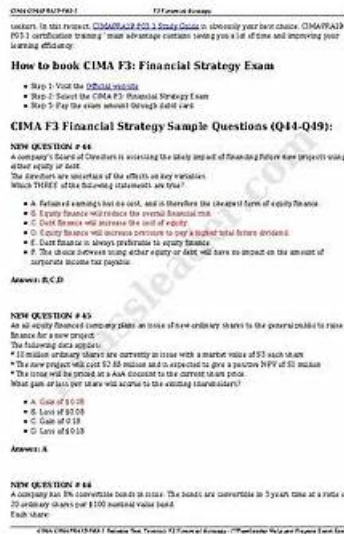


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## CIMA F3 Financial Strategy Sample Questions (Q210-Q215):

### NEW QUESTION # 210

The following information relates to Company ZZA's current capital structure:

Debt:Equity (Market value)	Asset beta	Equity beta	Cost of equity	After tax cost of debt
25:75	1.01	1.28	14.24%	4.00%

Company ZZA is considering a change in the capital structure that will increase gearing to 35:65 (Debt Equity).

The risk-free rate is 4% and the return on the market portfolio is expected to be 12%.

The rate of corporate tax is 25%

Using the Capital Asset Pricing Model, calculate the cost of equity resulting from the proposed change to the capital structure.

- A. 12.08%
- B. 11.03%
- C. 15.36%
- D. 14.24%

**Answer: C**

Explanation:

Given current structure: D:E = 25:75, tax = 25%, asset beta = 1.01.

Re-gear beta for new structure D:E = 35:65

$$\beta_E = \beta_A \left[ 1 + (1 - T) \frac{D}{E} \right] = 1.01 \left[ 1 + 0.75 \times \frac{35}{65} \right] = 1.01 \times 1.404 = 1.42$$

$$\beta_E = 1.01 \left[ 1 + 0.75 \times \frac{35}{65} \right] \approx 1.01 \times 1.404 \approx 1.42$$

Use CAPM with  $r_f = 4\%$ ,  $r_m = 12\%$

$$k_e = r_f + \beta_E (r_m - r_f) = 4\% + 1.42 \times 8\% \approx 4\% + 11.4\% \approx 15.4\%$$

Closest option: 15.36% # B.

### NEW QUESTION # 211

Company C has received an unwelcome takeover bid from Company P.

Company P is approximately twice the size of Company C based on market capitalisation.

Although the two companies have some common business interests, the main aim of the bid is diversification for Company P.

The offer from Company P is a share exchange of 2 shares in Company P for 3 shares in Company C.

There is a cash alternative of \$5.50 for each Company C share.

Company C has substantial cash balances which the directors were planning to use to fund an acquisition.

These plans have not been announced to the market.

The following share price information is relevant. All prices are in \$.

	Company P	Company C
	\$	\$
3 months ago	9.50	4.25
1 month ago	8.75	4.75
Today	7.75	5.25

Which of the following would be the most appropriate action by Company C's directors following receipt of this hostile bid?

- A. Write to shareholders explaining fully why the company's share price is under valued.
- B. Refer the bid to the country's competition authorities.
- C. Change the Articles of Association to increase the percentage of shareholder votes required to approve a takeover.
- D. Pay a one-off special dividend.

Answer: A

#### NEW QUESTION # 212

At the last financial year end, 31 December 20X1, a company reported:

	\$ million
Profit before interest and tax for the year	25
Total long term liabilities comprising: Bank borrowings at 5% annual interest	60

The corporate income tax rate is 30% and the bank borrowings are subject to an interest cover covenant of 4 times. The results are presently comfortably within the interest cover covenant as they show interest cover of 8.3 times. The company plans to invest in a new product line which is not expected to affect profit in the first year but will require additional borrowings of \$20 million at an annual interest rate of 10%.

What is the likely impact on the existing interest cover covenant?

- A. Interest cover would reduce to 5 times and the covenant would NOT be breached.
- B. Interest cover would reduce to 3 times and the covenant would be breached.
- C. Interest cover would reduce to 5 times and the covenant would be breached.
- D. Interest cover would reduce to 3 times and the covenant would NOT be breached.

Answer: A

### NEW QUESTION # 213

A company is planning a new share issue.

The funds raised will be used to repay debt on which it is currently paying a high interest rate.

Operating profit and dividends are expected to remain unchanged in the near future.

If the share issue is implemented, which THREE of the following are most likely to increase?

- A. The cost of equity
- B. The gearing (book value of debt as a percentage of the book value of equity + debt)
- C. Next year's payment of corporate income tax
- D. The number of shares in issue
- E. Interest cover

**Answer: B,C,D**

### NEW QUESTION # 214

A company proposes to value itself based on the net present value of estimated future cash flows.

Relevant data:

\* The cash flow for the next three years is expected to be £100 million each year

\* The cash flow after year 3 will grow at 2% to perpetuity

\* The cost of capital is 12%

The value of the company to the nearest \$ million is:

- A. \$966 million
- B. \$889 million
- C. \$1,260 million
- D. \$834 million

**Answer: A**

Explanation:

Cash flows:

Years 1-3: 100, 100, 100

From year 4: grow at 2% forever. Cost of capital = 12%.

PV of years 1-3:

$$PV_{1-3} = \frac{100}{1.12} + \frac{100}{1.12^2} + \frac{100}{1.12^3}$$

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