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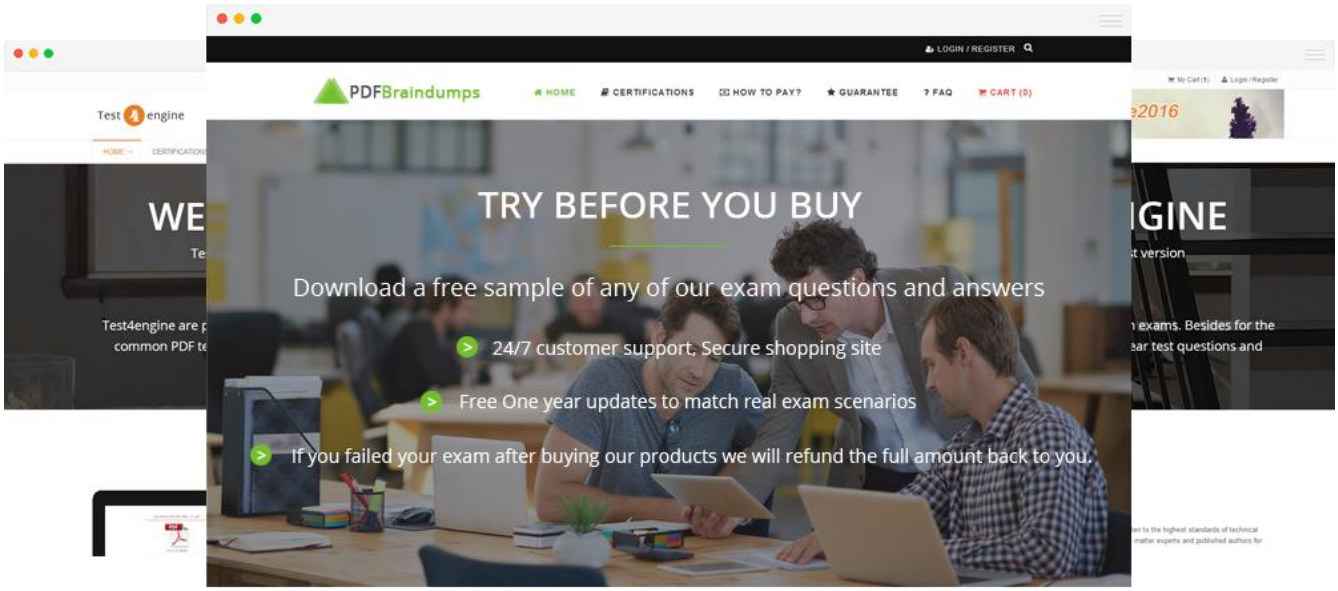

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Exam : **CIMAPRA19-F03-1**

Title : F3 Financial Strategy

Vendor : CIMA

Version : DEMO

QUESTION NO: 1
A company based in Country A with the A$ as its functional currency requires A$500 million 20-year debt finance to finance a long-term investment The company has a high credit rating, but has not previously issued corporate bonds which are listed on the stock exchange Which THREE of the following are advantages of issuing 20 year bonds compared with simply borrowing for a 20 year period?

A. Larger capital market

B. Greater availability of debt of 20-year duration

C. Lower arrangement costs

D. Less administrative effort to arrange the new finance

E. Lower interest rate

Answer: A B E

Explanation:
Advantages of issuing 20-year bonds vs a 20-year bank loan:
A). Larger capital market - bond markets tap many investors.
B). Greater availability of long-term funds - banks often prefer shorter maturities.
E). Lower interest rate - disintermediation can give cheaper funding for a strong credit.
C and D are usually disadvantages of bonds (higher arrangement cost and more admin).

QUESTION NO: 2
Company A is a listed company that produces pottery goods which it sells throughout Europe. The pottery is then delivered to a network of self employed artists who are contracted to paint the pottery in their own homes. Finished goods are distributed by network of sales agents.The directors of Company A are now considering acquiring one or more smaller companies by means of vertical integration to improve profit margins.
Advise the Board of Company A which of the following acquisitions is most likely to achieve the stated aim of vertical integration?

A. A company in a similar market to Company A.

B. A pottery factory in the Middle East.

C. A company that produces accessories.

D. A listed international logistics firm.

Answer: D

Explanation:
Vertical integration means moving up or down the value chain (suppliers or distributors), not acquiring similar producers (horizontal integration) or unrelated accessory businesses.
Buying a listed international logistics firm brings distribution in-house and so is the clearest example of vertical integration that could improve margins.

QUESTION NO: 3
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:

	The Overall Stock Market	The Retail Sector	Recent Takeovers in the Retail Sector
P/E multiples	20.0 times	10.0 times	13.0 times

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

A. $32.0 million

B. $41.6 million

C. $65.0 million

D. $50.2 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% × $10m = $1m
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=3.2m×13=41.6m\text{Equity value} = 3.2\text{m} \times 13 = 41.6\text{m}Equity

value=3.
2m×13=41.6m
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.

QUESTION NO: 4
A company is valuing its equity prior to an initial public offering (IPO).
Relevant data:
* Earnings per share $1.00
* WACC is 8% and the cost of equity is 12%
* Dividend payout ratio 40%
* Dividend growth rate 2% in perpetuity
The current share price using the Dividend Valuation Model is closest to:
A. $4.08
B. $6.12
C. $6.80
D. $4.00
Answer: A
Explanation:
Dividend Valuation Model (Gordon growth).
EPS = $1.00
Payout ratio = 40% # D0=0.40D_0 = 0.40D0=0.40
Growth g=2%=0.02g = 2\% = 0.02g=2%=0.02
Cost of equity ke=12%=0.12k_e = 12\% = 0.12ke=12%=0.12
Use:
P0=D1ke#g=D0(1+g)ke#gP_0 = \frac{D_1}{k_e - g} = \frac{D_0(1+g)}{k_e - g}P0=ke#gD1=ke#gD0(1+g) D1=0.40×1.02=0.408D_1 = 0.40 \times 1.02 = 0.408D1=0.40×1.02=0.408 P0=0.4080.12#0.02=0.4080.10=4.08P_0 = \frac{0.408}{0.12 - 0.02} = \frac{0.408}{0.10} = 4.08P0=0.12#0.020.408=0.100.408=4.08

