GX14

Ollscoil na hÉireann, Gaillimh

National University of Ireland, Galway

Summer Examinations 2002

Third Year Evening B. Comm. Degree

Financial Management (AY 318)

Professor N. Garrod
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Time Allowed: Two Hours.

Answer either Part A or Part B of Question 1, and two other questions

Present Value Tables, and a Table of Financial Formulae, are attached

Question 1:

This question is obligatory.

Answer Either Part A or Part B, for 20 Marks.

Part A:

Leavened plc and **Unleavened plc** are two companies in the bakery industry. The companies have the same business risk and are identical in all respects except for their capital structures and their total market values. Both companies have expected operating earnings (before interest) of £5 million per year which is expected to remain constant in perpetuity. Each year, all profits after interest (if any) are distributed to shareholders as dividends.

The companies are currently valued in the market as follows:

	Leavened Plc.	Unleavened Plc.
Value of Equity	£30,000,000	£36,000,000
Value of 10% Debt	£10,000,000	-
Total Company Value	£40,000,000	£36,000,000

Required:

Assume you own 1% of the ordinary shares of Leavened plc., and that capital markets are perfect in all respects.

(i) Explain what actions you could take to improve your financial position, and show by how much your financial position should improve by taking these actions.

(13 Marks)

(ii) Assume that capital markets are perfect in all respects, except that companies pay taxes on their profits after interest at a rate of 30%. Suppose Unleavened Plc. is valued at £38 million in equilibrium in these new conditions, and that Leavened's debt has a market value of £10 million. What value should Leavened's equity have in these conditions?

(7 Marks)

(Total: 20 Marks)

Part B of Question 1 begins on the next page **P.T.O ⇒**

Question 1: (Continued)

Answer Either Part A or Part B, for 20 Marks.

Part B:

Cyclovar Plc. has sold a consignment of antiviral medicines to a customer in Korea. By agreement, the customer will be invoiced in dollars ($), and will be allowed three months credit. Accordingly, Cyclovar expects to receive a remittance of $200,000 as payment in full for the consignment three months from today's date.

The company has a policy of hedging currency exposures and is considering its alternatives in respect of the Korean invoice.

Exchange rates and interest rates are as follows:

Exchange Rates:

Spot	$1.15 to £1
Three-month Forward:	$1.16 to £1

Interest Rates:

£: 4% per annum

$: 6% per annum

Required:

Calculate the value of the remittance of $200,000 in pounds (£s) in three months time, assuming the exposure is hedged (i) using the forward market, and (ii) using the money market. Which hedging method would you recommend, and why?

(20 Marks)

(Total for ONE part: 20 Marks)

Question 2 begins on the next page **P.T.O ⇒**

Question 2:

(a) Discuss the reasons why a Finance Lease may be more attractive than a bank term loan as a means of financing the acquisition of a fixed asset.

(20 Marks)

(b) **Recycled Plastics Plc.** has decided to install automated recycling equipment in its Galway manufacturing plant. The issue facing Sinead, the company's finance director, is whether to lease or buy the equipment.

Sinead asked the Eyre Bank to quote leasing terms for a five-year lease on the equipment. The Bank quoted an annual leasing charge of £130,000 per year, payable in advance over five years.

The following information is available:

- The equipment costs £500,000 and has an estimated life of five years. It would be depreciated for tax purposes on a straight line basis at £100,000 per year. The estimated pre-tax residual value of the equipment is £50,000 at the end of its five-year life.
- The rate of corporation tax payable by Recycled Plastics is 10%. Taxes are payable at the end of the year in which the liability arises, and the company has sufficient taxable profits to absorb any losses for tax purposes arising in connection with the leasing or the purchase of the equipment.
- Recycled Plastics Plc. has a weighted-average cost of capital of 15%, and a pre-tax borrowing cost of 10% per year. Sinead believes that a discount rate of 15% would adequately reflect the risk of the equipment's residual value if the company is obliged to dispose of it in five years time.
- The Bank has agreed that the leasing charge it quotes will include maintenance services, which would cost Recycled £10,000 per year if it bought the equipment. Since a fixed-cost maintenance contract would be used by Recycled Plastics if it bought the equipment, the maintenance costs are relatively certain, and are deemed of equivalent risk to debt-type cash flows.

Required:

Estimate the Net Advantage of Leasing from the point of view of Recycled Plastics Plc., and advise Sinead whether she should lease or buy the equipment.

(20 Marks)

(Total: 40 Marks)

Question 3 begins on the next page **P.T.O ⇒**

Question 3:

(a) Explain each of the following methods of raising equity financing by issuing ordinary shares to new investors:

(i) Private Placement

(ii) Offer for Sale

(iii) Offer for Sale by Tender

(15 Marks)

(b) **Needful Plc**. has 12,000,000 Ordinary Shares of £0.50 par value in issue. At present, these shares have a market value of £3.50 each.

It is now planning to make a rights issue of Ordinary Shares at 20 per cent (20%) below the current market price in order to fund an investment costing £4,200,000.

An investor with 10,000 shares in the company is considering whether to take up the rights issue, to sell the rights, or allow the rights offer to lapse.

Required:

(i) Calculate the ratio of new to old shares in this rights issue.

(5 Marks)

(ii) Assume that the earnings yield on the new funds raised will be the same as that on existing investment. Calculate the theoretical ex-rights price per share and the expected value of the rights attaching to each old share in these circumstances.

(7 Marks)

(iii) Evaluate each of the options being considered by the owner of the 10,000 shares, and recommend a course of action.

(8 Marks)

(iv) Explain the reasons why the actual ex-rights price may differ from the theoretical ex-rights price calculated at (ii) above.

(5 Marks)

(Total: 40 Marks)

Question 4 begins on the next page **P.T.O ⇒**

Question 4:

(a) Explain the "Homemade Dividends" argument for the irrelevance of corporate dividend policy in conditions of perfect capital markets.

(15 Marks)

(b) Discuss the factors which may suggest that dividend policy may not be a matter of indifference in real-world conditions.

(25 Marks)

(Total: 40 Marks)

Question 5:

(a) Discuss the alternative strategies which may be employed in the financing of the short-term seasonal working capital requirements of a manufacturing company which is engaged in a seasonal trade.

(20 Marks)

(b) Explain the main features of Debtors Factoring as a source of financing for a medium-sized enterprise, and discuss the costs and benefits of this source of financing.

(20 Marks)

(Total: 40 Marks)

End of Question Paper