THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC2 – Corporate Finance & Risk Management

December 2016

Answer 01

Relevant Learning Outcome/s: 3.1.3/3.1.2/2.3.5/1.1.2

Suggested Detail Answer:

(a) Dividend policy is considered an important tool for investors to assess the company's financial position and financial prospects. In general institutional investors prefer a steady cash flow each year for different reasons including meeting the, day to day running expenses of the institution.

Investors do recognise two types of returns namely realized gain and unrealized gain. In the event the dividends are not declared, the return will stand in the form of unrealized gain until the shares are sold out. There is pressure for an investing firm to pay dividends annually and steady dividends would ease such pressures i.e. bird-in-hand effect, as capital gains sometimes may not materialise due to certain factors.

Given the above is desired but may not necessarily be the prime motive of all investing firms, some institutional investors prefer large capital gains over recurring revenue in the form of dividends.

Therefore, ABC's potential investors need to closely look at the existing shareholder profile and understand the possible dividend policy that ABC would follow.

It should however, be stated that the relationship between the dividend policy and shareholder value is not straightforward and other factors including taxation, agency cost etc. need to be considered.

(b) Dividends irrelevance theory was introduced by Modigliani and Miller under several assumptions and they continued to argue that the dividend decision will not make any difference in the market place. It is important to understand that the dividend irrelevance theory follows the "capital structure irrelevance" theory introduced by the same theorists.

In order to understand the applicability of such a theory in the real world one should closely look at the assumptions on which the theory is built upon.

Accordingly, the indifference can be most simplified and presented as below.

Firms that pay more dividends offer less stock price appreciation. However, the total return from both dividends and capital gains to stockholders should be the same. If dividends are too small, a shareholder can simply choose to sell some portion of his stock. Therefore, if there are no tax advantages or disadvantages involved with these two options, shareholders would ultimately be indifferent between returns from dividends or returns from capital gains.

The advice for ABC potential shareholders is that the above explanation would be correct under the given assumptions only. Hence the dividend irreverence theory cannot be expected in today's terms and therefore the directors' attempt in maintaining a steady dividend payout is not meaningful.

(c) **EPS**

In the case of ABC PLC the EPS has been nearly the same from 2012/13 to 2015/16 suggesting the fact that the company has made very slight progress.

However we should not get misled by the said observation simply due to the reason that a new share issue has been made (50% increase) in 2015/16 and despite that maintaining the same EPS is an indication of proper management of the growth of the company and is a positive trend.

EPS Calculation		
	2015/16	**2012/13**
Dividends (Rs. million)	140	100
Retained profits (Rs. million)	305	205
Total earnings attributable to equity shareholders	445	305
No of shares in issue (in millions)	600	400
EPS (Rs.)	0.74	0.76

P/E ratio

P/E ratio reflects the market's appraisal of the share's future prospects. It is the relationship between the market value of a company's share and the earnings from those shares.

P/E ratio		
	2015/16	**2012/13**
Share price	5.5	4.5
EPS	0.74	0.76
P/E ratio	7.42	5.90

PE has increased by a large percentage (26%).This suggests that the investors have built confidence in the development program undertaken by ABC PLC. They seem to believe that the earnings power of the company will be strong in the future.

Dividend cover

The dividend cover is the number of times the actual dividend could be paid out of current profits. A high dividend cover means that a high proportion of profits are being retained. This might indicate that the company is investing to achieve earnings growth in the future.

Dividend cover		
	2015/16	**2012/13**
Total earnings attributable to equity shareholders	445	305
Dividends	140	100
Dividend cover	3.18	3.05

ABC's dividend cover is quite similar for both years. ABC is maintaining a steady Dividend cover to pay dividends even in the future at the same rate. This policy has allowed them to pay dividends at the same rate even when the earnings were negative.

(d). **Reasons for price increase in 2014/15**

1. There were two changes planned for ABC PLC by the end of 2014/15
   - New share issue and
   - New project
2. As per the efficient market hypothesis share price is a reflection of new information about the company future prospects. This suggests that the market was responding quite positively compared to historical years.
3. ABC declared and paid dividends at the same level as last year despite the loss making condition. This must have increased shareholder confidence.
4. Current market place where ABC operates may have shown positive signs for the future.
5. Debt financing in $Y_1 - Y_2$

Reasons for price decrease in 2015/16

1. The new share issue leads to a lower DPS compared to previous years. It has reduced from previous year. This must have reflected on the share price.

