

CA



THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

KC2 – Corporate Finance & Risk Management

June 2019

Answer 01

Relevant Learning Outcome/s: 5.2.1/2.3.4/2.3.5/1.2.1/1.2.2

Study text reference: Pages 439-444/162-165/62-70/230-232

- (a) (i) To: Mr. Wijayasekara,
Managing director
Mahaweli Engineers Company (Pvt) Ltd
From: Del consultants
Subject: Divestment of 50% stake to Mr. Tan
Date: June 2019

Dear Sir,

With regard to the proposed divestment of a 50% equity stake in MEL, we have valued the company based on the following valuation methodology.

EBITDA	=	5 + 200 + 110	= Rs. 315 million
X10 times multiple	=	Rs. 3,150 million	
Less: Debt (1,500+770)	=	Rs. (2,270) million	
Equity	=	Rs. 880 million	
P/BV (2 times)	=	700 x 2 = Rs. 1,400 million	
			whichever higher

The company is valued at Rs. 1,400 million, and the 50% stake is valued at Rs. 700 million.

Alternatively,

The company is valued at	=	Rs. 1,400 million
50% stake	=	Rs. <u>1,400 million</u> x 24 million 24 million shares
	=	Rs. 1,400 million

- (ii) Prior to the proposed fresh issue of shares it is proposed to do a share split of 1 for 1 which would increase the number of shares from 12 million to 24 million, where there would be more liquidity in the share for the Wijayasekara family shareholders.

- (iii) Mr. Tan negotiates the 50% stake at Rs. 630 million (700 x 90%)
Bank commission 0.25% Rs. 1.58 million
Total Rs. 631.58 million
USD/LKR = 175.1
Funds to be remitted in USD are 3.61 million (USD 3.606 million)

Alternatively,

Mr. Tan negotiates 50% stake	=	Rs. 1,260 million (1,400 x 90%)
Bank commission 0.25%	=	Rs. <u>3.15 million</u>
Total	=	Rs. 1,263.15 million
USD/LKR = 175.1		
Funds to be remitted	=	USD 7.214 million

(iv)

	Pre investment shareholding structure		Post investment shareholding structure	
	No. of shares (million)	Rs. million	No. of shares (million)	Rs. million
Sunath Wijayasekara	12.24 (51%)	61.2	12.24 (25.5%)	61.2
Chandula Wijayasekara	6.00 (25%)	30.0	6.00 (12.50%)	30.0
Ruwan Wijayasekara	2.88 (12%)	14.4	2.88 (6.00%)	14.4
Malith Wijayasekara	2.88 (12%)	14.4	2.88 (6.00%)	14.4
Mr. Tan	-	-	24.0 (50%)	630.0
	24.0 (100%)	120.0	48 (100%)	750.0

Alternatively,

	Post investment shareholding structure	
	No. of shares (million)	Rs. million
Sunath Wijayasekara	12.24 (25.5%)	61.2
Chandula Wijayasekara	6.00 (12.50%)	30
Ruwan Wijayasekara	2.88 (6.00%)	14.4
Malith Wijayasekara	2.88 (6.00%)	14.4
Mr. Tan	24.0 (50%)	<u>1,260</u>
	48 (100%)	<u>1,380</u>

- (v) The company receives Rs. 630 million and it increases its equity to Rs. 1,330 million and settles its short term loans. Afterwards the remainder of short term loans amount to Rs. 140 million and the long term liabilities remain same at Rs. 1.5 billion. Prior to the restructuring, the company's gearing was at 76.4% and now it has reduced to 53%.

Debt	Pre	Post
Debt + equity	$\frac{1,500 + 770}{1,500 + 770 + 700}$	$\frac{1,500 + 140}{1,500 + 140 + 1,430.4}$
	$\frac{2,270 \times 100}{2,970}$	$\frac{1,640 \times 100}{3070.4}$
	76.4%	53%

SMEL's financial stability has improved

Non-financial factors: the Wijayasekara family will need to maintain cordial relations with Mr. Tan to ensure a smooth transaction and to capitalise on the advancements in Chinese technology. They will not be able to run the business as they used to do earlier.

