LEARNING

ACT Practice Paper

Diploma in Treasury Management (AMCT)

Unit 1: Corporate finance for treasury

This is a practice paper for Unit 1 of the Diploma in Treasury Management (AMCT), based on the syllabus assessed from 01 August 2022.

INTRODUCTION

This practice paper has been produced by the Awarding Body at the Association of Corporate Treasurers (ACT) to assist students in their preparation for the Diploma in Treasury Management assessments. It contains a practice exam for the specified unit as well as the answers. Ideally, students should have completed the majority of their Diploma in Treasury Management studies for Unit 1 before attempting this practice paper.

Students should allow themselves 180 minutes to complete the exam plus an additional 25 minutes reading time. They should then review their performance to identify areas of weakness on which to concentrate the remainder of their study time. Although the practice paper in this guide is typical of a Diploma in Treasury Management assessment, it should be noted that it is not possible to test every single aspect of the syllabus in any one exam.

To prepare properly for the examination, candidates should make full use of the tuition options where available and read as widely as possible to ensure that the whole syllabus has been covered.

ASSESSMENT TECHNIQUE

This is a professional paper that as well as testing theory expects application to practice at a managerial level.

The best way to approach written assessments is to work methodically through the questions. Candidates should not spend too much time on any one question if you are struggling to think of an adequate answer. Remember you can flag any question to come back to later should you want to continue your way through the exam.

When all the questions have been answered, it is prudent to use any remaining time to go through each question again, carefully, to double-check that nothing has been missed. Altering just one response could make the difference between passing and failing.

Please ensure you show your workings within your answer when prompted as this means there are marks available for the workings out. You will be able to make rough workings on a piece of paper during the exam and on screen should you wish to, however these will not count towards your final mark.

ASSESSMENT INFORMATION AND TEST SPECIFICATION

The Diploma in Treasury Management assessments for Units 1 and 2 each have 4 written questions, of which you must answer 3, and will involve a pre-seen case study workbook, for Section A only, that is released no later than two weeks prior to the assessment date. The papers will be split into sections A and B and each unit exam is worth a total of 100 marks. For the purpose of this practice paper the questions follow each case study.

Diploma in Treasury Management assessment test specification:

Section	Number of questions	Marks available
Section A	1 case study based question	50
Section B	3 shorter case study based questions, of which candidates chose to only answer two	50
Total	3	100

Under exam conditions, 3 hours (180 minutes) is allowed for each of the Diploma in Treasury Management assessments plus an additional 25 minutes reading time.

When you take your actual exam, you will be sitting online using your own PC/Laptop. You have access to an online scientific calculator, but for the purpose of this practice paper, you may use a non-programmable scientific calculator.

In order for you to determine how well you have performed, exemplar answers are listed at the end of this paper. There are also references to the relevant Learning Outcomes if you need to revisit the associated material.

SECTION A – 50 marks

Answer ALL questions in Section A. This questions tests knowledge, analysis, application, insight, evaluation and justification as appropriate to level descriptors. This is a professional paper and application to practice should be at 'management' level.

Total available for Section A: 50 marks

Section A, Question 1 Case Study

Background

GetActive (GA) is the UK's largest sporting goods retailer by revenue and operates a diversified portfolio of sports, fitness, fashion and lifestyle products throughout the UK, Europe, the USA and Asia.

GA aims to be a leading sports and lifestyle retailer internationally and to deliver sustainable growth for shareholders in the medium to long term.

The company provides a full multi-channel retail approach in the UK, and increasingly in continental Europe and the rest of the world. GA also wholesales and licenses its group brands to partners in the UK, continental Europe, the Americas and the Far East. It continues to enhance and grow its store portfolio and operates 740 stores in the UK and internationally.

GA operates through four strategic business units: UK Sports Retail, International Sports Retail, Brands and Premium Lifestyle.

UK Sports Retail

Revenue for the financial year 2022: GBP2,136.4m, up 6.3% on the prior year, 65.8% of total group revenue.

UK Sports Retail includes the group's 450 core sports retail store operations in the UK, all of the group's sports retail online business globally and the group's fitness division.

International Sports Retail

Revenue for the financial year 2022: GBP665.6m, up 38.0% on the prior year, 20.5% of total revenue.

International Sports Retail includes all the group's 290 sports retail stores, management and operations outside of the UK, including the group's US and European distribution centres.

Brands

Revenue for the financial year 2022 GBP241.1m, up 4.1% on the prior year, 7.4% of total revenue.

The Brands unit operates the globally renowned Peak Group Brands, and GA's wholesale, licensing and distribution relationships across the world, as well as partnerships with third party brands that GA license-to sell particular products.

Premium Lifestyle

Revenue for the financial year 2022: GBP202.2m, up 11.6% on the prior year, 6.2% of total revenue.

The group's Premium Lifestyle unit offers a broad range of clothing, footwear and accessories from leading global contemporary and luxury retail brands through stores in the UK.

