currently 100 million shares in issue, trading at $2.00 each.
Taking the new project into account, what would the theoretical ex-rights price be?
Give your answer to two decimal places.

A. 2.02, 2.03

Answer(s): A

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3. Which THREE of the following are likely to be strategic reasons for a horizontal acquisition?

- [ ] A. Reduction of risk by building a larger portfolio
- [ ] B. Acquisition of an undervalued company
- [ ] C. To achieve economies of scale

- [ ] D. To secure key parts of the value chain

- [ ] E. Reduction of competition

Answer(s): B C E

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4. A company plans to raise $12 million to finance an expansion project using a rights issue.
Relevant data:
· Shares will be offered at a 20% discount to the present market price of $15.00 per share.
· There are currently 2 million shares in issue.
· The project is forecast to yield a positive NPV of $6 million.
What is the yield-adjusted Theoretical Ex-Rights Price following the announcement of the rights issue?

A. $16.00

B. $14.00

C. $9.00

D. $11.00

Answer(s): A

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5. Company T is a listed company in the retail sector.
Its current profit before interest and taxation is $5 million.
This level of profit is forecast to be maintainable in future.
Company T has a 10% corporate bond in issue with a nominal value of $10 million.
This currently trades at 90% of its nominal value.
Corporate tax is paid at 20%.
The following information is available:
Which of the following is a reasonable expectation of the equity value in the event of an attempted takeover?

A. $32.0 million

B. $41.6 million

C. $65.0 million

D. $50.2 million

Answer(s): B

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6. A private company manufactures goods for export, the goods are priced in foreign currency B$. The company is partly owned by members of the founding family and partly by a venture capitalist who is helping to grow the business rapidly in preparation for a planned listing in three years' time.
The company therefore has significant long term exposure to the B$.
This exposure is hedged up to 24 months into the future based on highly probable forecast future revenue streams.
The company does not apply hedge accounting and this has led to high volatility in reported earnings.
Which of the following best explains why external consultants have recently advised the company to apply hedge accounting?

A. To provide a more appropriate earnings figure for use in calculating the annual dividend.

B. To make it easier for the market to value the business when it is listed on the Stock Exchange.

C. To ensure that the venture capitalist receives regular annual returns on its investment.

D. To fully adopt IFRS in preparation for listing the company.

Answer(s): B

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7. Which of the following statements best describes a residual dividend policy?

A. Dividends are paid only after the on-going operational needs of the business have been met.

B. Dividends are paid only if no further positive NPV projects are available.

C. All surplus earnings are invested back into the business.

D. Dividends are paid at a constant rate.

Answer(s): B

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8. The Board of Directors of a small listed company engaged in exploration are currently considering the future dividend policy of the company. Exploration is considered a high-risk business and consequently the company has a low level of debt finance.
Forecasts indicate a period of profit fluctuation in the next few years as the company is planning to embark on a major capital investment project. Debt finance is unlikely to be available due to the project's high business risk.
Which THREE of the following are practical considerations when determining the company's dividend/retention policy?

- A. The timing and size of the cash flow requirements for the new investment.
- B. The fluctuating nature of the projected future profits.
- C. The legislation and regulation governing distributable profits.
- D. The dividend policies of mature listed multinational companies in the exploration industry.
- E. The general level of interest rates and the tax savings on interest costs relating to debt finance.

Answer(s): A B C

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9. Hospital X provides free healthcare to all members of the community, funded by the central Government.
Hospital Y provides healthcare which has to be paid for by the individual patients. It is a listed company, owned by a large number of shareholders.
In comparing the above two organisations and their objectives, which THREE of the following statements are correct?

- A. X is a not-for-profit organisation while Y is a for-profit organisation.
- B. X and Y have the same primary financial objective - to maximise shareholder wealth.
- C. The performance of X will be appraised primarily on the basis of value for money.
- D. Only Y is likely to have a mixture of financial and non-financial objectives.

- [ ] E. X and Y will have the same primary non financial objective - provision of quality of health care.

Answer(s): A C E

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10. Company M's current profit before interest and taxation is $5.0 million.
It has a long-term 10% corporate bond in issue with a nominal value of $10 million.
The rate of corporate tax is 25%.
It plans to continue to pay out 50% of its earnings in dividends and earnings are expected to grow by 3% each year in perpetuity.
Its cost of equity is 10%.
Using the dividend growth model, advise the Board of Directors of Company M which of the following provide a reasonable valuation of Company M's equity?

A. $73.6 million

B. $22.1 million

C. $44.1 million

D. $50.1 million

Answer(s): B

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11. Company C has received an unwelcome takeover bid from Company P.
Company P is approximately twice the size of Company C based on market capitalisation.
Although the two companies have some common business interests, the main aim of the bid is diversification for Company P.
The offer from Company P is a share exchange of 2 shares in Company P for 3 shares in Company C.
There is a cash alternative of $5.50 for each Company C share.
Company C has substantial cash balances which the directors were planning to use to fund an acquisition.
These plans have not been announced to the market.
The following share price information is relevant. All prices are in $.
Which of the following would be the most appropriate action by Company C's directors following receipt of this hostile bid?

A. Write to shareholders explaining fully why the company's share price is under valued.

B. Change the Articles of Association to increase the percentage of shareholder votes required to approve a takeover.

C. Pay a one-off special dividend.

D. Refer the bid to the country's competition authorities.

Answer(s): A

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12. Which of the following statements about IFRS 7 Financial Instruments: Disclosures is true?