QUESTION NO: 5
A company's current earnings before interest and taxation are $5 million.
These are expected to remain constant for the forseeable future.
The company has 10 million shares in issue which currently trade at $3.60.
It also has a $10 million long term floating rate loan.
The current interest rate on this loan is 5%.
The company pays tax at 20%.
The company expects interest rates to increase next year to 6% and it's Price/Earnings (P/E) ratio to move to
9.5 times by the end of next year.
What percentage reduction in the share price will occur by the end of next year if the interest rate increase and the P/E movement both occur?
A. Reduction of 7%

B. Reduction of 5%
C. Reduction of 1%
D. Reduction of 0%
Answer: A
Explanation:
Let's walk it through carefully.
1. Current earnings and EPS
EBIT = 5m
Current interest (5% × 10m) = 0.5m
Profit before tax = 5.0 # 0.5 = 4.5m
Tax (20%) = 0.9m
Earnings = 4.5 # 0.9 = 3.6m
Shares = 10m # EPS# = 3.6 / 10 = 0.36
Current share price = 3.60 # current P/E = 3.60 / 0.36 = 10 (matches the question context).
2. Earnings next year with higher interest
New interest rate = 6% # interest = 10m × 6% = 0.6m
Profit before tax = 5.0 # 0.6 = 4.4m
Tax (20%) = 0.88m
Earnings = 4.4 # 0.88 = 3.52m
EPS# = 3.52 / 10m = 0.352
3. New share price using new P/E
Expected P/E next year = 9.5
Price1=EPS1×P/E1=0.352×9.5=3.344\text{Price}_1 = \text{EPS}_1 \times \text{P/E}_1 = 0.352 \times 9.5 =
3.344Price1=EPS1×P/E1=0.352×9.5=3.344
4. Percentage reduction in share price
Current price = 3.60
New price # 3.344
Drop = 3.60 # 3.344 = 0.256
% reduction=0.2563.60#7.1%#7%\%\ \text{reduction} = \frac{0.256}{3.60} \approx 7.1\% \approx
7\%% reduction=3.600.256#7.1%#7%
So the closest option is A. Reduction of 7%.

QUESTION NO: 6
Three companies are quoted on the New York Stock Exchange. The following data applies:

Company	Equity Beta	Asset Beta
A	1.27	1.16
B	1.20	1.16
C	1.27	1.20

Which of the following statements is TRUE?
A. Company A has the greatest business risk
B. Companies A and B have the same capital structure

C. Companies A and C have the same business risk

D. Companies A and B have the same business risk

Answer: D

Explanation:

Correct answer: D. Companies A and B have the same business risk

Business risk is measured by asset beta.

A and B both have asset beta = 1.16, so same business risk.

C has higher asset beta (1.20), so highest business risk.

QUESTION NO: 7

A company currently has a 5.25% fixed rate loan but it wishes to change the interest style of the loan to variable by using an interest rate swap directly with the bank.

The bank has quoted the following swap rate:

* 4.50% - 455% in exchange for Libor

Libor is currently 4%.

If the company enters into the swap and Libor remains at 4%. what will the company's interest cost be?

A. 4.70%

B. 4.75%

C. 5.25%

D. 4.00%

Answer: B

Explanation:

A company has a 5.25% fixed-rate loan and wants to swap it to variable using a swap quoted:

4.50% - 4.55% in exchange for Libor

(Libor currently 4%)

To turn its fixed loan into a synthetic floating-rate loan, the company needs to:

Receive fixed (to offset part of the 5.25% it pays on the loan), and

Pay Libor (to end up with variable cost).

From the swap quote, if the company wants to receive fixed, it gets the lower rate: 4.50% (the bank's bid rate).

Cash flows:

Pay 5.25% fixed on the loan

Receive 4.50% fixed on the swap

Pay Libor (4.00%) on the swap

Net cost:

5.25%#4.50%+4.00%=0.75%+4.00%=4.75%5.25\% - 4.50\% + 4.00\% = 0.75\% + 4.00\% = 4.75\%5.25%#4.

50%+4.00%=0.75%+4.00%=4.75%

Answer to Q28: B. 4.75%

QUESTION NO: 8

Company F's current profit before interest and taxation is $5.0 million.

It has a 10% long-term corporate bond in issue with a nominal value of $10 million.

Corporate tax is paid at 25%.
The industry average P/E multiple is 10.
Company X has made an approach to acquire the entire share capital of Company F for $30 million.
Company X has announced that anticipated synergies (after interest and taxation) arising from its acquisition of Company F will be $1 million each year in perpetuity.
Advise the Board of Directors of Company F if the bid should be accepted, based on the above information?

A. Accept the bid because Company F is potentially worth $30 million to Company X.
B. Reject the bid because Company F is potentially worth $40 million to Company X.
C. Reject the bid because Company F is potentially worth $50 million to Company X.
D. Reject the bid because Company F is potentially worth $60 million to Company X.

Answer: B
Explanation:
EBIT = 5m
Interest = 10% × 10m = 1m # PBT = 4m
Tax @25% = 1m # Earnings = 3m
Stand-alone equity value using industry P/E 10 = 3m × 10 = 30m
Synergies after tax = 1m p.a. in perpetuity # value (using same multiple) = 1m × 10 = 10m
Value of F to X = 30m + 10m = 40m Offer of 30m is below this, so Board should reject on that basis.

QUESTION NO: 9
A company has some 7% coupon bonds in issue and wishes to change its interest rate profile.
It has decided to do this by entering into a plain coupon interest rate swap with it's bank.
The bank has quoted a swap rate of: 6.0% - 6.5% fixed against LIBOR.
What will the company's new interest rate profile be?