Five-year financial summary

GBPm	2018	2019	2020	2021	2022	5-Year CAGR
Revenue	2,186.0	2,706.0	2,833.0	2,904.0	3,245.3	10.4%
% growth	19.1	23.8	4.7	2.5	11.8	
Gross profit	894.8	1,154.9	1,240.8	1,285.0	1,330.6	10.4%
% growth	20.2	29.1	7.4	3.6	3.5	
Underlying EBITDA	287.9	331.1	383.2	381.4	272.7	(1.3%)
% growth	19.9	15.0	15.7	(0.5)	(28.5)	
Underlying basic EPS	NA	NA	NA	NA	11.4p	NA
% growth	NA	NA	NA	NA	NA	NA
Weighted average number of shares	NA	NA	NA	NA	583.5m	NA

Notes on cash and financing structure

GA has no debt and has GBP350m of cash on the balance sheet, which continues to grow each year despite being partly reinvested.

GA does not currently have a credit rating. One of the directors has recommended that steps are taken to acquire a full public credit rating now. Although there are no immediate plans to issue debt on the capital markets, the director feels it may be worthwhile to obtain a rating now ensuring smooth access to capital markets if and when GA decides to issue a bond.

Initial public offering (IPO)

The company is currently owned by a retail entrepreneur. GA is planning to list its stocks on a stock exchange to take advantage of favourable market conditions. However, following the listing, the owner plans to retain a 61% ownership in the business.

The company also sees significant opportunity for growth in the US market. One of the directors suggested a dual listing in the US and the UK to potentially fund initiatives planned for the US. The owner is sceptical of the benefits and implications of a dual listing.

Consultants

GA has appointed a renowned consultancy company to provide advice and guidance.

The consultancy company has wide and deep expertise in treasury management, corporate finance and strategy. GA is keen to have the consultancy company's observations and advices on best practice.

Q1		
	(a) Compare and contrast the requirements for GA of listing on a US stock exchange as compared to the London Stock Exchange.	10 marks
	(b) Justify the case for the dual listing of GA's shares.	7 marks
	(c) Discuss the extent to which holding excess cash can contribute to the maximisation of shareholder wealth for GA's shareholders.	10 marks
	(d) Discuss any alternatives to a full credit rating which may be appropriate for GA at this stage, given it is expected that access to the capital markets will be required at some stage in the future.	15 marks
	(e) Evaluate how GA's treasury department can add value to the business in managing shareholder relations following the IPO.	8 marks
		Total: 50 marks

Q1 answer

(a) — 10 marks

	In the UK	**In the US**
Structure of offering	GA can opt for one of the following: 1) a premium listing of the main market of the London Stock Exchange – this requires a min market capitalisation of GBP30m and a three-year historical track record for revenue	GA will have to start the registration process with the U.S. Securities and Exchange Commission.

	2) standard segment of the main market 3) the Alternative Investment Market, which is for early stage growth companies and there is not minimum requirement for market capitalisation.	
Documentation	In both countries, GA will have to provide a prospectus along with underwriting agreement, comfort letters from external auditors, legal opinions among other official documentations.	
Corporate governance requirement	In the UK, GA will have to comply with the UK Code of Corporate Governance if it decides to get a listing on the main market.	In the US, GA will have to comply with the Sarbanes-Oxley Act.
Financial Reporting requirements	Ongoing reporting of financial statements will need to be prepared in accordance with International Financial Reporting Standards.	Financial statements will need to be translated to the US GAAP.
Board requirement	If Get GA opts for a premium listing, in accordance to the UK Corporate Governance Code its chairman must be independent and must not act as CEO. The majority of the board should comprise independent non-executive directors. The size of the board should also be proportionate to the size of the company although at least three INEDs will be required to follow the recommendations on board committees.	The board must have an Audit committee with independent directors.

(b)

7 marks

- Dual listing refers to a listing of financial securities from the same company on more than one exchanges.
- Dual listing provides companies with increased access to capital through a broader and more diversified investors base.
- It increases the liquidity of the financial instruments and enable securities to be traded over a longer time zone.
- Dual listing helps to raise the profile on the company beyond its domestic market.
- Dual listing however comes with significant compliance costs, as the company will have to comply and report to the different requirements prevalent within each exchange.
- Dual listing may also increase the requirement for the investor relation team to engage and communicate with investors from the different markets.
- The dual listing can assist with payments for local acquisitions through share exchanges instead of cash, and it can also avoid FX risk for domestic shareholders.

(c)

10 marks

To maximise shareholder wealth surplus cash should be invested in projects with returns above hurdle rate. In the absence of such projects, return the cash to shareholders-dividend or share buyback: or use it for supply chain finance.

Why cash balances may contribute to shareholder value?

In the Global Financial Crisis and lockdowns during the COVID-19 pandemic, when revenues stopped but overheads continued, "cash is king". Survival means avoiding liquidation with the consequent "fire sales" of assets. The retail sector in which GA operates in, is notoriously volatile and as such retaining cash provides an element of headroom/stability to the financial wellbeing of the company.

Bank facilities such as Revolving Credit Facilities are less easily available and, in some cases, banks cannot be relied upon to honour them: "the scars from the credit crunch" – when banks suddenly pulled their credit lines – are even fresher. A whole host of companies have since learnt that they can't necessarily rely on the banks being there when they need them and have increased their own balances accordingly. The external environment, especially given ongoing trade wars and Brexit provide significant risks for GA.

