# Advanced Financial Management (AFM)

March/June 2021 (20/21 Syllabus)

## Get to know your exam

*These graphical representations are intended to give an indication of past exam requirements and associated question content.*

*Please note that you will not be able to complete answers within these documents and in isolation they will not sufficiently prepare you for your exam.*

*We encourage you to visit the ACCA Practice Platform in order to attempt up to date practice exams within the computer-based exam environment. Further instructions on how to use the platform will be provided before you attempt the exam.*

# Introduction screen

AFM March/June 2021 (20/21 syllabus)

ACCA Think Ahead

### Introduction

This exam contains past exam content and indicates how the live exam will be structured and assessed, the likely layout and style of questions and the range of response options that could be presented to you in each question's workspace.

You should use this exam to become familiar with the workspace and the features and functionality contained within the live exam.

The past content exam is reflective of the live exam experience but has some differences:

- The live exam will be timed, however there is no time limit in the past content exam.
- If you want to sit this exam in exam-style conditions you should answer the questions presented within a **3 hour 15 minute time period**.
- Once you have started this past content exam, you are able to leave at any time by closing the browser window. When you return, anything you have entered into the response options will be saved and you can continue sitting the exam.
- In the live exam your answers entered into the workspace response options will be expert-marked. At the end of this exam, you should use the solution material provided to assess your performance.
- You will be able to access solution material at the end of this exam when using the Self Marking resources which include a Marking Guide and Sample Answer for each question. If you wish to access these without completing the questions, click on End Exam on the Item Review Screen and navigate to the Marking tab on the Dashboard to Self-Mark.

## Exam summary screen

AFM March/June 2021 (20/21 syllabus)

### Exam Summary

**Time allowed**: This exam is not timed.

This exam is divided into two sections:

**Section A**

- One question worth 50 marks.
- 50 marks in total.

**Section B**

- Two questions, each worth 25 marks.
- 50 marks in total.

All questions are compulsory.

Select **Next** to start your exam.

# Exam summary screen (continued)

# Section A

AFM March/June 2021 (20/21 syllabus)

### Section A

This section of the exam contains **one question**.

This question is worth **50 marks** and is compulsory.

This exam section is worth **50 marks** in total.