A. VARIABLE at LIBOR
B. VARIABLE at LIBOR + 0.5%
C. VARIABLE at LIBOR + 1.0%
D. FIXED at 6.5%

Answer: C
Explanation:
Company currently pays fixed 7% on its bonds.
Swap quote 6.0%-6.5% fixed against LIBOR means:
Bank will pay 6.0% fixed and receive LIBOR, or
Receive 6.5% fixed and pay LIBOR.
To move from fixed to variable, the company should receive fixed and pay LIBOR, so it takes the 6.0% fixed leg.
Net position:
Pay 7% fixed on bond
Receive 6% fixed from swap
Pay LIBOR on swap

Total = (7% # 6%) + LIBOR = LIBOR + 1%

QUESTION NO: 10
Company A has made an offer to take over all the shares in Company B on the following terms:
* For every 20 shares currently held, Company B's shareholders will receive $100 bond with a coupon rate of 3%
* The bond will be repaid in 10 years' time at its par value of $100.
* The current yield on 10 year bonds of similar risk is 6%.
What is the effective offer price per share being made to Company B's shareholders?
A. $6.43
B. $4.50
C. $3.89
D. $6.89
Answer: C
Explanation:
Each block of 20 shares in B gets a $100, 10-year, 3% coupon bond.
Current yield on similar bonds = 6%, so we value the bond at 6%.
PV=3×a6%,10+100×(1.06)#10\text{PV} = 3 \times a_{6\%,10} + 100 \times (1.06)^{-10}PV=3×a6%,
10+100×(1.06)#10
Annuity factor at 6% for 10 years:
a6%,10=1#(1.06)#100.06#7.36a_{6\%,10} = \frac{1 - (1.06)^{-10}}{0.06} \approx 7.36a6%,10=0.061#(1.06)
#10#7.36
So:
PV of coupons=3×7.36#22.08\text{PV of coupons} = 3 \times 7.36 \approx 22.08PV of coupons=3×7.36#22.
08 PV of redemption=100×(1.06)#10#100×0.558#55.8\text{PV of redemption} = 100 \times (1.06)^{-10}
\approx 100 \times 0.558 \approx 55.8PV of redemption=100×(1.06)#10#100×0.558#55.8
Total bond value # 22.1 + 55.8 = $77.9 (# $78) This is for 20 shares, so effective offer per share:
77.920#3.89\frac{77.9}{20} \approx 3.892077.9#3.89

QUESTION NO: 11
A listed company in a high growth industry, where innovation is a key driver of success has always operated a residual dividend policy, resulting in volatility in dividends due to periodic significant investments in research and development.
The company has recently come under pressure from some investors to change its dividend policy so that shareholders receive a consistent growing dividend. In addition, they suggested that the company should use more debt finance.
If the suggested change is made to the financial policies, which THREE of the following statements are true?
A. It may give a signal to the market that the company is entering a period of stable growth.

B. There may be a change to the shareholder profile due to 'the clientele effect'.
C. The directors will not have to take shareholder dividend preferences into consideration in future.
D. Retained earnings have a lower cost than debt finance.
E. The company's financial risk will increase due to its increased use of debt finance.
Answer: A B E
Explanation:
If the company switches from a residual dividend policy to a stable, growing dividend and increases its use of debt:
A). This does signal to the market that the company may be entering a more stable, mature growth phase - True.
B). A more stable dividend stream can attract a different type of investor (clientele effect) - True.
C). Directors still need to consider shareholder preferences; this statement is incorrect - False.
D). Retained earnings have an opportunity cost equal to the cost of equity and are generally not cheaper than debt - False.
E). More debt increases financial gearing and therefore financial risk - True.
Answer (200273):

QUESTION NO: 12
Company ABD and Company BCD operate in the same industry and each has a significant market share.
The directors of Company ABD have heard rumours in the market that Company BCD is planning to bid to takeover Company ABD. They do not believe the takeover would be in the best interests of the shareholders and are therefore keen to prevent the bid from going ahead.
Which THREE of the following defense strategies could be used by the directors of Company ABD at this point in time?
A. Communicate effectively with their shareholders
B. Revalue the non-current assets
C. Refer the bid to the competition authorities
D. Poison Pill
E. White Knight
Answer: A B D
Explanation:
At the rumour stage (pre-bid), suitable defences are pre-emptive ones:
A - Communicate effectively with shareholders: build support and explain strategy to keep the share price fair and reduce vulnerability.
B - Revalue non-current assets: helps ensure the shares are not undervalued and makes any bid look less attractive.
D - Poison pill: introduce mechanisms (e.g. rights issues to existing shareholders) that make a hostile bid very costly.
C (competition authorities) and E (white knight) are reactive and typically used only once an

actual bid has been made.

QUESTION NO: 13
A company is concerned about the interest rate that it will be required to pay on a planned bond issue.
It is considering issuing bonds with warrants attached.
Advise the directors which of the following statements about warrants is NOT correct?
A. Warrants are a debt sweetener attached to the bond to drive down the interest rate payable on the bond.
B. Warrants give the holder the right to buy ordinary shares in the company at a fixed price at a future date.
C. Warrants can be sold back to the issuing company for the nominal value of the share if no longer required by the bond holder.
D. Warrants can potentially be very expensive because they can involve the issue of shares at a discount in the future if exercised.
Answer: C
Explanation:
Comprehensive and Detailed Step by Step Explanation with all CIMA F3: Financial Strategy documents: = CIMA F3 explains warrants as equity-linked sweeteners often attached to debt issues (such as bonds) to make them more attractive, allowing the issuer to reduce the coupon rate. This aligns directly with statement A, which is therefore correct: warrants are indeed used to "sweeten" a bond and drive down the interest rate.
Statement B is also correct: a warrant gives the holder the right, but not the obligation, to subscribe for a company's ordinary shares at a fixed exercise price on or before a specified future date. This is a core definition in the F3 syllabus under hybrid and derivative instruments.
Statement D reflects the idea that warrants can be costly to existing shareholders. If the share price in future is well above the exercise price, new shares will be issued at what is effectively a discount, diluting existing shareholders' value. This is a recognised downside in CIMA discussions of equity-linked incentives.
Statement C is the incorrect one. Warrants are typically detachable and tradeable, but they are not normally redeemable by the issuer at nominal share value at the discretion of the holder. They're exercised into shares or sold in the market, not "sold back" to the company for par. Hence C is NOT correct.
Questions no: 199044

QUESTION NO: 14
Company M plans to bid for Company J. Company M has 20 million shares in issue and a current share price of $10.00 before publicly announcing the planned takeover. Company J has 10 million shares in issue and a current share price of $4.00.
The directors of Company M are considering an all-share bid of 1 Company M shares for 2 Company J shares.
Synergies worth $20m are expected from the acquisition.
What is the likely change in wealth for Company M's shareholders (in total) if the bid is accepted?