Forecasted financials	
	Rs. Million
Project turnover	2,070
Cost of sales	1,437.4
Gross profit	632.6
Less: Administrative expenses	(156.6)
Depreciation	(99.0)
Selling and distribution expenses	(103.5)

Finance cost	(134.0)
(1,500 X 8% + 140 X 10%)	
Profit before tax	139.5
Tax at 28%	(39.1)
Profit after tax	<u>100.4</u>

50% share of profit = Rs. 50.2 million
Investment = Rs. 631.58 million
ROI = 7.95%

Alternatively, one could assume the finance cost to be Rs. 80.8 million (1,010 * 8%). Accordingly, the profit after tax would be: Rs. 138.7 million.

50% share of profit: 138.7 x 0.5 = Rs. 69.35 million
Investment = Rs. 1,263.15 million
ROI = 5.49%

	Pre	Post investment	
		If Rs. 630 million is infused	If Rs. 1,260 million is infused
D/E	= $\frac{1,500 + 770}{700}$	$\frac{1,640}{1,430.4}$	$\frac{1,010}{2,098.7}$ (700+1,260+138.7)
	= 3.24	1.146	0.48

(b) Risk has two components.

Unsystematic risk:

Which is unique to individual securities, which is diversifiable if a large number of securities are combined to form a diversified portfolio, where the unique risks of individual securities in a portfolio cancel out each other.

E.g.: Workers declare a strike in company A.

R&D expert leaves company B

Company C losses a big contract

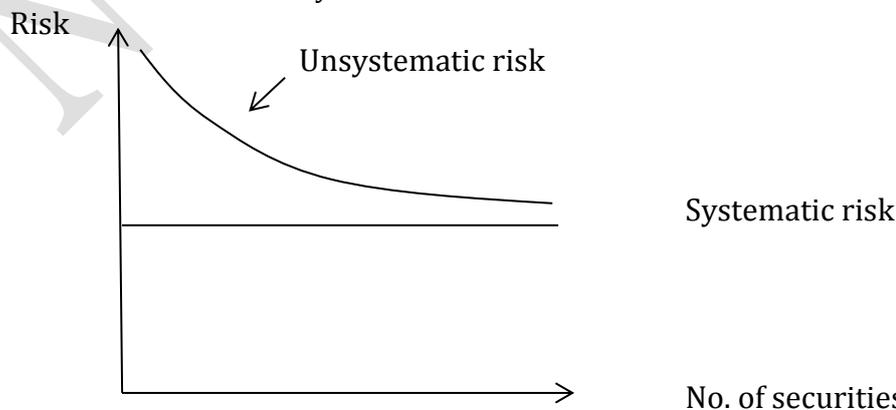
Systematic risk:

Risk which cannot be reduced through diversification. This is also called market risk.

E.g.: Government changes interest rate policy/infrastructure policy, Corporate tax rate is increased.

Government obtains a high loan from a country

Political instability



(Total: 25 marks)

Answer 02

Relevant Learning Outcome/s: 6.2.1/6.2.2/1.1.1/1.1.2

Study text reference: Pages 630-634/634-644/667/668/671/704/4-25

(a)

A summary is tabulated below for consideration. Some are pure forward market strategies while some are hybrid strategies.

The following 4 options can be considered.

Option 1: Accept Rwanda order and receive proceeds in RWF in 2 months.

Option 2: Accept Rwanda order and receive proceeds in USD in 3 months.

Option 3: Accept French order and receive proceeds in Euro in 3 months.

Option 4: Obtain an equivalent loan in USD in today's terms and convert proceeds to GBP and earn interest.

Options	Total proceeds in 3 months (GBP)
Option 1: Accept Rwanda order and receive proceeds in RWF in 2 months.	216,652
Option 2: Accept Rwanda order and receive proceeds in USD in 3 months.	215,753
Option 3: Accept French order and receive proceeds in Euro in 3 months.	215,703
Option 4: Obtain an equivalent loan in USD in today's terms and convert proceeds to GBP and earn interest.	214,954

Accordingly the Option 1 is the most beneficial option from a quantitative analysis.