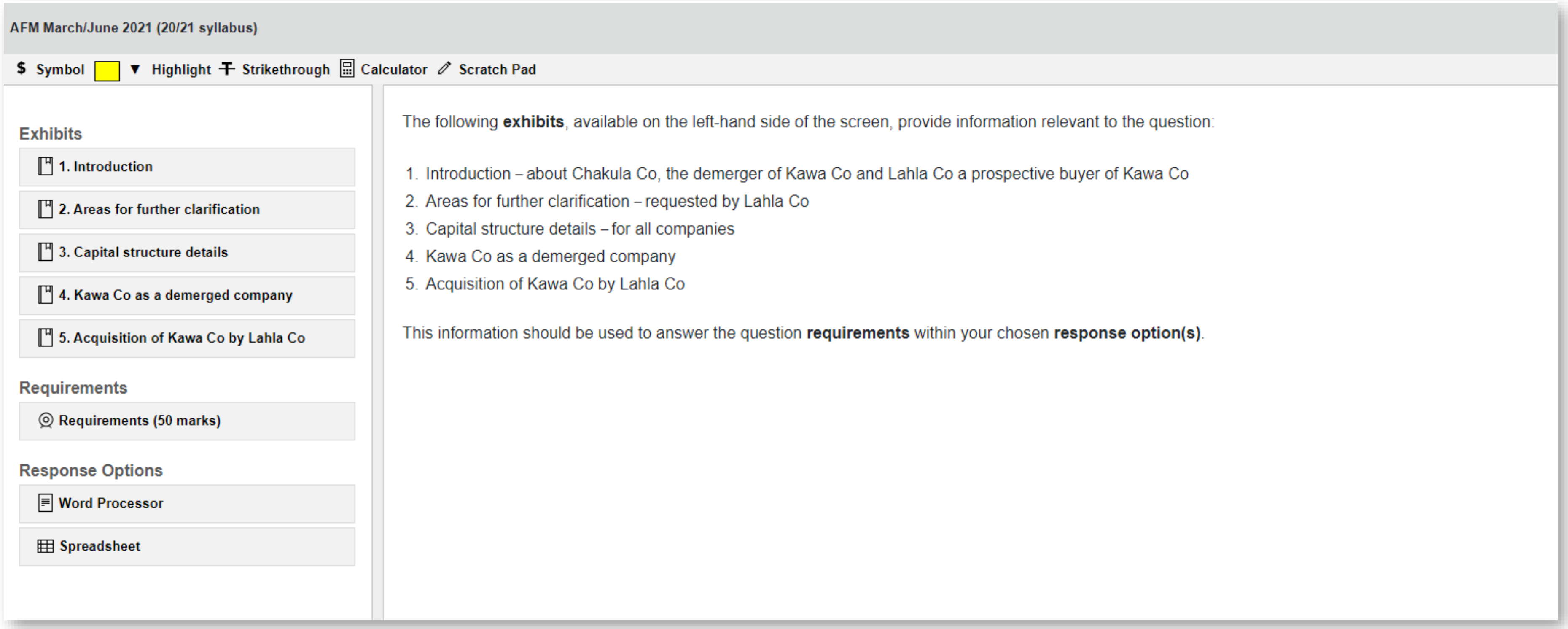
**Important:**

In your live exam, you should:

- Indicate which requirement each of your responses relate to so that this is clear for markers.
- Show all notes/workings that you want the marker to see within your responses. Remember, any notes/workings made on the Scratch Pad or on your workings paper will not be marked.

Select **Next** to continue.

# Scenario 1 – Initial screen



AFM March/June 2021 (20/21 syllabus)

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**Exhibits**

- 1. Introduction
- 2. Areas for further clarification
- 3. Capital structure details
- 4. Kawa Co as a demerged company
- 5. Acquisition of Kawa Co by Lahla Co

**Requirements**

- Requirements (50 marks)

**Response Options**

- Word Processor
- Spreadsheet

The following **exhibits**, available on the left-hand side of the screen, provide information relevant to the question:

1. Introduction – about Chakula Co, the demerger of Kawa Co and Lahla Co a prospective buyer of Kawa Co
2. Areas for further clarification – requested by Lahla Co
3. Capital structure details – for all companies
4. Kawa Co as a demerged company
5. Acquisition of Kawa Co by Lahla Co

This information should be used to answer the question **requirements** within your chosen **response option(s)**.

## Scenario 1: requirements

**Requirements (50 marks)**

**(a) Explain why a regulatory framework related to mergers and acquisitions is necessary to protect the interests of shareholders and other stakeholders.**

(5 marks)

**(b) Discuss the two theoretical propositions, as raised by Lahla Co's board of directors (BoD), in relation to a company's capital structure.**

(6 marks)

**(c) Prepare a report for the BoD of Lahla Co which:**

**(i) Estimates the value of each Kawa Co share if it is demerged and listed as an independent company;**

(12 marks)

**(ii) Estimates;**

- **the additional equity value created when combining Lahla Co and Kawa Co;**
- **the percentage gain to each of Lahla Co's and Kawa Co's shareholder group under each payment method;**
- **the impact on Lahla Co's capital structure under each payment method; and**

(12 marks)

**(iii) Evaluates the financial and other factors that both Lahla Co's shareholders and Kawa Co's shareholders would consider prior to agreeing to the acquisition, and the impact on Lahla Co's capital structure under each payment method.**

(11 marks)

Professional marks will be awarded in part (c) for the format, structure and presentation of the report.