Give your answer to the nearest $ million.
$? million
A. 8
B. 20m shares at $10 # value = $200m
C. 10m shares at $4 # value = $40mSynergies = $20mOffer: 1 M share for every 2 J shares # new M shares issued = 10m × ½ = 5m.Total M shares after deal = 20m + 5m = 25m.Total combined value (including synergies):200+40+20=260m200 + 40 + 20 = 260\text{m}200+40+20=260m Post- acquisition share price:260/25=10.40260 / 25 = 10.40260/25=10.40 Wealth of original M shareholders after:20m×10.40=208m20m \times 10.40 = 208m20m×10.40=208m Before: 20m × 10 = 200m.Change in wealth = 208m # 200m = $8m.
D. $8 million
Answer: A B C D

QUESTION NO: 15
PPA owns $500,000 of shares in Company ABB.
Company ABB has a daily volatility of 2% of its share price Calculate the 12-day value at risk that shows the most PPA can expect to lose during a 12-day period
(PPA wishes to be 90% certain that the actual loss in any month will be less than your predicted figure)
Give your answer to the nearest thousand dollars.

Answer:
$44,000
Portfolio value = $500,000Daily volatility = 2%12-day # = 0.02 × #12 # 0.02 × 3.464 = 0.0693 (6.93%)
For 90% confidence, z # 1.28VaR = 500,000 × 0.0693 × 1.28 # $44,340 # $44,000 (nearest $000)

QUESTION NO: 16
ZZZ wishes to borrow at a floating rate and has been told that it can use swaps to reduce the effective interest rate it pays. ZZZ can borrow floating at the risk-free rate + 1, and fixed at 10%.
Which of the following companies would be the most appropriate for ZZZ to enter into a swap with?
A. Company DDA - it can borrow at risk-free rate + 1 Vz and fixed at 10.5%
B. Company CCA - it can borrow at risk-free rate + Y% and fixed at 9%
C. Company BBA - it can borrow floating at risk-free rate +VA and fixed at 12%
D. Company AAB - it can borrow floating at risk-free rate + % and fixed at 9.5%
Answer: C
Explanation:
Against DDA

Fixed: ZZZ 10% vs DDA 10.5% # ZZZ cheaper by 0.5%
Floating: ZZZ rf+1 vs DDA rf+1.5 # ZZZ cheaper by 0.5%
ZZZ is better in both markets by the same margin # no comparative advantage, little reason for DDA to swap.
Against CCA
Fixed: ZZZ 10% vs CCA 9% # CCA cheaper by 1%
Floating: ZZZ rf+1 vs CCA rf+0.5 # CCA cheaper by 0.5%
CCA is cheaper in both, and also the one with greater advantage is fixed. There's no natural "ZZZ better at one, CCA better at the other" pairing.
Against BBA #
Fixed: ZZZ 10% vs BBA 12% # ZZZ cheaper in fixed by 2%
Floating: ZZZ rf+1 vs BBA rf+0.25 # BBA cheaper in floating by 0.75%
So ZZZ has an advantage in fixed, BBA has an advantage in floating.
ZZZ wants floating, so it can:
Borrow fixed at 10% (where it is strong),
Enter a swap with BBA (who wants fixed but is strong in floating),
End up with an effective floating rate below rf+1.
Against AAB
Fixed: ZZZ 10% vs AAB 9.5% # AAB cheaper by 0.5%
Floating: ZZZ rf+1 vs AAB rf+0.75 # AAB cheaper by 0.25%
AAB is cheaper in both; no obvious mutual gain.
So the classical swap pairing is ZZZ with BBA # Option C.

QUESTION NO: 17
A company needs to raise $40 million to finance a project. It has decided on a right issue at a discount of 20% to its current market share price.
There are currently 20 million shares in issue with a nominal value of $1 and a market price of $10.00 per share.
A. 1 new share for every 25 existing shares
B. 1 new share for every 4 existing shares
C. 1 new share for every 5 existing shares
D. 1 new share for every 20 existing shares
Answer: B
Explanation:
The company needs to raise $40 million via a rights issue.
Current share price = $10
Rights issue at a 20% discount, so issue price = 10×(1#0.20)=10×0.8=$810 \times (1 - 0.20) = 10 \times 0.8 = \$810×(1#0.20)=10×0.8=$8
Number of new shares needed:
New shares=40m8=5 million shares\text{New shares} = \frac{40\text{m}}{8} = 5\text{ million shares} New shares=840m=5 million shares There are currently 20 million shares in issue, so the rights issue ratio is:
New sharesExisting shares=520=14\frac{\text{New shares}}{\text{Existing shares}} = \frac{5}{20} = \frac
{1}{4}Existing sharesNew shares=205=41

So, shareholders will receive 1 new share for every 4 existing shares.

QUESTION NO: 18
A company generates and distributes electricity and gas to households and businesses.
Forecast results for the next financial year are as follows:

	$ million
Revenue from electricity sales at $2.00 per Kilowatt	300
Costs	200
Net profit	100

The Industry Regulator has announced a new price cap of $1.50 per Kilowatt.
The company expects this to cause consumption to rise by 10% but costs would remained unaltered.
The price cap is expected to cause the company's net profit to fall to:
A. $47.5 million profit
B. $27.5 million profit
C. $20.0 million profit
D. $35.0 million loss
Answer: A
Explanation:
Current revenue = $300m at $2.00/kWh # units = 300/2 = 150m kWh
New price cap = $1.50; demand rises 10% # units = 150m × 1.10 = 165m kWh New revenue = 165m × $1.50 = $247.5m Costs remain $200m # new profit = 247.5 # 200 = $47.5m profit

QUESTION NO: 19
Delta and Kappa both wish to borrow $50m.
Delta can borrow at a fixed rate of 12% or at a floating rate of the risk-free rate +3% Kappa can borrow at 15% fixed or the risk-free rate +4%.
Delta wishes a variable rate loan and Kappa a fixed rate loan The bank for the two companies suggests a swap arrangement The two companies agree to a swap arrangement, sharing savings equally What is the effective swap rate for each company?

