ACT LEADING TREASURY PROFESSIONALS

The Association of Corporate Treasurers

# MCT ADVANCED DIPLOMA GENERAL EXAMINATION

## Friday 08 April 2016 09.30 – 13.00

## Instructions:

Answer **EIGHT COMPULSORY** questions.

Time allowed: **3 hours + 30 minutes reading time.**

During the reading time you may annotate the examination paper but you may not write in your answer booklet or use your calculator.

- Enter your student number on the answer booklet: **do NOT write your name**
- You must write in blue or black ink and ensure your handwriting is legible.
- Enter the order in which questions are answered in the box provided on the front of the answer booklet.
- Ensure that all additional submissions (if applicable) are attached to the answer booklet by the tag provided and write your student number on all items to be marked.
- Show all your workings and state your assumptions in all questions, as appropriate.

## QUESTION 1

A Californian company (CA) is considering the acquisition of a Texas company (TX) at a 33% premium on current share price, using either an all-share offer or an all-debt offer. Earnings, share-price and related data are given in the table below.

| EPS data - Companies CA and TX | Company CA | Company TX | Acquisition of TX | CA plus TX (all-share acquisition) | CA plus TX (all-debt acquisition) |
|---|---|---|---|---|---|
| earnings (USD millions) | 100 | 50 | 50 | 150 | 134 |
| share price (USD) | 8.00 | 3.00 | 4.00 | 7.43 | 10.40 |
| number of shares (millions) | 250 | 200 | 100 | 350 | 250 |
| cost of company debt after tax % | 2.0% | | | | |
| eps (USD) | 0.40 | 0.25 | 0.50 | 0.43 | 0.54 |
| P/E (times) | 20 | 12 | 16 | 17.3 | 19.4 |
| earnings yield % | 5.0% | 8.3% | 6.3% | | |
| market cap. (USD millions) | 2000 | 600 | | 2,600 | 2,600 |
| acquisition cost (USD millions) | | | 800 | | |
| interest cost (USD millions) | | | | | 16 |

**Required:**

**a) Explain why CA's eps increases under each of the two funding scenarios, whether this eps accretion is advantageous for CA's shareholders and say which alternative is best for them and why.**

**(5 marks)**

**b) Explain the issues which will determine the market capitalisation of CA after the acquisition, which may not necessarily be 2,600 as shown in the table.**

**(4 marks)**

**(Total 9 marks)**

## QUESTION 2

ABC plc is a FTSE 250 company with three separate divisions devoted to niche technological-based businesses; industrial safety, healthcare solutions and site security. It has a 10-year growth record that has seen sales average 7.0% compound annual growth rate, pre-tax profits 9.9%, earnings per share 9.5% and share price 14.1% CAGR.

Over the five years to 2015 the total return to shareholders for FTSE 250 companies has averaged 64.8% with a dividend yield of 2.6, as against FTSE 100 companies of 24.4%, dividend yield 3.4%. The long-term cyclically-adjusted P/E ratio for the FTSE 250 is 20, as against 16 for the FTSE 100. For FTSE 100 companies the market / book ratio averages 2.48.

A summary of key financials for ABC plc is shown on page 3.

Table A shows selected statistics on comparable sector companies.

Table A: Selected statistics on comparable sector companies

| ABC Sector Comparables | | | | | |
|---|---|---|---|---|---|
| | Market Cap. GBP millions | EV/EBITDA | Price/Earnings | Price/Book | Dividend Yield |
| Company S | 2,075 | 10 | 14.8 | 2.6 | 2.6% |
| Company M | 640 | 9.5 | 15.8 | 3.9 | 3.4% |
| Company R | 1,200 | 15.5 | 20.8 | 5.6 | 2.7% |
| Company O | 333 | 9.1 | 12.1 | 2.6 | 2.2% |

**Required:**

a) **Calculate, evaluate and comment on ABC's key valuation multiples; Price/Earnings, EV/EBITDA and Price/Book Values, as at 2015.**

**(8 marks)**

b) **Calculate a WACC for the company, stating and supporting your assumptions, and estimate sustainable cash flow as at 2015. From these calculate the growth rate implied by the EV from part a).**

**Comment on your calculated growth rate in relation to the company's past growth record, given the background information on the company.**

**(11 marks)**

c) **Calculate the average total return to shareholders since 2012 and comment on the level of return, its key components and its key drivers.**

