THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC2 – Corporate Finance & Risk Management

June 2018

Answer 01

Relevant Learning Outcome/s: 2.3/2.4/1.1.3/1.2
Pages: 225,175,43,64,68

(a) (i)

	Price per juice can (Rs.)
Fruit juice (FOB price) (S$ 1.10)	129.80
Insurance and freight (S$ 0.15)	17.70
CIF price (S$ 1.25)	147.50
Duty 30%	44.25
PAL 7.5%	11.06
NBT 2% on 110% (CIF + duty + PAL)	4.46
VAT 15% on 110% (CIF + duty + PAL)	33.46

Taxes = Rs. 93.23
Tax rounded up = Rs. 94
Price per juice can (147.5 +94) = Rs. 241.50

(ii) **Famas International**

	Rs.	Rs.
Sales		12,420,000
Landed price	(8,694,000)	
Warehouse 1%	(86,940)	
Salaries 2.5%	(217,350)	
Finance cost	(160,521)	
Net profit		**3,261,189**
Debtors 12,420,000 x 60/365 x 10% =		204,164.38
Creditors 5,310,000 x 30/365 x 10% =		(43,643.84)
		160,520.54

Supermarket

Supermarket profit	Sales	16,560,000
	Cost	12,420,000)
		4,140,000
Interest income 16,560,000 x 60/365 x 7%		190,554
Total profit		**4,330,554**

Alternatively,

		Rs.
Gross profit	=	4,140,000
Interest income		
16,560,000 x 30/365 x 7%	=	95,277
	=	**4,235,277**

(On the assumption that full amount of Revenue is generated in 30 days)

Alternatively, on the assumption that input VAT can be recovered

(i)

	Price per juice can (Rs.)
Fruit juice (FOB price) (S$ 1.10)	129.80
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Duty 30%	44.25
PAL 7.5%	11.06
NBT 2% on 110% (CIF + duty + PAL)	4.46
VAT 15% on 110% (CIF + duty + PAL)	33.46

Taxes = Rs. 59.77
Tax rounded up = Rs. 60
Price per juice can (147.50+60) = Rs. 207.50

(ii) **Famas International**

	Rs.	Rs.
Sales		10,671,428
Landed price	(7,470,000)	
Warehouse 1%	(74,700)	
Salaries 2.5%	(186,750)	
Finance cost	(131,776)	
		(7,863,226)
Net profit		**2,808,202**

Debtors 10,671,428 x 60/365 x 10% =	175,420
Creditors 5,310,000 x 30/365 x 10% =	(43,644)
	131,776

Supermarket

Supermarket profit	Sales	14,228,570
	Cost	(10,671,428)
		3,557,142
Interest income		
14,228,570 x 60/365 x 7%		163,726
Total profit		**3,720,868**

(b) (i)

Profit before tax (Rs. billion)	=	7.00
Tax at 14% (Rs. billion)	=	(0.98)
Profit after tax (Rs. billion)	=	6.02
No. of shares	=	120,000,000
Earnings per share (Rs.)	=	50.167
Dividend per share (Rs.)	=	30.1

$$P = \frac{Do\ (1 + g)}{ke - g} = \frac{30.1\ (1 + 11\%)}{(15\% - 11\%)}$$

Market price (Rs.) = 835.28

Price earnings multiple = 835.28 / 50.167
= 16.65 times

(ii) Dividend yield = $\frac{30.1}{835.28}$
= 3.6%

Explanation

As the PE ratio indicates that the company is trading at a high earnings multiple, and the dividend yield is not very high, taking into consideration expected future growth rates and the high dividend payout, investment in the shares of Telstra, is recommended.

(c) (i) Bond value = USD 100 million, i = 9.25

Bond proceeds raised $= \frac{100}{[1+9.25\%]^5}$

$= \frac{100}{1.56}$

= USD 64.10 million

(ii) The Government of Sri Lanka recently issued a 5 year and 10 year USD bond. These were priced at around the 6%-7% range. These prices were within the expectations of the initial fund raising.