Why these "cash piles" might destroy valve or be examples of consequences of agency theory rather than shareholder wealth maximisation:

- motive could be "survival", so managers keep their jobs
- having surplus cash gives managers more discretion- avoids scrutiny of projects by lenders
- returns on cash are low, net interest "cost of carry" high if cash obtained by borrowing
- agency reasons that are explicit in GA where managers pursued self-interested projects that build empires and generate bonuses but destroy shareholder wealth for example the purchase of hotels and jets.

(d)

Many unrated companies, such as GA consider obtaining a credit rating to ensure smooth capital markets access. As a first step to obtaining a public rating such companies are increasingly using the different services offered by the rating agencies to assess their credit rating. Two of the options GA may consider instead of a public credit rating are outlined below.

15 marks

Rating evaluation/assessment services

Private rating evaluation/assessments services are typically used for internal purposes to help GA better understand what a full rating outcome might be, or what the potential impact of a key financing transaction might be on its credit profile. GA must understand it is essentially a point-in-time desktop exercise and not a firm credit rating, nor is it monitored on an ongoing basis. The two-to-three-page report typically takes eight to 10 business days to produce and contains an analysis of public information, but does not include any management meetings and is not sanctioned by a ratings committee (and thus is not a formal rating opinion or even a rating indication).

It is reviewed by the sector rating analysts for policy consistency, but is little more than a point in time view with no ongoing obligation on either side. This compares with a full (private or public) internal credit rating process which takes four to eight weeks and involves more in-depth analytics, a Management Meeting and a formal Ratings Committee.

Private credit rating

If GA gained a full corporate credit rating, it can choose to publish the rating or maintain the rating on a private/confidential basis. Both Moody's and S&P offer a confidential monitored rating service whereby they maintain the confidential credit rating periodically similar to a public rating and the rating can be published on request. Public dissemination of a private credit rating is not permitted.

Overall, it would be recommended that GA engage with a private rating as a first step.

Other considerations for GA

Public guidance

Guidance provided publicly to debt investors concerning ratings can give support to the rating. For example, publicising the company "target rating" will be seen as a moral commitment, and will give investors and agencies comfort that GA are committed to a given financial policy. Clearly this undertaking carries its own risks and could impose certain constraints on a company to necessitate hitting a specific rating target.

Credit ratings through the cycle

Although rating agencies claim to "rate through the cycle", this generally reflects the framework (including ratio targets) and not the potential cyclical recovery prospects of a rated entity.

"What if" rating analysis

When considering a first-time rating or a rated issue, or if unsure of the impact of a corporate event (such as an acquisition or debt raise) on an existing rating, it can make sense for GA to take advice from a ratings adviser. Given that GA may well optimise their balance sheet, i.e. add debt, such analysis is crucial.

Book-runners often offer some form of advisory service as part of the overall issue process but it is important to be comfortable that the incentives of any adviser are closely aligned with those of GA to deliver the best possible rating (to minimise cost of capital and maximise flexibility of financing), rather than delivering terms which might work best from an underwriting perspective. In this respect, an independent rating adviser may be particularly valuable when employed at an early stage in the process, before structure has been determined and banks mandated.

The agencies will offer a desktop credit assessment as a rating guideline (as discussed above). However, if greater certainty of rating outcome is required, the agencies can provide firm rating guidance on a private basis of rating outcome under a particular corporate scenario (e.g. the raising of GBPXm and return of cash or an acquisition) under their Rating Evaluation/Assessment Service. The former generally takes two to three weeks and the latter four to eight weeks (but both can be done more quickly in certain situations).

Better answers would also comment on rating risk, such as these below.

GA should be cognisant that it is possible for a rating agency to change its approach or fundamental view of a sector without any change occurring to the credit profile of a company in the "real world".

Rating agencies can also change their analytical approach to a specific accounting item, such as lease accounting, that presumably impacts GA. However, as the capital markets become more transparent and investors and issuers more critical, this risk is diminishing.

In the context of capital markets issues, it has become fairly standard for investment grade bond issues to have coupon step-ups which are triggered by ratings downgrades (typically on descent to non-investment grade). For GA, maintaining investment grade credit ratings is crucial to avoid a steep increase in debt financing costs if debt is issued.

Overall, it would be recommended that GA engage with a private rating as a first step.

(e)

The goal for GA should have been to have had an upgraded finance function in place on the day of the IPO. That way, GA has the people, processes and systems it needs to enable the needed controls and reporting mechanisms right from the start. To go public, a GA's finance/treasury function should have had in place/will need to address:

8 marks

- process standardisation and automation and data management capabilities equal to the financial compliance and reporting demands placed upon public companies
- capacity and capabilities that support the control environment and optimise finance operations
- processes that include a calendar of filings (quarterly and annual financial reports and necessary proxy filings), as well as scorecards
- methods of working with business unit heads to leverage strategic opportunities associated with having access to the public equity markets and to the base of investors and amounts of capital which that access affords.

Better answers would consider that these changes that GA must make are a reasonable cost of doing business, given the potential value of access to the public capital markets. In other words, an upgrade to the finance function is part of the price GA pays for access to the public equity market.

https://www2.deloitte.com/content/dam/Deloitte/ie/Documents/Finance/CFO/ready_for_ipo_spotlight_deloitte_2012.pdf

GA faces numerous new risks in areas such as compliance and reporting, and with regard to legislation that applies only to public companies and also face an audience of investors, regulators, analysts, and journalists who have become sensitised to risk issues. This generates greater risks to reputation, which can jeopardise GA's base of customers and investors, which evidently has been the case.

