QUESTIONS

SECTION B

Q.2)

(a) Retilon plc is a medium sized UK company that trades with companies in several European countries. Trade deals over the next three months are shown below. Assume that it is now 20 April.

| | Two months' time | | Three months' time | |
|---|---|---|---|---|
| | Receipts | Payments | Receipts | Payments |
| France | – | €393,265 | €491,011 | €60,505 |
| Germany | – | – | €890,217 | €1,997,651 |
| Denmark | – | – | Kr 8.6m | – |

Foreign exchange rates:

| | Dkroner/£ | Euro €/£ |
|---|---|---|
| Spot | 10.68 – 10.71 | 1.439 – 1.465 |
| Two months forward | 10.74 – 10.77 | 1.433 – 1.459 |
| Three months forward | 10.78 – 10.83 | 1.431 – 1.456 |

Annual interest rates (valid for 2 months or 3 months)

| | Borrowing % | Investing % |
|---|---|---|
| United Kingdom | 7.50 | 5.50 |
| France | 5.75 | 3.50 |
| Germany | 5.75 | 3.50 |
| Denmark | 8.00 | 6.00 |

Futures market rates

Three month Euro contracts (125,000 Euro contract size)

Contracts are for buying or selling Euros. Futures prices are in £ per Euro.

| | |
|---|---|
| June | 0.6964 |
| September | 0.6983 |
| December | 0.7013 |

Required

(i) Using the forward market, money market and currency futures market as appropriate devise a foreign exchange hedging strategy that is expected to maximise the cash flows of Retilon plc at the end of the three month period.

Transactions costs and margin requirements may be ignored for this part of the question. Basis risk may be assumed to be zero at the time the contracts are closed out. Futures contracts may be assumed to mature at the month end.
(15 marks)

(ii) Successive daily prices on the futures market for a June contract which you have sold are:

| | |
|---|---|
| Selling price | 0.6916 |
| Day 1 | 0.6930 |
| Day 2 | 0.6944 |
| Day 3 | 0.6940 |

Initial margins are £1,000 per contract. Variation margin is 100% of the initial margin. Spot exchange rates may be assumed not to change significantly during these three days. For each of the three days, show the effect on your cash flow of the price changes of the contract.
(4 marks)

(b) Discuss the advantages and disadvantages of forward contracts and currency futures for hedging against foreign exchange risk.
(6 marks)

(Total = 25 marks)

Q.3)

The directors of Minprice Inc, a food retailer with 20 superstores, are proposing to make a takeover bid for Savealot. Inc, a company with six superstores. Minprice will offer four of its ordinary shares for every three ordinary shares of Savealot. The bid has not yet been made public.

Summarised statements of financial position as at 31 March 20X0

| | Minprice Inc | | Savealot Inc | |
|---|---|---|---|---|
| | $m | $m | $m | $m |
| Land and buildings (net) | | 483 | | 42.3 |
| Non-current assets (net) | | 150 | | 17.0 |
| | | 633 | | 59.3 |
| Current assets | | | | |
| Inventory | 328 | | 51.4 | |
| Receivables | 12 | | 6.3 | |
| Cash | 44 | | 5.3 | |
| | | 384 | | 63.0 |
| **Total assets** | | 1,017 | | 122.3 |
| Equity and liabilities | | | | |
| Original shares | 25 cents par | 75 | 50 cents par | 20.0 |
| Retained earnings | | 147 | | 34.7 |
| Total equity | | 222 | | 54.7 |
| Current liabilities | | | | |
| Trade payables* | 459 | | 48.1 | |
| Taxation | 22 | | 2.0 | |
| | | 481 | | 50.1 |
| Non-current liabilities | | | | |
| 14% loan stock | | 200 | | |
| Floating rate bank term loans | | 114 | | 17.5 |
| **Total liabilities** | | 795 | | 67.6 |
| Total equity and liabilities | | 1,017 | | 122.3 |

* Trade payables include dividends of $12m for Minprice and $2m for Savealot.