Hence, the price offered for the bond of the property developer, though higher when compared with the above, may be reflective of market perception, of risk to the issuer. Also, since it is a zero coupon bond, with no intermediate cash flows, it appears reasonable that the market would require a higher price, as compared with a normal interest paying bond.

Hedging the foreign exchange risk is very expensive in Sri Lanka, especially for a 5 year period. There may be a natural hedge in that the developer may price his apartments in USD equivalent, but a majority of the revenue will be in LKR. Hence, one of the main hedging strategies would be to deposit the USD funds locally and borrow against that in LKR. However, considering the high cost of USD funding, this may not be financially viable.

(Total: 25 marks)

Answer 02

Relevant Learning Outcome/s: 4.1.2/4.1.1/2.3.1/2.6
Pages: 144/151/268/269/329/401/402

To: Board of directors
From: TBC Consultants
Date: 30th June 2018
Subject: Evaluation of potential investments

This report evaluates four options available to management, and sets out reasons for recommendations being made.

1. **Selection Sequence - Impact on Acquisition of undervalued companies (PQR, RST, XYZ) applying both NPV and profitability index methods, as well as considering the risk profile & the balance capital available.**

The project evaluation summary is depicted below.

Company	NPV (Rs. million)	Profitability index (PI)	PI (NPV/Outlay)
PQR	(318)	0.77	-23%
RST	160	1.13	13%
XYZ	161	1.13	13%

Refer annexure 01 for workings.

As reflected above, acquiring PQR would have a negative impact on cash flows, based on both NPV as well as profitability index methods. However both RST and XYZ report positive NPVs. Therefore, further evaluation of these two options may be made, to pick the best option.

RST and XYZ give similar results using NPV and profitability index methods. Hence other qualitative factors should be considered, to decide between RST and XYZ.

XYZ receives its cash flows at the end of the project, and has a larger terminal value than RST, with a differential of Rs. 122 million (present value). It therefore appears that the rate of payback is faster in RST, which appears to be a lower risk, when compared with the timing of cash flows from XYZ.

Therefore RST stands out among the rest and qualifies for selection. However given that partial acquisition is not possible, neither RST nor XYZ can be acquired.

This investment decision would leave Rs. 310 million (Rs. 1,500 million – Rs. 1,190 million) available for reducing debt or for other investment options.

2. **Discussion on whether the investment should be made in undervalued companies, Stock market or Money market,**

The reason for disposal of its foreign subsidiary by ABC, was to shift long-term investment into more profitable and diversified market segments, particularly consumer products, towards maximising shareholder value and diversifying risk.

The Money market, which encompasses short-term, high quality debt securities issued by the government and corporates, does not seem to be a suitable option, as it focuses on short-term returns.

Maturities can range from overnight to up to a year. The Money market creates liquidity for borrowers to fund their short-term cash flow needs.

Hence an investment of Rs. 1.5 billion in common Money market instruments would include treasury bills (T-bills), certificate of deposit (CDs), commercial paper, and banker's acceptances. Rates of return from such Money Market instruments however, stay low, when compared with that of equity market investments or of one's own business investments.

Average Money market returns remained between 8.7% – 9.5% at the end of the period under review (TB as the base).

The Stock market on the other hand, could be an investment method, targeting longer-term returns, and the market indices could be used as a Dash Board to figure out an average rate of return.

Average returns for the last year have been calculated in the table below using ASPI and S&P SL 20 as indicators.

	ASPI	**S&P SL 20**
Beginning	6,164	3,492
End	6,612	3,872
Movement	448	380
Return	7%	11%

This shows that SL Stock market returns have remained even lower than the money market returns under review.

An alternative way to maximise shareholder value would be to look for a venture capital arrangement, where the company can invest in a start-up with high growth potential, towards making larger profits in the long-run. As venture capital investments span unrelated businesses in various industries, the objective of diversification too is achieved.

Given the circumstances, the largest possible return that can be achieved from available options, would appear to be from investing in one of the companies - RST or XYZ.

Summary

Segment	Average return
RST/XYZ	13%
Money market	9.1% (8.7% ∞ 9.5%)
Stock market	9% (7% ∞ 11%)

The criteria for selecting any one option would therefore be dependent on whether the company can make sufficient payout to investors. Both Money market and Stock market returns do not exceed the WACC of ABC company, and would therefore not enable a dividend payout to its stakeholders.