   - DPS 2014/15 110 /400 = Rs. 0.275
   - DPS 2015/16 140/600 = Rs. 0.23

2. The performance of a new project may not have been up to the expectation of shareholders.
3. There may have been a general drop in the stock market due to unfavorable market conditions for general business such as.
   - Introduction of more aggressive tax for companies
   - Inflationary effect
   - Forex effects
   - New rules being introduced.
4. Due to the rights issue.

(e) **Investment decisions**

ABC PLC operates under tremendous pressure to keep up with technological changes and to respond to competitor strategies positively. This requires a substantial investment to be made each year. ABC has invested Rs. 200 million on average each year. This has been well balanced by the company as positively seen by the shareholders and interestingly the trend has continued even during hard times where the company has recorded a loss.

Dividend decisions

The shareholders of ABC PLC are mainly institutional investors and they prefer a steady dividend payout ratio, liquidity in each year to meet monetary obligations and to meet day to day expenses. ABC's dividend policy has been determined based on such a scenario and a decent payout ratio has been maintained.

	2012/13	2013/14	2014/15	2015/16
Stated capital (Rs. million)	600	600	600	1,000
No. of shares (in millions)	400	400	400	600
Debt capital (Rs. million)	1,000	1,100	1,350	1,150
(B) loan/repayment		100	250	(200)
(B) rights issue (Rs. million)				400
(A) Investment in PPE (Rs. million)	200	250	100	300
(B) Retained earnings (Rs. million)	205	255	(150)	305
(C) Dividends paid (Rs. million)	(100)	(110)	(110)	(140)
Net Profit after tax (Rs. million)	305	365	(40)	445
(C) % of stated capital	16.67%	18.33%	18.33%	14%
(C) Dividend pay out	32.7%	30.1%	-	31.46%
Market price per share (Rs.)	4.50	5.50	6.50	5.50
Earnings per share	0.76	0.91	-	0.74

Financing Decisions

The financing decision has been triggered from the opportunity to invest and the company has utilized more equity financing than debt financing. The rest of the investment requirements for the last 4-year period has used retained earnings rather than raising additional debt financing.

Interrelation of decisions in each year

YE 2012/13
The investment in PPE was made mainly through retained earnings (RE).

YE 2013/14
New investment made was recorded at 250 million whereas the RE was Rs. 255 million. The debt may have been used for WC to meet increasing operational requirements as new PPE were replaced.

YE 2014/15
A tough year for ABC PLC. Distributable profits were negative at Rs. 40 million. Despite the loss the company has attempted to maintain the same level of dividend payout ratio and made investments in the regular replacement cycle totaling Rs. 100 million (the lowest for 4 years due to a tight cash situation). This resulted in further debt being taken valued at Rs. 250 million to be prepared for next year.

YE 2015/16
Distributable profits increased up to Rs. 445 million indicating the fact that investments made at the beginning of year have started to yield positive results within the same year, in keeping with organic growth. At the beginning of the year 2015/16, ABC raised funds through a rights issue amounting to Rs. 400 million, that has been used together with retained earnings of Rs. 305 million to meet the investment requirement of Rs. 300 million and to settle Rs. 200 million of the loan.

(Total: 25 marks)

Answer 02

Relevant Learning Outcome/s: 6.1.1/6.1.2/5.2.4/1.2.2/4.1.2/4.1.1

Suggested Detail Answer:

(a)

To	:	The Board of directors of "Infinity ∝"
From	:	Finance Director
Subject	:	Risk factors in investing in Maldives
Date	:	December 2016

Maldives has been facing a political crisis in the recent past, where the Vice President and Minister of Tourism were arrested, on the alleged suspicion of threatening the life of the President, where a bomb exploded in a boat hurting the first lady. The previous president is also in exile, seeking asylum in the U.K. Thus the country is regarded as a politically unstable country, which poses a high risk when investing in Maldives.

