SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer ALL of the following questions. Marks will be awarded for logical argumentation and appropriate presentation of the answers.

CASE

The Delicious Pizza Company Limited (DPC) is a subsidiary of ATL Fast Food Group (ATL) listed on the Hong Kong Stock Exchange. DPC operates many pizza restaurants in Hong Kong, Macau and mainland China. The company mission is to deliver hot and fresh pizza to customers on time, with excellent service and at a competitive price.

Pizza Delivery Service

Due to the escalating rental costs, DPC has introduced a pizza delivery service to customers which has received an enthusiastic response. To date, DPC has more than 5,000 dedicated and professional delivery teams located in 100 express delivery centres in the region. Hotline centres take orders from customers and are normally situated at different locations from the kitchens in order to optimise the costs involved. Currently, there are 200 hotline order operators.

The Chief Executive Officer (CEO), Mike Chan, strongly believes in the importance of quality service and on-time delivery to customers. The current operation is that when customers call in for a pizza, they often ask the hotline order operators how long it will take to deliver the pizza to them. If the operators quote too long a time interval, customers will very often turn to other pizza restaurants. If the operators quote too short a time interval, but could not meet it, customers will be upset and DPC will lose potential repeat customers.

Mike is very keen to monitor the delivery time to customers in order to improve the service quality. The industry benchmark for the delivery time to customers is within 45 minutes upon receiving the order ("Benchmark"), and rival pizza restaurants can achieve this Benchmark about 50% of the time (out of the total number of deliveries each month). Mike is unsure whether DPC could quote a delivery time of 45 minutes and achieve an on-time delivery performance of 50% for the past three months.

Delivery performance

DPC pizza delivery schedule		**2011**		
		Sept	**Oct**	**Nov**
1.	Delivery in 30 minutes or less	10,440	11,780	13,650
2.	Delivery between 31 & 45 minutes	17,400	19,840	22,750
3.	Delivery between 46 & 60 minutes	20,300	21,700	19,500
4.	Delivery between 61 & 90 minutes	9,860	8,680	9,100
Total Pizza deliveries		58,000	62,000	65,000

December Proposal

Mike is also thinking of giving an on-time guarantee for the month of December in order to promote sales. His initial idea is that if a pizza could not be delivered within 30 minutes of placing the order, the customer will get a free pizza. Mike estimates that an extra 25,000 pizzas will be sold while 10,000 pizzas will be given away free. Below is the analysis:

1.	Average price for a pizza	$200
2.	Cost per pizza	
	- Variable costs	$70
	- Fixed costs	50
	Total	$120

Prospectus

On 12 Dec 2011, the Marketing Director of ATL, Dick Lee, invited Frank Chan, the CFO, for a high tea chat at a 5-star hotel. They shared views about the current public invitation of subscription of shares of a subsidiary where a prospectus is due to be issued shortly. Dick told Frank that some key customers of the subsidiary may be running into financial trouble attributable to their customers having been hard hit by the recent economic slowdown in Europe. Dick does not want Frank to look into this matter and quantify the financial impact on the subsidiary or to update the Prospectus.

Question 1 (22 marks – approximately 40 minutes)

Assume that you are Frank Chan, the CFO, and you are going to write a memorandum to the CEO to explain the past performance and concerns regarding the December proposal. Your memorandum should cover the following areas:

(a) analyzing the past performance of the pizza delivery, including the comment on whether DPC could achieve a delivery time of 45 minutes and on-time delivery performance of 50%;

(6 marks)

(b) the estimated financial impact of the December proposal; (4 marks)

(c) consideration of non-financial indicators for the December proposal; and

(7 marks)

(d) other actions for improving the delivery time. (5 marks)

<u>Question 2</u> **(15 marks – approximately 27 minutes)**

<u>Potential Acquisitions</u>

DPC believes that the more pizza locations they run, the higher the market share that DPC will be able to achieve by satisfying the customers' demand in terms of delivery time and lowering the material purchase cost. Based on this principle, DPC's board of directors has asked the management to consider acquiring smaller pizza chain stores in the areas covered by DPC. Another principle that DPC wishes to implement is that the targets for acquisition should adopt the DPC brand for future operations.