Therefore, GA requires:

- formal risk management (and governance) structures and practices
- ways for management to identify, assess, and manage risk and to communicate with the GA board about risks and risk management
- mechanisms for disclosing risks and risk management methods to the public, particularly in light of new requirements regarding risk disclosures
- ways of systematically prioritising risks and of allocating risk management resources and management time and attention to specific risks.

Other key issues that better answers should address include:

- establishment and engagement of investor relations
- dealing with analysts
- need to consider information flow and releases – i.e. management of price sensitive information
- closed dealing periods
- window dressing at year end – i.e. chasing up monies due and delaying payments
- considering the tax consequences of the anticipated use and flow of IPO proceeds
- readying the tax function with qualified staff and appropriate tax return and tax financial statement reporting processes and supporting IT systems
- benchmarking against comparable public companies
- considering the tax and other implications of changes to compensation and benefit plans, particularly for the executive team, given that issues such as changes to the legal entity, deferred compensation, share transfers, and secondary offerings can significantly affect their net worth and the employer's compliance processes
- GA will need to put in place more rigorous segregation of duty controls.

Total: 50 marks

SECTION B – 50 marks

Answer TWO of the following THREE questions. Questions test knowledge, analysis, application, insight, evaluation and justification as appropriate to level descriptors. This is a professional paper and application to practice should be at 'management' level. Candidates are expected to be able to synthesise knowledge from different elements of the syllabus rather than be tested on discrete areas.

Total available for Section B: 50 marks

Section B, Question 1 Case Study

Background

Liber Ltd (LL) is one of the last remaining chains of specialist bookshops on the UK and US high streets. LL is staffed with passionate, knowledgeable booksellers, selling the right range of books for the local market, who are ready to recommend the book that customers did not know they wanted.

The local aspect is hugely important to Liber, and the "one size fits all" approach is firmly in the past. No two LL bookshops are the same, with each shop tailoring its range to reflect the trends and interests of their local market, as well as the big national bestsellers that are in demand across the country. The local approach also extends to the Café Liber locations across the UK, where the company aims to bring the best produce from local suppliers to cut down on food miles and support the local business community.

LL has recently reported an 80% jump in annual profits, with the bookseller predicting an even brighter future just six years after the rise of the ebook threatened its existence.

LL announced that pre-tax profits increased from GBP20m to GBP36m in the year to April 2022 due to cost savings and a shift away from selling low margin academic course books into more profitable products like stationery and toys. 2021 was the first time LL had made a profit since the 2008 financial crisis. Sales in 2022 were flat at GBP404m.

Non-book items accounted for more than 10% of sales and that LL carries far fewer textbooks and technical books since ten years ago.

Analyst comments

An analyst commented that: "the product mix has changed fairly significantly. The business is better run with every passing year. It's run with fewer people both in store and at head office. Also, given the carnage witnessed on the high streets, the economics of running some stores had been improved by falling rents when leases were renewed".

Ownership and funding profile

Given the more positive environment, LL decided to expand and opened five new bookshops in the UK last year and will open another 15 in the UK this year, and 12 in the US.

LL continues to be privately owned and has no plans to list. In the past it has managed to be self-funding. However, as the business expands and given the changing nature of how the book market works, the company is looking at appointing a relationship bank to aid with their expansion plans in the US and to advise on a bond issue. The company is exploring a US bond issue either via the US market or the Eurobond market to raise funds for this expansion. The

company is likely to seek around USD75m-USD100m. Whilst reluctant to get a rating, the company accept that this might be necessary.

Q1	(a) Discuss the key criteria that LL should use when selecting a relationship bank and maintaining an effective long-term relationship with the bank. (b) Recommend and justify whether a US bond or a USD-denominated Eurobond would be the most suitable for LL.	10 marks 15 marks
		Total: 25 marks

Q1 answer	(a) The criteria that Liber should use when selecting a bank, and for developing a long-term working relationship, should include the following: • the amount of financial support (balance sheet support) the bank is prepared to give Liber. Financial support means not only the level of committed borrowing facilities from the bank but also the willingness of the bank to support business development, such as acquisitions or capex which may demand substantial funding • the capital adequacy and credit rating of the bank. This is particularly important when the general level of credit quality for banks is relatively low, such as in a period of recession or slow economic growth. If a bank is financially stretched, it might be unable to extend sufficient credit lines to Liber • the bank's ability to deliver good quality customer service to Liber and operate efficiently. Operating efficiency is particularly important; mistakes at the processing level need to be kept at a minimum to avoid management time being taken up with mundane matters such as the incorrect processing of cheques or the incorrect transfer of funds between bank accounts • the bank's reputation and management quality. There is now a much greater awareness of corporate governance and the way that organisations are managed. Just as banks will be aware of the corporate governance practices of their large corporate customers, so too should Liber monitor the corporate governance of banks and select their bank (or banks) accordingly • the bank's sophistication. Banks should have sufficient capacity to match the key requirements of Liber (i.e. FX, funding and cash management) along with the advice needs of Liber • the bank's territorial spread. The bank should have sufficient territorial reach in its operations to match the corresponding geographical diversity of Liber (i.e. a good	10 marks

presence in the US and other areas Liber might expand into), otherwise 'local banks' will need to be used in specific geographical locations. This would not be convenient or effective for Liber

- the bank's product portfolio. Is it able to offer a proven portfolio of products and services to meet the requirements of Liber?
- the bank's ability to understand the book retail sector
- the bank's ability to innovate. The corporate might want to select a bank able to offer its customers new products or services. Areas such as payment innovation would be crucial to Liber
- the bank's price-competitiveness. Liber should be aware of the prices charged for products and services in the marketplace and ensure that the chosen banks remain competitive, although not necessarily the cheapest
- the bank's willingness to maintain (where possible) the same relationship manager for several years. It is frustrating when the relationship manager changes on a regular basis since on every occasion Liber will have to invest time developing an understanding of the business from a new relationship manager.

