

Example 3

Part a

Executive directors were among founder of the company and spend many years to make it successful. Also currently they are main shareholders of company. Therefore they felt extremely connected with Company and fear losing company and their influence there. Kingtim Co has agency issues when Executive Directors more concentrate on their own interest rather than company wealth.

Obviously Directors try to make company less attractive for potential investors and avoid possible take overs how it happened with their competitors.

Selling individual garden centres for sure bring that result Directors looking for. From other side Kingtim Co will lose it's competitive advantages as chain of Garden centres. Company is known under it's brand and separating individual centres and selling them to supermarkets or other potential investors may create a kind of Internal competition but under different brands.

Changing Directors contracts also covered mainly their own needs. Directors much more concentrating on own benefits then company good future. Kingtim Co want to develop their own chain and need more investments for it. Changes in Directors contracts may have negative influence for investors who wishes to invest into Kingtim Co. and it may affect the whole finance position of company. To have a solution between company needs and Agent problems some additional discussion and negotiation should be done.

Part b

This report prepared to evaluate the possible impact of issuing new bonds to finance future Development of company. It takes under consideration interest of existing and new investors as well as equity owners. Calculation for supporting this report present in Appendixes (Excel spreadsheet).

To start evaluating new possible debts issuing, the current estimated cost of capital was calculated (Appendix i) and it's value is 12.28%.

If company take a decision to issue new bonds their estimated Market Value will be 106.65 USD (Appendix ii) which is higher than the existing ones the company have. It can have negative influence for existing bond holders due to fact that price of current bonds is not changed. From other side higher market value of new bond should increase interest from potential investors and it help company faster receive additional funds to grow company.

Issuing new bond in generally will change the structure of Capital (Appendix iii) and it can give a negative feeling of Directors who is an equity owner that they lose control on the company. In such situation it can demotivate them to continue put maximum effort into further company development. From other side such changes increase company gearing rate that should bring additional benefit from Tax shield of paid interest. Such changes should have a positive effect since such level of gearing company has bring advantages but not put company in dangerous situation of lack of future possible debt issued or loan taken.

Also new capital structure should attract new investors who will feel more involved in company decision making and have more influence on it.

As it shown in Appendix iii the cost of capital will increase to 13.702% compare to initial 12.28% due to the new bond issuing. So Company shall moderate it carefully to be able to pay their liabilities on-time.

Proposal of new extra investment to outdoor activity unfortunately will not bring positive impact. Based on cost of capital similar company and return expected from such investment it will give negative effect in amount 2.65 m USD. So it is suggested to postpone such investment until better market condition appear.

c) It seems that Kingtim company only values the permanent "old" staff who are loyal to the company. Low level remuneration provides negative motivation for the new staff. Based on assumption company wants to grow they should invest more to the new staff. Since company declares itself as socially responsible company it should be fair to it's employee and pay them at least minimum required salary. It helps the company to keep positive image of it s brand and help attract new customers and investors.

Professional skills summary

This answer scores a total of 5 marks out of 10 for the professional skills.

Marks summary

Technical	
(a)	3
(b)(i)	2
(b)(ii)	1
(b)(iii)	1
(b)(iv)	3
(c)	3
Professional skills	
Communication	3
Analysis and evaluation	1
Scepticism	0
Commercial acumen	1
Total professional skills	5
Total	18

Question 1

Part b

i)

Share Capital

139 0.748116

Debt

46.8 0.251884

Total 185.8

Beta of assets

0.92

Cost of capital before issuing new bonds

12.28

ii)

Estimated Future value of new bonds

Redeemable in 4 year on spot rate is 5.2%

Credit spread for BBB- for 4 years 135 points

6.55

Market value for bond

106.65

iii) Revised cost of equity

Share Capital

139 0.556467

Debt

110.79 0.443533

Total

249.79

Cost of debt

0.045

Premium

1

2

3

4

@8%

48

48

48

48

NPV

158.9821

Ungeared equity beta

1.125

Cost of equity before new bond

14.125

Revised

22.179

Cost of capital

Asset beta

1.07746

Cost of capital

13.702

Boullain marked scripts

Example 1

(a)

As Boullain Co started to sell its products to the US it now faces transaction risk and economic risk. Although economic risk cannot be hedged (due to its nature it depends on macro economic factors or risks) it can be reduced through diversification.