Option 1

Accept Rwanda order and receive proceeds in RWF in 2 months.

$$250,000 \text{ EURO} \times 1,007.88 = 251,970,000 \text{ RWF}$$

$$251,970,000 \text{ RWF} / 1,166.89 = 215,932.95 \text{ GBP}$$

We need to consider 1 month interest income in GBP also for comparison purposes.

$$\text{One month interest} = 720 \text{ GBP}$$

$$\text{Total position at the end of the 3}^{\text{rd}} \text{ month} = 216,652 \text{ (} 215,932.75 + 720 \text{)}$$

Option 2

Accept Rwanda order and receive proceeds in USD in 3 months.

$$279,853 \text{ USD} / 1.2971 = 215,753 \text{ GBP}$$

Option 3

Accept French order and receive proceeds in Euro in 3 months.

$$250,000 \text{ EURO} / 1.159 = 215,703 \text{ GBP}$$

Option 4

HCH may borrow USD 279,853 under 5% borrowing cost per annum and settle the full amount, in three months once the money is received.

How much to borrow is calculated as given below.

$276,398 \text{ USD} \times 5\% / 4 \text{ months} = 3,455 \text{ interest}$ ($276,398 + 3,455 = 279,853$)

Therefore the amount to borrow would be = USD 276,398.

Convert the proceeds to GBP = $276,398 \text{ USD} / 1.2987 = 212,826 \text{ GBP}$

When placing GBP 212, 826 on a deposit, the interest applicable would be:

$\text{GBP } 212, 826 \times 4\% / 4 \text{ months} = 2,128 \text{ GBP}$

Total value (GBP) = $212, 826 + 2,128 = 214,954 \text{ GBP}$

(b) The potential benefits that HCH group could gain through a swap arrangement is summarised below. Two types of swap arrangements can be considered namely Interest rate swaps and Currency swaps.

1. HCH has obtained a large long term foreign currency loan in GBP terms. This is assumed to be in line with long term interest rates in the market. In the event HCH's short term operational cash flows are correlated with short term cash flows then an interest rate swap is a great opportunity for them to swap with a company who has the opposite position. BHCH's presence in the UK would be a great opportunity for them to find the correct partner and arrange the same.
2. Similarly, the interest costs for foreign currency in Sri Lanka are assumed to be higher than that a UK firm could borrow in the UK. BHCH-UK is a great advantage for HCH. They should check the possibility of obtaining the required loan at a lower interest rate being a company operating in the UK and transfer the required funds to HCH. Swap arrangement could be used in a situation of this nature.
3. The LKR has been volatile against the GBP in the recent past and we may assume the same for the recent period. If the assumption is valid, a currency swap is a way that HCH may mitigate foreign exchange exposure.

(c) Shareholder value maximisation is more of a monetary measure to assess the success of the management of a company. While stakeholder value maximisation provides a wide spectrum, it has its own weaknesses in assessing the success of a firm.

The management team may use various techniques to boost short-term earnings and shareholder earnings of a firm with the help of various inappropriate techniques at the cost of a firm's goodwill. For example: Miscalculated tax, illegal business.

Accordingly any inappropriate corporate governance practices would damage the firm's goodwill and hamper long term earnings.

Therefore the planned earnings boost, for the coming year would not necessarily mean that the management is on track.

Therefore the management of BHCH-UK should look at maximising the firm's value rather than simply looking at shareholder value maximisation. The areas to consider in addition to shareholder value maximisation are:

01. Building up the firm's goodwill
02. Employee development
03. Customer vendor relationship management
04. Meeting social responsibility
05. Implementation and operation of proper corporate governance
06. Environmental friendly business model

(Total: 25 marks)

Answer 03

Relevant Learning Outcome/s: 5.2.1/2.3.5/2.3.3/2.3.4/2.4/4.1.2/5.2.4/3.1.3
Study text reference: Pages 452/164/230-231/234/242/171-190/374-376/327-339/519-526/292-299

- (a) The asset-based valuation indicates that the company has reported a net asset value of Rs. 8.5 billion after allowing for any value reductions.

Therefore this value can be considered as the bear minimum value (refer Working 1).

