First Section

Question one (This question is compulsory (50 mark)

(1) Since becoming independent just over 20 years ago, the country of Topland has adopted protection measures which have made it difficult for multinational companies to trade there. However, recently, after discussions with the world trade organisation (WTO), it seems likely that Topland will reduce its protectionist measures significantly.

Encouraged by these discussions, Camiro Co, a company producing packaged foods, is considering a project to set up a manufacturing base in Topland to sell its goods there and in other regional countries nearby. An initial investigation costing $500,000 established that Topland had appropriate manufacturing facilities, adequate transport links and a reasonably skilled but cheap work force. The investigation concluded that, if the protectionist measures were reduced, then the demand potential for Camiro Co's products looked promising. It is also felt that an early entry into Topland would give Camiro co an advantage over its competitors for a period of five years, after which the current project will cease, due to the development of new advanced manufacturing processes.

Topland's currency, the Peso, is currently trading at 72 Peso per $1. Setting up the manufacturing base in Topland will require an initial investment of 2,500 million peso immediately, to cover the cost of land and buildings (1,250 million) and machinery (1,250 million) tax allowable depreciation is available on the machinery at an annual rate of 10% on cost on a straight-line basis. A balancing adjustment will be required at the end of year five, when it is expected that the machinery will be sold for 500 million Peso (after inflation). The market value of the land and buildings in five years' time is estimated to be 80% of the current value. These amounts are inclusive of any tax impact.

Camiro Co will require 200 million Peso for working capital immediately. It is not expected that any further injections of working capital will be required for the five years. When the project ceases at the end of the fifth year, the working capital will be released back to Camiro Co.

Production of the packaged foods will take place in batches of product mixes. These batches will then be sold to supermarket chains, wholesalers and distributors in Topland and its neighboring countries, who will repackage them to their individual requirements. All sales will be in Peso. The estimated average number of batches produced and sold each year is given below:

Year	**1**	**2**	**3**	**4**	**5**
Batches produced and sold	10,000	15,000	30,000	26,000	15,000

The current selling price for each batch is estimated to be 115,200 Peso the costs related to producing and selling each batch are currently estimated to be 46,500 peso. In addition to these costs, a number of products will need a special packaging material which Camiro Co will send to Topland. Currently the cost of the special packaging material is $200 per batch. Training and development costs, related to the production of the batches, are estimated to be 80% of the production and selling costs (excluding the cost of the special packaging) in the first year, before falling to 20% of these costs (excluding the cost of the special packaging) in the second year, and then nil for the remaining years. It is expected that the costs relating to the production and sale of each batch will increase annually by 10% but the selling price and the special packaging costs will only increase by 5% every year.

The current annual corporation tax rate in Topland is 25 % and Camiro Co pays annual corporation tax at a rate of 20% in the country where it is based. Both countries' taxes are payable in the year that the tax liability arises. A bi-lateral tax treaty exists between the two countries which permits offset of overseas tax against any tax liabilities Camiro Co incurs on overseas earnings.

The risk-adjusted cost of capital applicable to the project on $-based cash flows is 12%, which is considerably higher than the return on short-dated $ treasury bills of 4%. The current rate of inflation in Topland is 8%, and in the country where Camiro Co is based, it is 2%. It can be assumed that these inflation rates will not change for the foreseeable future. All net cash flows from the project will be remitted back to Camiro Co at the end of each year.

Camiro Co's finance director is of the opinion that there are many uncertainties surrounding the project and has assessed that the cash flows can vary by a standard deviation of as much as 35% because of these uncertainties.

Recently Balad Co. offered Camiro Co the option to sell the entire project to Balad Co for $28 million at start of year three. Camiro Co will make the decision of whether or not to sell the project at the end of year two.

<u>Required:</u>

A- **Discuss the role of the World Trade Organisation (WTO) and the possible benefits and drawbacks to Topland of reducing protectionist measures.** (9 marks)

B- **Prepare an evaluative report for the Board of Directors of Camiro Co which addresses the following parts and recommends an appropriate course of action:**

(i) **An estimate of the value of the project before considering Balad Co's offer. Show all relevant calculations.**

(14 marks)

(ii) **An estimate of the value of the project taking into consideration Balad Co's offer. Show all relevant calculations.**

(9 marks)

(iii) **A discussion of the assumptions made in parts (i) and (ii) above and the additional business risks which Camiro Co should consider before it makes the final decision whether or not to undertake the project.**

(14 marks)

Professional marks will be awarded in part (b) for the format, structure and presentation of report.

(4 marks)

Total (50 marks)

<u>Second Section</u>

Answer only two questions from this section

Question Two:

Mohammed Ali is the CEO of Telecom, a very large listed company in the telecommunications business. The company is in a very strong financial position, having developed rapidly in recent years through a strategy based upon growth by acquisition. Currently, earnings and earnings growth are at all-time highs although the company's cash reserves are at a low level following a number of strategic investments in the last financial year. The previous evening Mohammed Ali gave a speech at a business dinner and during questions made some remarks that Pluto limited was an attractive company with 'great assets' and that he would be a 'fool' if he did not consider the possibility 'like everyone else' of acquiring the company. Pluto is a long established supplier to Telecom and if acquired would add substantially to the market capitalisation of the business.