A. Delta pays 11%, Kappa pays the risk-free rate +3%

B. Delta pays the risk-free rate +3%, Kappa pays 15%

C. Delta pays 12%, Kappa pays the risk-free rate +4%

D. Delta pays the risk-free rate +2%, Kappa pays 14%

Answer: D
Explanation:
Delta: 12% fixed or rf + 3% floating
Kappa: 15% fixed or rf + 4% floating
Delta's advantage:
Fixed: 3% better (15 # 12)
Floating: 1% better (rf+4 # (rf+3))
Comparative advantage is in fixed; total potential gain from a swap = 3% # 1% = 2%, shared equally # 1% saving each.
So:
Delta (wants floating): (rf + 3%) # 1% = rf + 2%
Kappa (wants fixed): 15% # 1% = 14%
So D: Delta pays rf + 2%, Kappa pays 14%.

QUESTION NO: 20
A publicly funded school is focused on providing Value for Money
It pays its leaching staff less than other schools, because class sizes are generally smaller than elsewhere Despite some staff demotivation from low pay, exam pass rates are high given the close one-to-one attention many pupils receive.
On which aspect of Value for Money is the school underperforming?

A. Effectiveness

B. Environmental

C. Economy

D. Efficiency

Answer: D
Explanation:
Value for Money is usually assessed using the 3 Es:
Economy - acquiring inputs at the lowest cost for a given quality (they pay less than other schools, so economy is actually good).
Effectiveness - achieving objectives (exam pass rates are high, so effectiveness is good).
Efficiency - the relationship between outputs and inputs (how well resources are turned into results).
Here, small class sizes mean more teaching resource per pupil. Even though results are

good, they're achieved with relatively high input (lots of teacher time per pupil), indicating weaker efficiency, not economy or effectiveness.

QUESTION NO: 21
A listed company plans to raise new capital which will be required for future investment projects. The company has a gearing ratio of 50%, which is just below the company's target ratio.
The directors are comparing the benefits and drawbacks of each of the following two alternative sources of finance;
* Unsecured bank borrowings.
* Convertible bonds.
Which of the following statements is correct?
A. If the share price does not increase sufficiently for conversion to take place the company will have more expensive debt with a convertible bond than with unsecured borrowings.
B. Additional finance will be raised upon conversion of the convertible bond but not with unsecured borrowings.
C. The coupon rate of a convertible bond is likely to be lower than for unsecured borrowings.
D. If the convertible bond holders eventually convert to shares the company's gearing ratio will rise whereas it will be unaffected if finance is with unsecured borrowings.
Answer: C
Explanation:
Key convertible bond points:
Investors accept a lower coupon on convertibles because they get the equity conversion option.
If converted, no new cash comes in: debt simply becomes equity.
On conversion, debt falls and equity rises, so gearing falls, not rises.
So:
A - False (convertible debt is usually cheaper, not more expensive).
B - False (no extra cash on conversion).
C - True (coupon is usually lower on convertibles).
D - False (conversion lowers gearing).
Answer Q73: C

QUESTION NO: 22
Company C invests heavily in Research and Development an need to raise $45 million to finance future projects. It has decided to use equity finance raised by a tender offer, The following tender offers have been received from potential investors:

Maximum price offered ($ per share)	Number of shares requested at this price (million)
$4.25	12.0
$4.50	3.0
$4.75	2.0
$5.00	5.0

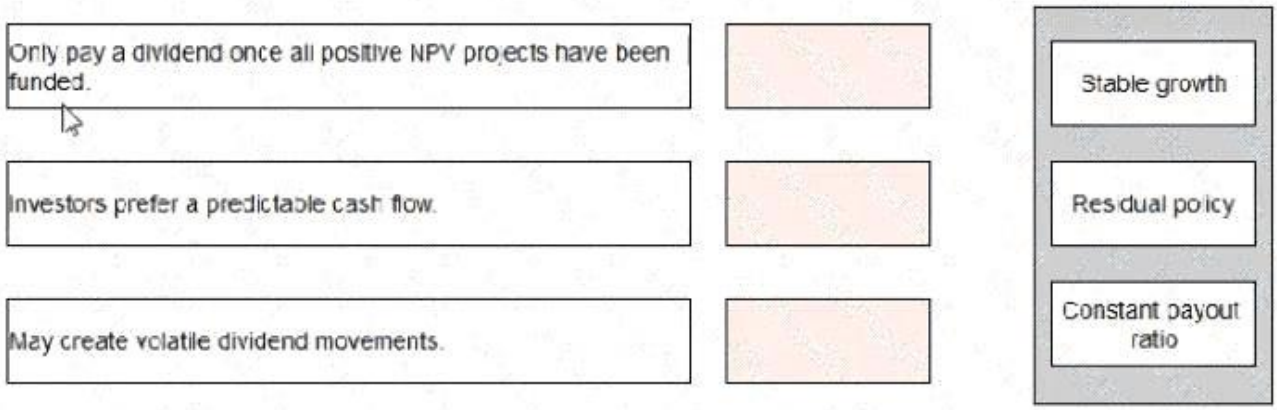
Company C wishes to select an offer price that will project shareholders from a significant dilution of control but still raise the required amount of finance.
What offer price should Company C's select?