David Scott's share value is calculated as given below after considering his portion of equity.

Net assets value of Rs. 8.5 billion x David Scott's share of 36% = Rs. 3.07 billion

Free cash flow based valuation reports a value of Rs. 35.5 billion after allowing for a 50% value reduction.

(Refer workings 2 to 5)

David Scott is supposed to receive Rs. 12.7 billion as his share of equity even after allowing for a 50% discounting (refer Working 6).

Conclusion:

Accordingly the range can be set between Rs. 3 billion (asset-based) and Rs. 12.7 billion.

Most likely it is going to be quite close to Rs. 12.7 billion rather than Rs. 3 billion as the share valuation should represent market values.

Commenting on the opinion of the finance director:

In addition it's clear that internal funding would not be an option as the company has no adequate asset base to meet this payment. In other words the total asset base of the company is estimated at Rs. 8.5 billion whereas the share buyback requires Rs. 12.7 billion.

Hence the finance director's opinion seems to be correct.

Working 1

Net asset- based valuation	2019
	Rs. '000
Total assets	19,563,203
Less: Overvalued assets (8%)	1,565,056
Total liabilities	9,466,971
Net assets	8,531,176

Working 2

Calculation of WACC

Calculation of Beta

1. **Asset Beta** = Levered Beta
(1+(1-t)x(total debt/equity))
Peer company Beta = 0.89
Debt-equity ratio = 0.666666667
= $\frac{0.89}{1+0.72 \times 0.67}$
= $\frac{0.89}{1.4824}$
= 0.600377766
2. **Own company's debt to equity ratio**
Equity = 10,096,232
Debt = 1,150,525
Debt/Equity = 11%
Own company levered Beta = 0.600377766 x (1+0.72 x 0.11)
= 0.647927685
3. **Own company cost of equity**
Cost of equity = Risk free rate + Beta factor * Risk premium
= 11% + 0.65 * 5%
= 14.24%
= 14%
4. **Cost of debt**
Cost of debt before tax = 8%
Cost of debt after tax = 5.80%
Round up = 6%

5. **WACC**

	Rs.	Cost	%	Cost
Equity	10,096,232	14%	89.8%	12.6%
Debt	1,150,525	6%	10.2%	0.6%
	11,246,757			13.2%

Working 3

Year	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
	Rs.'000					
Gross profit	7,233,018	8,833,070	10,726,630	12,977,724	15,665,183	
Other operating income	1,625,833	1,715,253.39	1,818,168.60	1,936,349.56	2,071,894.02	
Selling and distribution expenses	(1,761,180)	(1,858,044.90)	(1,969,527.59)	(2,097,546.89)	(2,244,375.17)	
Administrative expenses	(1,487,434)	(1,569,243.08)	(1,663,397.67)	(1,771,518.51)	(1,895,524.81)	
Other operating expenses	(797,833)	(841,713.82)	(892,216.64)	(950,210.73)	(1,016,725.48)	
Operating profit before interest and taxes	4,812,403	6,279,322	8,019,657	10,094,797	12,580,452	
Finance cost	-	-	-	-	-	
Finance income	110,163	116,221.81	123,195.12	131,202.80	140,386.99	
EBIT	4,922,566	6,395,543	8,142,852	10,226,000	12,720,839	
Depreciation	500,000	500,000	500,000	500,000	500,000	
Capital expenditure	(425,000)	(175,000)	-	-	-	
Changes in working capital	(125,000)	(110,000)	(75,000)	(52,000)	(42,000)	
Income tax payment	(1,443,721)	(1,883,796)	(2,405,897)	(3,028,439)	(3,774,135)	
Free cash flows	3,428,845	4,726,747	6,161,955	7,645,561	9,404,703	96,868,441.84 (Refer Working 4)
Discounting factor at WACC 13%	0.885	0.783	0.693	0.613	0.543	0.543
PV	3,034,376	3,701,736	4,270,544	4,689,166	5,104,496	52,576,309
PV of the company	73,376,627					

Discounting factor calculation							
	113%						
Discounting factor at 13%							
Year	0	1	2	3	4	5	6
DF	1	0.885	0.783	0.693	0.613	0.543	0.480

