

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL FOUR

CORPORATE FINANCIAL MANAGEMENT - PAPER 18

WEDNESDAY, 12 DECEMBER 2007

INSTRUCTIONS TO CANDIDATES

1. Time allowed: **3 hours**.
2. Section **A** has **one** compulsory question carrying 60 marks.
3. Section **B** has **three** questions and only **two** questions should be attempted. Each question carries 20 marks.
4. Tables are provided on page 7.
5. Please read further instructions in the answer book.

SECTION A

Question 1

The National Pensioners' Association Limited (NPAL) is a private pension services provider formed in the mid 1980s. It draws members from a cross-section of Ugandans working in different sectors of the economy. The company's investment portfolio stands at Shs 560 billion, with only 5% of this invested in equities compared to 75% tied in fixed-income assets like treasury bonds and bills, and 17% in real estate. To-date, it has close to 115,000 members who are expected to double in the next 5 years due to increased awareness and need for social security services in the country.

NPAL is due to launch their five-year strategic business plan (SBP) 2008 – 2013 in the last week of December 2007, in response to the anticipated increase in membership. While at the pre-launch press briefing, the Head of Corporate Affairs gave the following highlights:

" ... the future of our members shall continue to be more secure and brighter with the launch and successful implementation of this SBP. We shall be taking on the most profitable investments with emphasis on equity investments, up to 55% of our portfolio. Despite the risks involved in equity holdings, they provide better returns and have been utilised by pension funds worldwide, and we are not going to be an exception.

Fixed income securities (both short and long-term) shall definitely continue to feature on our portfolio, but with a maximum proportion of 15% of the total investments, while real estate shall increase to 25%. Besides, our investments shall take on both international and local facets from now onwards, to any proportions only subject to the said investment mix.

With this diversification and the resultant investment mix, members' savings shall be earning a rate of 11% up from the current 8%. We are also diversifying our directly managed internal projects. Over the SBP period, we envisage no risks shall significantly affect our investment both locally and abroad. The mistakes of the previous management shall not bog us down any more".

The public has received the news with mixed reactions. On one side there are concerns about taking on offshore investments, and also on risking savers' money in the more risky equities. To others, however, the change was timely, and commenting on the old NPAL's investment structure, one expert has said: "... their investment mix was too cautious to yield meaningful returns for members. Little wonder that NPAL has been paying only 8% interest on members' savings, when the inflation rate is consistently 9% and above".

Members of the press were privileged to receive copies of the SBP and the following were the outstanding information attached to the plan (in form of the extracts below):

Extract I:

The local investments shall focus on the Government of Uganda's Treasury bonds of 2-year, 3-year and 5-year tenure whose coupon rates are 10.25%, 10.50% and 10.75% respectively. The 'yield to maturity' in the primary market for the 5-year bond was an average of 14.75% at the most recent trading. These give a secure and liquid investment following the creation of a secondary market for these securities. The longer maturities shall be given priority, as the economy's yield curve is now normal and is expected to remain like that over the SBP period. Analysts also suggest that rates are generally expected to keep increasing.

Extract II:

NPAL shall be finalising negotiations expected to lead to an acquisition of a 35% shareholding in Value-Adders Limited (VAL), a major local manufacturer of electrical equipment. The market capitalisation of VAL was Shs 75 billion on 1 January 2007, which largely attributed to its consistent dividend policy with a pay-out ratio of 70%. The capital structure of VAL at that date was 40% equity and 60% debt (being 10-year 10% debentures). The company (VAL) had planned to raise Shs 25 billion during the year for new projects, and all their new projects earn an average return of 20%.

VAL's equity shares are currently selling at Shs 30,000 per share, and have a nominal value of Shs 8,000. The next dividend is expected to be Shs 4,000 per share. Retained earnings for the year are expected to be Shs 2,500 million. The coupon rate on new bonds available from Bank of Uganda is, on average, 10.5%. VAL pays tax at a rate of 30%.

Required:

- (a) Briefly explain the focus and content of a strategic business planning process from a financial management perspective. **(6 marks)**
- (b) Give a reasoned account in favour of **either** the old **or** the new investment mix, in view of general investment considerations. **(6 marks)**
- (c) Discuss the various special considerations that NPAL shall take into account before making any cross-boarder investments. **(6 marks)**
- (d) Illustrate, to an investor in treasury bonds, the relevance of the following terms:
 - (i) Coupon rate.

- (ii) Yield to maturity.
- (iii) Yield curve.