If investors hold well-diversified portfolios they reduce unsystematic risk and only face systematic risk. However, introduction of hedging techniques might help further reduce risks of cash flow fluctuations. Investors and shareholders might benefit from it.

If the policy is communicated to the key stakeholders, shareholders will also be able to benefit from it for example debt providers might demand companies who operate abroad make sure they that they have hedging strategies in place. If the company does not have it and it does not communicate the debt providers might increase its compensation for increased risk (interest) or reduce / do not give funding. This would mean Boullain Co will not be able to invest in the new project and this will not increase shareholder wealth.

Due to new operations abroad of the company suppliers of Boullain Co might become worried that the company might not be able to pay and won't give long credit terms, therefore cash operating cycle will become shorter.

Customers might be worried about the situation where prices might increase as Boullain Co would try to compensate for the FX risk, therefore, if they are informed about foreign exchange risk strategies, they will not switch to another supplier.

(b) See spreadsheet for calculations

Comparing these three hedging methods, it is obvious that hedging the exchange risk using future contracts is most effective as it shows the biggest receipts of €16,284,113 while options show the smallest receipts of €16,177,711 due to the huge amount of premium needing to be paid. However Boullain Co should consider its risk preference to determine the final hedging method. Options can be used to hedge the exchange rate with a limit and the downside but no limit to the upside that is to say if the exchange rate moves favourably to Boullain Co, the company can let the option lapse to gain a higher return but the return of using futures is predetermined.

Based on marking to market, the profit and loss of the margin account will be calculated daily and reduce or increase the account balance. If after deducting the loss, the balance is below the maintenance level the broker will ask the investor to pay extra funds to the margin account to keep the balance at a minimum level of maintenance.

Professional skills summary

This answer scores a total of 5 marks out of 5 for the professional skills.

Marks summary

Technical	
Part (a)	5
Part (b)	12
Professional skills	
Analysis and evaluation	3
Scepticism	0
Commercial acumen	2
Total professional skills	5
Total	22

Example 2

(a)

Operating or receiving cash flows from foreign countries gives rise to numerous different risks; economic, translation and political risks.

In the case of Boullain Co, the receipt of \$18,600,000 will give rise to an uncertain euro amount as the FX rate is ever changing. This change is caused by numerous factors, such as inflation, interest rate, balance of payments, therefore in order to ascertain a definite value of the receipt hedging must occur.

There are numerous benefits arising from hedging. Hedging reduces the volatility of future foreign cash flows thus if Boullain Co needs additional finance in the form debt this could be acquired at a lower cost of debt. The ability to gain financing would allow the company to invest in more profitable projects thus increasing shareholder wealth.

(b)

The futures market hedge offers the highest receipt of €16,284,113. This scenario assumes that basis risk is zero however this may not be the case. If basis risk is present it may result in a profit or loss on the hedge receipt as it will not equate to the future futures contract price.

The forward market hedge provides the next best hedge and this is followed by the currency option which offers the worst hedge receipt. Although the option provides the worst hedge receipt once exercised if the FX moves in favour to offer a higher receipt at the spot rate this can be taken advantage of.

In terms of which method to prescribe the pros and cons need to be taken into effect, however I would prescribe the futures market hedge.

Professional skills summary

This answer scores a total of 5 marks out of 5 for the professional skills.

Marks summary

Technical	
Part (a)	1
Part (b)	8
Professional skills	
Analysis and evaluation	3
Scepticism	1
Commercial acumen	1
Total professional skills	5
Total	14

Example 3

(a)

The rationale for the policy of hedging Boullain Co's foreign exchange risk is that having a policy would be in line with IFRS and being able to benefit from application of hedging standards.