Liber should monitor the appointed bank by:

- keeping abreast of news on the banking sector
- reviewing each bank's strategy with a senior bank manager
- ensuring that ratings of the relationship banks are monitored on a regular basis (including monitoring CDS spreads, bond prices and share price performance)
- checking whether the bank's personnel changes on a regular basis
- ensuring that each is clear about the exact relationship and expectations under different circumstances
- Liber should monitor the service quality of each bank.

(b) US debt markets

15 marks

US investors comprise the deepest, most liquid and arguably most sophisticated of all global fixed income investor bases. Liber could raise debt finance in the US markets in four ways:

- a public bond – registered with the Securities and Exchange Commission (SEC) and traded freely in the debt markets (this type of dollar instrument is commonly known

as a "Yankee"– a US domestic bond issued by a non-US resident)

- a quasi-public bond – not registered with the SEC but tradable by qualified institutional buyers (QIBs) in secondary markets ("144A issues" as issued under the Rule 144A exemption from SEC registration)
- a private placement – not listed or traded, but placed directly with a small group of institutional investors which will typically own the note to maturity
- Liber borrow USD and swap into GBP if required via a relationship bank that could be used to finance Liber's future UK expansion plans as well as US expansion programme.

Liber would require two formal debt ratings (usually from Standard & Poor's and Moody's) to issue a Yankee and these are commonly obtained for a 144A bond. Both rated and non-rated companies can execute private placements.

Yankee and 144A issues are typically underwritten by an investment bank, thus indicating the need for Liber to appoint a suitable bank. Private placements are not usually underwritten but are undertaken on a "best efforts" basis. Most public US bonds are between USD300m and USD1bn in size, so a PP might be the most suitable/viable for Liber.

Private placements can be arranged in any size from USD25m to USD300m, and sometimes even more. The term is usually between five and 12 years. Deals can be split between (for example) a five-year and a 10-year tranche if the Liber prefers and investor demand permits. Documentation for a US private placement has become increasingly standardised. Some financial covenants are usually required.

<u>Eurobond markets</u>

A Eurobond (or international bond) is a publicly traded debt instrument with a standard format admitted to listing by a listing authority, typically the UK Financial Conduct Authority, the Luxembourg Commission de Surveillance du Secteur Financier or the Central Bank of Ireland and/or admitted to trading on a recognised exchange, typically the London, Luxembourg or Irish Stock Exchanges. Eurobonds are usually bearer instruments, with legal title evidenced by production of the Note, whether in global or definitive form.

Liber payment of coupons and repayment of the principal at maturity is affected through the two main euromarket clearing systems, Euroclear or Clearstream, Luxembourg, or can be made

manually by presentation of the note to or to the order of a paying agent if held in definitive form.

The Eurobond market is split into different currency sectors, e.g. the Eurodollar sector, the Eurosterling sector, and, the “euro” sector. These different sectors each have their own characteristics deriving from the composition of the domestic investor base and the degree of non-domestic demand for the currency:

Eurodollars – typical issue size between USD100m and USD500m. As such Liber would probably be able to get a USD100m issue away but this is at the top end of its expected issuance. The standard maturities are three, five, seven and 10 years.

One thing of note for Liber is that Eurobonds are bought by investors globally free and clear of withholding tax – as such it could have to manage a diverse investor base.

There are, however, selling restrictions in most countries which will often restrict sales to retail buyers. There are additional stringent regulations governing sales into the US and generally speaking a bearer Eurobond cannot be sold into the US until 40 days after closing, and even then there are further restrictions if the notes form part of the underwriter’s original allocation.

Documentation is more straightforward and less extensive than for a Yankee or 144A issue, particularly in the case of an investment grade issuer. Liber would not formally need a credit rating to access the Eurobond markets, but, typically, investors will only buy rated issues. Thus at least one long-term rating from Standard & Poor’s, Moody’s or Fitch is the norm.

Choosing between the different bond markets will depend upon several criteria that Liber will need to consider:

- relative pricing levels
- amount required
- choice of investor base
- most appropriate maturity for the business
- preferred currency (taking account of the availability and cost of the appropriate currency swaps)
- covenants
- ease of documentation/management time; and
- subject to the above discussion on ratings requirements for a Eurobond, need for a rating.