Working 4

Terminal value calculation	Rs.'000
2023/24 Free cash flows	9,404,703
2024/25 Free cash flows	9,686,844
Formula	$D1/r-g$
D1	9,686,844
r	13%
g	3%
r-g	10%
PV	96,868,441.84

Working 5

Free cash flow based valuation	Rs.'000
Valuation based on free cash flows	73,376,627
50% discounting	36,688,314
	36,688,314
Less: Interest bearing loans and borrowings	1,150,525
Value attributable for equity	35,537,788

Working 6

		Value (Rs.'000)
David Scott	36%	12,793,604
Kamal Fernando	8%	2,843,023
Harain	25%	8,884,447
Jacky	20%	7,107,557
Yamuna	11%	3,909,157
	100%	35,537,788

Alternatively,
Based on the assumption that finance income does not form part of operating profit

	2019/20	2020/21	2021/ 22	2022/23	2023/24	2024/25
	Rs.'000					
Gross profit	7,233,018	8,833,070	10,726,630	12,977,724	15,665,183	
Other operating income	1,625,833	1,715,253	1,818,169	1,936,350	2,071,894	
Selling and distribution expenses	(1,761,181)	(1,858,046)	(1,969,528)	(2,097,548)	(2,244,376)	
Administrative expenses	(1,487,434)	(1,569,243)	(1,663,398)	(1,771,519)	(1,895,525)	
Other operating expenses	(797,833)	(841,714)	(892,217)	(950,211)	(1,016,726)	
Operating profit before interest and taxes	4,812,403	6,279,321	8,019,656	10,094,796	12,580,451	
EBIT	4,812,403	6,279,321	8,019,656	10,094,796	12,580,451	
Depreciation	500,000	500,000	500,000	500,000	500,000	
Capital expenditure	(425,000)	(175,000)	-	-	-	
Changes in working capital	(125,000)	(110,000)	(75,000)	(52,000)	(42,000)	
Income tax payment	(1,443,721)	(1,883,796)	(2,405,897)	(3,028,439)	(3,774,135)	
Free cash flows	3,318,682	4,610,524	6,038,759	7,514,357	9,264,315	95,422,445
Discounting factor at WACC 13%	0.885	0.783	0.693	0.613	0.543	0.543
PV	2,937,033	3,610,041	4,185,163	4,608,696	5,028,299	51,791,480
PV of the company	72,160,712					

Computation of the terminal value	
2023/24 cash flows	9,264,315
2024/25 cash flows	9,542,244.53
Terminal value	95,422,445

- (b) Share buy back is an option used by many companies with multiple purposes but one should look at a share buy back option with clear objectives to avoid negative impacts. We can look at each of the facts discussed and actions proposed to see whether the company will maximise shareholder wealth in an attempt to buy back as many shares as possible.

Important fact: The research team positively predicted that CBC shares will be overvalued in coming years due to promotor profiles and political affiliations in addition to market potential.

This is a clear sign that the company should not go ahead with a share buy back as it could result in the dilution of the value of the company.

A company buying overvalued stock is destroying shareholder value and would be better off by paying that cash out as dividends, so that shareholders can invest it more effectively.

A company should go ahead with the share buy back only with undervalued shares as they know for a fact that the market value of a share is not a correct representation of the company's value and it would be beneficial for existing shareholders in the event undervalued shares are repurchased.

Therefore the company should avoid a share buy back in the event the shares are overvalued by the market.

1. Debt finance will be used heavily in order to fund a share buy back in coming years

Managers, have a tendency to assume that their companies' shares are undervalued regardless of the price. Another reason for taking on debt finance to fund a share buy back would be more efficient because interest on debt is tax deductible, unlike dividends. However, debt has to be repaid at some time. Therefore it should be carefully decided after realising the fact that what gets a company into financial difficulties is not lack of profits, but lack of cash.

As per the action agreed, debt would be used for this purpose. Using debt heavily would raise the WACC and would dilute shareholder value.

Therefore a healthy level of debt should be agreed before raising funds for a share buy back.

