

Question 03 (based on the common pre-seen case study)

In addition to the information given in the common pre-seen case study, the following information is provided.

The finance director of SWH group emphasised the fact that its market price per share was gradually declining away from the book value per share, and that it needed immediate attention. As a result, a restructuring plan was put forward for board consideration as illustrated below.

Divestment of Coral Beach Bay Negombo (Pvt) Ltd,

There was an interested party to purchase all the shares of Coral Beach Bay Negombo (Pvt) Ltd, held by SWH PLC and there were several discussions to agree on a selling price. However, the final price for the deal has not been agreed by both parties as there is a major disagreement on the valuation of the business.

The following additional information is available in respect of valuing Coral Beach Bay Negombo (Pvt) Ltd, shares. The market value of property, plant and equipment should be reduced by Rs. 1050 million due to a permanent impairment over the value reported in the 2022 financial statements. Inventory should also be reduced by Rs. 10 million to match the correct market value. Trade and other receivables include long outstanding balances totaling Rs. 25 million that need to be written off in full. Both parties do agree that the value of Coral Beach Bay Negombo (Pvt) Ltd.'s brand name is Rs. 35 million. The average annual earnings for the last 5-year period were Rs. 35 million. The price earnings ratio of a similar business to Coral Beach Bay Negombo (Pvt) Ltd, was estimated to be 12 times.

Coral Beach Bay Negombo (Pvt) Ltd, is reported 60% of the hotel & restaurants sector's assets and 50% of the liabilities of the same.

Further investments in the energy sector

The solar power operation will be expanded to Bangladesh as a pilot project using the retained earnings of SWH PLC. This will be set up as a joint venture with an existing local company operating in the power & energy sector, by equally contributing towards stated capital (50% ownership by each party). The initial investment has been estimated to be Rs. 1 billion and SWH PLC will contribute Rs. 500 million.

The summarised forecasted income statement for the Bangladesh operation for the first 5 years is given below. Values in BDT

	Year 1	Year 2	Year 3	Year 4	Year 5
Gross Profit	382,460	476,670	624,960	634,710	626,650
Depreciations	(176,000)	(176,000)	(176,000)	(176,000)	(176,000)
Royalty fees to SL office	(10,360)	(14,460)	(19,370)	(21,630)	(24,150)
Admin Cost	(4,144)	(75,070)	(96,870)	(118,970)	(144,900)
EBIT	191,956	211,140	332,720	318,110	281,600
Finance Cost	(157,900)	(143,630)	(128,120)	(111,310)	(91,950)
PBT	34,056	67,510	204,600	206,800	189,650
Tax 30%	-	(19,280)	(61,380)	(62,040)	(56,900)
	34,056	48,230	143,220	144,760	132,750
Avg Exchange rate 1BDT = LKR	1.86	1.90	1.94	1.97	2.01

A royalty fee is payable to SWH PLC for the use of the brand name and it will be remitted at the end of each year after deducting a withholding tax of 5%, paid at source. Dividends will be declared from Year 2 onwards, calculated at 50% on profit after tax and remitted to SWH PLC at the end of each year subject to a withholding tax of 15%. The operation will come to a maturity stage by the end of Year 5 and the cash flows will remain at the same level with a zero-growth rate from Year 6 onwards.

Group Treasury plans to recover the investment (Rs. 500 million) from its remittances (royalty and dividends) denominated in BDT and convert them to USD in order to pay for goods purchases in USD for their retail sector.

The finance director of SWH PLC is planning to enter into a forward exchange contract to hedge the BDT exposure against USD for the first year. The current exchange rate is USD 1 = BDT 78.

Finance costs and other variables – SWH PLC

Interest has been calculated at 22% per annum (before tax) for the financial year 2021/22 and after having series of negotiations with the bankers, finance director succeeded to have two-year moratorium starting from 2022/23. According to the agreement entered with bankers, SWH PLC not required to repay both capital and interest for the next two years and repayments will be commenced from 2024/25 at a fixed interest rate of 20% per annum.

The company pays corporate tax at 28%. In addition, 2% will be added to the weighted average cost of capital (WACC) for any cross-border investment. The number of shares outstanding for the year 2021/22 was 6.85 million. Assume that the market value of the debt of SWH PLC equals its book value.

You are a senior manager working for a consultancy firm hired to evaluate the above restructuring plan.

Required

(a)

(i) The board of directors is keen to know the extent of dilution of the market price per share of the group. Advise the board on the above giving your viewpoint with calculations, and comment on the validity of comparing market value per share against the book value per share from a theoretical perspective, giving due reference to SWH PLC's current situation. (5 marks)

(ii) Discuss possible reasons for the diluted market value per share of SWH PLC with the information provided in the common pre-seen case study, by considering each business sector. (7 marks)

(iii) Calculate the value of Coral Beach Bay Negombo (Pvt) Ltd, using the asset based and the earnings-based valuation methods. (3 marks)

(iv) The finance director argued, "neither the asset-based valuation method nor the earnings-based valuation method is easily applicable in light of the Coral Beach Bay Negombo (Pvt) Ltd, sale and instead recommend discounted cash flow method". Evaluate the above comment made by the finance director.

(5 marks)

(b)

(i) Advise the board of directors on the financial feasibility of the Bangladesh project from SWH PLC's perspective as a cross border investment, along with the required calculations. (You may assume that the operation will continue at the Year 5 level for the foreseeable future). (10 marks)

(ii) Compare the forward exchange contract with currency options as a hedging alternative in respect of Treasury's arrangement to convert BDT into USD in paying for imports. (5 marks)

(iii) Assess whether SWH PLC will actually gain or lose from the currency hedge arrangement assuming that the forward rate of exchange offered by banks will simply reflect the interest differential in the two countries at any time. The risk-free interest rate in the United States is estimated to be 4% per annum and the equivalent rate in Bangladesh is 8% per annum. You may assume that USD has appreciated by 6% against BDT at the end of Year 1. (7 marks)