(4 marks)

# Scenario 1: Exhibits

## Exhibit 1: Introduction

1. Introduction

Chakula Co is a large listed company involved in two business sectors. Its main business is in the production of food and drink for supermarkets and other large traders. It also owns a chain of coffee shops nationwide. Chakula Co's board of directors (BoD) thinks that the company is undervalued and is of the opinion that it should focus on the rapid innovation taking place in the food and drink production sector.

Therefore, Chakula Co's BoD has decided to unbundle the coffee shops' business into a company called Kawa Co. Chakula Co will then either demerge Kawa Co through a spin-off or sell Kawa Co. Chakula Co will then turn its full focus on its remaining business of food and drink production. Initially, Chakula Co's shareholders will own Kawa Co on the basis of owning one Kawa Co share for every Chakula Co share owned by them.

Lahla Co is a large unlisted company controlled by 20 shareholders who all have a significant stake in the business. Lahla Co owns a number of hotels around the country and is looking to diversify into the coffee retail business. Lahla Co has approached Chakula Co about the possibility of purchasing Kawa Co. Lahla Co will finance the purchase either through a cash-only offer or a share-for-share offer.

If Kawa Co is demerged, it will be listed on the stock exchange as an independent company. Chakula Co is unsure whether to sell Kawa Co to Lahla Co or to demerge it into an independent company.

## Exhibit 2: Areas for further clarification

2. Areas for further clarification

Further clarification has been sought by Lahla Co's BoD on the following two areas:

(i) Lahla Co's chief executive officer (CEO) has determined that a regulatory framework in the area of mergers and acquisitions is designed to protect the interests of shareholders and other stakeholders. She wants to find out why there is a need for a regulatory framework.

(ii) The acquisition of Kawa Co will be a major investment for Lahla Co and its BoD has concerns about how the acquisition will be financed. The BoD has heard that there are several theories explaining the capital structure of a company, including the following two propositions:

- A company should maximise its debt financing; and
- Too much debt can be harmful to a company and there needs to be a balance between equity and debt financing.

## Exhibit 3: Capital structure details

3. Capital structure details

Extracts from Chakula Co's financial statements are as follows:

| | $m |
|---|---|
| Assets less current liabilities | 5,010 |
| **Financed by:** | |
| Share capital (nominal value $0·50 per share) | 1,000 |
| Reserves | 1,180 |
| Non-current liabilities: Loan notes A (nomimal value $100 per loan note) | 2,470 |
| Non-current liabilities: Loan notes B (nomimal value $100 per loan note) | 360 |

Chakula Co's shares are trading at $2·45 each and have an equity beta of 1·3. The part of the business which will become Kawa Co accounts for 24·5% of Chakula Co's total equity value.

Chakula Co's loan notes A currently have a total market value of $2,100m. Loan notes B currently have a total market value of $400m. The pre-tax cost of debt has been determined at 4·3% for loan notes A and 4·1% for loan notes B. After the unbundling, loan notes B will be serviced by Kawa Co and loan notes A will remain with Chakula Co, but the pre-tax cost of debt for both will increase by 0·3%. It is expected that Kawa Co will maintain its capital structure after the unbundling.

Lahla Co's debt to equity ratio is estimated to be 40:60 in equivalent market value terms and it has 1,200 million shares in issue.

The coffee retail industry is dominated by Buni Co, a large listed company which owns many coffee shops around the country. The average asset beta for the coffee retail industry is estimated at 1·15.

All companies pay corporation tax at a rate of 20% per year and tax is payable in the same year as the profits it is based on. The risk-free rate of return is estimated at 3% and the market risk premium at 7·2%.

## Exhibit 4: Kawa Co as a demerged company

4. Kawa Co as a demerged company

The following estimated information will be applicable to Kawa Co if it is demerged.

Chakula Co's sales revenue is $4,500m currently, of which 20% is attributable to Kawa Co. It is estimated that after Kawa Co is demerged, its annual sales revenue growth rate will be 6% and the profit margin before interest and tax will be 21% of sales revenue, for each of the next four years. It can be assumed that the current tax allowable depreciation will remain equivalent to the amount of investment needed to maintain the current level of operations, but that Kawa Co will require an additional investment in assets of $0·25 for every $1 increase in sales revenue.