Comparing the US and Eurobond markets: Treasurers handbook

	Liber Advantages	**Liber Disadvantages**
US/Yankee/ 144A/ private placements	• Gives secure term finance and spread of refinancing risk • Establishes access to the world's deepest investor base • Largest issue size • Longest available maturities (except possibly for the Eurosterling market) • Flexible structures available	• Usually more expensive than bank debt except for very best AAA, AA and some A-rated companies • Yankee and 144A-documentation relatively onerous and expensive • US private placements require covenants • Inflexible – prepayment usually expensive
Eurobonds / MTN	• Provides term debt and enables spreading of refinancing risk • Establishes new permanent investor base capable of speedy access • Advent of euro gives an investor base to rival the US in terms of size • MTN market permits opportunistic financing	• Usually more expensive than bank debt except for very best AAA, AA and some A-rated companies • Inflexible – prepayment usually expensive • MTN programme expensive to set up and can involve significant management time if renewed each year

	• Straightforward and time efficient procedures and documentation	

Better answers will discuss market conditions. Market conditions are impacted by a number of factors. Macro-economic global events can lead to large moves of global capital and big changes in investor sentiment which impacts both bond prices and liquidity. This has been particularly marked in recent times, post "Credit Crunch" and owing to "Eurozone crisis" concerns. Domestic economic trends such as monthly releases of inflation data and employment numbers can be important indicators as to future moves in interest rates and can alter market sentiment – with USD rates moving higher recently. The relative strength of USD will influence overseas investors and affect the flow of funds.

Finally, the volume of other bond issues and the market reaction to these will also be a key factor in determining new issue conditions.

Total: 25 marks

Section B, Question 2 Case Study

QCL Ltd (QCL), an asset management company.

Potential investments

QCL has shortlisted two companies (Beta and Kappa) for potential investments. Below is some financial information relating to these two companies:

	Beta	**Kappa**
	(USDm)	**(USDm)**
Revenue	550.0	450.0
Interest	(9.0)	(18.0)
Profit before tax	66.0	42.0
Income tax	(20.6)	(18.0)
Net income	45.4	24.0
Dividend declared	(20.0)	(20.0)
Transfer to retained earnings	25.4	4.0
Book value of equity (USDm)	320	120
Book value of loans & debentures (USDm)	150	200
Annual interest rate for loans & debentures	6%	9%
Number of shares (m)	32	10

Beta and Kappa are both quoted companies with stock prices of USD14.00 per share and USD12.50 per share, respectively, at the start of the financial year. Figure 1 shows the monthly closing stock price for the two companies.

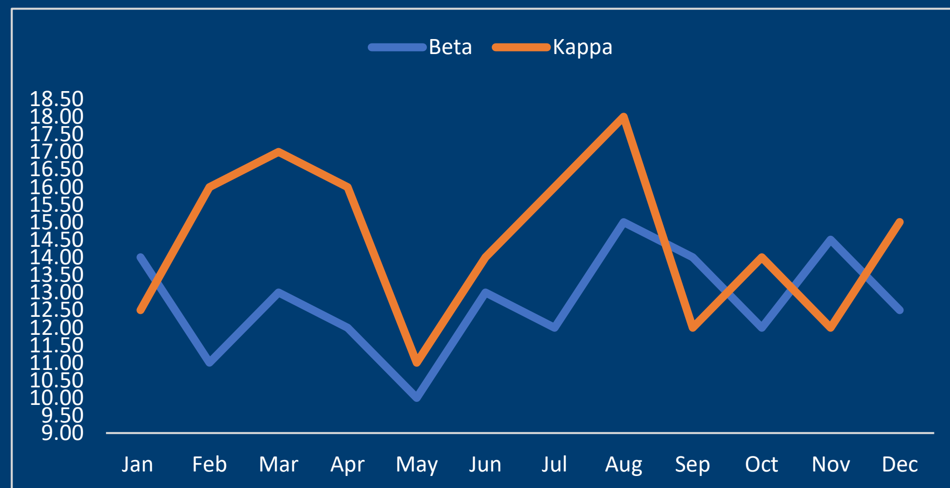

Figure 1: Monthly closing stock prices for Beta and Kappa

At the start of the financial year, the two companies indicated their targeted return of equity to be between 16% to 20%. The loans and debentures are unquoted debt instruments issued at fixed interest rates.

Rights issues within the portfolio

QCL also holds a portfolio of stocks, fixed income securities, cash and other liquid assets. Within the portfolio, QCL has 15,000 shares in Alpha. Alpha announced a rights issue of two new shares for five existing ones at USD72.50 per share.

Additional information

The following additional information is available on Alpha, Beta and Kappa:

- Alpha's stocks were trading at USD75 per share before the announcement of the rights issue
- Beta's effective tax rate is 27.5% and Kappa's is at 30%
- analysts estimated Beta's cost of equity capital to be 12.5% and 15% for Kappa.

Q2

(a)

i. Calculate and comment on the weighted average cost of capital for Beta and Kappa. You are required to show your workings. (4 marks)

ii. Using **THREE** metrics, assess the value that Beta and Kappa created for their shareholders during the financial year 2022. (9 marks)

(b) Calculate, showing your workings, the theoretical ex-rights market value of Alpha plc's share. If QCL decides to take 60% of the rights issue and sell the remaining 40%, assess the effect on its portfolio. (8 marks)

(c) For an asset management company, like QCL, with portfolios made up of stocks of listed companies, discuss whether markets operate in the "strong form" of market efficiency as described by the Efficient Market Hypothesis. (4 marks)

Total: 25 marks

Q2 answer

Mark scheme

This mark scheme is not exhaustive – all valid points within answers will be awarded marks.

