
Answers

1 Chakula

- (a) The key reason for a regulatory framework to exist in merger and acquisition (M&A) activity is to ensure that the interests of stakeholders are protected, and where the natural market forces may not be sufficient on their own to ensure that this happens. The regulatory framework aims to ensure a well-functioning market for corporate control.

With respect to shareholders, as a major stakeholder group, the regulatory framework aims to establish that shareholders of the target company are not affected negatively by ensuring that:

- Minority shareholders' rights are protected;
- The target company's management cannot block a M&A where it is in commercial and economic interest of shareholders; and
- Sufficient time is made available for a proposal to be properly scrutinised. The regulatory framework also aims to ensure that sufficient information is provided about the proposed M&A for all investor groups to evaluate the proposed deal properly.

With respect to other stakeholders, the aim of the regulatory framework is to ensure that there is not a substantial lessening of competition after the M&A has taken place. This will protect the choice that consumers, suppliers and employees have in engaging with a range of organisations in that business sector, and within a properly functioning economic market.

- (b) The two theoretical propositions are based on the opinion that a company's capital structure does matter to the value of the company. The first proposition posits that since debt is cheaper than equity and there is a 'tax shield' attached to debt finance, it is better for a company to be financed by as much debt as possible. This is the view presented by the Modigliani and Miller with taxes model. Since interest is paid before a company pays corporation tax, but dividends are not, a company does not have to pay taxes on profits used to pay interest. This is referred to as a tax shield. The presence of a tax shield results in the cost of capital reducing as the proportion of debt financing increases.

The second proposition builds on this by arguing that although debt carries with it the advantage of a tax shield, at high levels of gearing this position no longer holds true. Here, financial risk increases significantly and the company experiences increasing levels of financial distress, resulting in the cost of equity increasing significantly. This overrides the benefits gained from the tax shield. As a result, the cost of capital increases. At very high levels of gearing, even the cost of debt starts to increase significantly. Hence, there is a trade-off between the benefits of the tax shield and the costs related to financial distress, such that the cost of capital reduces initially but then rises, meaning that there is an optimal, minimum cost of capital where corporate value is maximised.

(c) Report to the board of directors (BoD), Lahla Co

This report evaluates and discusses the financial and other factors that both Lahla Co's and Kawa Co's shareholders would consider prior to agreeing to the acquisition. It also evaluates and discusses the impact of the acquisition on Lahla Co's capital structure under the two payment methods.

Factors to consider

Demerger (Appendix 2)	Additional value created for Kawa Co's shareholders 18·3%	
Acquisition, cash payment (Appendix 3)	Additional value created for Kawa Co's shareholders 10·0%	Additional value created for Lahla Co's shareholders 22·0%
Acquisition, share-for-share exchange (Appendix 3)	Additional value created for Kawa Co's shareholders 26·7%	Additional value created for Lahla Co's shareholders 14·0%

The initial evaluation would indicate that the demerger is the better option for Kawa Co's shareholders, compared to the acquisition, if the acquisition is paid for by cash. However, the share-for-share exchange gives a higher return compared to the demerger and therefore, on purely financial grounds, this is the best option for Kawa Co's shareholders. Although Lahla Co's shareholders lose some additional value derived from the acquisition if the share-for-share option is chosen, they would probably still be in favour of the acquisition because the company's value will increase and so will the value of their shares.

However, the following additional factors also need to be considered in the evaluation:

The value estimates are based on predicted variables, both for the demerger valuation and for the acquisition valuations. It is likely that there will be changes to the actual variables, and it is recommended that Lahla Co undertake sensitivity analysis and assess the results of this before making the final acquisition decision.

Kawa Co's shareholders probably have three main areas they would want considered further with respect to the acquisition with the share-for-share exchange.

First, they would become part of a larger company with interests both in hotels and in coffee shops and they would own just under 36% (667m shares/1,867m shares) of the share capital of the new combined company. However, they would be minority shareholders. As such, they may feel that they do not have sufficient influence in the major decisions the company makes.