Additionally, a formal hedging policy would show stakeholders that Boullain has procedures in place for hedging foreign currency risk which would increase shareholder confidence in Boullain Co. This confidence may lead to an increase in Boullain's share price as opposed to it being reduced if no policy were in place as their shareholders may view this as reckless.

A formal hedging policy maybe seen more favourably by Boullain's lenders which may allow for Boullain to benefit from eased debt covenants from its bank as the bank would have more confidence in Boullain's management of foreign currency exchange risk.

(b)

I would recommend forward contracts as these can be tailored to Boullain Co's needs as opposed to entering for fixed amount currency futures or currency options where an inefficiency due to a shortfall or surplus arises.

The currency options have the drawback of having an expensive premium however, the currency options allow Boullain Co to benefit if the exchange rate isn't favourable with the option as it can voluntarily abandon or not take up the option. The trade off to this is the expensive premium.

Although currency futures would work in this scenario, they are usually only for large and fixed amount and would be unable to be tailored for Boullain's needs. Additionally the currency in which futures are available are often limited and Boullain may not always be able to access these.

If the settlement price is less than Boullain's exercise price, Boullain will not need to meet the mark to market requirement to put in additional cash.

Professional skills summary


This answer scores a total of 1 mark out of 5 for the professional skills.

Marks summary


Technical	
Part (a)	2
Part (b)	4
Professional skills	
Analysis and evaluation	0
Scepticism	0
Commercial acumen	1
Total professional skills	1
Total	7

Script 3


Forward contracts

 16,263,840

Exchange traded future

 Go for September future

No of contracts 16202460
 81.0123
 81 contracts

 2460 € hedged using forward market

Example 3

a) See spreadsheet

b)

As Colvin Co wants to use mix of equity and debt finance both those components have different risk. As Canvia is a developing economy it may be more sensitive to the inflation changes hence interest would increase what would make debt borrowing more expensive. On that basis it makes sense to adjust WACC used for project appraisal.

Professional skills summary

This answer scores a total of 2 marks out of 5 for the professional skills.

Marks summary

Technical	
Part (a)	5
Part (b)	1
Professional skills	
Analysis and evaluation	2
Scepticism	0
Commercial acumen	0
Total professional skills	2
Total	8

(a) Evaluate the suitability of the investment proposal in Canvia, including the impact of the country risk premium on the net present value of the project.

CL IN MILLIONS					
YEAR	0	1	2	3	4
PRE-TAX CONTRIBUTIC		419.40	500.20	671.30	961.20
TAX ALLOWABLE DEPN		-175.00	-175.00	-175.00	-175.00
TAXABLE C.FLOWS		244.40	325.20	496.30	786.20
TAX AT 25%		-61.10	-81.30	-124.08	-196.55
ADD DEPN		175.00	175.00	175.00	175.00
INVESTMEI (75.00)					
MACHINER (700.00)					
WORKING I (25.00)		(27.50)	(30.30)	(33.30)	116.10
CASHFLOW (800.00)		330.80	388.60	513.93	880.75
CONTRIBUTION ON PA		9.57	11.68	15.38	22.07
TAX ON PARTS		(1.91)	(2.34)	(3.08)	(4.41)
NET CASHF (800.00)		338.46	397.95	526.23	898.40
DF @ 16%	1	0.862	0.743	0.641	0.552
PV (800.00)		291.75	295.67	337.31	495.92
NPV		620.6526			

WORKINGS

W1	COMPONENT SALES			
YEAR	1	2	3	4
UNITS	109,725.00	121,795.00	148,590.00	197,624.00
PRICE	8.32	8.65	8.83	9.00
EXCHANGE	10.48	11.09	11.73	12.40
AMOUNT	9,568,897.80	11,683,648.20	15,377,938.23	22,065,193.10

TAX ALLOWABLE DEPN 175