2. Key executive employees will be rewarded with shares as a method of compensation

As per the proposal the executives would get their compensation in the form of stock options. Accordingly buy backs are a convenient way for executives to maximise their own wealth and a way for them to maintain their individual wealth rather than shareholder wealth.

Some executives may even be tempted to pursue share buy backs to boost the share price in the short term and then sell their shares.

The company should not get into a trap as executives are the key personnel who would provide necessary information to the board of directors to make the decision on a share buy back. Therefore due care is important in executing share buy backs together with an executive share rewarding mechanism.

3. High priority should be placed on share buy back over large new projects or expansions owing to the reason that we should not go behind new projects when we have our own shares in the market to buy back. It is meaningless to accept additional risks by accepting new projects, mentioned the Chairman.

This is not an acceptable argument to admit at all as it contradicts with financial management principles. The company should never pursue overvalued company share buy backs in the event profitable new projects are available due to the following:

01. Overvalued share buy back reduces shareholder wealth and
02. Company would face a large opportunity cost if a profitable project is forgone.

To comment on chairman's viewpoint of going behind new projects with large risk instead of buying back own shares with calculated risk seems to be incorrect as the positive NPV takes into consideration all the risks involved and discounted accordingly. Hence talking of risks involved again does not make much sense.

(c)

(i)

Working 7

Option 02: Merger arrangement

Exchange Rate 1 MVR = Rs.	12	12.47	12.95	13.45	13.98	14.52	15.08
Investment Schedule	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Free Cash Flows (MVR million)	0	14.57	15.70	16.59	22.27	23.47	31.47
CBC Portion (50% & 40%) (MVR million)		7.29	7.85	8.30	11.14	11.74	12.59
Remittance tax (10%)		(0.73)	(0.79)	(0.83)	(1.11)	(1.17)	(1.26)
Net proceeds (MVR million)		6.56	7.07	7.47	10.02	10.56	11.33
Equivalent LKR (Rs. million)		82	91	100	140	153	171
Loan given (Rs. million)	(480)	89.78	93.24	96.84	100.66	104.54	
Terminal value (Rs. million)							1,381
Net proceeds (Rs. million)	(480)	171.54	184.73	197.25	240.76	257.90	1,552
Discounting factor (18%)	1	0.847	0.718	0.609	0.516	0.437	0.370
	(480.00)	145.38	132.67	120.05	124.18	112.73	574
NPV (Rs. million)	729	1					

Terminal value	
Year 6 FCFs	171
Year 7 FCFs	179.55
R	18%
G	5%
Terminal value (Rs. million)	1,381

Loan proceeds		Rate	Proceeds without tax	Proceeds with tax
Year 0	-40	12	(480.0)	
Year 1	8	12.47	99.8	89.78
Year 2	8	12.95	103.6	93.24
Year 3	8	13.45	107.6	96.84
Year 4	8	13.98	111.8	100.66
Year 5	8	14.52	116.2	104.54
Year 6		15.08	-	

Qualitative factors to be considered:

The above conclusion is purely based on arithmetical calculations, based on a few assumptions. Therefore the final outcome may not end up positive for the company if any of the assumptions used in the calculations are invalid. Therefore a qualitative analysis is important as much as the NPV calculation.

Given below are some factors to be considered.

01. **Cultural misfit in the merger** – It has been historically proven that successfully blending two organisational cultures is the hardest element to overcome in a merger. The revenue and EBIT have been calculated on the assumption that both companies will merge without any issues but any mismatch in culture would hamper the productivity and turn to be unsuccessful. The said risk is larger given the situation that two parties are from two different countries who share different set of cultural aspects.
02. The second most important area to clear before making a call to go ahead with the project is to validate the acceptability of EBIT figures presented by the assistant accountant. For example the EBIT reported in the first year has increased to MVR 21 million at the end of year 5. How is this possible? When all free cash flows are withdrawn by two parties. Two questions to raise would be:
 - (a) What makes the business growth as much as 163% when all FCFs are taken out from the business without being re-invested. (21- 8/8)
 - (b) How did the company find money for working capital requirements and expenses of capital nature?
03. **Terminal value is based on optimistic assumptions**– This has been the most important or largest figure in deriving a healthy NPV. But the acceptability level of such a figure is doubtful due to the following reasons.
 - (a) Terminal value has been calculated based on the optimistic EBIT figures as explained above.
 - (b) A 163% business growth is not acceptable, as organic growth, unless new investment is introduced (in the absence of retained earnings).
04. **Incorrect terminal value calculation:** Most importantly the terminal value calculation seems to be incorrect as the assistant accountant has assumed that the depreciation which is added back is applicable into the indefinite future in the NPV calculation.