On the economic front, the country mainly depends on tourism and fisheries. During the recent years, due to the political crisis and recession in Europe has led to a decline in the number of tourist arrivals, although there has been an increase in the Chinese Tourist arrivals. Further, the economy has seen difficulties in remitting outward USDs, due to the shortage of USD in the economy.

Geographically, due to the increasing global warming, the Maldives Island is forecasted to disappear from the world in the next 50 years.

Overall, investing in Maldives poses higher financial risk, although it is one of the finest tourism destinations in the world.

(b) There are generally three forms of acquisition for structuring a merger or acquisition deal: the asset purchase, the share deal and the merger. All of these acquisitions can be paid in exchange for buyer stock, cash, debt, or some combination; however, specific advantages and disadvantages exist in each option and the "strategically best option" should be selected depending on the circumstances.

Deal structuring addresses identifying and satisfying as many of the primary objectives of the parties involved and determining how risk will be shared**.** Choices made in one area of the "deal" are likely to impact on other aspects of the transaction. These transactions are usually quite complex, and one type of structure may favor one party more than the other and both parties (and their attorneys) must consider the respective legal, tax and business issues and structure the transaction to make it mutually beneficial. Therefore, choosing the best structure for a merger or acquisition is critical to the deal's success for both parties.

"Infinity ∝"should be recognized from the perspective of "the Buy-Side" of the M&A Process.

Deal structuring generally consists of:

- Identifying strategic objective
- Developing acquisition plan
- Establishing key screening criteria
- Generating deal flow
- Preparing letter of intent
- Due diligence
- Documentation
- Negotiation
- Determining the acquisition vehicle
- Closing

Note: Question requires to explain from the point of "infinity ∝". Therefore, answers written in that manner may also be considered.

(c) Lease hold acquisition cost = USD 25 million – USD 5 million = USD 20 million

		In USD million
1. Mortgage payable to bank	=	10
2. Interest paid to bank	=	0.75
3. Trade creditors	=	0.15
4. Employee salaries	=	0.05
5. Lease rent payable to ministry	=	1
		11.95

Net payment received by Mohamed Ameel (In USD million) = 8.05

		USD
(d) Gross revenue = USD 800 x 50 x 75% x 365	=	10,950,000
Cost of sales	=	(2,190,000)
Gross profit (80%)	=	8,760,000
Less: Administration cost	=	(1,000,000)
Operating profits before amortisation and management fee	=	7,760,000
Management fee	=	(871,700)
(3% revenue+7% operating profit) 328,500 + 543,200		
Leases hold rights & refurbishment amortisation		
(20 million + 5 million) / 25	=	(1,000,000)
Earnings before interest & tax	=	5,888,300
Interest at 6.5%	=	(1,625,000)
Profit before tax	=	4,263,300
Tax at 15%	=	(639,495)
Profit after tax	=	3,623,805
Dividends = USD 3,623,805 x 60%	=	2,174,283

Note: Answers with an annual guaranteed lease rental may also be considered. (based on the information given on paragraph 3 of the question)

(e)

	(In USD)					
Year	Y_o	Y_1	Y_2	Y_3	Y_4	Y_5
Investment	(25,000,000)					
EBIT (1-t) 5,888,300x0.85		5,005,055	5,005,055	5,005,055	5,005,055	5,005,055
Add: Amortisation		1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Management fee		871,700	871,700	871,700	871,700	871,700
		6,876,755	6,876,755	6,876,755	6,876,755	6,876,755
df 6.5% (1-t) 5.525%	1	0.948	0.898	0.851	0.806	0.764
	(25,000,000)	6,519,164	6,175,326	5,852,118	5,542,664	5,253,840
					4 years + 910,728 x 12 5,253,840 4 years & 2 months	

Project is a medium term investment, and it would take 4 years & 2 months to recover the investment. Based on the project's discounted payback period, the board could go ahead with the project.

(Total: 25 marks)

Answer 03

Relevant Learning Outcome/s: 6.1.1/1.1.3/5.1.1/2.6.2/2.6.3/2.6.4/5.2.1/4.1.2/2.4.1/2.4.2

Suggested Detail Answer:

(a)

There could be various types of risks associated with investment decisions. The level of risk associated may be different from one situation to another. For example, in this situation the political or government risk could be more significant than any other risk. Accordingly explained below are some of the risks associated with CSL and SDL.