After the initial four years, the annual growth rate of the company's free cash flows is expected to be 2·5% for the foreseeable future.

# Exhibit 5: Acquisition of Kawa Co by Lahla Co

5. Acquisition of Kawa Co by Lahla Co

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The following estimated information applies to the acquisition of Kawa Co by Lahla Co, if Kawa Co is acquired.

The average price to earnings (PE) ratio for the hotel industry is 15·61, however, Lahla Co's PE ratio is estimated to be 10% lower than this.

Extracts from the current statements of profit or loss applicable to Lahla Co and Kawa Co are as follows:

| | Lahla Co<br>$m | Kawa Co<br>$m |
|---|---|---|
| Profit before interest and tax | 305·0 | 161·2 |
| Interest | (91·2) | (14·8) |
| Tax (20%) | (42·8) | (29·3) |
| Profit after tax | 171·0 | 117·1 |

After the acquisition, it is expected that the PE ratio of the combined company will be the midpoint between the two individual companies' PE ratios. The annual after-tax profits will increase by $62m due to combining the two companies.

Lahla Co has proposed to pay for acquiring Kawa Co either through a cash offer of $0·66 for a Kawa Co share, or one Lahla Co share for every three Kawa Co shares. Lahla Co will borrow the money needed to pay for the acquisition.

# Exam summary screen (continued)

## Section B

**AFM March/June 2021 (20/21 syllabus)**

### Section B

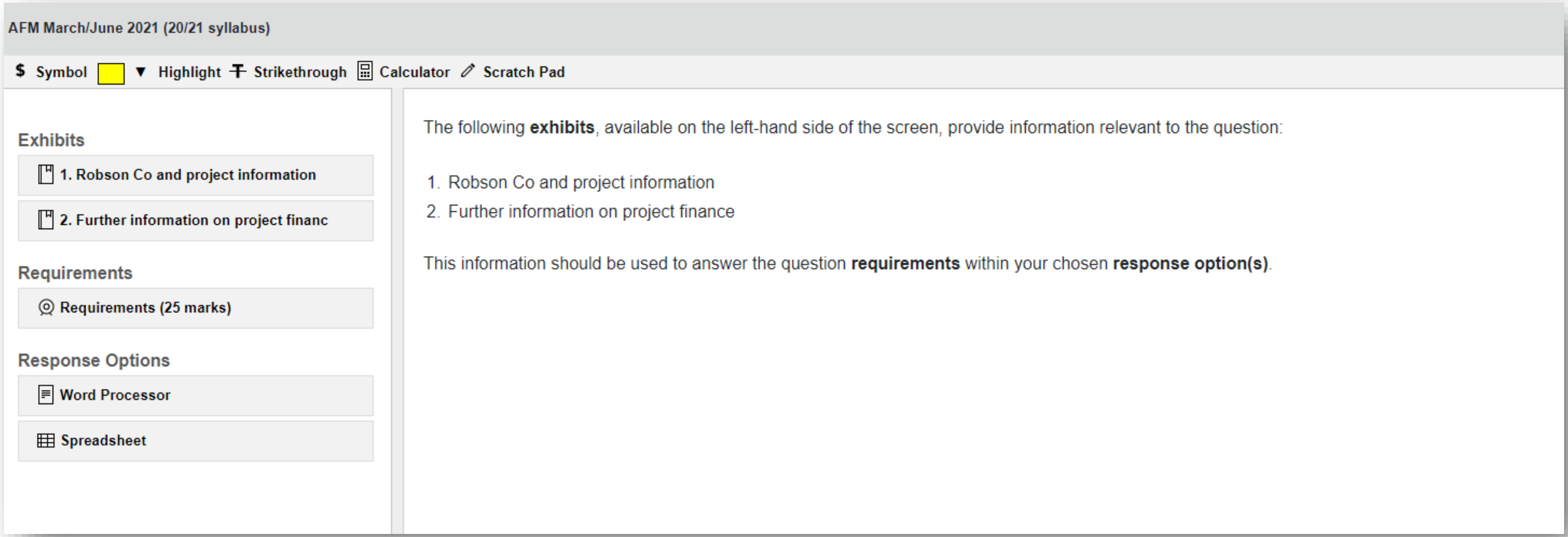
This section of the exam contains **two questions.**
Each question is worth **25 marks** and is compulsory.
This exam section is worth **50 marks** in total.