(a)

Part a i)

4 marks

	Beta	**Kappa**	**Marking scheme**
WACC	10.28%	10.03%	(1.5 mark x 2) = 3 marks

Appropriate comments = 1 mark

SP	12.5	15
mkt cap equity	400,000,000.00	150,000,000.00
loans	150,000,000.00	200,000,000.00
Tc	27.50%	30.00%
Ke	12.5%	15.0%
Kd	6.0%	9.0%
Kd after tax	4.35%	6.30%
d/(d&e)	0.272727273	0.571428571
d/(d&e)*Kd*(1-Tc)	0.011863636	0.036
E/(D&E)	0.727272727	0.428571429
E/(D&E)*Ke	0.090909091	0.064285714
WACC	10.28%	10.03%

9 marks

Part a ii)

	Beta	**Kappa**	**Marking scheme**
Economic Value Add (EVA) calculation:			Definition & limitation of EVA (0.5 mark + 0.5 mark) = 1 mark
NOPAT	54.4	42	
WACC	10.28%	10.24%	
Capital employed	550	350	(0.5 mark x 2) = 1 marks
EVA	**(2.15)**	**6.15**	**(0.5 mark x 2) = 1 marks**
			Total mark for EVA = 3 marks
Total Shareholder's Return (TSR)			Definition & limitation of TSR = 1 mark
Capital (loss) / gain	(1.50)	2.50	Calculation of capital gain (0.5 mark x 2) = 1 mark
Dividend income	0.63	2.00	Calculation of dividend income (0.5 mark x 2) = 1 mark
Total shareholder's return	0.87	4.50	
Total shareholder's return %	(6.3%)	36%	Calculation of TSR (0.5 mark x 2) = 1 mark
			Total marks for TSR = 4 marks
Return on Equity (ROE)	17.0%	35.0%	Definition & limitation of ROE (0.5 mark + 0.5 mark) = 1 mark
			Calculation of 1 mark
			Total marks for ROE = 2 marks

Total marks = 3 + 4 + 2 = 9 marks

Part b)

9 marks

					Marking scheme for each correct step
Number of shares	15,000				
	Shares		**USD**		
Current holding	5	Value	75	375	
Rights	2	Cost	72.5	145	
Total	**7**		**74.29**	**520**	
New market value - TERP			74.29		2 marks
Value of rights	(75 - 72.50)	2.5			1 mark
				USD	
Current value of portfolio (15,000*75)				1,125,000	
New portfolio					
Shares (15,000 + (60% x 2/5 x 15,000) at GBP74.29)	18600			**1,381,714**	
	Number of shares	**Value $**			
Sale of rights	2400	6,000			1 mark
Cost of rights	3600	(267,429)			1 mark
Impact on portfolio				**1,120,286**	1 mark

Part c)

	Arguments against the strong form of efficient market hypothesis: - recurrence of financial crises is evidence that markets do not operate in the strong form - market imperfections due to overconfidence, overreaction, herd behavior - though illegal, corporate insiders' dealings do exist - empirical evidence demonstrated that markets do not operate within the strong form - other relevant points. Implications for the asset management company: - to be aware that stock prices may not capture full information; when trading on the stock markets and doing any portfolio rebalancing or adjustment - to consider the market imperfections when trading to exploit any identified arbitrage opportunities - any other relevant points. Marking scheme Argument against stock markets being able to operate in the "strong form" 1 mark x 2 = 2 marks Implications for the portfolio manager: 1 mark x 2 = 2 marks Total marks =4 marks	4 marks
		Total: 25 marks

Section B, Question 3 Case Study

AlphaJo Ltd (AJ) is a medium-sized private company specialising in advertising in public areas through billboards, public transport and street furniture. It has recently appointed a new chief financial officer (CFO).

Corporate governance

The founder holds the roles of chief executive officer (CEO) and chairperson of the board of directors (BOD). The founder has 52% of the shareholding within the company and the rest is owned by several small shareholders. Most of these small shareholders are current and former employees of AJ and some private equity companies. The small shareholders tend to take a rather passive role in directing and controlling the company. Of the existing eight board members, the founder has personally appointed six. Three of these board members are close relatives and the other three are school friends.

Growth plan

To fund the growth of the business, the founder loaned the company substantial funds with no fixed repayment date at an effective annual interest of more than 20%. These loans are treated as part of the long-term debt on the company's financial statements and were approved by the founder and a former treasury manager. The CFO realises that the interest that AJ pays is significantly higher than the current market rates. The company has no other outstanding loans and debentures.

With the CFO's support, the founder has developed an ambitious international expansion plan, which the board has approved. To implement this plan, AJ will need additional funding and the board has agreed to issue new shares to some of the existing private equity firms.

The founder is pleased with the CFO's work and has promised significant additional financial incentives to the CFO in terms of salary increases and employee stock options. The main condition is that the CFO must structure a solution that prevents the founder's shareholding from dilution after the additional capital injection. The founder also recommended the CFO to consider converting part of the company loan into equity and/or issue new classes of shares without any voting rights given. The founder's view is that the private equity shareholders have historically had little interest in running the business as long as the return is positive. As this matter is salary related, the founder has requested the CFO to keep the conditions and additional incentives confidential.