Note – Students are not expected to write on generic investment risks types but be case study specific. Generic discussions should attract ONLY minimum marks

01. **Social/Political /Legislative Risk**

Risks associated with the possibility of nationalization, unfavorable government action or social changes resulting in a loss of value is called "social or political risk". Because the SL government has the power to change laws affecting securities, any ruling that results in adverse consequences is also known as "legislative risk".

This could be severe in the case of both CSL as well as SDL due to the reason that changes in government policy, political land scape or legislation would impact the entire investment.

Example –
Acquiring of low performing entities to entire government control. In that case CSL will be taken over by the government with 100% ownership.

1. Setting up a maximum price for sugar sale
2. Limitations in importing sugar to SL
3. Minimum labour usage requirement for each Hectare used in production

02. **Liquidity Risk**

Liquidity risk refers to the possibility that an investor may not be able to sell an investment as and when desired or in sufficient quantities because of limited opportunities. A good example of liquidity risk with regard to CSL shares in case the investor wants to quit. It would be difficult due to many reasons, including;

- The entity is controlled by the government. Hence, the reluctance from the investment community.
- Shares are not listed

- Regulated industry through maximum price , minimum wage
- Large value of investment
- Banks are reluctant in providing finance
- Politicized land space in sugar industry of SL

03. **Business Risk**

Business risk is the measure of risk associated with a particular security. It is also known as unsystematic risk and refers to the risk associated with a specific issuer of a security. Generally speaking, all businesses in the same industry have similar types of business risk. But used more specifically, business risk refers to the possibility that the issuer of a stock or a bond may go bankrupt.

Exposure in the case of CSL:

01. Government change and political influence
02. Conflicts in commercial terms and national welfare at the cost of business failure

04. **Market Risk**

Market risk, also called systematic risk, is a risk that will affect all securities in the same manner. In other words, it is caused by some factor that cannot be controlled by diversification. Exposure in the case of CSL.

- Rigid rules due to commodity market value imposed by the government
- Higher cost of production compared to other countries such as Brazil which produces at a lower cost
- Government change and different policies for the sugar market
- Unfavourable market conditions for the commodity market
- Restrictions in exports

05. **Taxability Risk**

This means heavy tax burden on profits or revenue and applicable for both CSL and SDL due to the reason that the current landscape in SL for tax is more susceptible and specially for importing companies.

06. **Currency/Exchange Rate Risk**

Currency or exchange rate risk is a form of risk that arises from the change in price of one currency against another. The frequent fluctuations in the foreign currency in which an investment is denominated vis-à-vis one's home currency may add risk to the value of a security.

In the case SDL being a sugar importer is highly exposed to forex. In the event the local currency depreciates the chances for margin shrinking is high.

(b) As per Sri Lanka's Companies Act No. 07 of 2007, a serious loss of capital arises when the net assets of the company is less than half of the stated capital of the company.

In Ceylon Sugar Ltd:

The stated capital is Rs. 1 billion, where the net assets are a negative Rs. 2.1 billion. The company's accumulated losses of Rs. 3.1 billion has wiped out the company's stated capital, and is insolvent, where assets are less than its liabilities.
So the situation is much worse than a serious loss of capital.

(c) Given the circumstances the exit strategy with minimum losses could be planned as below.

Exit Routes in Private Equity Transactions

Given the circumstances, given below are some of the options that Mahen and Ajith can think of at the point of purchase.

01 Initial Public Offering

This is one of the most popular exit strategies used by private equity providers, due to the fact that when the proper market conditions are available, this method is likely to enable the investor to realize the highest return on its investment. Therefore it will be possible for Mahen and Ajith to dispose shares in the open market on the stock exchange.

However, they will have to agree with the government directors if they are willing to go for this option.

02. Leveraged Recapitalization

Leveraged recapitalization is a partial exit method, whereby the private equity investor is able to extract cash from a business without actually selling the company. This is achieved by re-leveraging the company i.e. substituting some of the company's equity with additional debt. It is usually done by the company raising money by borrowing from a bank or issuing bonds, which is then used to repurchase the company's own shares from the investor.