Therefore, Kawa Co's shareholders may be of the opinion that operating as a stand-alone demerged independent company may give them a better opportunity to shape the company's strategy. On the other hand, they may equally decide that they would need to be part of a large company to be able to compete effectively against Buni Co.

Second, Kawa Co's shareholders cannot be certain whether the 26.7% additional value is realistic or not. This may be especially pertinent because Lahla Co is an unlisted company and therefore may keep proprietary/strategic information private, limiting the ability for external parties to undertake a full and effective evaluation.

Third, because Lahla Co is an unlisted company, Kawa Co's shareholders may be concerned about how they would be able to exit the company, if they want to. For instance, if their investment portfolios become imbalanced when the companies are combined, they may need to sell some shares to rebalance it. Lahla Co should consider the possibility of undertaking a partial listing in order to make the deal more palatable for Kawa Co's shareholders.

In addition to ensuring that the acquisition is financially beneficial for them, Lahla Co's shareholders' main concern would be that Kawa Co's shareholders will own a significant portion of the combined company (just under 36%). This could mean that the new shareholders would have a significant influence on the way the company is run and its strategic direction, which may be different to what Lahla Co's current shareholders want.

Capital structure changes

Capital structure	Equity	Debt
Original: Lahla Co	60.0%	40.0%
Cash payment: Combined company (Appendix 3)	46.9%	53.1%
Share-for-share exchange: Combined company (Appendix 3)	68.0%	32.0%

The cash payment option means that the proportion of market value of debt increases significantly and is higher than the market value of equity. This would probably increase the costs related to financial distress and future borrowing costs would increase as a result.

On the other hand, the share-for-share exchange increases the proportion of equity compared to debt financing. This may reduce financial distress costs, but also reduce Lahla Co's ability to benefit from the tax shields.

On the face of it, it would appear that Lahla Co would find it difficult to raise the funds needed through just debt financing, although the BoD could explore this option further. Equity finance through a partial listing may be a necessary option which Lahla Co will need to explore as well, although this may require Lahla Co to disclose private information to the markets.

Tutorial note: Additional consideration which could be made

If the cash payment to Kawa Co's shareholders is increased to \$0.71/share, to bring it in line with the value obtained from the demerger, and the funding is sought from debt financing, then the debt percentage compared to total firm value will increase to 53.8% (as shown below):

[\$0.71 x 2,000m shares = \$1,420m.

Market value of equity: \$2,933.7m, 46.2%

Market value of debt = (\$1,601.7m + \$1,420m + \$400m) = \$3,421.7m, 53.8%]

Conclusion

The share-for-share exchange gives the highest return for Kawa Co's shareholders and also makes a good return for Lahla Co's shareholders. The impact on capital structure from this method is a higher percentage of equity and therefore scope to raise more finance through debt if required.

However, concerns that Lahla Co is unlisted and complications arising from this might make the cash payment method the preferred one for Kawa Co shareholders. The current cash offer is less than the value generated from the demerger and therefore unlikely to be accepted. Therefore, a cash offer to match the benefit from the demerger would need to be made. The initial cash offer and a higher revised cash offer would have a significant impact on Lahla Co's capital structure in terms of increased debt. Therefore, it is recommended that Lahla Co should consider equity finance through a partial listing. This would also enable Kawa Co's shareholders to trade their shares and thereby make the deal look better for them.