Financial information

AJ has historically paid high dividends, which the founder views positively as this would imply that the company will need to issue a small number of shares at an already high valuation.
Below is some financial information on AJ.

	2019	**2020**	**2021**	**2022**
	(USDm)	**(USDm)**	**(USDm)**	**(USDm)**
Revenue	10.0	18.0	25.0	28.0
Net income	1.2	3.2	4.0	5.6
Dividend paid during the year	0.9	2.8	3.7	6.0
Total equity	7.0	7.4	7.7	7.3

Total long-term debt	5.0	10.8	17.5	16.0

AJ currently has one million outstanding shares – all with voting rights.

Q3

(a) Evaluate AJ's current dividend policy and its impact on AJ's plan. 9 marks

(b) Advise AJ's board of the adverse financial impacts of a weak system of corporate governance. 10 marks

(c) Discuss the ethical issues the CFO will be facing in their new role. 6 marks

Total: 25 marks

Q3 answer

Mark scheme

This mark scheme is not exhaustive – all valid points within answers will be awarded marks.

Part (a) 9 marks

	2019	2020	2021	2022
	(USDm)	(USDm)	(USDm)	(USDm)
Dividend paid during the year	(0.9)	(2.8)	(3.7)	(6.0)
Change in capital employed		6.3	6.9	(2.6)
Dividend pay-out ratio	75%	86%	93%	107%

Based on the above analysis:

- for a growth company, which needs funding, the company has a high dividend pay-out ratio. The already high ratio increased in the last year to a point that exceeded its net income
- dividends over the last four years grew by more than 88%. The board should enquire whether such high pay out and growth in dividend is the norm within the industry and also the expectation considering the company's growth potentials and expectations
- if during the financial years 20X2 and 20X3, AJ did not pay any dividend, it would have borrowed at least 45% lesser that the amount it took as loans
- should AJ continue to distribute dividends at such high pay-outs, it will have difficulties financing its ambitious international expansion plan, unless it raises additional capital
- AJ does not seem to have a sound and formal dividend policy. Given that it is currently a private company, this is not surprising that the payout policies are influenced by the expectations of individual shareholders
- it will be good that the board to reflect on its priorities and articulate a clear policy that will help the company to manage its expectations for growth and provide a reasonable cash return to its shareholders
- reinvesting the net income in profitable projects will increase shareholders' wealth and will reduce the need to raise loans. This

helps in keeping the gearing ratios at a reasonable level. Thus, reducing the financial risk and the company's cost of capital
- any other valid points and observations.

Part (b)

10 marks

It is essential for companies to operate with a strong system of corporate governance. Companies with weak corporate governances' practices expose them to disproportionate risks that harm their long-term value creation capabilities to the extent that they destroy value for shareholders, stakeholders and society. Some of the risks/financial impacts that companies with weak corporate governance are exposed to are:

- accounting risks: the risk that the financial statements of the company are incomplete, misleading or materially misstated
- assets on are misappropriated by employees, managers or directors
- the management enters into excessive obligations that increase its liabilities (including excessive directors' compensations)
- management enters into contracts that can result in unwarranted off-balance-sheet obligations
- management enters in related party transaction which are not at arms-length – for example the high interest rate loans
- actions by the company that negatively impact stakeholders and the society
- management enters into strategic ventures that increase business risk but are not in the long-term interest of shareholders
- these practices destroy shareholders' value
- some examples are: Enron, Worldcom, Theranos, etc.

The lack of independence/conflict of interest between the non-executive directors and CEO, and the dual positions of the CEO also poses a corporate governance issue.

Companies that have strong corporate governance practices have robust internal governance policies. Codes of conduct and ethics are an important part of such policies. These internal codes of conduct and ethics help:

- to promote honest and ethical conduct within the organisation
- to ensure accountability across all levels
- to comply with laws, rules and regulations
- to improve timely and fair reporting

	Benefits to the company: • helps to build a strong, capable qualified board • improves transparency, accountability and corporate responsibility • may reduce capital cost • reinforces the system of internal control, governance, including performance management • any other relevant points. **Part (c)** Some of the requests from the CEO might pose some ethical threats to the CFO: • whilst there appears nothing wrong with maintaining confidentiality on salary-related matters, in this case, the proposal from the CEO puts the CFO in a difficult position • the CFO should clarify he or she will act in the best interests of the board and its shareholders (including the minority shareholders with non-controlling interests) • the CFO should ensure that any variable remuneration and stock options are aligned to the overall performance of the company not to serve any specific interest of selected board members or selected shareholders. In other words, the CFO should not accept any rewards or incentives that would impair his integrity and independence of judgement. In this case, the condition for the salary increases and employees stock options is more for the personal interest of the CEO less for the company • the CFO should not embark on implementing any change in the shareholding without approval from the board or which are not in compliance with the law and regulations • the CFO should ensure that they and their function provide independent and transparent information to the board and the shareholders. This includes information like the company's actual cost of capital and also possible ways to optimise it • in other words, the CFO should act with integrity, independence, high professional competence and conduct • any other relevant points or reference to the ACT's Ethical Code to guide the CFO (and CE0 and board) on the way forward and how to tackle the conflicts.	6 marks
		Total: 25 marks

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