This will not be easy unless prior discussions are held with government directors and an agreement to execute this is obtained, provided the government is going to behave in such a way that is not favorable for an independent business to run. If such circumstance arises then this step would be put into action. Example – the government runs the company not for profit but for public benefit, then levered recapitalization would be activated.

03. Trade Sale

Another commonly used exit route is the trade sale in which the private equity investor sells all of its shares held in a company to a trade buyer, i.e. a third party often operating in the same industry. This method is preferred by private equity providers mainly because it provides a complete and immediate exit from the investment. Another advantage of the trade sale is that in this case, the negotiations take place with a single buyer which allows for a quicker and more efficient process which is not subject to the regulatory restrictions applicable to IPO transactions.

The biggest challenge to Mahen and Ajith would be to look for a third party who is a related player and get their agreement and inputs from the beginning and make it ready for a deal at the end of 4th year. Signing a MOU would be necessary. Alternatively, they can commence discussions with all other players and get each party to partially contribute.

04. De-merger
05. Spin off
06. Debt/Equity SWAP

(d) (i)

Calculation of WACC for APL and CSL

APL – WACC

APL				
Risk free rate		10%		
Risk premium		4%		
Beta		1.8		
Cost of equity (Ke)		17.2%		
Interest rate		14%		
Tax rate		28%		
After tax rate- Cost of debt (Kd)		10%		
WACC				
		Cost	Weight	
Equity	100	17.2	0.7692	13.23
Debt	30	10	0.2308	2.31
	130			15.54
				15.5%

Calculation of WACC

Assumptions

01. Bank overdraft and related party loans are deemed short term, hence excluded from WACC calculations.

CSL

Cost of debt (Kd)			Market values		
Interest rate	14%		Equity	1,000	18%
Tax rate	28%		Loans	4,428	82%
After tax debt cost	14% (1- 0.28)		Total	5,428	
Kd	10%				

Cost of equity (Ke)				
Levered company Beta		1.14		
D/E Ratio		0.4		
Tax rate		0.28		
Unlevered company Beta	=	Beta / (1+(1-t) debt/equity)		
		1.14		
		1.288		
Unlevered Beta	=	**0.885**		
Re-lever the Beta				
	=	0.885	*	4.428*0.72 + 1
	=	0.885	*	4.188
Levered Beta		**3.71**		
Cost of equity	=	Risk free rate + Risk premium * Beta		
	=	10% + 4% * 3.71		
Ke	=	**24.84**		

WACC			
Equity	18%	24.84%	4.47%
Debt	82%	10%	8.2%
CSL WACC (approximately)			**13%**

Note: Alternative answers have also been considered in the process of marking.

(ii) Cannot agree with Mahen's statement based on the following explanations.

WACC is a reflection of many factors including the business risk (systematic risk) and capital structure. The following explanation is from a project risk perspective assuming that the new investment is going to maintain the same capital structure.

Currently the beta factor is higher for APL probably due to the reason that the IT sector risk is high. However in the event the business segment is largely diversified from IT to sugar industry the systematic risk would adjust accordingly and the beta factor should come down provided that the two investments are not positively correlated. Therefore, the required WACC would also come down not necessarily to the degree that you may invest directly in CSL but slightly higher than that due to the reason that IT sector exposure is still there.

On the other side the diversification effect would again reduce the security risk and with such effect the bottom line WACC would be close to CSL individual WACC.

