

# Accountancy@UJ



Department of Accountancy

## Financial Strategy

FIS8X00 / FST8X00 / FNB15X7

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### SUPPLEMENTARY ASSESSMENT OPPORTUNITY

03 December 2018

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**Time: 3 Hours 20 minutes (200 Minutes)**

**Marks: 100**

**Assessor:** Mr K Thomas

**Internal Moderator:**

Mr B Mogapi

**External Moderator:**

Ms S Jooste

#### INSTRUCTIONS:

- Question 2 of the assessment consists of **6** pages (including the cover page).
- Remove the password from all the files (File / Protect Document / Encrypt with Password).
- Answer question 2 in the MS Word and MS Excel **answer templates** provided. Show all calculations and workings clearly.
- The question 1 objective test questions (OTQ's) are available separately on uLink. The OTQ's are not printed in the question paper and **MUST** be answered electronically.
- Silent, non-programmable financial calculators may be used.
- Where applicable, round all calculations to two decimal places, unless stipulated otherwise.
- You are allowed 15 minutes reading time during the assessment. The purpose of the reading time is to allow you an opportunity to read through the question paper and, if you wish, make annotations on the question paper as well as to plan your answers.
- You are allocated 5 minutes to upload your answers into uLink.
- Do not use a tick mark ✓ as a bullet when answering the required.
- **The printed question paper MUST be handed in at the end of the assessment.**
- Good Luck!

| Question | Topic                                                                 | Marks      | Time               |
|----------|-----------------------------------------------------------------------|------------|--------------------|
| 1        | Reading and Uploading Answer Templates                                | ---        | 20 minutes         |
|          | Objective Test Questions – Various Topics (See uLink)                 | 50         | 90 minutes         |
| 2        | Case Study Question – Financing Decision, Mergers & Dividend Decision | 50         | 90 minutes         |
|          |                                                                       | <b>100</b> | <b>200 minutes</b> |

## QUESTION 2

**[50 marks]**

You are provided with the unseen case material below. This unseen case material should be read in conjunction with the pre-seen material in answering the required for question two.

**Assume today is 01 January 2017 (as the financial information in the pre-seen is for the period up to 31 December 2016).**

### **Introduction**

Evestar is a large, listed company in Teeland. Evestar is quoted (listed) on the Teeland Stock Exchange, reports using International Financial Reporting Standards (IFRS) and has the T\$ as its currency.

Evestar is Teeland's largest producer of "reality" television, when measured by revenue from programme sales. Reality television is a generic title for programmes that are largely unscripted and put participants in "real-life" situations that may be simulated.

### **Acquisition of Evestar**

Ed Lanson (Finance Director) called you into his office when you arrived at work this morning. Ed indicated that what he was about to tell you was confidential at this stage and should not be shared with anyone else yet. He had permission to discuss this confidential information with you.

Ed mentioned that IndTV are considering acquiring control of Evestar. Jennifer Watson (IndTV's Chairperson) met with Denny White, the Chief Executive Officer (CEO) and Chairman of Evestar, last night and outlined a proposal to acquire a controlling interest in Evestar on the basis of a share for share exchange. Jennifer explained to Denny that "IndTV wishes to obtain greater control over the production companies that provide its programmes. IndTV believes that acquiring control over Evestar would give it control over important programmes such as Teeland Variety as well as some influence over any future programmes that Evestar develops.

However, following the acquisition, Evestar will be free to continue to develop and sell reality programmes as before, including making sales to competing television networks. Jennifer expects annual synergistic after-tax benefits of T\$41 million to arise for the combined company as a result of cost savings.

Denny will not be the CEO and Chairman of the combined company, but will be offered a seat on the Board of Directors. Denny has stated that he wants Evestar's Board of Directors to resist the takeover approach by IndTV.

### **Planned bid offer for Evestar**

Due to the size of the takeover, initial plans are for IndTV to offer 3 IndTV shares for 10 Evestar shares (i.e. 1 for 3.33 shares). No official announcement has been made to the market concerning the potential takeover.

### **Financial information for Evestar**

A relevant extract of Evestar's financial statements for the year ended 31 December 2016 is provided below (refer to the pre-seen material on pages 18 – 19 for the financial extracts relating to Evestar):

## QUESTION 2 (CONTINUED)

**[50 marks]**

### Financial information for Evestar (Continued)

#### Statement of Profit and Loss of Evestar for the year ended 31 December

|                           | 2016<br>T\$m | 2015<br>T\$m |
|---------------------------|--------------|--------------|
| Revenue                   | 261          | 242          |
| Cost of sales             | (96)         | (79)         |
| Gross profit              | 165          | 163          |
| Administrative expenses   | (29)         | (22)         |
| Advertising and promotion | (21)         | (22)         |
| Operating profit          | 115          | 119          |
| Finance charges           | (20)         | (20)         |
| Profit before tax         | 95           | 99           |
| Tax expense               | (23)         | (22)         |
| Profit for the year       | 72           | 77           |