Report compiled by:

Date

(Note: Credit will be given for alternative and valid discursive comments)

Appendices:

Appendix 1: Estimate of Kawa Co cost of capital (Part (c)(i))

Kawa Co, market value of equity = $24.5\% \times (\$2.45 \times 2,000 \text{ million shares}) = \$1,200\text{m}$ approximately
 Kawa Co, market value of debt = \$400m

Kawa Co, estimate of equity beta = $1.15 \times (\$1,200\text{m} + \$400\text{m} \times 0.8) / \$1,200\text{m} = 1.46$

Kawa Co, cost of equity = $3\% + 7.2\% \times 1.46 = 13.51\%$

Kawa Co, post tax cost of debt = $4.4\% \times 0.8 = 3.52\%$

Kawa Co, cost of capital = $(13.51\% \times \$1,200\text{m} + 3.52\% \times \$400\text{m}) / (\$1,200\text{m} + \$400\text{m}) = 11.01\%$, say 11%

Appendix 2: Estimate of Kawa Co equity value if demerger is undertaken (Part (c)(i))

Current sales revenue attributable to Kawa Co = $20\% \times \$4,500\text{m} = \900m

Per year, sales revenue growth rate = 6%

Profit before interest and tax (PBIT) = 21%

Tax rate = 20%

Additional asset investment = \$0.25/\$1

Cost of capital (appendix 1) = 11%

Per year, free cash flow growth rate after first four years = 2.5%

Cash flows, years 1 to 4 (\$m)

Year	1	2	3	4
Sales revenue	954.0	1,011.2	1,071.9	1,136.2
PBIT	200.3	212.4	225.1	238.6
Tax	40.1	42.5	45.0	47.7
Additional asset investment	13.5	14.3	15.2	16.1
Free cash flows	146.7	155.6	164.9	174.8
Present value of free cash flows (11%)	132.2	126.3	120.6	115.1

Corporate value, years 1 to 4: \$494.2m

Corporate value, year 5 onwards: $(\$174.8\text{m} \times 1.025 / (0.11 - 0.025)) \times 1.11^{-4} = \$1,388.5\text{m}$

Total corporate value: \$1,882.7m

Value attributable to equity: $75\% \times \$1,882.8\text{m} = \$1,412.0\text{m}$

Per share value = $\$1,412.0\text{m} / 2,000 \text{ million shares} = \0.71 per share

Kawa Co original value = $\$1,200\text{m} / 2,000 \text{ million shares} = \0.60 per share

Gain = $(\$0.71 - \$0.60) / \$0.60 = 18.3\%$, if Kawa Co gets demerged

Appendix 3: Sale of Kawa Co to Lahla Co (Part (c)(ii))

Lahla Co PE ratio = $90\% \times 15.61 = 14.05$

Lahla Co equity value = $14.05 \times \$171.0\text{m} = \$2,402.6\text{m}$

Kawa Co equity value = \$1,200m

Kawa Co estimate of PE ratio = $\$1,200\text{m} / \$117.1\text{m} = 10.25$

Profits after tax of combined company = $\$171.0\text{m} + \$117.1\text{m} + \$62\text{m} = \350.1m

Average PE ratio of combined company = $(14.05 + 10.25) / 2 = 12.15$

Estimate of equity value of combined company = $\$350.1\text{m} \times 12.15 = \$4,253.7\text{m}$

Additional equity value created from combining the two companies = $\$4,253.7\text{m} - (\$1,200\text{m} + \$2,402.6\text{m}) = \651.1m

Cash offer

Chakula Co's shareholders will receive \$0.66 per share from sale of Kawa Co, or $\$0.66 \times 2,000 \text{ million shares} = \$1,320\text{m}$ in total

Kawa Co original value per share = \$0.60

Gain = $\$0.66 / \$0.60 = 10\%$

Lahla Co's total shareholders' value is estimated at = $\$4,253.7\text{m} - \$1,320\text{m} = \$2,933.7\text{m}$, or $\$2,933.7\text{m} / 1,200 \text{ million shares} = \2.44 share

Lahla Co estimate of original value = $\$2,402.6\text{m} / 1,200 \text{ million} = \2 per share

Gain = $\$0.44 / \$2 = 22\%$

Share-for-share offer

Additional shares issued by Lahla Co = $2,000 \text{ million} / 3 = 667 \text{ million}$