However the maximum depreciation which would be added back is possible only up to 12 years (200/16.67). Therefore the terminal value calculation is incorrect and needs reassessment.

05. **Tax adjustments:** There are two areas to consider with respect to tax adjustments.
- a) The accountant has assumed that a 15% corporate tax rate would continue in the future. Any sizable change to the tax rate would change the picture drastically. This can be considered as important due to the reason that a 15% corporate tax rate is a small percentage when compared to Asian countries.
 - b) The tax on EBIT has been calculated using a flat rate of 15% which needs revalidation as the depreciation allowance has not gone into the project and the total impact comes to MVR 200 million. Hence, the revalidation is quite important.
- (ii) There are two options available to CBC.
01. Dissolution of the existing operation and remit the money to Sri Lanka. Given below is a NPV calculation which ends up with Rs. 694 million. Refer Working 8 for detailed calculations.

Working 8

Option 01: Disposal of Maldives operations and remitting the money to Sri Lanka

Exchange rate 1MVR=LKR	12	12.47	12.95
	Year 0	Year 1	Year 2
		MVR million	
Net realisable value of investment		73.00	
Less: Remittance tax (10%)		<u>(7.30)</u>	
Net proceeds		65.70	
Equivalent LKR (Rs. million)		819.02	
Discounting factor		<u>0.847</u>	
PV (Rs. million)		694	
NPV (Rs. million)		694	

Option 02: Merger arrangement with a Maldivian leading beverage company and receive annual payments

This option would require CBC to transfer the net assets together with the employees with a further MVR 40 million as an interest-free loan to secure better returns for the money already invested in the business. This option would result in a positive NPV of Rs. 729 million. (Refer Working 7)

Conclusion:

Based on the above calculations the recommended option is to merge with the Maldivian company and carry out operations. The merger generates an incremental NPV of Rs. 35 million (Rs. 729 million – Rs. 694 million)

- (d) Irrespective of the fact that it's a listed company or otherwise, the simple rule applies in declaring dividends. That is if the company cannot make at least the market return, the earnings should be distributed as dividends simply due to the reason that the shareholder may be in a better position to gain greater returns.

Hence cannot agree with the CEO's viewpoint that the initiation of a dividend policy is not necessary as the shareholders have the option to *sell their shares and convert capital gains to dividends*. However, retained earnings should be re-invested only if profitable opportunities are available.

In addition, in the case of a listed company, there are additional factors to be aware of. Hence the management should consider such factors and make the right choice. There is no rule that a listed company should always initiate a healthy dividend policy and maintain a healthy dividend payout. It's about shareholder value maximisation. The Chairman's viewpoint is also valid to some extent.

Given below are some highlights.

- 01 **Shareholder profile:** If the new shareholders are going to be institutions or risk averse investors who wish to receive regular steady income, then the company may have to consider them and decide on a reasonable dividend distribution method to keep them invested.

In contrast, if the shareholders are mainly risk takers then earnings can be reinvested without any dividend what so ever but yet with a condition that the company can give them a better return than the market.

Therefore CBC will have to gain a thorough understanding about future investor profiles before making a decision on this.

02. **Growth stage of the company:** The historical research indicates that dividend policy of a company is linked to the stage of life time of the company and investors are patient enough to wait for dividends if the company is at its early stage with potential for higher growth.

For example: Tech companies would hardly distribute dividends at its early stage but yet investors would invest knowing the future earning possibilities.

CBC could make a call after analysing the growth stage of the company.

03. **Peer comparison:** Peer company analysis would also give some guidelines as the company may not want to be seen totally different from the other players in the market.

(Total: 50 marks)



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