Additionally, Money market and Stock market investments can easily be made by the shareholders themselves, instead of their investing in ABC to achieve this end. Hence maximising Shareholder Value is of greater importance.

The ABC company should therefore look to achieving 'higher than WACC' returns from avenues other than investing in the Money market or Stock market.

3. **Looking for debt capital or extra capital in accepting both RST and XYZ from a financial management perspective**

The current capital structure does not seem to be highly geared unless the fund providers already raised their concerns in raising further funds as debt.

However, raising of funds as capital or debt, for the proposed acquisitions, amounting to Rs. 920 million, may be acceptable, if the WACC of the company remained below the expected returns from the projects/investments, i.e. showing positive net present values after factoring for increased gearing.

Additional funds needed: Rs. 920 million (1,190+1,230 -1,500).

Note: WACC is supposed to come down as the company adds more and more debt to the capital structure unless the company is very highly geared.

Therefore, raising additional capital or debt, to finance both projects RST & XYZ, may be acceptable, from a financial management perspective, given their healthy positive net present values, as reported.

4. **The chairman's attempt to repay debts**

The chairman's attempt to repay debt at the cost of proceeding with the new project, would bring down company's value in many ways. Given below are three ways.

- It will create an upward pressure on WACC with reduced debt in capital structure; hence future cash flows will be discounted at a greater WACC, in valuations of ABC.
- As the proposed investment would have brought down aggregated beta factor for ABC, through diversification, if the chairman opts to utilize cash for debt settlement instead, the beta factor reduction would not be possible, and as a result, cost of equity in ABC, would be greater.
- There would be a negative impact from the diluted tax shield benefit.

Annexure 01

Risk free rate =	11% + 10.5% +9.5%	
=	10.33%	
	Based on the CAPM model:	Approximately
PQR =	10.33% + 1.4(3)= 14.50%	15%
RST =	10.33% + 1(3) = 13.33%	13%
XYZ =	10.33% + 0.8(3)= 12.73%	13%

PQR				
Year	Cash flows (Rs. million)	DF	PV (Rs. million)	NPV (Rs. million)
		15%		
0	(1,360)	1	(1,360)	
1	(20)	0.870	(17)	
2	150	0.756	113	
3	220	0.658	145	
4	1,400	0.572	801	(318)

Profitability index

PV of cash flows
Initial investment

1,042
1,360
0.77

RST				
Year	Cash flows (Rs. million)	DF	PV (Rs. million)	NPV (Rs. million)
		13%		
0	(1,190)	1	(1,190)	
1	410	0.885	363	
2	330	0.783	258	
3	255	0.693	177	
4	900	0.613	552	160

1,350
1,190
1.13

XYZ				
Year	Cash flows (Rs. million)	DF	PV (Rs. million)	NPV (Rs. million)
		13%		
0	(1,230)	1	(1,230)	
1	90	0.885	80	
2	300	0.783	235	
3	580	0.693	402	
4	1,100	0.613	674	161

1,391
1,230
1.13

(Total: 25 marks)

Answer 03

Relevant Learning Outcome/s: 6.1/5.2.1/4.1/3.1.3/1.2.3
Page No: 588/436/320/292/265

(a)

	ETD PLC		ET Engineering		ET Electricals		ET Finance	
	2018	**2017**	**2018**	**2017**	**2018**	**2017**	**2018**	**2017**
Revenue (Rs. million)	3,217	3,210	1,625	1,550	925	726	2,845	2,785
Operating profit (Rs. million)	313	460	5	6	67	57	148	170
Change in sales %	0.2%		4.8%		27.4%		2.2%	
Change in EBIT %	-32%		-17%		18%		-13%	
Degree of operating leverage	**-147**		**-3.44**		**0.64**		**-6.01**	

Interpreting the information given above, poses a challenge as, in both ETD PLC and ET Engineering, the revenue and EBIT have moved in opposite directions, which is not usual under a theoretical DOL Model. As a result, the DOL calculation ends up with a negative figure, which is not easily explainable, without adequate information on fixed costs. ET Finance PLC is also moving in the same direction.