(6 marks)

- (e) NPAL is planning to participate in the next primary auction for the 5-year Treasury bond (with interest paid annually) due on 27 December 2007, and the company requires a minimum return of 15% for a maturity value of Ushs 1,000 million.

Determine how much NPAL should invest in the bond at the auction.

(5 marks)

- (f) If NPAL was to buy a similar 5-year Treasury bond in the same week of auctioning from the Treasury bond secondary market at Ushs 880 million, determine the resultant yield to maturity.

(5 marks)

- (g) Determine how much of the new investment must be financed by an issue of equity, in order for VAL to maintain its capital structure.

(5 marks)

- (h) Using the Modgiliani and Miller theory of capital structure, calculate VAL's cost of debt and cost of equity.

(8 marks)

- (i) In the sense of the world of capital markets, explain why dividends are a cost to a company; why it is important for dividends to keep on growing; and whether dividend policy matters.

(8 marks)

- (j) In your assessment, explain the risks the company faces if the proportion of debt increased, and whether capital structure matters.

(5 marks)

(Total 60 marks)

SECTION B

Question 2

The Chief Operations Manager of Regional Business Solutions (U) Ltd (RBS), Ms J Nkesa, has convinced her bosses to venture into regional business. She is currently focusing on the Tanzanian market, where a deal to export goods worth Tzsh 550 million is close to conclusion. The Tanzanian importer promises to pay in a month's time. The spot rate of exchange is Tzsh 0.625/Ushs while the one month rate is Tzsh 0.605 /Ushs.

To borrow in Tanzania for one month will cost 0.8 per cent whereas borrowing in Uganda for one month will cost 1 % of the amount borrowed. It has also been established that the inflation rate in Tanzania is at an average of 4% while the Ugandan one is reported at 3 % per annum.

The Managing Director (MD) of RBS is sceptical about international trade. He (the MD) would like an analysis of the proposed export contract and the likely movements in exchange rates so that he could direct on avoidance of more volatile markets, and also to know the key influences on these economic variables.

Required:

- (a) Advise whether RBS should use either a money market or a forward market to hedge the above stated transaction.
(6 marks)
- (b) Advise the Managing Director on the maximum amount, in Tzshs, that RBS should offer as discount to try and obtain payment immediately as an alternative to hedging in the markets assuming all other factors remain constant.
(4 marks)
- (c) Using the purchasing power parity theory, explain to the MD the expected movements in the foreign exchange rates in a year's time using the Tzsh / Ush rate.
(4 marks)
- (d) Explain the following terms in relation to foreign currency receipts and payments, stating the circumstances under which each technique might be most relevant:
- (i) Leading and lagging.
 - (ii) Matching.

(6 marks)
(Total 20 marks)

Question 3

Sky Equipment Limited (SEL), is a manufacturer of general household and building materials, incorporated in the year 2003. The SEL management is evaluating a project, whose total initial investment is Ushs 500 million (all depreciable), with the following anticipated revenues and costs:

Year	2008	2009	2010	2011	2012
	Shs 'million	Shs 'million	Shs 'million	Shs 'million	Shs 'million
Sales	450	510	520	560	610
Costs	(260)	(300)	(350)	(400)	(450)
Depreciation	(100)	(100)	(100)	(100)	(100)
Interest	<u>(50)</u>	<u>(50)</u>	<u>(50)</u>	<u>(50)</u>	<u>(50)</u>
Profit before tax	<u><u>40</u></u>	<u><u>60</u></u>	<u><u>20</u></u>	<u><u>10</u></u>	<u><u>10</u></u>

The company would need to finance the project partly by internally generated funds and the balance would be borrowed. The interest cost shown above shows the cost associated with this borrowing. The company would pay tax at

a rate of 30% payable one year after the accounting period end, and the straight-line depreciation amount is the same as the writing down allowance for tax purposes. The company's cost of capital is 14%.

The company does not have an investment policy, and so they find it difficult to determine what investment appraisal methods to use. Their Investment Analyst has however said that "... being a new company, borrowed capital has many implications on project's viability. ... in any case, this project is more risky than is apparent. The appraisal method that can take account of all risk is the 'adjusted present value' (APV)".