**Important:**
In your live exam, you should:

- Indicate which requirement each of your responses relate to so that this is clear for markers.
- Show all notes/workings that you want the marker to see within your responses. Remember, any notes/workings made on the Scratch Pad or on your workings paper will not be marked.

Select **Next** to continue.

# Scenario 2 – Initial screen



## Scenario 2: requirements

Requirements (25 marks)

(a) Calculate the adjusted present value of the investment and recommend whether the project should be accepted or not.

(14 marks)

(b) Discuss the factors the capital providers, excluding the bank, will consider before deciding whether or not to approve the funding decision for Robson Co's investment in a new manufacturing plant.

(11 marks)

# Scenario 2: Exhibits

## Exhibit 1: Robson Co and project information

1. Robson Co and project information

Robson Co is a food manufacturer with a portfolio of well-known brands. The founding directors retain a significant minority shareholding in the company and continue to serve on the board following a successful listing ten years ago. After obtaining the listing, Robson Co's gearing ratio increased significantly above the sector average as the result of a poorly timed expansion strategy, mainly financed by debt. Earnings became increasingly volatile and the debt burden triggered a decline in the company's financial performance. The board responded to these problems five years ago by pursuing a debt-reduction turnaround strategy, which has been financed by a series of rights issues and asset disposals.

Even though this strategy successfully reduced the gearing ratio, which is now equal to the industry average, the share price remains depressed due to competitive pressures within the industry. The company's credit rating has recently been downgraded once again. Robson Co's chief executive officer (CEO) has identified an opportunity to relocate the manufacturing plant and develop a state-of-the-art automated production line, which will reduce the underlying cost base and be a source of competitive advantage.

**Project information**

Robson Co's finance director has prepared estimates of the free cash flows generated by the project, based on a four-year time horizon:

| **Year** | **0** | **1** | **2** | **3** | **4** |
|---|---|---|---|---|---|
| | **$m** | **$m** | **$m** | **$m** | **$m** |
| Free cash flows | | 20·9 | 20·6 | 28·7 | 104·6 |

The investment cost is $120m, which Robson Co's CEO proposes to finance as follows:

| | **$m** |
|---|---|
| Disposal of existing manufacturing plant | 20 |
| Rights issue | 10 |
| Subsidised loan, 3·5% annual interest rate | 40 |
| Bank loan, 9% annual interest rate | 50 |
| Total | 120 |

The bank loan is repayable in equal annual instalments over four years. Issue costs of 2% are payable on gross external financing and are not allowable for corporation tax. Issue costs are payable out of available cash reserves. The finance director has asked you to ignore underwriting costs relating to the rights issue.

**Additional information**

Robson Co's current equity beta is 1·418 and the debt:equity ratio is 1:5 based on market values. The risk free rate is 3% and the market risk premium is 9%. The CEO expects the business risk of the company to remain unchanged as a result of the investment.

Corporation tax is payable at an annual rate of 20%.

## Exhibit 2: Further information on project finance

2. Further information on project finance

Page: 1 of 1 Automatic Zoom

The board discussed the financing of the project at a recent meeting. Robson Co's corporate bankers have already approved the funding decision for the $50m bank loan but the finance director is concerned about the following capital providers:

**External shareholders**
The last rights issue took place 18 months ago and there were two others in the previous five years. A group of shareholders have formed an action group to exert pressure on the board for more drastic change. This included a campaign to replace the CEO, which was only narrowly avoided when the shareholders voted at the most recent annual general meeting. The CEO is optimistic about the prospects of a rights issue but suggested underwriting the issue to reduce the risk of failure.

