

UNIVERSITY OF BOLTON
BOLTON BUSINESS SCHOOL
ACCOUNTANCY PATHWAY
SEMESTER 2 EXAMINATIONS 2008/2009
FINANCIAL MANAGEMENT
MODULE NO: ACC2505

Date: Thursday 28th May 2009

Time: 14:00 – 17:00

INSTRUCTIONS TO CANDIDATES:

There are **FIVE** questions on this paper.

Answer **ALL** questions.

All questions carry equal marks.

Discount tables are enclosed.

Candidates are advised that the examiners attach importance to legibility of writing and clarity of expression.

Bolton Business School
 Accountancy Pathway
 Semester 2 Examinations 2008/2009
 Financial Management
 Module No. ACC 2505

Answer ALL questions

Q1

Direct Lenses is a listed company that plans to spend £10m on expanding its existing business. It is intended that the money will be raised by issuing 9% loan notes redeemable in 10 years time. Current financial information is as follows:

The Income statement for last year

	£000
Profit before interest and tax	7,000
Interest	<u>(500)</u>
Profit before tax	6,500
Tax	<u>(1,950)</u>
Profit for the period	<u>4,550</u>

The Balance sheet for last year

	£000
Non-current assets	20,000
Current assets	<u>20,000</u>
Total assets	<u>40,000</u>

Equity and liabilities

Ordinary shares, par value £1	5,000	
Retained earnings	<u>22,500</u>	
Total equity		27,500
10% loan notes	5,000	
9% preference shares	<u>2,500</u>	
Total non-current liabilities		7,500
Current liabilities		<u>5,000</u>
Total equity and liabilities		<u>40,000</u>

The current ex-div ordinary share price is £4.50 per share. An ordinary dividend of 35p per share has just been paid and dividends are expected to increase by 4% per year for the foreseeable future. The current ex-div preference share price is 76.2p. The loan notes are secured on the existing non-current assets of Direct lenses and are redeemable at par in 8 years time. They have a current ex interest market price of £105 per £100 loan note. Direct lenses pays tax on profits at an annual rate of 30%

The expansion of the business is expected to increase profit before interest and tax by 12% in the first year. Direct lenses has no overdraft.

**Q1 continued over
PLEASE TURN THE PAGE...**

Bolton Business School
 Accountancy Pathway
 Semester 2 Examinations 2008/2009
 Financial Management
 Module No. ACC 2505

Q1 continued

Average sector ratios:

Financial gearing: 45% (prior charge capital is divided by equity capital book value)
 Interest cover ratio: 12 times

Required:

- a) Calculate the current weighted average cost of capital of Direct lenses **(14 marks)**
- b) Evaluate the factors that may affect the weighted average cost of capital measure. **(6 marks)**

Total 20 Marks

Q2

Conservatory Co plans to buy a new machine to meet expected demand for a new product, Product Z. This machine will cost £250,000 and last for 4 years, at the end of which time it will be sold for £5,000. Conservatory Co expects demand for Product Z to be as follows:

Year	1	2	3	4
Demand (units)	35,000	40,000	50,000	25,000

The selling price for Product Z is expected to be £12.00 per unit, and the variable cost of production is expected to be £7.80 per unit. Incremental annual fixed production overheads of £25,000 per year will be incurred. Selling price and costs are all in current terms.

Selling price and costs are expected to increase as follows:

	Increase
Selling price of Product Z:	3% per year
Variable cost of production:	4% per year
Fixed production overheads:	6% per year

Other information:

Conservatory Co has a real cost of capital of 5.7% and pays tax at an annual rate of 30% one year in arrears. It can claim capital allowances on a 25% reducing balance basis. General inflation is expected to be 5% per year

**Q2 continued over
 PLEASE TURN THE PAGE...**

Bolton Business School
Accountancy Pathway
Semester 2 Examinations 2008/2009
Financial Management
Module No. ACC 2505

Q2 continued

Conservatory Co has a target return on capital employed of 20%. Depreciation is charged on a straight-line basis over the life of the asset.

Required:

- a) Calculate the net present value of the investment in the new machine **(12 Marks)**
- b) Evaluate the use of the Internal rate of return in appraising capital investments. **(8 marks)**

Total 20 Marks

Q3

Acquisitions and Mergers take place regularly in the UK market place. Critically evaluate why businesses might consider this option when trading on the UK stock market.

