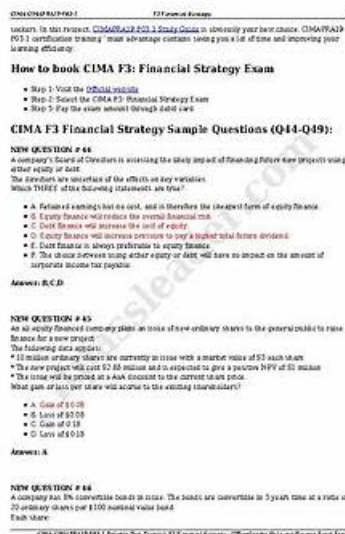


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### CIMA F3 Financial Strategy Sample Questions (Q188-Q193):

#### NEW QUESTION # 188

Company T is a listed company in the retail sector.

Its current profit before interest and taxation is \$5 million.

This level of profit is forecast to be maintainable in future.

Company T has a 10% corporate bond in issue with a nominal value of \$10 million.

This currently trades at 90% of its nominal value.

Corporate tax is paid at 20%.

The following information is available:

Which of the following is a reasonable expectation of the equity value in the event of an attempted takeover?

- A. \$50.2 million
- B. \$41.6 million
- C. \$32.0 million
- D. \$65.0 million

**Answer: B**

Explanation:

In CIMA F3, equity valuation using P/E multiples is based on earnings available to ordinary shareholders (i.e. profit after interest and tax). The syllabus emphasises that when valuing a potential takeover target, you should (1) derive maintainable post-tax earnings and then (2) apply a P/E multiple that reflects prices actually paid in comparable acquisitions, not just average stock-market multiples.

Calculate maintainable earnings:

Profit before interest and tax (PBIT) = \$5m

Less interest on 10% bonds:  $10\% \times \$10\text{m} = \$1\text{m}$

Profit before tax = \$4m

Tax at 20% = \$0.8m

Earnings for equity = \$3.2m

Select the appropriate P/E multiple:

F3 explains that "takeover P/Es" are usually higher than sector trading P/Es, reflecting the control premium.

Here we have:

Overall market P/E = 20

Retail sector P/E = 10

Recent retail takeovers P/E = 13

For a takeover valuation we use the 13× multiple from recent sector takeovers.

Compute equity value:

Equity value =  $3.2\text{m} \times 13 = 41.6\text{m}$

$2\text{m} \times 13 = 41.6\text{m}$

Debt's market value (90% of \$10m) is not added here because the P/E method already gives the equity value.

So, a reasonable expected equity value in a takeover is \$41.6 million.

#### NEW QUESTION # 189

Which THREE of the following methods of business valuation would give a valuation of the equity of an entity, rather than the value of the whole entity?

- A. Forecast future cash flows to equity, discounted at the cost of equity.
- B. Expected dividend in one year's time / (cost of equity - growth rate).

- C. Non-current assets, plus current assets, minus current liabilities
- D. Forecast future cash flows to all Investors, discounted at the weighted average cost of capital.
- E. Total earnings x appropriate price-earnings ratio.

**Answer: A,B,E**

#### NEW QUESTION # 190

STU has relatively few tangible assets and is dependent for profits and growth on the high-value individuals it employs. Which of the following statements best explains why the net asset valuator method's considered unstable for TU?

- A. STU does not account for its tangible assets
- B. STU accounts for its intangible assets at net realisable value.
- C. STU accounts for its intangible assets at historical value.
- D. STU does not account for its intangible assets.

**Answer: D**

Explanation:

STU's value is mainly in its people (human capital) and has few tangible assets. Net asset valuation relies on balance sheet assets, but internally generated intangibles like human capital are not recognised under normal accounting rules. So the accounts understate the real value of the business.

#### NEW QUESTION # 191

A company has a financial objective of maintaining a gearing ratio of between 30% and 40%, where gearing is defined as debt/equity at market values.

The company has been affected by a recent economic downturn leading to a shortage of liquidity and a fall in the share price during 20X1.

On 31 December 20X1 the company was funded by:

- \* Share capital of 4 million \$1 shares trading at \$4.0 per share.
- \* Debt of \$7 million floating rate borrowings.

The directors plan to raise \$2 million additional borrowings in order to improve liquidity.

They expect this to reassure investors about the company's liquidity position and result in a rise in the share price to \$4.2 per share.

Is the planned increase in borrowings expected to help the company meet its gearing objective?

- A. No, gearing would increase and the gearing objective would be exceeded both before and after the announcement.
- B. No, gearing would increase and the gearing objective would be met before the announcement but exceeded after the announcement.
- C. Yes, gearing would fall and the gearing objective would be exceeded before the announcement but met after the announcement.
- D. No, gearing would increase but the gearing objective would be met both before and after the announcement.

**Answer: A**

Explanation:

Before announcement:

Equity = 4m shares × \$4.0 = \$16m

Debt = \$7m

Gearing =  $7 / 16 = 43.75\%$  # already above 40%.

After additional \$2m debt and higher share price:

Debt = 7 + 2 = \$9m

Equity = 4m × \$4.2 = \$16.8m

Gearing =  $9 / 16.8 = 53.6\%$  # even further above the 40% ceiling.

So the gearing objective is exceeded both before and after, and gearing rises.

#### NEW QUESTION # 192

A company has in a 5% corporate bond in issue on which there are two loan covenants.

- \* Interest cover must not fall below 3 times

\* Retained earnings for the year must not fall below \$3.5 million

The Company has 200 million shares in issue.

The most recent dividend per share was \$0.04.

The Company intends increasing dividends by 10% next year.

Financial projections for next year are as follows:

Advise the Board of Directors which of the following will be the status of compliance with the loan covenants next year?

- A. The company will be in compliance with both covenants.
- B. The company will be in breach of both covenants.
- C. The company will be in breach of the covenant in respect of interest cover only.
- **D. The company will breach the covenant in respect of retained earnings only.**

**Answer: D**

Explanation:

From the projections, the company's interest cover remains above the required 3 times, so that covenant is satisfied. However, after paying the increased dividend (10% rise in DPS), the retained earnings for the year fall below the required \$3.5 million, so the company would breach only the retained earnings covenant.

## NEW QUESTION # 193

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