Equity value of combined company = \$4,253.7m

Per share value = $\$4,253.7\text{m} / 1,867 \text{ million shares} = \2.28

Gain to Kawa Co's shareholders

$\$2.28 - (\$0.60 \times 3) = \$0.48$

$\$0.48 / \$1.80 = 26.7\%$

Gain to Lahla Co's shareholders from combining the company

$(\$2.28 - \$2) / \$2 = 14.0\%$

Lahla Co: Impact on capital structure from the two payment methods

Lahla Co, before acquisition

Market value of equity: \$2,402·6m (see above)

Market value of debt = $40/60 \times \$2,402\cdot6m = \$1,601\cdot7m$

Combined company, cash payment through debt borrowing

Market value of equity: \$2,933·7m or 46·9%

Market value of debt = $\$1,601\cdot7m + \$1,320m + \$400m^* = \$3,321\cdot7m$ or 53·1%

(Note: $\$2,933\cdot7m + \$3,321\cdot7m = \$6,255\cdot4m$; 46·9% = $(\$2,933\cdot7m/\$6,255\cdot4m) \times 100\%$ and 53·1% = $(\$3,321\cdot7m/\$6,255\cdot4m) \times 100\%$)

Combined company, share-for-share exchange

Market value of equity: \$4,253·7m or 68·0%

Market value of debt: $\$1,601\cdot7m + \$400m^* = \$2,001\cdot7m$ or 32·0%

(Note: $\$4,253\cdot7m + \$2,001\cdot7m = \$6,255\cdot4m$; 68·0% = $(\$4,253\cdot7m/\$6,255\cdot4m) \times 100\%$ and 32·0% = $(\$2,001\cdot7m/\$6,255\cdot4m) \times 100\%$)

* In the above cases, when the two companies are combined, it is assumed that Lahla Co will continue to service loan notes B or cancel them by paying them off through an equivalent borrowing.

2 Robson

(a) Project cash flows: All figures are in \$m

Year	0	1	2	3	4
Cash flows	(120·0)	20·9	20·6	28·7	104·6
Discount factors – 14% (w1)	1·000	0·877	0·769	0·675	0·592
Present values	(120·0)	18·3	15·8	19·4	61·9

Base case net present value = (\$4·6m)

Base case net present value is negative and on this basis should therefore be rejected.

Financing side effects: All figures are in \$m

Issue costs (w2)	(2·0)
Tax shield on subsidised loan (w3)	0·9
Tax shield on bank loan (w4)	2·0
Subsidy benefit (w5)	5·7
Total benefit of financing side effects	6·6

Recommendation

The adjusted present value of the project is \$2·0m and so the project should be accepted.

Workings:

Working 1 (w1): Ungeared cost of equity

$$\beta_a = \beta_e \times [MV_e/(MV_e + MV_d(1-t))]$$

$$\beta_a = 1·418 \times [5/(5 + 1(0·8))] = 1·222$$

$$K_{eu} = r_f + \beta_a(r_m - r_f) = 0·03 + (1·222 \times 0·09) = 14\%$$

Working 2 (w2): Issue costs

$$\$100m \times 0·02 = \$2,000,000$$

(Note: Issue costs are payable out of cash reserves, so the finance does not need to be grossed up)

Working 3 (w3): Tax shield on subsidised loan

$$\text{Annuity factor (9%, 4 years)} = 3·240$$

$$\$40m \times 0·035 \times 0·20 \times 3·240 = \$907,200$$

(Note: The risk free rate would also be acceptable as a discount rate)

Working 4 (w4): Tax shield on bank loan

Annual repayment = \$50m/3·240 = \$15,432,098

Year	1 \$ 000	2 \$ 000	3 \$ 000	4 \$ 000
Opening balance	50,000	39,068	27,152	14,164
Interest at 9%	4,500	3,516	2,444	1,275
Repayment	(15,432)	(15,432)	(15,432)	(15,432)
Closing balance	39,068	27,152	14,164	7
Tax relief on interest (20%)	900	703	489	255
Discount factor (9%)	0·917	0·842	0·772	0·708
Present value	825	592	378	181