A. $4.50
B. $4.00
C. $4.75
D. $4.25

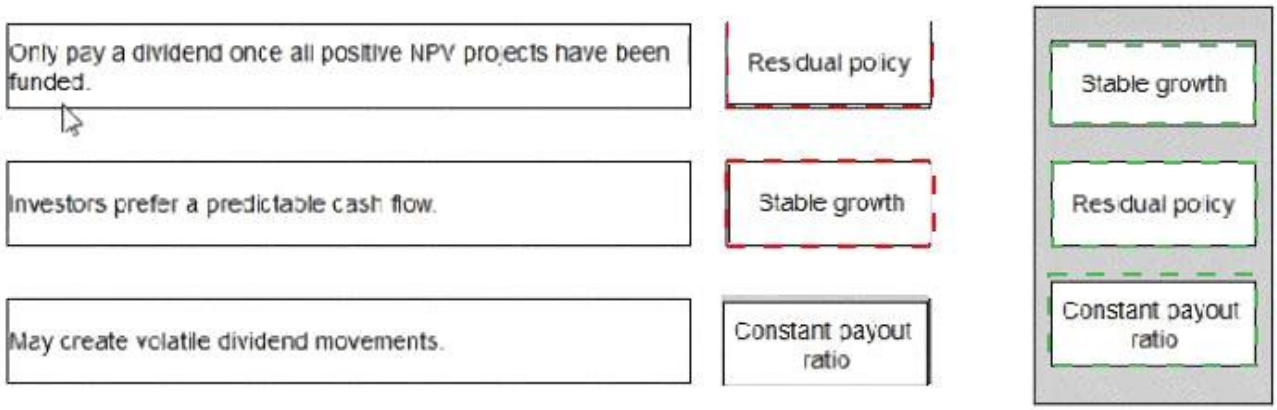
Answer: A

Explanation:
We need to raise $45m with minimum dilution, so choose the highest price at which there is sufficient demand.
Demand at or above each possible offer price:
$5.00 # 5m shares # $25m (insufficient)
$4.75 # (2 + 5) = 7m shares # 7 × 4.75 = $33.25m (insufficient)
$4.50 # (3 + 2 + 5) = 10m shares # 10 × 4.50 = $45m (exactly enough)
$4.25 or $4.00 would raise more than $45m but require issuing more shares # more dilution.
So the best price that still raises $45m is $4.50.

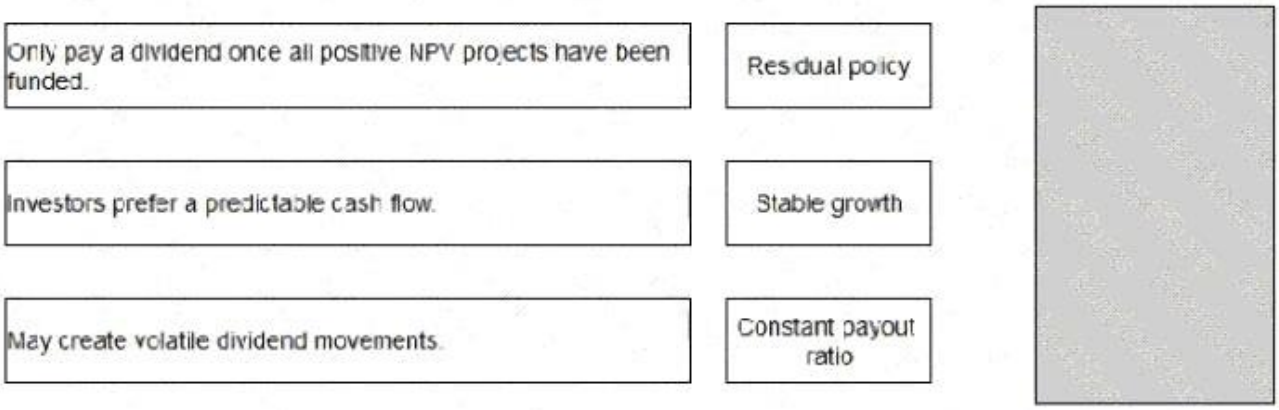
QUESTION NO: 23
Select the most appropriate divided for each of the following statements:



Answer:



Explanation:



"Only pay a dividend once all positive NPV projects have been funded." # Residual policy
Under a residual dividend policy, the firm first uses earnings to finance all projects with a positive NPV.
Whatever profit is left over (the "residual") may be paid out as dividends.
So dividends are not the target; investment in value-adding projects is. That's exactly what the statement describes.
"Investors prefer a predictable cash flow." # Stable growth
A stable (or steadily growing) dividend policy aims to provide shareholders with a smooth, predictable stream of dividends.
Even if earnings are volatile, management tries to keep dividends level or with a modest regular increase.
This appeals to investors who value certainty of income, which is what the statement is referring to.
"May create volatile dividend movements." # Constant payout ratio
With a constant payout ratio, the company always pays the same percentage of earnings as dividends (e.g.
40% of earnings every year).
If earnings go up and down, the dividend per share will also go up and down proportionally.
That leads to volatile dividend movements, which is exactly what the statement says.
So the final mapping is:
Residual policy # "Only pay a dividend once all positive NPV projects have been funded."
Stable growth # "Investors prefer a predictable cash flow." Constant payout ratio # "May create volatile dividend movements."

QUESTION NO: 24
Which THREE of the following would be of most interest to lenders deciding whether to provide long-term debt to a company?
A. Quality of current management
B. Current gearing ratio
C. Earnings per share
D. Dividend cover
E. interest cover on existing debt
Answer: A B E
Explanation:
A - Quality of current management: affects risk of default and how well the business is run.

B - Current gearing ratio: shows how much existing leverage there is and the risk of over -gearing.
E - Interest cover on existing debt: key indicator of the firm's ability to service interest payments.
EPS (C) and dividend cover (D) are more relevant to equity investors than to new long-term lenders.

QUESTION NO: 25
A company needs to raise $20 million to finance a project.
It has decided on a rights issue at a discount of 20% to its current market share price.
There are currently 20 million shares in issue with a nominal value of $1 and a market price of $5 per share.
Calculate the terms of the rights issue.
A. 1 new share for every 4 existing shares
B. 1 new share for every 20 existing shares
C. 1 new share for every 5 existing shares
D. 1 new share for every 25 existing shares
Answer: A
Explanation:
Current price = $5.00
Rights discount = 20% # Issue price = 5 × 0.8 = $4.00
Funds required = $20m
Number of new shares:
20m4=5m shares\frac{20\text{m}}{4} = 5\text{m shares}420m=5m shares
Currently 20m shares in issue, so ratio:
5m20m=14\frac{5\text{m}}{20\text{m}} = \frac{1}{4}20m5m=41
So terms = 1 new share for every 4 existing # A.