**(5 marks)**

**(Total 24 marks)**

## Key Financials - ABC plc

| Income Statement (March, GBP million) | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|
| **Sales Revenue** | **579.9** | **619.2** | **676.5** | **726.1** |
| (Depreciation & Impairment of Tangible Assets) | (12.2) | (12.7) | (13.6) | (14.0) |
| (Amortisation & Impairment of Goodwill) | (13.4) | (15.8) | (17.5) | (19.5) |
| (Amortisation & Impairment of Intangibles) | (2.1) | (3.4) | (5.2) | (2.0) |
| **Operating Profit** | **113.4** | **126.1** | **143.4** | **138.5** |
| Other Financial Income & Expenditure | (0.2) | (1.6) | (2.6) | (2.0) |
| Interest Received | 0.2 | 0.2 | 0.6 | 0.2 |
| (Gross Interest Paid) | (1.5) | (2.5) | (2.7) | (3.1) |
| **Profit before Tax** | **112.0** | **122.3** | **138.7** | **133.6** |
| **Profit after Tax** | **86.7** | **95.2** | **106.3** | **104.0** |
| (Dividends) | (36.7) | (39.4) | (42.2) | (45.3) |
| **Retained Profit for Year** | **50.0** | **55.8** | **64.1** | **58.7** |
| **Balance Sheet** | | | | |
| Goodwill | 267.5 | 351.8 | 335.3 | 406.2 |
| Other Intangible Fixed Assets | 74.5 | 134.5 | 112.8 | 138.7 |
| Tangible Fixed Assets | 85.1 | 110.3 | 100.2 | 119.1 |
| *Accumulated depreciation* | *86.1* | *91.7* | *95.9* | *101.5* |
| Stocks, Inventories, Work in Progress | 57.4 | 69.7 | 71.0 | 79.7 |
| Receivables | 115.4 | 133.9 | 135.8 | 157.6 |
| Cash and Short-term Investments | 45.3 | 49.7 | 34.5 | 41.2 |
| **Total Assets** | **645.2** | **849.9** | **789.6** | **942.5** |
| Short-term Debt | - | 5.1 | 4.1 | 1.7 |
| Trade and Other Payables | 121.5 | 138.1 | 107.8 | 131.3 |
| Medium & Long-term Debt | 64.0 | 154.9 | 104.9 | 140.4 |
| Tax, Pension & Other Long-term Provisions | 61.6 | 98.5 | 86.8 | 120.2 |
| **Total Liabilities** | **247.1** | **396.6** | **303.6** | **393.6** |
| Issued Share Capital | 37.9 | 37.9 | 37.9 | 38.0 |
| Share Premium Account, Treasury Shares | 22.2 | 22.6 | 22.8 | 23.6 |
| Revaluation Reserve | | | | |
| Other Reserves | 26.2 | 39.5 | 4.7 | 33.2 |
| Revenue Reserves | 311.9 | 353.2 | 420.6 | 454.2 |
| **Total Capital and Reserves** | **398.1** | **453.3** | **486.0** | **548.9** |
| **Cash Flow Summary** | | | | |
| Operating Profit | 113.5 | 126.4 | 143.1 | 138.5 |
| Other Non-cash & Exceptional Items | 5.6 | 5.5 | 4.1 | 21.5 |
| (Increase) / Decrease in Net Working Assets | (7.6) | (10.9) | (10.9) | (6.0) |
| Tangible Asset Depreciation | 12.2 | 12.7 | 13.6 | 14.0 |
| Net Capital Expenditure | (14.0) | (13.6) | (14.1) | (20.8) |
| (Tax Paid | (27.8) | (25.5) | (28.4) | (30.8) |
| (Dividends Paid) | (35.2) | (37.8) | (40.5) | (43.4) |
| (Net Interest Paid) | (1.5) | (2.5) | (2.7) | (3.1) |
| **Internal Cash Flow** | **45.3** | **54.6** | **64.5** | **70.1** |
| (Acquisitions & Investments) | (24.7) | (155.3) | (23.4) | (96.4) |
| Disposals | 3.6 | 19.6 | 1.9 | 4.2 |
| Increase / (Decrease) in Share Capital | (3.5) | (5.1) | (7.3) | (6.0) |
| Increase in Debt | 76.5 | 92.3 | 7.5 | 69.0 |
| (Decrease) in Debt | (97.1) | (1.7) | (58.3) | (34.3) |
| (Increase) / Decrease in Cash | | (4.4) | 15.2 | (6.7) |
| **Net Financing Cash Flow** | **(45.3)** | **(54.6)** | **(64.5)** | **(70.1)** |
| **Share Prices and Numbers** | | | | |
| Average number of shares (million) | 376.9 | 377.6 | 377.8 | 378.3 |
| Share Price - opening (£) | 3.73 | 4.05 | 5.00 | 5.61 |
| Share Price - closing (£) | 4.05 | 5.00 | 5.61 | 7.12 |
| Levered Beta | 0.82 | 0.89 | 0.87 | 0.99 |
| Variability % | 27 | 27 | 24 | 20 |

**QUESTION 3**

This question also relates to ABC plc.

**Required:**

**Identify the key strategic financial management issues relevant to company ABC, with reference to the principal financial statements.**

**(8 marks)**

**QUESTION 4**

**Required:**

a) **Define "mezzanine finance", explaining its function in corporate capital structures and the broad principles of its attractiveness to both lenders and investors.**

**(5 marks)**

b) **Provide an illustrative, quantified example of a typical capital structure containing at least two forms of mezzanine finance, explaining the key risk and return features for <u>all</u> financing components, not just the mezzanine.**

**(8 marks)**

**(Total 13 marks)**

**QUESTION 5**

Tax authorities are increasingly concerned about the opportunities which companies with overseas subsidiaries have to optimise their post-tax returns at the expense of individual countries' tax gathering.