Summarised statements of profit or loss for the year ending 31 March 20X0

| | $m | $m |
|---|---|---|
| Revenue | 1,130 | 181 |
| Earnings before interest and tax | 115 | 14 |
| Net interest | (40) | (2) |
| Profit before tax | 75 | 12 |
| Taxation | (25) | (4) |
| Available to shareholders | 50 | 8 |
| Dividend | (24) | (5) |
| Retained earnings | 26 | 3 |

The current share price of Minprice Inc is 232 cents, and of Savealot Inc 295 cents. The current loan stock price of Minprice plc is $125.

| Recent annual growth trends: | Minprice Inc | Savealot Inc |
|---|---|---|
| Dividends | 7% | 8% |
| EPS | 7% | 10% |

Rationalisation following the acquisition will involve the following transactions (all net of tax effects):

(a) Sale of surplus warehouse facilities for $6.8 million
(b) Redundancy payments costing $9.0 million
(c) Wage savings of $2.7 million per year for at least five years

Minprice's cost of equity is estimated to be 14.5%, and weighted average cost of capital 12%. Savealot's cost of equity is estimated to be 13%.

Required

(a) Discuss and evaluate whether or not the bid is likely to be viewed favourably by the shareholders of both Minprice Inc and Savealot Inc. Include discussion of the factors that are likely to influence the views of the shareholders.
All relevant calculations must be shown.
(15 marks)

(b) Discuss the possible effects on the likely success of the bid if the offer terms were to be amended to 325 cents per share cash.
(3 marks)

(c) The directors of Savealot Inc have decided to fight the bid and have proposed the following measures:

(i) Announce that their company's profits are likely to be doubled next year.

(ii) Alter the Articles of Association to require that at least 75% of shareholders need to approve an acquisition.
(iii) Persuade, for a fee, a third party investor to buy large quantities of the company's shares.
(iv) Introduce an advertising campaign criticising the performance and management ability of Minprice Inc.
(v) Revalue non-current assets to current values so that shareholders are aware of the company's true market values.

Acting as a consultant to the company, give reasoned advice on whether or not the company should adopt each of these measures.
(7 marks)

(Total = 25 marks)

Q.4)

A division of Reflator Inc has recently experienced severe financial difficulties. The management of the division is keen to undertake a buyout, but in order for the buyout to succeed it needs to attract substantial finance from a venture capital organisation. Reflator Inc is willing to sell the division for $2.1 million, and the managers believe that an additional $1 million of capital would need to be invested in the division to create a viable going concern.

Possible financing sources

Equity from management $500,000, in 50 cents ordinary shares

Funds from the venture capital organisation

Equity $300,000, in 50 cents ordinary shares

Debt: 8.5% fixed rate loan $2,000,000

9% subordinated loan with warrants attached $300,000

The warrants are exercisable any time after four years from now at the rate of 100 ordinary shares at the price of 150 cents per share for every $100 of subordinated loan.

The principal on the 8.5% fixed rate loan is repayable as a bullet payment at the end of eight years. The subordinated loan is repayable by equal annual payments, comprising both interest and principal, over a period of six years.

The division's managers propose to keep dividends to no more than 15% of profits for the first four years.

Independently produced forecasts of earnings before tax and interest after the buyout are shown below:

| | | $'000 | | |
|---|---|---|---|---|
| Year | 1 | 2 | 3 | 4 |
| EBIT | 320 | 410 | 500 | 540 |

Corporate tax is at the rate of 30% per year.

The managers involved in the buyout have stated that the book value of equity is likely to increase by about 20% per year during the first four years, making the investment very attractive to the venture capital organisation. The venture capital organisation has stated that it is interested in investing, but has doubts about the forecast growth rate of equity value, and would require warrants for 150 shares per $100 of subordinated loan stock rather than 100 shares.

Required

(a) Discuss the potential advantages of a management buyout of the division, compared to selling to a third party. Do not limit discussion to advantages for Reflator Inc.
(7 marks)

(b) On the basis of the above data, estimate whether or not the book value of equity is likely to grow by 20% per year.
(7 marks)

(c) Evaluate the possible implication of the managers agreeing to offer warrants for 150 ordinary shares per $100 of loan stock.
(4 marks)

(d) Produce a short memorandum explaining the role of a venture capitalist in this management buyout. You should also mention the typical requirements the venture capital organisation will demand from the buyout team.
(7 marks)

(Total = 25 marks)