QUESTION NO: 26
A company has:
* 10 million $1 ordinary shares in issue
* A current share price of $5.00 a share
* A WACC of 15%
The company holds $10 million in cash. No interest is earned on this cash.
It will invest this in a project with an expected NPV of $4 million.
In a semi-strong efficient stock market, which of the following is the most likely share price immediately after the announcement of the new investment?
A. $5.40
B. $6.40
C. $6.80
D. $5.30
Answer: A
Explanation:
Current market value of equity = 10m shares × $5 = $50m.
The $10m cash is already on the balance sheet and therefore already reflected in the $5

share price.
The project has NPV = $4m, so it increases firm value by $4m.
New total equity value = $50m + $4m = $54m.
New share price = $54m ÷ 10m shares = $5.40.

QUESTION NO: 27
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:

	$ million
Profit before interest and taxation	20.0
Interest ($100 million @ 5%)	5.0
Profit before taxation	15.0
Taxation @ 20%	3.0
Earnings	12.0

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 breach the covenant in respect of retained earnings only.

D. The company will be in breach of the covenant in respect of interest cover only.

Answer: C

Explanation:

Interest cover = PBIT / Interest = 20 / 5 = 4 times # 3 # covenant met.

Next year dividend per share = 0.04 × 1.10 = 0.044.

Total dividend = 0.044 × 200m = 8.8m.

Retained earnings = Earnings - Dividends = 12 - 8.8 = 3.2m < 3.5m # retained-earning s covenant breached only.

QUESTION NO: 28

Two companies that operate in the same industry have different Price/Earnings (P/E) ratios as follows:

	P/E ratio
Company A	8
Company B	15

Which of the following is the most likely explanation of the different P/E ratios?

A. Company B has a greater profit this year than Company A.

B. Company B has higher business risk than Company A.

C. Company B has higher expected future growth than Company A.

D. Company B has higher gearing than Company A.

Answer: C

Explanation:

A higher P/E ratio usually reflects higher expected future growth and/or lower perceived risk. Among the options, only higher expected growth explains why Company B's P/E (15) is greater than Company A's (8).

Higher risk or higher gearing would normally reduce the P/E, not increase it, and current profit level alone doesn't determine the multiple.

QUESTION NO: 29

Company Z has identified four potential acquisition targets: companies A, B, C and D.

Company Z has a current equity market value of $590 million.

The price it would have to pay for the equity of each company is as follows:

	A	B	C	D
Equity market value ($ million)	25	62	67	60

Only one of the target companies can be acquired and the consideration will be paid in cash.

The following estimations of the new combined value of Company Z have been prepared for each acquisition before deduction of the cash consideration:

	Z+A	Z+B	Z+C	Z+D
Equity market value ($ million)	620	655	666	652

Ignoring any premium paid on acquisition, which acquisition should the directors pursue?

A. A - 25

B. B - 62

C. C - 67

D. D - 60

Answer: C

Explanation:

Current value of Z = 590m.

Price for targets: A 25m, B 62m, C 67m, D 60m.

Synergy (or value added) = Combined value - (Z value + Target price):

A: 620 - (590 + 25) = 5m

B: 655 - (590 + 62) = 3m

C: 666 - (590 + 67) = 9m

D: 652 - (590 + 60) = 2m

QUESTION NO: 30

A company plans to raise finance for a new project.

It is considering either the issue of a redeemable cumulative preference share or a Eurobond

.
Advise the directors which of the following statements would justify the issue of preference shares over a bond?

A. Preference shares are not secured against the assets of the business - however, the Eurobond would be.

B. If profits are poor, dividends do not have to be paid on the preference share - however, interest would need to be paid on the Eurobond.

C. The issue of the preference share would reduce the company's gearing - however, the Eurobond would increase it.

D. The company can claim tax relief on the dividend paid on the preference share at a higher rate than the interest paid on the Eurobond.

Answer: B

Explanation:

CIMA F3 compares different forms of long-term finance, including preference shares and bonds/Eurobonds, focusing on control, tax treatment, gearing impact, and flexibility.

Statement B captures a key advantage of preference shares from the company's perspective: if profits are poor, preference dividends can be omitted or deferred, especially when they are cumulative. Although unpaid dividends accumulate, non-payment does not normally constitute default in the same way as missing an interest payment on a bond. For a Eurobond, failure to pay interest when due would place the company in default, triggering legal and reputational consequences. This extra flexibility is exactly why preference shares might be favoured over bonds.

Statement A is misleading: Eurobonds are often unsecured, and security (or lack of it) is not a defining difference versus preference shares.

Statement C is incorrect in this context: redeemable cumulative preference shares are typically treated as a financial liability under IFRS (like debt), so they would generally increase gearing, not reduce it.

Statement D is clearly wrong as dividends are not tax-deductible, whereas bond interest normally is.

Therefore, the best justification for issuing preference shares rather than a Eurobond is B.

QUESTION NO: 31

On 1 January 20X1, a company had:

* Cost of equity of 10 0%.
* Cost of debt of 5.0%
* Debt of $100Mmilion
* 100 million $1 shares trading at $4.00 each.

On 1 February 20X1:

* The company's share police fell to $3.00.
* Debt and the cost of debt remained unchanged

The company does not pay tax.

Under Modigliani and Miller's theory without lax. what is the best estimate of the movement in the cost of equity as a result of the fall in ne share price?

A. It will stay the same at 10.0%.

B. It will rise to 10.3%.

C. It will fall to 9.3%.

D. It will rise to 11.2%.

Answer: A

Explanation:

At 1 Jan:

Cost of equity, ke=10%k_e = 10\%ke=10%

Cost of debt, kd=5%k_d = 5\%kd=5%

Debt D=100D = 100D=100

Shares = 100m @ $4 # Equity E0=400E_0 = 400E0=400

Total value V0=D+E0=500V_0 = D + E_0 = 500V0=D+E0=500.