Required:

- (a) Advise SEL if they should undertake the project on the basis of the project's APV.
(8 marks)
- (b) Explain any **four** approaches that SEL should use to mitigate the risk associated with long-term projects.
(6 marks)
- (c) Discuss the advantages that would accrue to SEL if they financed the project by means of a lease arrangement, compared to the use of mezzanine finance.
(6 marks)

(Total 20 marks)

Question 4

The Chief Executives Association of Uganda (CEAU) has arranged a series of consultation meetings on "the role of the business community in capital markets development". At the most recent of such meetings, a press release indicated, "... the development of the financial sector and the Ugandan economy in general shall greatly depend on how fast the capital markets develop. We observe that the capital market, despite its over-a-decade's existence in Uganda, remains significantly inefficient. To an ordinary market participant, the efficient market hypothesis shall not make sense in a long time, until the Capital Markets Authority (CMA) deliberately takes steps to remove the inefficiencies. ...".

Required:

- (a) Discuss the relevance of capital markets to a corporate finance manager.
(8 marks)
- (b) Describe the efficient market hypothesis (EMH) and explain how relevant the hypothesis is to the Ugandan situation.
(8 marks)
- (c) Explain whether or not the money markets are more developed than capital markets in Uganda and the reasons why.
(4 marks)

(Total 20 marks)

Table 1: PVIF- Present Value of Shs 1 Due at the End of n Periods

Period	9%	10%	11%	12%	13%	14%	15%	16%	18%	20%
1	0.917	0.909	0.901	0.893	0.885	0.877	0.870	0.862	0.847	0.833
2	0.842	0.826	0.812	0.797	0.783	0.769	0.756	0.743	0.718	0.694
3	0.772	0.751	0.731	0.712	0.693	0.675	0.658	0.641	0.609	0.579
4	0.708	0.683	0.659	0.636	0.613	0.592	0.572	0.552	0.516	0.482
5	0.650	0.621	0.593	0.567	0.543	0.519	0.497	0.476	0.437	0.402
6	0.596	0.564	0.535	0.507	0.480	0.456	0.432	0.410	0.370	0.335
7	0.547	0.513	0.482	0.452	0.425	0.400	0.376	0.354	0.314	0.279
8	0.502	0.467	0.434	0.404	0.376	0.351	0.327	0.305	0.266	0.233
9	0.460	0.424	0.391	0.361	0.333	0.308	0.284	0.263	0.225	0.194
10	0.422	0.386	0.352	0.322	0.295	0.270	0.247	0.227	0.191	0.162
11	0.388	0.350	0.317	0.287	0.261	0.237	0.215	0.195	0.162	0.135
12	0.356	0.319	0.286	0.257	0.231	0.208	0.187	0.168	0.137	0.112
13	0.326	0.290	0.258	0.229	0.204	0.182	0.163	0.145	0.116	0.093
14	0.299	0.263	0.232	0.205	0.181	0.160	0.141	0.125	0.099	0.078
15	0.275	0.239	0.209	0.183	0.160	0.140	0.123	0.108	0.084	0.065

TABLE 2: PVAF - Present Value of an Annuity of Shs 1 per Period for n Periods

Period	9%	10%	11%	12%	13%	14%	15%	16%	18%	20%
1	0.917	0.909	0.901	0.893	0.885	0.877	0.870	0.862	0.847	0.833
2	1.759	1.736	1.713	1.690	1.668	1.647	1.626	1.605	1.566	1.528
3	2.531	2.487	2.444	2.402	2.361	2.322	2.283	2.246	2.174	2.106
4	3.240	3.170	3.102	3.037	2.974	2.914	2.855	2.798	2.690	2.589
5	3.890	3.791	3.696	3.605	3.517	3.433	3.352	3.274	3.127	2.991
6	4.486	4.355	4.231	4.111	3.998	3.889	3.784	3.685	3.498	3.326
7	5.033	4.868	4.712	4.564	4.423	4.288	4.160	4.039	3.812	3.605
8	5.535	5.335	5.146	4.968	4.799	4.639	4.487	4.344	4.078	3.837
9	5.995	5.759	5.537	5.328	5.132	4.946	4.772	4.607	4.303	4.031
10	6.418	6.145	5.889	5.650	5.426	5.216	5.019	4.833	4.494	4.192
11	6.805	6.495	6.207	5.938	5.687	5.453	5.234	5.029	4.656	4.327
12	7.161	6.814	6.492	6.194	5.918	5.660	5.421	5.197	4.793	4.439
13	7.487	7.103	6.750	6.424	6.122	5.842	5.583	5.342	4.910	4.533
14	7.786	7.367	6.982	6.628	6.302	6.002	5.724	5.468	5.008	4.611
15	8.061	7.606	7.191	6.811	6.462	6.142	5.847	5.575	5.092	4.675