A. IFRS 7only applies to entities that are designated as financial institutions by a regulatory authority.

B. IFRS 7 requires disclosures to be given for each separate class of financial instruments.

C. The main requirement of IFRS 7 is for qualitative disclosures relating to financial instruments and market risks.

D. IFRS 7 requires sensitivity analysis in relation to credit risk.

Answer(s): B

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13. A profit-seeking company intends to acquire another company for a variety of reasons, primarily to enhance shareholder wealth.
Which THREE of the following offer the greatest potential for enhancing shareholder wealth?

- [ ] A. Achieving more press coverage for the company.
- [ ] B. Creating new opportunities for employees.
- [ ] C. Achieving greater cultural diversity.
- [ ] D. Acquiring Intellectual Property assets.
- [ ] E. Exploiting production synergies.

- [ ] F. Elimination of existing competition.

Answer(s): D E F

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14. A company is undertaking a lease-or-buy evaluation, using the post-tax cost of bank borrowing as the discount rate.
Details of the two alternatives are as follows:
Buy option:
· To be financed by a bank loan
· Tax depreciation allowances are available on a reducing-balance basis
· Assets depreciated on a straight-line basis
Lease option:
· Finance lease
· Maintenance to be paid by the lessee
· Tax relief available on interest payments and book depreciation
Which THREE of the following are relevant cashflows in the lease-or-buy appraisal?

- [ ] A. Tax relief on tax depreciation allowances
- [ ] B. Bank loan payments
- [ ] C. Maintenance payments
- [ ] D. Lease payments
- [ ] E. Tax relief on the book depreciation

Answer(s): A D E

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15. A company currently has a 6.25% fixed rate loan but it wishes to change the interest style of the loan to variable by using an interest rate swap directly with the bank.
The bank has quoted the following swap rate:
· 5.50% - 5.55% in exchange for LIBOR
LIBOR is currently 5%.
If the company enters into the swap and LIBOR remains at 5%, what will the company's interest cost be?

A. 5.00%

B. 5.75%

C. 5.70%

D. 6.25%

Answer(s): B

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16. A company has:
· 10 million $1 ordinary shares in issue
· A current share price of $5.00 a share
· A WACC of 15%
The company holds $10 million in cash. No interest is earned on this cash.
It will invest this in a project with an expected NPV of $4 million.
In a semi-strong efficient stock market, which of the following is the most likely share price immediately after the announcement of the new investment?

A. $5.40

B. $6.40

C. $6.80

D. $5.30

Answer(s): A

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17. A company has in a 5% corporate bond in issue on which there are two loan covenants.
· Interest cover must not fall below 3 times
· Retained earnings for the year must not fall below $3.5 million
The Company has 200 million shares in issue.
The most recent dividend per share was $0.04.
The Company intends increasing dividends by 10% next year.
Financial projections for next year are as follows:
Advise the Board of Directors which of the following will be the status of compliance with the loan covenants next year?

A. The company will be in compliance with both covenants.

B. The company will be in breach of both covenants.

C. The company will breach the covenant in respect of retained earnings only.

D. The company will be in breach of the covenant in respect of interest cover only.

Answer(s): C

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18. A company wishes to raise additional debt finance and is assessing the impact this will have on key ratios.
The following data currently applies:
· Profit before interest and tax for the current year is $500,000
· Long term debt of $300,000 at a fixed interest rate of 5%
· 250,000 shares in issue with a share price of $8
The company plans to borrow an additional $200,000 on the first day of the year to invest in new project which will improve annual profit before interest and tax by $24,000.
The additional debt would carry an interest rate of 3%.
Assume the number of shares in issue remain constant but the share price will increase to $8.50 after the investment.
The rate of corporate income tax is 30%.
After the investment, which of the following statements is correct?

A. Interest cover will fall; P/E ratio will fall.

B. Interest cover will fall; P/E ratio will rise.

C. Interest cover will rise; P/E ratio will rise.

D. Interest cover will rise; P/E ratio will fall.

Answer(s): B

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19. A new company was set up two years ago using the personal financial resources of the founders.
These funds were used to acquire suitable premises.
The company has entered into a long-term lease on the premises which are not yet fully fitted

out.
The founders are considering requesting loan finance from the company's bank to fund the purchase of custom-made advanced technology equipment.
No other companies are using this type of equipment.
The company expects to continue to be profitable for the forseeable future.
It re-invests some of its surplus cash in on-going essential research and development.
Which THREE of the following features are likely to be considered negatives by the bank when assessing the company's credit-worthiness?

- [ ] A. The equipment is advanced technology custom-made equipment.
- [ ] B. The company will continue to remain profitable and to generate net cash.
- [ ] C. The company premises are on a long-term lease but are not yet fully fitted out.
- [ ] D. The founders invested their personal financial resources in the company.
- [ ] E. Essential on-going research and development expenditure is required.

Answer(s): A C E

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20. Company Y plans to diversify into an activity where Company X has an equity beta of 1.6, a debt beta of zero and gearing of 50% (debt/debt plus equity).
The risk-free rate of return is 5% and the market portfolio is expected to return 10%.
The rate of corporate income tax is 30%.
What would be the risk-adjusted cost of equity if Company Y has 60% equity and 40% debt?

A. 11.6%

B. 11.9%

C. 9.1%

D. 13%

Answer(s): B