The effectiveness of DOL (Degree of Operating Leverage)

ETD PLC

As ETD PLC is a retail business, the fixed costs should be comparatively lower compared with a manufacturing company. As the majority of expenses are supposed to be variable, a lower DOL is expected.

Also retail prices are generally aligned with the purchase price of goods, and margins are supposed to be lower but steady, and moving in the same direction.

Although the above are the general attributes of DOL in a retail business, surprisingly, the total opposite appears to be true, as far as ETD PLC is concerned.

ET Engineering

An Engineering Company usually operates with a high labor component. Hence, higher fixed costs will be reported, comprised mainly of a fixed salary component, unless subcontracted to a greater degree, with the expectation of greater contribution from higher margins.

However, surprisingly the GP margins are reported as low as 5%. Hence the EBIT is moving in the opposite directions. This again is contrary to industry norms as would be evident in peer company comparisons.

ET Finance PLC

The company has not considered the loan loss provision. Hence the DOL seems to be incorrect.

ET Electricals

ET Electricals reports a lower DOL suggesting that the variable costs are greater than its fixed costs. Lower operating leverage implies that the business risk of the company is lower.

We need to understand however, that there are fundamental issues in the way each operation is run and how DOL is reported. The use of DOL is quite limited due to the reasons given below.

DOL is a representation of EBIT movement in comparison with changes in sales. We need to bear in mind that DOL is not merely a function of sales levels but a mix of

- Output price and
- Unit costs

Hence the use of DOL is not recommended in the given situation.

Actions for strengthening the bottom line

01. Inventories of ETD PLC are high (Rs. 1,572 million in 2018) given the quantum of sales of Rs. 3,217 million. This implies inefficiencies in working capital management.

As this is linked with a pool of fixed costs, close attention to this aspect is needed urgently.

02. PPE also seems quite high given the nature of operations. It stands at almost Rs. 1,205 million (together with leasehold property) whereas the annual turnover is Rs. 3,217 million (2018). A Review of the Operation Model is needed. A Managed Operation Model (Outsourced Model) may be an option, towards changing some of the fixed costs to variable.

(b)

Date: 30th June 2018
From: Best Value Consultants
To: Board of Directors – ETD PLC
Subject: Clarifications to the points raised by CEO at board meeting 2

The undervaluation of approx. Rs 9 billion, inherent in the low Market Capitalisation of ETD PLC, as raised by the CEO, contains a fundamental error, which is explained as follows.

The Market capitalisation, calculated using the Market Price per Share multiplied by the number of equity shares in issue, is a representation of 'true value' of Equity Shareholders and not the Total Assets of the company. In other words it shows how much value is attributable to Equity Shareholders. Therefore the CEO should look at the equity book value or the net assets value position to arrive at a comparable amount. Also it should be noted that Market Value per Share could be volatile, due to many reasons. However, long-term price movements could give a more stable view compared to ad-hoc price changes, when coming to a conclusion.

We agree with the CEO's view however, that the company's shares have been undervalued heavily, given the net book value of the company and the market capitalisation, as illustrated below.

Group position as at 31 March 2018
Rs. billion

Net assets value:	7.3
Market capitalisation:	3.8
Deficit:	**3.5**

Note: Whilst this is an over simplification of 'true value' of the company, it is a good starting point to get into a deep analysis. For purposes of comparison.

In response to the question as to why ETD PLC has not been a target for a possible take-over bid, can only be answered after a closer look at the future earnings potential of the company, rather than simply looking at the value of the asset base. This would be due to many reasons including:

- The Net Asset Value is a book value and does not necessarily reflect True Value, as it could be way below the actual market price.
- The Asset Value may include redundant assets, which may not generate any future value.
- The Assets Pool could include specialised PPE which would be of negligible value to a third party, if isolated from operations.

Hence one must look at the True Value of the company using future earnings potential and then arrive at a conclusion as to whether the company is being undervalued by the market.

Given below is a fair valuation of each of company, except for the joint venture (JV) based on the information available. Refer Annexure 01 for calculations.