One area under scrutiny is intragroup funding where possibilities arise for thin capitalisation and profit shifting.

In the UK the broad approach is that such lending must be seen to be "at arm's length", ie as if between two independent parties.

To evidence that this is so, there are two principal criteria.

- the borrowing entity could potentially get access to a similar level of debt with similar terms and conditions from a third party lender

- the interest rate is in accordance with arm's length pricing for similar agreements with feasible unrelated third parties.

Recently the G20 and OECD countries set up the Base Erosion and Profit Shifting (BEPS) project to propose new regulations in this area. The key regulation emerging is a cap on net interest rate expense deductions at a fixed percentage of EBITDA (or at the discretion of each member country, the level of a company's net interest/EBITDA for the worldwide group – whichever rate is higher would apply).

Your Group is UK-based and has subsidiaries in the UK, the USA, the EU (France, Germany, Greece and Poland) and Asia-Pacific (Australia, China). UK, USA, EU and Asia-Pacific each account for 25% of revenue. Intragroup funding is the norm.

Your Group CFO wishes to be briefed about how the above requirements could be met.

**Required:**

**a) Draft a policy statement for how the transfer pricing of intra-group debt could be calculated to satisfy the two principal arm's length criteria, distinguishing between the various geographic regions where appropriate.**

**(5 marks)**

**b) Draft an addendum to the policy statement outlining the implication of the cap on interest deductibility for the Group, should it be introduced as a result of the BEPS project.**

**(3 marks)**

**(Total 8 marks)**

**QUESTION 6**

Your France-based company has grown by acquisition over the past decade, in part by opportunistic acquisition of distressed businesses. A process of consolidation and rationalisation has now begun. The management of foreign exchange risk is fragmented because of all the acquisitions. Initial attempts to manage it more closely have identified *four* types of fx regime in the countries where subsidiaries are located.

- freely traded spot and forward markets and other derivative markets, influenced by government action aimed at supporting economic growth (subsidiary revenue 25% of total, growth flat).
- active management of spot rates by the government, thin markets in derivatives (30% revenue, growth medium).
- currency pegged to the USD (10% revenue, growth high).
- spot rates and the use of forward contracts controlled by the central bank (15% revenue, growth volatile).

So far, the acquisition and foreign direct investment policy has been to acquire 100% ownership of subsidiaries. Their primary role is to market and distribute. This means developing contacts with existing and potential customers, spotting opportunities to innovate, importing product from the parent, delivering on time to call-off schedules and responding quickly to customer problems eg quality issues. To underline this focus on selling, it has been decided to centralise the management of currency risk.

The product is a range of specialist "fastener" solutions, replacing more traditional and costly methods – eg non-ferrous clips instead of screws. The end users are manufacturers of retail and industrial engineering-based products and the three main competitors are from the US, Japan and China.

Your company is the smallest, but also the most innovative and the fastest growing. Both your company and your competitors manufacture only at their home base.

The product cost to your overseas subsidiaries averages 50% of sales price.

**Required:**

a) **Identify and prioritise the key areas of impact of currency risk on the Group Profit and Loss and Balance Sheet.**

**(5 marks)**

b) **List and explain the impact of this currency risk on the Group's potential financial performance from the shareholder viewpoint.**

**(5 marks)**

c) **Given the variety of currency environments in which the group's subsidiaries operate. Explain how you might organise and execute the centralised management of currency risk.**

**(10 marks)**

**(Total 20 marks)**

**QUESTION 7**

Two new non-executive directors (NEDs) have joined the Board of your £3bn turnover UK-based global engineering company which manufactures a wide range of industrial pumps in domestic and overseas subsidiaries. The company has three core universal banks and a large number of much smaller overseas local banks.

These new NEDs know the sector but do not have a finance/treasury background, so the Chief Financial Officer (CFO) to whom you report as Group Treasurer is preparing a briefing note and enlists your help with one specific area.

**Required:**

**From your perspective draft a note for the CFO identifying and briefly explaining how the new banking regulations currently in course of implementation may impact on the services the company now enjoys from its three relationship banks.**

**(10 marks)**

**QUESTION 8**

In April 2015 Coinbase, the world's best funded Bitcoin company, opened its exchange and online wallet in the UK after gaining a "green light" from the Financial Conduct Authority, (the regulator for financial institution – customer conduct) as well as securing a banking partnership with an unnamed European bank.

In mid-2015, the UK Treasury said it would regulate digital currencies.

However The British Bankers' Association, which represents the UK's largest banks, has warned it could be helping to fund terrorism.

**Required:**

**As Treasurer of a UK high street store and online retailer of domestic goods, describe the risks that your business would be exposed to if you were to introduce Bitcoin as a means of payment and explain how you might mitigate these.**

**(8 marks)**