

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL FOUR

CORPORATE FINANCIAL MANAGEMENT - PAPER 18

WEDNESDAY, 18 DECEMBER 2002

INSTRUCTIONS TO CANDIDATES

1. Time allowed: **3 hours**
2. Section **A** has **one** compulsory case study question carrying 60 marks
3. Section **B** has **three** questions and only **two** are to be attempted. Each question carries 20 marks.
4. Please, read further instructions on the answer book.

SECTION A

Question 1

Bulago Investments has made substantial use of debts to finance its operations in recent years. This is to such an extent that market analysts think the company is highly leveraged with respect to both the book and market valuations. Additional acquisition of debt would lead to a downgrading of the company's debt.

As Chief Finance Officer, you think that the next capital investment programme be financed with a new equity issue. However, the company's securities and market have been performing poorly. In fact, the rate of return on investment has been **just** equal to the cost of capital.

The financial statements show that the market value of the firm is less than its book value. This means that even a profitable project's EPS may decrease if new equity is raised.

The firm is considering a housing project which costs Shs 400,000,000 but with a gross present value of Shs 500,000,000. This project is expected to increase total earnings by Shs 60,000,000 per annum. The CEO of your company thinks that the project should be delayed because of the following reasons:

- It is too expensive to issue new debt.
- Financing the project with new equity will reduce EPS because market values are lower than book values.
- The equity markets are currently depressed. If the firm waits until the market index rises, the market value of equity will rise to exceed the book value and make equity financing attractive.

The summarised balance sheet and other data concerning the company are as follows:

Summarised Balance Sheet as at 31 December 2001

	Shs millions
Non-current assets	10,000
Current assets	<u>6,000</u>
Total Assets	<u>16,000</u>
Share Capital	4,000
Reserves	2,000
Current Liabilities	4,000
Non-current liabilities	<u>6,000</u>
Total equity & liabilities	<u>16,000</u>
No. of shares in issue	10,000,000
Current price per share	Shs 2,000
Total Earnings for year ended 31 Dec, 2001	Shs 600,000,000

Required:

- (a) Using comparative numerical calculations, show the effect on earnings per share of adoption of the project and issue of new shares. Use your calculations to critically appraise the CEO's thinking. **(20 marks)**
- (b) One of the arguments presented for a possible improvement in the price of the company's shares is the fact that the market index is expected to improve. Using your knowledge of market efficiency, write a memo to the CEO explaining why this is a fallacious assumption. **(15 marks)**
- (c) Part of the debt of Bulago Investments is a 15%, 10 year loan stock issued with warrants several years ago. These warrants may be exercised at any time during the next four years, and each warrant allows the purchase of one ordinary share at Shs 4,000. The company also issued a 9% convertible debenture which is due for redemption at par value (Shs 100,000) in five years time. Conversion rights are exercisable at any time and allow one debenture to be exchanged for 25 ordinary shares. The current market yield on straight debentures is 12% per annum for a company in the same risk class as Bulago Investments.
- (i) Suppose the price of the company's shares were to rise to Shs 3,000, Shs 4,200 and Shs 5,000 per share, estimate the minimum market price of a warrant and a Shs 100,000 convertible debenture.
- (ii) Explain why the market price of the warrant or convertible debenture may be higher than your estimate. **(20 marks)**
- (d) Write a brief memo to the CEO explaining the effect of warrants and convertible bonds on the position of existing shareholders. **(5 marks)**
- (Total 60 marks)**

SECTION B

Question 2

The following information relates to three securities quoted on the Uganda Securities Exchange for the year 2001:

	Company	$\sigma(R)_i$	β_i
A	Kapeka Products	0.40	0.7
B	Faulu Exports	0.28	0.9
C	Gomba Industries	0.32	1.2

The pairwise correlations between the returns of these securities are as follows:

$$\begin{aligned} r_{AB} &= 0.14 \\ r_{AC} &= 0.50 \\ r_{BC} &= 0.40 \end{aligned}$$

Required:

- (a) Assuming that $E(R_m) = 0.18$ per annum and $R_f = 0.10$ per annum, calculate the expected annual return on each stock. Why is $E(R_B) > E(R_A)$ when $\sigma(R_A) > \sigma(R_B)$? **(6 marks)**
- (b) Compute the expected return and variance of equally weighted portfolios of:
 (i) A and B
 (ii) A and C. **(4 marks)**
- (c) Given that $\sigma(R_B) = 0.28$, $\sigma(R_C) = 0.32$ and $r_{BC} = -1$, what weights for B and C would create a perfectly hedged portfolio? **(4 marks)**
- d) As financial advisor to the Federation of Industrial Company Employees, advise on the policy of the Gomba Industries pension fund not to invest in blue chip chemical companies. Also comment on the plan of Gomba to introduce an equity participation scheme for employees. **(6 marks)**

(Total 20 marks)

Question 3

Star Products Limited is a Ugandan company involved in the export of coffee and other primary products such as avocados, ginger, passion fruit and pineapples. Its exports are sold in various markets worldwide including Europe and the Middle East. In order to improve cleaning and packaging capacity in the competitive market, the company wishes to import equipment worth US \$ 1,655,000 from Dubai. It is expected that the equipment will be delivered in six months time, and payment should be made then.

The financial controller of Star Products is however worried about the rising rate of the US \$ to the Uganda shilling, which she expects to move from US \$ 1 = Shs 1820 to US \$ 1 = 1875 over the period. Economic forecasts from Bank of Uganda however suggest that the forward market rate will rise by 0.5% only. Such an increase (as projected by the financial controller) would raise the buying cost by about Shs 90,000,000, and significantly affect profitability and cash flow.

The financial controller decides to assess the currency risk using three methods.

- (i) Take out a six month forward contract in dollars.
- (ii) Buy a dollar bond worth US \$ 1,655,000 on the NYSE, repayable in six months time.
- (iii) Do nothing and assume that Bank of Uganda's forecast of a 0.5% rise is the correct forecast.

Required:

- (a) Calculate the cost of these three options assuming that the spot and forward market rates and the interest rates on short term borrowing in Uganda and USA are as follows:

Spot rate now	Shs 1,820 per dollar
Forward rate: six months forward	Shs 1,854 per dollar

Current annual interest rates on six month loans:

Uganda	14%
USA	8%

- i) Evaluate each alternative and indicate Star Products best course of action.
- ii) Suppose the spot rate in six months time is Shs 1,840 to the shilling, which option would be chosen?

(12 marks)

- (b) Explain the types of foreign exchange risk that a company operating in different international markets through out the world may face.

(8 marks)

(Total 20 marks)

Question 4

You work for a multi-national company as Corporate and Regulatory Affairs Manager. You have just attended a seminar at which one of the presenters used the following quotation on corporate social responsibility, which was adopted by the Commonwealth Association for Corporate Governance, 2000.

‘Governance is the manner in which power is exercised in the management of economic and social resources for sustainable development. It is a vital ingredient in the dynamic balance between the need for order and equality in society, the efficient production and delivery of goods and services, accountability in the use of power, the protection of human rights and freedoms, and the maintenance of an organized Corporate framework within which each citizen can contribute fully towards finding innovative solutions to common problems’.

Required:

Write a memo to your Chief Executive Officer, explaining the importance to your company of observing and practising responsible corporate citizenship, in light of the above quotation.

(20 marks)