Note: Our attempt here is to look at each company separately and then arrive at a consolidated value.

ETD PLC consolidated value estimation		**Rs. million**
Parent company free cash flow based valuation	(Note 4)	407
ET Engineering	(Note 4)	413
ET Electricals	(Note 4)	930
ET Finance	(Note 4)	295
Total value (excluding JV)	(Note 4)	**2045**

The total fair value derived is Rs. 2.045 billion as calculated above. Hence if we go with the assumption that the total market capitalisation for ETD PLC, shows the correct value for the entire group, the value left for JV is as follows.

	Rs. million
Total market capitalisation	3,824
Total value (Without JV)	2,045
Value attributable to JV	**1,779**

Therefore in summary, in considering the possibility of the company being a target for acquisition, due to under valuation, the answer is that this is unlikely.

Even if we consider that the JV investment can be fully recovered, and because the total value derived without the JV is as small as Rs. 2.045 billion it would give us a total value of Rs. 4.245 billion (Rs. 2.2 billion + Rs. 2.045 billion) which is not a significant value for a forced acquisition.

In deciding who has contributed mostly to this large deficit, the following companies can be identified as responsible. Accordingly all three companies are responsible to a larger extent while the finance company investment shows a major impairment.

ETD PLC

	Rs. billion
Total net assets value	5.3
Less: Subsidiary	(1.2)
JV	(2.4)
Value remaining for equity	1.7
Actual value based on FCF	0.407

ET FINANCE

	Rs. billion
Total Net assets value	1.9
Group holding – 70%	1.34
Actual value - Market cap based	0.295

JV

Group holding value	2.2
Actual value attainable (As above)	1.78

Annexure 01

Note 01: Cost of equity of ETD PLC

Risk free rate	10%
Risk premium	6%
Beta	1.5
Cost of equity	19%

Note 02: Computation of WACC

	Rs.	%	Cost	
Equity value	3,823,750,000	71%	19.00%	13.47%
Debentures	750,250,000	14%	4.32%	0.60%
Short term interest bearing loans	820,333,000	15%	8.6%	1.31%
WACC	5,394,333,000	100%		15.38%

Note 03 (a): Free cash flows of ETD PLC in 2018/19

ETD PLC		
Year		**2018/19 (Rs. million)**
Operating profit		344
Tax rate	0.28	
EBIT * (1-t)		248
Net capital expenditure		-30
Incremental working capital		-5
FCF		213

Note 03 (b): Free cash flow based valuation of ETD PLC

Year	**2017/18**	**18/19**	**19/20**	**20/21**	**21/22**	**22/23**	**23/24**	**24/25**	**25/26**	**26/27**	**27/28**
	Rs. million										
Cash flows Note 03(a)		213	234	253	273	287	301	316	332	349	366
Terminal value											2,440
		213	234	253	273	287	301	316	332	349	2,806
	1										
DF	1.15	0.870	0.756	0.658	0.572	0.497	0.432	0.376	0.327	0.284	0.247
1,977.39	-	185.10	177.05	166.27	156.15	142.57	130.18	118.86	108.52	99.09	693.60

Total value: Rs. 1,977.39 million

Alternatively,

Free cash flow based valuation of ETD PLC

Year	2017/18	18/19	19/20	20/21	21/22	22/23	23/24	24/25	25/26	26/27	27/28
	Rs. million										
EBIT	313	344	379	409	442	464	487	511	537	564	592
EBIT(1-t)		248	273	294	318	334	351	368	387	406	426
Capex/ WC		(35)	(39)	(42)	(45)	(47)	(50)	(52)	(55)	(57)	(60)
		213	234	253	273	287	301	316	332	349	366
Terminal value											2,440
		213	234	253	273	287	301	316	332	349	2,806
DF – 15%		0.870	0.756	0.658	0.572	0.497	0.432	0.376	0.327	0.284	0.247
PV		185	177	166	156	143	130	119	109	99	694
Total		1,977									