(20 Marks)

Q4

Bridge Ltd is a privately owned family business that has been successfully trading for the last 40 years. The business plans a major expansion to modernise its plant to improve productivity and reduce unit costs. The existing capital base is fairly evenly divided between equity and debt, and it is clear that the capital investment programme can only partly be funded through profit retention.

Critically evaluate the options available to the business in order to raise the necessary finance for future expansion and how this may affect the capital mix of this business. You are also required to analyse how changes to the capital structure of the business may affect its future financial viability, including any inherent risks involved in raising debt and equity capital.

(20 Marks)

PLEASE TURN THE PAGE...

Bolton Business School
Accountancy Pathway
Semester 2 Examinations 2008/2009
Financial Management
Module No. ACC 2505

Q5

Planella plc is considering the immediate purchase of some, or all, of the share capital of one of two firms: Amber Ltd and Green Ltd. Both Amber and Green have one million ordinary shares issued and neither company has any debt capital outstanding.

Both firms are expected to pay a dividend in one years time, Amber's expected dividend amounting to 30p per share and Green's being 27p per share. Dividends will be paid annually and are expected to increase over time. Amber dividends are expected to display perpetual growth at a compound rate of 6% per year. Green dividends will grow at the high annual compound rate of 33 1/3% until a dividend of 64p is reached in year 4. Thereafter Green's dividend will remain constant.

If Planella plc is able to purchase all the equity capital of either firm then the reduced competition would enable Planella to save some advertising and administration costs which would amount to £225,000 per year indefinitely and, in year 2, to sell some office space for £800,000. These benefits and savings would only occur if a complete takeover were to be carried out. Planella would change some operations of any company completely taken over. The details are as follows:

- (i) Amber: no dividend would be paid until year 3. Year 3 dividend would be 25p per share and dividends would grow at 10% per year indefinitely.
- (ii) Green: no change in total dividends in years 1 to 4, but after year 4, dividend growth would be 25% per year compound until year 7. Thereafter annual dividends would remain constant at year 7 amount per share

An appropriate discount rate for the risk inherent in all cash flows is 15%.

Required:

- (a)** Calculate the valuation per share for a minority investment in each of the two firms, Amber and Green, that would provide the investor with a 15% return (ignore tax). **(8 marks)**
- (b)** Calculate the maximum amount per share that Planella should consider paying for each company in the event of a complete takeover (ignore tax). **(12 marks)**

Total 20 Marks

END OF QUESTIONS

TABLE OF PRESENT VALUE FACTORS

Present values of $1/(1+r)^n$

<i>period (n)</i>	<i>discount rates (r)</i>									
	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621
6	0.942	0.888	0.837	0.790	0.746	0.705	0.666	0.630	0.596	0.564
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149

<i>period (n)</i>	<i>discount rates (r)</i>									
	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	0.812	0.797	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694
3	0.731	0.712	0.693	0.675	0.658	0.641	0.624	0.609	0.593	0.579
4	0.659	0.636	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482
5	0.593	0.567	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402
6	0.535	0.507	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335
7	0.482	0.452	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279
8	0.434	0.404	0.376	0.351	0.327	0.305	0.285	0.266	0.249	0.233
9	0.391	0.361	0.333	0.308	0.284	0.263	0.243	0.225	0.209	0.194
10	0.352	0.322	0.295	0.270	0.247	0.227	0.208	0.191	0.176	0.162
11	0.317	0.287	0.261	0.237	0.215	0.195	0.178	0.162	0.148	0.135
12	0.286	0.257	0.231	0.208	0.187	0.168	0.152	0.137	0.124	0.112
13	0.258	0.229	0.204	0.182	0.163	0.145	0.130	0.116	0.104	0.093
14	0.232	0.205	0.181	0.160	0.141	0.125	0.111	0.099	0.088	0.078
15	0.209	0.183	0.160	0.140	0.123	0.108	0.095	0.084	0.074	0.065
16	0.188	0.163	0.141	0.123	0.107	0.093	0.081	0.071	0.062	0.054
17	0.167	0.146	0.125	0.108	0.093	0.080	0.069	0.060	0.052	0.045
18	0.153	0.130	0.111	0.095	0.081	0.069	0.059	0.051	0.044	0.038
19	0.138	0.116	0.098	0.083	0.070	0.060	0.051	0.043	0.037	0.031
20	0.124	0.104	0.087	0.073	0.061	0.051	0.043	0.037	0.031	0.026