(e) (i)

Challenges found in CSL share valuation

- Most of the property, plant and equipment are quite old, may be fully depreciated and a proper revaluation has not been done. Hence the market value of assets is a big question. Similarly other current assets such as inventory, loans given to farmers and trade and other receivables may need adjustments. APL as a third party may not get full visibility hence placing a value based on assets approach may be quite challenging.
- There has been government involvement for a long period with inefficient process management. Therefore the earning capability has not been tested and if somebody tries to value the business with past earnings it may not reflect the correct picture.
- The conflict of interest (social welfare vs commercial value) must have overshadowed the real capability of the company in the past and there is no guarantee even in the future which way it will move. Hence, the cash flows cannot be predicted with a reasonable degree of confidence.
- Calculation of WACC is quite challenging as already explained in previous parts due to heavy country risk including, political risk, legislation risk.
- CSL is a private limited company without share listing details and owned by two parties. Also not many similar companies are found in the Colombo Stock Exchange to benchmark. Therefore, the market based valuation is challenging.
- The business landscape is obviously supported by the government and related parties. Hence the true business value cannot be estimated with precision.
- The lands provided to CSL on lease are charged a nominal value and if that had been factored in, what could have been the value is a concern. Nobody carries such information to factor into the valuation equation.

(e) (ii) The DCF valuation places a value of Rs. 4 billion approximately for a 49% stake in CSL.

WACC					
Equity	18%	24.84%	4.47%		
Debt	82%	10%	8.2%		
CSL WACC (Approximately)			13%		
VALUATION OF CSL Based on DCF method					
	Rs. million				
Year		**2017/18**	**2018/19**	**2019/20**	**2020/21**
EBIT(1-t)		714	1,046	1,304	1,816
Depreciation		160	180	200	220
Capex		(275)	(355)	(490)	(700)
WC		(75)	(125)	(200)	(315)
Terminal value					17,538
FCF		524	746	814	18,559
Discounting factor at 13%		0.885	0.783	0.693	0.613
		464	584	564	11,377
NPV		**12,989**			
Debt		**(4,428)**			
		8,561			
At 49% stake		**4,194**			
EBIT(1-t)		1,907			
Depreciation		231			
Capex		(735)			
		1,403			
Terminal value		1403			
		13% - 5%			
		17,538			

Recommended price is Rs. 4.2 billion.

(f) Proposed alternative investment ends up with a 5.6 billion positive NPV hence recommended.

	Rs. million				
	Year 0	**Year 1**	**Year 2**	**Year 3**	**Year 4**
Initial investment & recovery	(6,000)				6,000
Management fees		218	284	341	443
S&D expense charge back		218	284	341	443
Core product selling net revenue		1,748	2,272	2,726	3,544
By product revenue		1,525	1,650	1,880	2,100
Net working capital	(800)	(90)	(40)	(175)	1,105
Capex		(250)	(150)	(175)	(250)
Tax payments		(964)	(1,167)	(1,375)	(1,698)
Other operational cash flows		(371)	(449)	(529)	(653)
	(6,800)	2,034	2,684	3,034	11,034
Discounting factor	1.000	0.877	0.769	0.675	0.592
(12%+2%)					
PV	(6,800)	1,784	2,064	2,048	6,532
NPV	5,628				

(g) The IRR of the bond issue stands at 8.6% as calculated below. The loan options results in an after tax cost of debt of 9.5%. Therefore, the bond option looks less expensive. However, they need to be mindful of the issuing costs.

The impact on the D/E ratio stands indifferent due to the reason that both are classified as debts.

Financing options						
Corporate bond option		CF	Discounting factor	PV	Discounting factor	PV
			10%		15%	
Year 0	Bond issue	5.7	1.000	5.70	1.000	5.70
Year 1-4	Interest after tax	-0.432	3.170	(1.37)	2.855	(1.23)
Year 4	Repayment	-6	0.683	(4.10)	0.572	(3.43)
				0.23		**1.04**
Discounting at 10%			Discounting at 15%			
1.1			1.15			
	1			1		
Year 1	0.909		Year 1	0.870		
Year 2	0.826		Year 2	0.756		
Year 3	0.751		Year 3	0.658		
Year 4	0.683		Year 4	0.572		
	3.170			**2.855**		
IRR calculation	NPV					
At 10%	0.23					
At 15%	1.04					
	(0.80)					
	0.1	+	0.23	* (0.15-0.10)		
			0.23-1.04			
	0.1	+	0.23	* (0.05)		
			-0.81			
	0.1	-	0.014			
Therefore IRR =	8.6%					

(Total: 25 marks)

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1. to provide a detailed example of a suggested solution to an examination question; and

2. to assist students with their research into the subject and to further their understanding and appreciation of the subject.

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