

Market insight reports received by CAPL after the initial sales forecasts showed that a fundamental error was present in the next 5-year sales forecast (which has already been shared with parties concerned) as future market trends had not been considered in the estimates. The future market trends and their impacts on the future EBIT to sales ratio are given below.

Future market trends and their impact	Probability	EBIT to sales ratio drop
Local manufacturing starts in mass scale, and as a result, the price levels drop.	30%	(2%)
As a result of the rupee depreciation against the USD, cost of sales increase.	10%	(1%)
Local manufacturing starts in mass scale together with the rupee depreciation against the USD.	60%	(3%)

FD updated the rest of the directors at the recent board meeting that the new share issue needs to be planned now as CAPL is interested in issuing new shares to Blue-Rock Capital. He further explained that approaching private firms would be a better option when considering the time, cost and effort taken in share valuation. The managing director is of the view that there aren't any private equity firms available in Sri Lanka, and therefore looking for venture capital companies would be a better choice.

Non-current assets contain land and buildings that can reasonably be valued at Rs. 30 million above their book value, while plant and machinery could be sold for Rs. 20 million less than their book value. Inventory contains Rs. 10 million worth of drugs that are already expired or banned for sale in Sri Lanka. A key drug agency has also become bankrupt and the amount receivable from them is Rs. 15 million.

However, Blue-Rock Capital has raised its concerns over the FCF-based valuation approach and suggested that an earnings-based valuation approach (based on PE method) should be applied, which would result in a valuation that is greater than FCF method.

Due to uncertainty in opening proposed distribution centers, you may ignore next 5-year forecast (given in the pre-seen). However, assume that the current level of sales will continue to increase at 4.5% per annum and the current EBIT to sales ratio will continue subject to any changes in market conditions. Net additions to fixed assets (additions minus depreciation) will be maintained at 0.1% of sales while incremental working capital will be maintained at 0.5% of sales. You may also assume that CAPL's book value of equity and debt

(non-current and current portion of interest-bearing loans and borrowings) equal the market value.

CAPL has not engaged in hedging in the past and the board of directors was interested in analysing a scenario to understand it better. A scenario given by the management has been worked out under various hedging options by the market research team. CAPL assumes that USD 150,000 is payable to a drug supplier from the US in three months from now.

The rupee equivalent cost under various hedging options calculated by the research team is given below.

- Stay un-hedged LKR 54,750,000
- Forward market LKR 60,00,000
- Money market LKR 55,000,000

Data and assumptions used in deriving such calculations are as follows.

- ✓ Spot exchange rate LKR 365/USD
- ✓ Sri Lanka annual borrowing rate 18%
- ✓ Three months forward rate LKR 400/USD
- ✓ US annual investing rate 6%
- ✓ The company's foreign exchange advisory service forecasts that the spot rate in three months will be LKR 401/USD.

Assume the corporate tax rate is 28%.

(a) You have been approached by the managing director to assist him on Blue-Rock Capital argument that the FCF-based approach would value the business significantly lower than the earnings-based valuation method. Write an explanatory note to the managing director as to whether you agree with Blue-Rock Capital statement. (Support your answer with calculations and reasons including why CAPL cannot directly apply the earnings-based valuation method. Also consider the impact of the assets-based valuation method in your answer). (15 marks)

(b) Validate the findings and calculations carried out under various hedging options by the market research team to determine the best course of action for CAPL. (10 marks)