Total present value = \$1,976,000

Working 5 (w5): Subsidy benefit

Subsidy benefit = \$40m x (0·09 – 0·035) x 0·80 x 3·240 = \$5,702,400

(b) Factors each capital provider may consider

External shareholders

The chief executive's optimism regarding the rights issue may be misplaced. Robson Co's shareholders may question the need for another rights issue so soon after the last one. Nor may they have the funds available to take up their rights, particularly when there has been a series of fund raising exercises in the last six years. Whilst in theory the shareholders are able to sell their rights, this would mean accepting a dilution in their voting power, which may not be acceptable. Therefore it is possible a rights issue could fail. Even if Robson Co has the issue underwritten, failure of the rights issue would have an adverse impact on Robson Co's share price and the market's confidence in the board.

Shareholders may question the logic behind the new project and whether the forecast results can be delivered. They may need reassurance that lessons from the past have been learnt. The underwriting costs have been ignored in the financial appraisal even though these are likely to be significant and may prove fatal to the final outcome, particularly when the project's APV is quite marginal at \$2m.

The loan will mean that Robson Co's gearing once again exceeds the average and shareholders will require higher returns to compensate for the increase in financial risk. The shareholders may question whether the commitment to service and repay the new loans may mean that Robson Co will have difficulty paying an acceptable level of dividend.

Founding directors

The directors may also lack the funds required to take up their rights but their participation is likely to be critical to the success of the rights issue. Any reluctance to participate could send a signal to external investors that the risks involved in the new project are too high, particularly when there are information asymmetries about the project.

Tensions between the board and shareholders have increased to the extent that the shareholder action group only narrowly lost a recent vote to replace the CEO. If the directors do not take up all of their rights and the rights issue is still successful, the balance of power may alter in favour of the action group if there was ever a renewed effort to remove the board.

Subsidised loan provider

The subsidised loan programme provides capital for investment with the objective of boosting employment in a deprived part of the country. Since the funds ultimately originate from the taxpayer, the government is accountable for any funding decisions made. Robson Co's ability to service and ultimately repay the debt is therefore paramount. Robson Co's credit rating provides an assessment of the probability of default and the recent downgrade may cause concern. Even though Robson Co is unable to provide assets for security, the directors may still be faced with other covenants, for example, restrictions on dividends or further borrowing which may upset shareholders.

The subsidy means demand for such loans is likely to be high and the selection criteria difficult, so it is unlikely that the outcome is a foregone conclusion in the way Robson Co's CEO suggests. Based on the information provided, it is unclear whether the new project would meet those selection criteria. Although Robson Co's new project is to be located in an area targeted for regeneration, it remains the case that the objective of the move is to automate the production line. Whilst jobs may still be created in a deprived area, net job creation nationwide is still likely to be negative. Whether such a policy would be attractive to the government, or the taxpayer, remains to be seen.

(Note: Credit will be given for alternative and valid comments)

3 Gogarth

(a) Net receipt

$$\$37,400,000 - \$14,500,000 = \$22,900,000$$

Forward contract

$$\$22,900,000/0.2374 = \text{MR}96,461,668$$

Futures

Buy MR September futures

Basis

Assume that basis reduces to zero at contract maturity in a linear fashion.