WACC under Modigliani & Miller (no tax):

k0=E0V0ke+DV0kd=400500#10%+100500#5%=8%+1%=9%k_0 = \frac{E_0}{V_0}k_e + \frac{D}{V_0} k_d = \frac{400}{500} \cdot 10\% + \frac{100}{500} \cdot 5\% = 8\% + 1\% = 9\%

k0=V0E0ke+V0Dkd=500400#10%+500100#5%=8%+1%=9% k0k_0k0 stays constant.

After the share price falls to $3:

Equity E1=100m×3=300E_1 = 100m \times 3 = 300E1=100m×3=300

Debt still 100 # D/E1=100/300=0.3333D/E_1 = 100/300 = 0.3333D/E1=100/300=0.3333 MM no-tax formula:

ke=k0+(k0#kd)DE=9%+(9%#5%)#100300=9%+4%#0.3333#9%+1.33%=10.33%k_e = k_0 + (k_0 - k_d)\frac

{D}{E} = 9\% + (9\% - 5\%) \cdot \frac{100}{300} = 9\% + 4\% \cdot 0.3333 \approx 9\% + 1.33\% = 10.33

\%ke=k0+(k0#kd)ED=9%+(9%#5%)#300100=9%+4%#0.3333#9%+1.33%=10.33%

Rounded # 10.3%.

QUESTION NO: 32

Company YZZ has made a bid for the entire share capital of Company ZYY

Company YZZ is offering the shareholders in Company ZYY the option of either a share exchange or a cash alternative Which THREE of the following would be considered disadvantages of accepting the cash consideration for the shareholders of Company ZYY?

A. Interest rates on deposit accounts are currently at an historic low and are expected to remain low

B. Taxation is payable on realised capital gains.

C. Company YZZ Is not expected to change *s dividend policy post-acquisition

D. Cash consideration is certain whereas Company YZZ's future share price performance is uncertain

E. There will be no opportunity to participate in the future economic success of Company YZZ

Answer: A B E

Explanation:

Disadvantages of accepting cash for ZYY's shareholders:

A). Low interest rates - cash reinvested in deposits earns little.

B). Capital gains tax is crystallised on disposal.

E). No chance to share in YZZ's future growth once they've taken cash.

C and D are not disadvantages of cash (D is actually an advantage: certainty).

QUESTION NO: 33
Company Z has identified four potential acquisition targets: companies A, B, C and D.
Company Z has a current equity market value of $580 million.
The price it would have to pay for the equity of each company is as follows:

	Z+A	Z+B	Z+C	Z+D
Equity market value ($ million)	625	643	640	655

Only one of the target companies can be acquired and the consideration will be paid in cash.
The following estimations of the new combined value of Company Z have been prepared for each acquisition before deduction of the cash consideration:
Ignoring any premium paid on acquisition, which acquisition should the directors pursue?
A. A
B. B
C. C
D. D
Answer: C

QUESTION NO: 34
Company X plans to acquire Company Y.
Pre-acquisition information:

	Shares in issue	Earnings	P/E Multiple	Share price	Market capitalisation
Company X	100 million	$50 million	10 times	$5.00	$500 million
Company Y	50 million	$15 million	10 times	$3.00	$150 million
Total		$65 million			$650 million

Post-acquisition information:
Total combined earnings are expected to increase by 10%
Total combined P/E multiple will remain at 10 times

Which of the following share-for-share exchanges will result in an increase of 10% in Company X's share price post-acquisition?

A. 1 share in Company X for 2.75 shares in Company Y

B. 3 shares in Company X for 5 shares in Company Y

C. 2 shares in Company X for 1 shares in Company Y

D. 1 share in Company X for 2 shares in Company Y

Answer: B

Explanation:

Pre-acquisition:

Company X: earnings = $50m, P/E = 10 # value = 50 × 10 = $500m; shares = 100m # price = $5 Company Y: earnings = $15m, P/E = 10 # value = 15 × 10 = $150m; shares = 50m # price = $3 Combined earnings = 50 + 15 = $65m Post-acquisition assumptions:

Earnings increase by 10% # 65 × 1.10 = $71.5m

Combined P/E remains 10 # total market value = 71.5 × 10 = $715m

We want X's new share price to be 10% higher than $5 # target price = $5.50.

Share price = total value ÷ total X shares after issue:

5.50=715Total shares#Total shares=7155.5=130m5.50 = \frac{715}{\text{Total shares}} \Rightarrow \text{Total shares} = \frac{715}{5.5} = 130\text{m}5.50=Total shares715#Total shares=5.5715=130m X currently has 100m shares, so must issue 30m new shares to Y's shareholders.

Y has 50m shares # each Y share must get:

30m50m=0.6 X shares per Y share\frac{30m}{50m} = 0.6 \text{ X shares per Y share}50m30m=0.

6 X shares per Y share

Check options:

B: 3 X for 5 Y # 3/5 = 0.6 X per Y #

So that exchange ratio gives exactly 30m new X shares and hence a 10% increase in X's share price.

Correct answer: B - 3 shares in Company X for 5 shares in Company Y.

QUESTION NO: 35

Which THREE of the following statements about stock market listings are correct?

A. The reporting requirements for listed companies are more onerous than those for private companies

B. When seeking a listing to raise capital companies typically must ensure they include any costs of underwriting shares they need to issue.when determining the number of

C. Listed companies may be viewed more favorably by suppliers and consequently granted more generous payment terms than private companies

D. The increased scrutiny that applies to listed companies makes them less attractive to investors.

E. A prerequisite to obtaining a listing is that a public company must reregister as a private company first.

Answer: A B C

Explanation:
A - True: listed companies face more onerous reporting and disclosure.
B - True: flotation planning must allow for issue/underwriting costs when deciding how much capital to raise.
C - True: listing can enhance reputation and credit standing, often improving supplier terms.
D - False: increased scrutiny usually reassures investors.
E - False: a company must become/remain a public company to list, not re-register as private
.
Answer (Q118): A, B, C