A Mohammed Ali comment was widely reported in the following morning's financial newspapers and, by 10 am, the share price of Pluto had risen 15% in out-of-hours and early trading. The first that you, Telecom's chief financial officer, heard about the issue was when you received an urgent call from Mohammed Ali office. You have just completed a background investigation of Pluto, along with three other potential targets instigated at Telecom's last board meeting in May. Following that investigation, you have now commenced a review of the steps required to raise the necessary debt finance for a bid and the procedure you would need to follow in setting up a due diligence investigation of each company.

On arriving at Mohammed Ali's office you are surprised to see the chairman of the board in attendance. Mohammed Ali has just put down the telephone and is clearly very anxious. They tell you about the remarks made by Mohammed Ali the previous evening and that the call just taken was from the office of the regulator for Public Companies. The regulator had wanted to know if a bid was to be made and what announcement the company intended to make. They had been very neutral in their response pending your advice but had promised to get back to the regulator within the hour. They knew that if they were forced to admit that a bid was imminent and then withdrew that they would not be able to bid again for another six months. Looking at you they ask as one: 'what do we do now?' after a short discussion you returned to your office and began to draft a memorandum with a recommendation about how to proceed.

Required:

- **A- Discuss of the advantages and disadvantage of growth by acquisition as compared with growth by internal (or organic) investment.**

(5 marks)

- **B- Assess the regulatory, financial and ethical issues in this case.**

(15 marks)

- **C- Propose a course of action that the company should now pursue, including a draft of any announcement that should be made, given that the board of Telecom Systems wishes to hold open the option of making a bid in the near future.**

(5 marks)

Total (25 marks)

Question Three:

Gapco is a large listed company, has a number of subsidiaries in different industries but its main line of business is the petrol industry. Gapco decided to sell one of its subsidiaries (Taco Company) which involved in spare parts of petroleum equipment. Taco is a profitable business and is anticipated that its revenue and costs will continue to increase at their current rate of 8% per year for the foreseeable future.

Taco co's managers and some employees want to buy the company through a management buy-out. An independent assessment estimates Taco's market value at $ 81 million if Gapco Company agreed to cancel its current loan to Taco co. The managers and employees will invest $ 12 million for the 75% of the equity of the company, with another $ 4 million coming from a venture capitalist for the remaining 25% equity.

International Financial bank has agreed to lend of the required funds in the form of a 9% loan. The interest is payable at the end f the year, on the loan amount outstanding at the start of each year. A covenant on the loan states that the following debt/equity ratios should not be exceeded at end of each year for the next five years:

Year	**1**	**2**	**3**	**4**	**5**
Debt/equity	350%	250%	200%	150%	125%

Shown below is an extract of the latest annual income statement for Taco co:

	$000
Sales revenue	60,000
Materials and consumables	12,000
Labour costs	22,000
Other costs	4,000
Allocated costs charge payable to Gapco co	14,000
Interest paid	2,000
Profit before taxation	6.000
Taxation	1,500
Retained earnings	4,500

As part of the management buy-out it is expected that Gapco Company will provide management services costing $12 million for the first year of the management buy-out, increasing by 8% per year thereafter. The current tax rate is 25% on profits and it is expected that 25% of the after tax profits will be payable as dividends every year. The remaining profits will be allocated to reserves. It is expected that Taco Company will repay $ 3 million of the outstanding loan at the end of each of the next five years from the cash flow generated from its business activity.

Required:

A- Briefly discuss the possible benefits to Gapco co of disposing Taco Company through management buy-out. **(5 marks)**

B- Calculate whether the debt/equity covenant imposed by the International Financial bank on Taco Company may be breached over the five years period. **(9 marks)**

C- Discuss briefly the implications of the results obtained in part (B) and outline to possible actions Taco company may take if the covenant is in danger of being breached. **(5 marks)**

D- Discuss the reasons why a management buy-out may ultimately not succeed. **(6 marks)**

Total (25 marks)

Question Three:

Zal is an international company which has a foreign direct investment in one of developing countries. Whose government until recently has protectionist measures in place.

However the country has joined the World Trade Organisation (WTO) and Zal is concerned about the effects that this membership might have on its operations current protected status.

(1) Briefly discuss the possible effects of the developing country's membership of the (WTO) on Zal's foreign direct investment activities.

(5 marks)

Zal uses transfer pricing between its foreign direct investment and the parent company and is thinking about manipulating the transfer price to remit more funds back to it

(2) Outline the mechanism which prevents transfer price manipulation by multinationals companies.

(5 marks)

(3) Discuss why conflicts of interest might exist between shareholders and bond-holders.

(8 marks)

(4) Provide examples of covenants that might be attached to bonds and briefly discuss the advantage and disadvantage to companies of covenants.

(7 marks)

Total (25 marks)

'End of questions'