$$\text{Predicted futures rate} = 0.2366 + ([0.2378 - 0.2366] \times 2/3) = 0.2374$$

$$\text{Alternatively, use spot rate, } 0.2358 + ([0.2378 - 0.2358] \times 4/5) = 0.2374$$

$$\text{Expected receipt} = \$22,900,000/0.2374 = \text{MR}96,461,668$$

$$\text{Number of contracts} = \text{MR}96,461,668/\text{MR}500,000 = 192.9, \text{ say } 193$$

$$\text{Amount over-hedged} = (500,000 \times 193 \times \$0.2374) - \$22,900,000 = \$9,100$$

$$\text{Payment at forward rate} = \$9,100/0.2370 = \text{MR}38,397$$

Outcome

	MR
Futures (500,000 x 193)	96,500,000
Payment on forward market	<u>(38,397)</u>
	96,461,603

Options

Purchase MR September call options

$$\text{Receipt} = \$22,900,000/0.2368 = \text{MR}96,706,081$$

$$\text{Number of contracts} = \text{MR}96,706,081/\text{MR}500,000 = 193.4 \text{ contracts, approximately 193 contracts}$$

$$\text{Premium} = 193 \times \$0.0014 \times 500,000 = \$135,100$$

$$\text{Premium in MR, translated at spot rate} = \$135,100/0.2355 = \text{MR}573,673$$

$$\text{Amount under-hedged} = \$22,900,000 - (193 \times 500,000 \times \$0.2368) = \$48,800$$

$$\text{Translated at forward rate} = \$48,800/0.2374 = \text{MR}205,560$$

Outcome, assuming options are exercised

	MR
Options (500,000 x 193)	96,500,000
Receipt on forward market	<u>205,560</u>
Premium	<u>(573,673)</u>
	96,131,887

Recommendations

The forward contract gives a marginally higher receipt than the futures. Futures would be subject to basis risk, the risk that the difference between the futures price and spot rate does not decrease linearly towards the maturity of futures. This means that the receipt may be uncertain. Futures also require a margin payment, an initial payment of cash into a margin account operated by the futures exchange, with further payments if losses are made on contracts.

Options give a lower receipt, because of the need to pay a premium. Gogarth Co may consider options if it considers there is a chance that the dollar will be in a stronger position against the Malaysian ringgit than suggested by the forward rate, or if one or other transaction is likely to fall through.

Overall, Gogarth Co should choose the forward contract as it offers the marginally higher receipt and is not subject to basis risk.

Note: Other valid recommendations could be made.

(b) Advantages of exchange-traded options

The price and contract details of exchange-traded options are readily available and do not need to be negotiated by Gogarth Co, unlike over-the-counter options.

Gogarth Co can sell exchange-traded options at any time before expiry. It may not be possible to sell over-the-counter options, although they can be allowed to lapse if not required.

Exchange-traded options are less risky for Gogarth Co than over-the-counter options, due to their being subject to transparency and other regulations set by the exchange. The exchange also requires participants to set up an initial margin, so that counterparty risk should not be a problem, although margin requirements will impact Gogarth Co's cash flow.

Exchange-traded options are generally American style options, which means that they can be exercised at any time before their expiry date. This may be useful for Gogarth Co if transaction settlement dates are uncertain. Over-the-counter options tend to be European style options, which means that they can only be exercised on their expiry.

Disadvantages of exchange-traded options

The contract sizes and maturity date of exchange-traded options are fixed, whereas those of over-the-counter options can be negotiated to meet Gogarth Co's risk exposure. The standardisation of exchange-traded options also means that they are subject to hedge inefficiencies if the exact amount being hedged is not matched by the option contracts.

Over-the-counter options have a greater range of currencies available than exchange-traded options. This may be useful for Gogarth Co if it is looking to expand significantly abroad.

Exchange-traded options tend to be for shorter terms than those available for over-the-counter options. Longer-term options may be better for Gogarth Co depending on transaction settlement arrangements.

- (c) Economic risk is the longer-term risk that the present value of future cash flows may be increased or reduced by exchange rate movements. The treasury function will be involved in the development of longer-term responses, as the derivatives the treasury function will use for hedging of short-term exchange risk will not be appropriate.