**Founding directors**
The production and marketing directors indicated they would not be able to take up their rights due to personal financial commitments but would otherwise provide full support for the new strategy.

**Subsidised loan provider**
The government funds the subsidised loan programme to boost job creation in the economically deprived northern region of the country, which is where the new automated manufacturing plant is to be located. Although the loan has yet to be approved, the chief executive is optimistic about the outcome of their application. One feature of the loan programme is that it is open to applicants without assets available to provide security although other restrictions may be imposed. This is relevant to Robson Co since surplus assets were disposed of during the turnaround strategy and those which remain will be used to secure the new bank loan.

# Scenario 3 – Initial screen

AFM March/June 2021 (20/21 syllabus)

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**Exhibits**

1. Gogarth Co's currency risk management

2. Board queries about risk management

**Requirements**

Requirements (25 marks)

**Response Options**

Word Processor

Spreadsheet

The following **exhibits**, available on the left-hand side of the screen, provide information relevant to the question:

1. Gogarth Co's currency risk management
2. Board queries about risk management

This information should be used to answer the question **requirements** within your chosen **response option(s)**.

## Scenario 3: requirements

Requirements (25 marks)

(a) Advise Gogarth Co on, and recommend, an appropriate hedging strategy for its US$ cash flows on 31 August. Include relevant calculations.

(15 marks)

(b) Discuss the advantages and disadvantages for Gogarth Co in using exchange-traded currency options compared with using over-the-counter currency options.

(5 marks)

(c) Discuss the role of Gogarth Co's treasury function in relation to the management of economic risk.

(5 marks)

# Scenario 3: Exhibits

## Exhibit 1: Gogarth Co’s currency risk management

1. Gogarth Co’s currency risk management

Gogarth Co is an electrical equipment manufacturer, based in Malaysia, looking to develop its operations abroad. One of its biggest sales markets is the USA and Gogarth Co also imports components from the USA. Gogarth Co regularly hedges transactions in foreign currencies.

It is currently 1 May. On 31 August, Gogarth Co is due to pay $14,500,000 to an American supplier and receive $37,400,000 from an American customer.

The following quotations have been obtained:

**Exchange rates (quoted as US dollar per Malaysian Ringgit US$/MR1)**

| | |
|---|---|
| Spot | 0·2355 – 0·2358 |
| Four months forward | 0·2370 – 0·2374 |

**Currency futures (contract size MR500,000, futures price quoted as US$/MR1)**

| | **Futures price** |
|---|---|
| June | 0·2366 |
| September | 0·2378 |

**Currency options (contract size MR500,000, exercise price quoted as US$/MR1, premium: US cents/MR1)**

| | Calls | | Puts | |
|---|---|---|---|---|
| **Exercise price** | **June** | **September** | **June** | **September** |
| 0·2368 | 0·11 | 0·14 | 0·19 | 0·23 |

Futures and options contracts mature at the month end. The number of contracts to be used should be rounded to the nearest whole number in calculations. If the amount cannot be hedged using an exact number of futures or options contracts, the amount unhedged or over-hedged should be hedged using the forward market. For the purposes of the calculations, it should be assumed that the options are exercised.

## Exhibit 2: Board queries about risk management

2. Board queries about risk management

The head of Gogarth Co's treasury function gave a presentation about the treasury function and what it does to manage foreign exchange risk at the last board meeting. Directors have subsequently raised two questions:

– The marketing director has asked whether Gogarth Co should consider using over-the-counter currency options to hedge exchange rate risk.

– A new non-executive director has stated that he understands what the treasury function does in relation to the management of transaction risk, but is unclear on the treasury function's role in the management of economic risk.