#### Statement of Financial Position of Evestar as at 31 December

|                                              | 2016<br>T\$m | 2015<br>T\$m |
|----------------------------------------------|--------------|--------------|
| <b>ASSETS</b>                                |              |              |
| <b>Non-current assets</b>                    | 418          | 412          |
| Property                                     | 184          | 188          |
| Plant and equipment                          | 188          | 173          |
| Intangibles – programme development          | 46           | 51           |
| <b>Current assets</b>                        | 40           | 42           |
| Trade receivables                            | 26           | 24           |
| Cash and cash equivalents                    | 14           | 18           |
| <b>TOTAL ASSETS</b>                          | <b>458</b>   | <b>454</b>   |
| <b>EQUITY AND LIABILITIES</b>                |              |              |
| <b>Equity attributable to equity holders</b> | 174          | 171          |
| Share capital and share premium              | 50           | 50           |
| Retained earnings                            | 124          | 121          |
| <b>Non-current liabilities</b>               | 250          | 250          |
| Bonds                                        | 250          | 250          |
| <b>Current liabilities</b>                   | 34           | 33           |
| Trade payables                               | 10           | 9            |
| Tax payable                                  | 24           | 24           |
| <b>TOTAL EQUITY AND LIABILITIES</b>          | <b>458</b>   | <b>454</b>   |

## QUESTION 2 (CONTINUED)

**[50 marks]**

### Financial information

Additional financial information as at 31 December 2016 is provided below:

|                                               | <b>IndTV</b> | <b>Evestar</b> |
|-----------------------------------------------|--------------|----------------|
| Corporate income tax rate                     | 25%          | 25%            |
| Earnings (i.e. profit after tax) for the year | T\$357 m     | T\$72 m        |
| Forecast earnings growth (in perpetuity)      | 7%           | 4%             |
| Ordinary shares in issue (millions)           | 1 000 m      | 500 m          |
| Share price (today)                           | T\$4.29      | T\$1.30        |

### Additional information

- You may assume a risk free rate of 6% and an expected return on the market of 13%.
- Evestar's equity beta is not available, but IndTV's and Evestar's asset betas are expected to be quite similar. IndTV's equity beta is quoted as 0.9.
- The only non-current liability that IndTV currently has is a 5 year bank-loan of T\$1 000 million. Evestar's bonds are currently trading at par.
- You may assume that the debt betas are all zero.
- The market value of Evestar's property was recently valued by a professional valuer at T\$250 million.
- It may be assumed that Evestar's bondholders would accept the change of ownership of Evestar's business and would reassign Evestar's bonds to IndTV.
- Evestar's historical ordinary dividend policy (up to 31 December 2016) has been to follow a constant pay-out rate of between 90% to 100% of earnings. This has resulted in an average annual historical dividend growth rate of 6%.
- Evestar's future cash flows attributable to all investors can be assumed to be approximately 95% of its annual earnings (i.e. profit after tax) and will arise at the end of each year.

**THE REQUIRED FOR QUESTION 2 STARTS ON PAGE 5**

## QUESTION 2 (CONTINUED)

**[50 marks]**

### PART A

#### REQUIRED:

2.1 **Calculate** an appropriate:

- (a) Cost of equity; **and**
- (b) Weighted average cost of capital (WACC) using market values of Evestar at 01 January 2017.

**(7)**

2.2 **Calculate** a range of values (in total **and** per share) for Evestar as at 01 January 2017 using the following valuation methods (use a cost of equity of 13% and a WACC of 11%, where appropriate):

- (a) Assets;
- (b) Dividends;
- (c) Earnings; **and**
- (d) Discounted cash flow (DCF).

**(11)**

2.3 **Calculate** the following forecast post-merger values for IndTV following the acquisition of Evestar (assuming the acquisition goes ahead):

- (a) Combined number of shares;
- (b) Combined earnings per share (EPS);
- (c) Share price of IndTV, assuming the current P/E ratio of IndTV is maintained and the synergy achieved;
- (d) The total value of the proposed bid; **and**
- (e) The percentage of shares owned by Evestar's shareholders in the combined company.

**(7)**

#### NOTE:

- Show all workings clearly.
- Round answers to 2 decimal places, where applicable.
- State any assumptions you consider necessary.
- You **MAY** answer 2.1, 2.2 and 2.3 in either MS Word or you can use the attached MS Excel template.
- Please ensure that you upload the MS Excel template into uLink if you make use of it.

**(Total for question 2 Part A = 25 marks)**

## QUESTION 2 (CONTINUED)

**[50 marks]**

### PART B

#### REQUIRED:

2.4 Assume you are a senior manager at Evestar. **Prepare** an e-mail addressed to the board of directors that:

- (a) **Identifies** the type of merger that will occur between IndTV and Evestar if the acquisition goes ahead **and provide** a reason/s for your answer; (2)
- (b) **Discusses** the strategic benefits **and** risks of IndTV acquiring Evestar; (9)
- (c) **Evaluates** Evestar's current dividend policy; **and** (7)
- (d) **Advises** on suitable reactive measures to resist the takeover bid by IndTV. (4)

#### NOTE:

- You **MUST** answer 2.4 in MS Word.
- Marks will be awarded for structure and presentation. (3)

**(Total for question 2 Part B = 25 marks)**

**(Total for question 2 = 50 marks)**

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**Total = 100**