Total value: Rs. 1,977 million

Note 04: Company valuation

			Rs. million
ETD PLC valuation (FCF method) Note 03 (b)			1,977.39
Less: Debt value (Long-term)			750.25
Debt value (Short-term)			820.33
Value available for equity shareholders			407
ET Engineering (Pvt) Ltd: (551*75%*100%)			413.25
ET Electricals (Pvt) Ltd (930*100%*100%)			930
	Price per share	No. of shares	
ET Finance PLC	99	4,256,000 (0.7)	294.94
Total value excluding JV			2,045.00
Current market capitalisation	175	21,850,000	3,823.75
Value placed on JV by market forces			1,779
JV book value			3,735
JV investment value impairment			1,956

(c) The first option, redeemable preference shares, gives a positive NPV of Rs. 235.96 million discounted at 15% WACC, assuming that the existing capital structure has been used, to make the said investment.

However when we compare this with the cash offer which is set at 80% of the market price per share, the difference between the two options seems insignificant.

Therefore both options are placed at the same level of NPV. Hence other factors should be considered to arrive at a decision. The redeemable preference share issue is a long-term (15 years) investment and would take a long time to exit. The longer the investment period, the more risky it would be.

An immediate cash infusion could help the group to reduce its large finance cost component, which is quite high.

The financial statements of ETD PLC have not considered the loan loss provision, which would significantly impact future reporting.

Continuing to own the company as a hybrid capital holder will continue to expose ETD PLC to such risk elements. Hence it is recommended that ETD PLC exit this investment as soon as possible, as this would be of benefit to current ETD shareholders.

Conclusion: Recommended that ETD PLC should accept the cash offer (Option 2).

	ET Finance PLC	**USB PLC**
No. of shares	4,256,000	3,200,000
Earnings after tax (Rs.)	24,750,000	35,850,000
Earnings per share (Rs.)	5.82	11.20
Market price per share (Rs.)	99.00	234
Price earnings ratio(times)	17.024	21

Option 01	
Value of ET Finance PLC	421,344,000
Value per USB PLC's preference share	105
No. of shares to be issued	4,012,800
Group portion (70%)	2,808,960
Total nominal value (Rs.)	280,896,000.00

Issue 12% redeemable preference shares of Rs. 100 each at a 5% premium redeemable after 15 years at Rs.112.5

Number of preference shares available for the group	2,808,960
Nominal value (Rs.)	280,896,000
Dividends per year at 12% per annum (Rs.)	33,707,520
Redemption value (Rs.)	316,008,000

Year	Interest 12% (Rs. million)	Redemption (Rs. million)	Total cash flows (Rs. million)	DF (15%)	Annuity factor	PV (Rs. million)
0						
1 -15	33,707,520		33,707,520	NA	5.847	197,087,869
15		316,008,000		0.123	NA	38,868,984
NPV						**235,956,853**

Option 02	
	(Rs. million)
Today's market value (4,256,000 *99)	294,940,800
80% value guaranteed	235,952,640

(d) It cannot be stated that the shareholders have viewed company performance positively in the recent past.

We arrive at this conclusion as market capitalisation is vastly lower than the net assets attributable to equity shareholders.

Therefore share prices have NOT been high when compared with what it was supposed to be.

The payment of dividends is a management decision which would be based on many factors, as set out below.

- Shareholder profiles – Individuals vs. institutional owners
- Past dividends payment pattern
- Expectations created by the company and the practice of peer companies
- Profitability and liquidity position of the company
- Alternative investment opportunities available to the company

It would be more appropriate to look at each of above factors, before making a call as to whether to start paying dividends.

The directors should do the solvency test before declaring and distributing dividends, if they experience bottom line losses at the end of a period, as required by the companies act.

Declaring dividends is not a decision to be taken by merely looking at the net profit or loss for the period or the cash position of the company, but after completing the solvency test as required by section 56 and 60 of the Companies Act. Therefore even borrowing funds is considered acceptable, provided the directors comply with section 56 and 60 of Companies Act.

The alternative options available to the company, in the event the dividends are not declared, is what matters most when we look at it from a good governance of financial management perspective. If the investment opportunities available in the market can give returns greater than its cost of capital, then the company should convince Shareholders and proceed with such, as it would maximise shareholder wealth.

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