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F3 Financial Strategy

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Question: 70

A company's main objective is to achieve an average growth in dividends of 10% a year.

In the most recent financial year:

Sales are expected to grow at 8% a year over the next 5 years.

Costs are expected to grow at 5% a year over the next 5 years.

What is the minimum dividend payout ratio in 5 years' time that would allow the company to achieve its objective?

- A . 21.7%
- B . 30.0%
- C . 27.5%
- D . 22.5%

Answer: A

Question: 71

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 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

Question: 72

Which THREE of the following remain unchanged over the life of a 10 year fixed rate bond?

- A . The coupon rate
- B . The yield
- C . The market value
- D . The nominal value
- E . The amount payable on maturity

Answer: A,D,E

Question: 73

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

Question: 74

A company's current earnings before interest and taxation are \$5 million.

These are expected to remain constant for the foreseeable 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

Question: 75

A company financed by equity and debt can be valued by discounting:

- A . free cash flow before interest at WAC
- C . free cash flow before interest at the cost of equity.
- D . free cash flow after interest at WAC
- F . free cash flow after interest at the cost of equity.

Answer: A

Question: 76

A company has a covenant on its 5% long-term bond, stipulating that its retained earnings must not fall below \$2 million.

The company has 100 million shares in issue.

Its most recent dividend was \$0.045 per share. It has committed to grow the dividend per share by 4% each year.

The nominal value of the bond is \$60 million. It is currently trading at 80% of its nominal value.

Next year's earnings before interest and taxation are projected to be \$11.25 million.

The rate of corporate tax is 20%.

If the company increases the dividend by 4%, advise the Board of Directors if the level of retained earnings will comply with the covenant?

- A . Covenant is not breached as retained earnings = \$2.40 million.
- B . Covenant is not breached as retained earnings = \$2.10 million.
- C . Covenant is breached as retained earnings = \$1.92 million.
- D . The covenant is not breached as retained earnings = \$4.68 million.

Answer: C

Question: 77

A company wishes to raise additional debt finance and is assessing the impact this will have on key ratios.

The following data currently applies:

- Profit before interest and tax for the current year is \$500,000

- Long term debt of \$300,000 at a fixed interest rate of 5%
- 250,000 shares in issue with a share price of \$8

The company plans to borrow an additional \$200,000 on the first day of the year to invest in new project which will improve annual profit before interest and tax by \$24,000.

The additional debt would carry an interest rate of 3%.

Assume the number of shares in issue remain constant but the share price will increase to \$8.50 after the investment.

The rate of corporate income tax is 30%.

After the investment, which of the following statements is correct?

- A . Interest cover will fall; P/E ratio will fall.
- B . Interest cover will fall; P/E ratio will rise.
- C . Interest cover will rise; P/E ratio will rise.
- D . Interest cover will rise; P/E ratio will fall.

Answer: B

Question: 78

A company based in Country D, whose currency is the D\$, has an objective of maintaining an operating profit margin of at least 10% each year.

Relevant data:

- The company makes sales to Country E whose currency is the E\$. It also makes sales to Country F whose currency is the F\$.
- All purchases are from Country G whose currency is the G\$.
- The settlement of all transactions is in the currency of the customer or supplier.

Which of the following changes would be most likely to help the company achieve its objective?

- A . The D\$ strengthens against the E\$ over time.
- B . The F\$ weakens against the D\$ over time.
- C . The D\$ strengthens against the G\$ over time.
- D . The D\$ weakens against the G\$ over time.

Answer: C

Question: 79

Company A plans to acquire Company B, an unlisted company which has been in business for 3 years.

It has incurred losses in its first 3 years but is expected to become highly profitable in the near future.

No listed companies in the country operate the same business field as Company B, a unique new high-risk business

process.

The future success of the process and hence the future growth rate in earnings and dividends is difficult to determine.

Company A is assessing the validity of using the dividend growth method to value Company B.

Which THREE of the following are weaknesses of using the dividend growth model to value an unlisted company such as Company B?

- A . The company has been unprofitable to date and hence, there is no established dividend payment pattern.
- B . The future projected dividend stream is used as the basis for the valuation.
- C . The future growth rate in earnings and dividends will be difficult to accurately determine.
- D . The dividend growth model does not take the time value of money into consideration.
- E . The cost of capital will be difficult to estimate.

Answer: A,C,E

Question: 80

A company's gearing (measured as $\text{debt}/(\text{debt} + \text{equity})$) is currently 60% and it is investigating whether an optimal gearing structure exists within the industry.

It has analysed the capital structure of similar companies in the industry and it would

appear that there is evidence supporting the traditional theory of capital structure.

Companies with the lowest WACC in the industry have gearing of around 45% to 50%.

Which of the following actions would result in the company achieving a more optimal capital structure?

- A . Undertaking a rights issue of equity to repay some of its debt.
- B . Refinancing to replace some of its short term debt with long term debt.
- C . Increasing the level of dividend to return more cash to shareholders.
- D . Using retained cash to undertake a buyback of some of its equity.

Answer: A

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