Risk analysis

The treasury function needs to identify the cash flows which may be affected by exchange rate movements. These may not just include transactions with overseas customers and suppliers. Home market sales can also be affected if, for example, the currency of the country where a foreign competitor is based weakens against the ringgit and the competitor can then afford to charge cheaper ringgit prices.

The treasury function must also identify the factors affecting exchange rate movements in the longer term and assess what their impact is likely to be. This could include predicted movements, for example, changes in the economic cycle, and also the impact of sudden economic shocks. The treasury function will need to assess the impact of these exchange rate movements on Gogarth Co. This will include consideration of the other impacts which the factors affecting exchange rates will have, for example, a change in interest rate policy affecting demand for electrical equipment directly as well as influencing exchange rate levels.

Risk management

The treasury function will be particularly involved in determining funding policy in the context of the need to manage economic risk. One aspect of economic risk management is matching any assets held in a foreign country with a loan in that country's currency. The treasury function will determine the suitability of borrowing abroad and the best possible arrangement if foreign currency loans are required.

Economic risk can also be managed by diversifying customer, supplier and operational bases and changing pricing policy. The treasury function will be involved in assessing the possible impacts of policy changes. However, the decisions will be taken in the context of operational considerations, such as supplier management, and wider strategic considerations, such as scope of operations.

	<i>Marks</i>
1 Chakula	
(a) Shareholders	2–3
Other stakeholders	2–3
Other comments	1–2
	Max
	5
(b) 3 marks for discussing each of the two propositions	6
(c) (i) (Appendices 1 and 2)	
Kawa Co demerged	1
Kawa Co, value of equity	1
Kawa Co, equity beta	1
Kawa Co, cost of equity	1
Kawa Co, cost of debt	1
Kawa Co, cost of capital	1
Sales revenue years 1 to 4	1
PBIT years 1 to 4	1
Taxation years 1 to 4	1
Additional asset investment years 1 to 4	1
Corporate value	2
Value per share	1
	12
(ii) (Appendix 3)	
Lahla Co, current equity value	1
Kawa Co, estimate of PE ratio	1
Combined company, current equity value	1
Estimate of additional value	1
Cash offer: gain (both groups of shareholders)	2
Share offer: gain (both groups of shareholders)	3
Financing implications	3
	12
(iii) Report	
Evaluation of financial and other factors	7–8
(Evaluation report could include, for example, financial returns from demerger and each form of consideration, exit strategies, concerns about becoming minority shareholders, but also concerns for majority shareholders on the impact minority shareholders may have, assumptions made and whether the value created from the share-for-share exchange is realistic)	
Impact on the capital structure	3–4
	Max
	11
Professional marks for part (c)	
Report format	1
Structure and presentation of the report	3
	4
	Total
	50

	<i>Marks</i>
2 Robson	
(a) Base case	1
Ungeared cost of equity	2
Issue costs	1
Tax shield on subsidised loan	2
Tax shield on bank loan	4
Subsidy benefit	1
Adjusted present value	1
Recommendations	2
	14
(b) Shareholders (e.g. fund availability, control, track record)	4–5
Directors (e.g. signalling, asymmetries, action group)	3–4
Subsidised loan provider (e.g. job creation, default risk, covenants)	3–4
	Max 11
	Total 25
3 Gogarth	
(a) Netting of receipt and payment	1
Forward contract	1
Futures	
Buy September futures/options and number of contracts	1
Lock in rate	2
Expected receipt	1
Receipt from over/under hedge	1
Options	
Number of contracts	1
Premium	2
Receipt from over/under hedge	1
Outcome	1
Discussion	3–4
	Max 15
(b) Advantages of exchange-traded options	2–3
Disadvantages of exchange-traded options	2–3
	Max 5
(c) Understanding of economic risk	1
Up to 2 marks for each well-developed point	
(Points could include identification of cash flows affected, identification of influences on exchange rate, role in implementing economic risk management, role in advising on economic risk management)	
	Max 5
	Total 25