

UNIVERSITY OF SWAZILAND

DEPARTMENT OF ACCOUNTING

SUPPLEMENTARY EXAMINATION QUESTION PAPER

DEGREE/YEAR OF STUDY : B COMM V

TITLE OF PAPER : BUSINESS FINANCE 11

COURSE CODE : AC 503

TIME ALLOWED : THREE (3) HOURS

INSTRUCTIONS

- 1. TOTAL NUMBER OF QUESTIONS ON THIS PAPER: FOUR (4)**
- 2. ANSWER ALL QUESTIONS**
- 3. WHERE APPLICABLE ALL WORKINGS SHOULD BE SHOWN**
- 4. ALL CALCULATIONS ARE TO BE MADE TO THE NEAREST LILANGENI.**

NOTE: YOU ARE REMINDED THAT IN ASSESSING YOUR WORK, ACCOUNT WILL BE TAKEN OF ACCURACY OF THE LANGUAGE AND THE GENERAL QUALITY OF EXPRESSION, TOGETHER WITH THE LAYOUT AND PRESENTATION OF YOUR FINAL ANSWER.

SPECIAL REQUIREMENT: PV TABLES

THIS PAPER IS NOT TO BE OPENED UNTILL PERMISSION HAS BEEN GRANTED BY THE INVIGILATER.

QUESTION 1

Paradigm has operated in the heavy engineering sector for many years. A number of newspaper commentators have attacked the company's management because of succession of poor results. The directors have become convinced of the need to improve the poor growth rate. The share price of Paradigm has fallen to 99 cents from a peak of 422 cents four years ago. This years after tax profits were E4, 500 000.00. The company has 50 million 50cents shares in issue.

The company's corporate advisors have proposed a policy of growth by acquisition, to be financed from cash holdings and additional borrowing. The board of Cover to Cover Ltd. are known to be amenable to a take over bid. Cover to Cover Ltd. is regarded as sound but unexciting. Although the last few years have seen considerable growth, the expiry of patents means that post-tax earnings are not expected to grow by more than 3% per year. The Managing Director of Paradigm is keen to present the acquisition of Cover to Cover Ltd. as the turning point for group growth. However, he is unaware of any synergistic gains that might be possible.

Covers to Cover's shares are currently traded at E0.50, ex div. This year after-tax profits were E2 000 000.00. The company has 16 million 20cents shares in issue. It is estimated that costs of acquisition would reduce Paradigm's profits by E500, 000.00

Clinton-Rodham, a firm of management consultants, was brought in to conduct a due diligence study of a company called Cover to Cover Ltd. once the latter's board had agreed to discuss the possibility of a sale. Their objective is to gather sufficient information to allow a discounted cash flow valuation of Cover to Cover Ltd.

Cover to Cover's previous year's profits were:

2001/2002	:	1.8 million
2000/2001	:	1.6 million
1999/2000	:	1.45 million

Analysis of the company's cash flows suggests that Cover to Cover is presently capable of generating the following flows in the next five years, before dividends:

2003/2004	:	2, 060, 000
2004/2005	:	2, 100, 000
2005/2006	:	2, 150, 000
2006/2007	:	2, 225, 000
2007/2008	:	2, 000, 000 (after a one off payment to convert a lease into a freehold of E270, 000)

The weighted average cost risk capital of the Paradigm Group is 16% that of Cover to Cover is 12%. The latter's cost of equity capital is 14%. Paradigm's board has already

decided that Cover to Cover will effectively continue to operate as a separate unit. Its board will be responsible for all but the highest level decisions. It will raise its own finance.

If the bid is successful, Clinton-Rodham believes that Paradigm can restructure Cover to Cover's operations to reduce after tax costs by E500, 000.00 per annum. There are also assets in the balance sheet which could be disposed off to give a profit of E1, 000, 000 after tax. The company's balance sheet records net assets of E10 million. It should also be possible to release a deferred tax provision of E500, 000.

Osborne, Cover to Cover's non executive Chairman, who retires next year, is particularly keen to obtain as high a value as possible. His perception is coloured by his position as a minority shareholder. He has recommended that his board accept an offer based on previous growth. Cover to Cover pays one dividend per annum, at the year end. The payout ratio will be 60% this year.

Required:

(i) Based on Cover to Cover's due diligence study, how much should Paradigm be prepared to pay for Cover to Cover? The group values acquisitions using future cash flows, projecting the last year for which data is available forward as perpetuity.

(19 marks)

(ii) How does your result compare to the current market price? Estimate what is likely to happen to Cover to Cover's current share price if a bid is announced.

(3 marks)

(iii) What are the weaknesses of the discounted cash flow valuation method?

(3 marks)

QUESTION 2

Over the past decade, Thebi Ltd. has achieved an average annual growth of approximately 7% and is about to declare a dividend 8% higher than that paid last year. This level is consistent with expectations contained in recent press comment.

However, Thembi is offered an opportunity to invest in a project which promises DCF return considerably above the weighted average cost of capital but which will produce no significant cash flows for about three years. The only funds available are those which would otherwise be used for the dividend and undertaking the project would entail not paying a dividend at all this year.

The Managing Director is of the opinion that shareholders deserve some reward and suggests that if the dividend is not paid this year, the company should make a bonus issue of shares to give shareholders a 'dividend of a capital nature'

Advise Thembi on the major theoretical and practical factors to be considered before arriving at a decision concerning undertaking the project of paying a dividend. Comment on the Managing Director's suggestion for rewarding shareholders.

(Total: 25 marks)

QUESTION 3

Peter, the owner of a Sports Exports Company in Swaziland is concerned about the value of the British Pound over time because his firm receives pounds as payment for footballs exported to the United Kingdom. He recently read that the Bank of England is likely to use direct intervention in the foreign exchange market by flooding the market with British Pounds.

Required:

- (a) Forecast whether the British pound will weaken or strengthen based on the information provided. *(5marks)*
- (b)
- (i) Explain why it is virtually impossible to set an exchange rate between the Swazi Lilangeni and the Pound and to maintain a fixed exchange rate. *(5marks)*
- (ii) Distinguish between a fixed exchange rate and a floating exchange rate and explain the advantages and disadvantages of each. *(15marks)*

(Total: 25 marks)

QUESTION 4

(a) A company's shares have a covariance of returns of 20% relative to returns for the world market portfolio. The risk free rate of return is 5% and the expected return on the world market portfolio is 9%. The standard deviation of returns for the world market is 25%.

Required:

- (i) Calculate the international cost of equity for the company. **(5marks)**
- (ii) Explain the main motivations behind the establishment of a diversified portfolio internationally. **(5marks)**

(b) Since the Second World War there have been attempts to reduce impediments to free trade in the world.

- (i) What are the five types of integration members can arrange? **(10marks)**
- (ii) Explain two main Blocs that have been established in practice. **(5marks)**

(Total: 25 marks)

End of Question Paper