Assume you are Mike:

(a) What selection criteria would you consider for the acquisitions targets? Particular concerns should be addressed in acquiring pizza chain in mainland China.

(5 marks)

(b) Recommend the possible way(s) the structure of acquisition or any additional terms can be secured assuming that the liabilities or contingent liabilities were not ascertainable to mitigate the risks of the acquisitions; and

(6 marks)

(c) If DPC would like to perform due diligence on the potential targets, what are the limitations of performing financial due diligence on the past financial results and position.

(4 marks)

<u>Question 3</u> **(13 marks – approximately 23 minutes)**

Refer to the prospectus issue in the case. Assume that you are the CFO and you wish to consider the following before discussing them with the CEO.

<u>Required:</u>

(a) State the ethical dilemmas and problems that arise in this issue. **(3 marks)**

(b) If you were the CFO who had the following choices:

<u>Do nothing:</u>

(i) What would be the consequence(s) for Sponsor, reporting accountants, and directors and management involved in the IPO?

(4 marks)

Conduct investigation:

(ii) **What would be procedures that you are going to carry out?**

(2 marks)

(iii) **What are the additional disclosures in the prospectus you will consider?**

(2 marks)

(iv) **What would be the expected impact on the current and future financial statements?**

(2 marks)

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End of Section A

SECTION B – ESSAY / SHORT QUESTIONS (Total: 50 marks)

Answer ALL of the following questions. Marks will be awarded for logical argumentation and appropriate presentation of the answers.

Question 4 **(15 marks – approximately 27 minutes)**

Company ABC has the following capital structure:

- 1,000,000 common stocks that have a dividend history of $0.65, $0.70, $0.72, and $0.75 per share over the last four years, respectively. The last dividend was $0.75. The firm's cost of equity is 7.93%.

- 80,000 bonds outstanding with a face value of $1,000 and coupon rate of 10% per year. Yield to maturity of this bond is 8% per year and pays interest semi-annually. This bond will be redeemed at 110 in four years.

Required:

(a) **Calculate the current stock price per share based on a simple arithmetic average of dividend growth rate for the past four years.**

(2 marks)

(b) **Evaluate how much each $1,000 bond is selling for now.** **(3 marks)**

(c) **Bond prices are very much affected by Yield- to- Maturity (YTM). What are the main determinants of a bond's YTM?**

(5 marks)

(d) **Are preference shares (also known as preferred stocks) debt or equity? Base your answers on the characteristics of conversion, redemption, maturity date and voting rights.**

(5 marks)

Question 5 **(20 marks – approximately 36 minutes)**

XYZ has just obtained a big contract which has a very high chance of resulting in a sustainable profit increase for at least 10 years. The company just also sold a major asset and realised $100M in cash which the Directors are planning to return to shareholders. The relevant information is not made known to the market.

The recent global financial crisis has caused a significant drop in the share price and also led to uncertainty as to future profitability. The Directors consider the current share price is undervalued.

Today the Directors meet and consider one of the following policy options:

(i) Declare an increase in dividends over the last dividend payment.
(ii) Declare a one time special dividend.
(iii) Repurchase shares from the market.

Required:

(a) What are the advantages and disadvantages of share repurchase?

(5 marks)

(b) Which of the two dividend policies should the company adopt for each of the following two independent scenarios? Support your answers based on the benefits and risks of each policy.

(1) as a result of winning a big contract and despite the financial crisis, the company expects a permanent increase in profits starting next year ;

(2) despite the positive impact of winning a big contract, future profit remains unstable due to the financial crisis.

(6 marks)

(c) After careful deliberation, the Directors decide that there is a higher chance of future profit remaining unstable. In this case, which of the three policy options will you recommend to the company? Provide reasons to support your answer.

(3 marks)

(d) Assume XYZ at present has a long term debt of $350M and equity value of $1,000M, i.e. a Debt/Equity (D/E) ratio of 35%. In addition, a debt protective covenant indicates the D/E ratio cannot be higher than 37%. What is the maximum amount of dividend payment or share repurchase that XYZ can make, if total equity remains at $1,000M before the cash distribution?

(6 marks)

<u>Question 6</u> **(15 marks – approximately 27 minutes)**

DEF is a UK company that regularly trades with companies in the United States. It has a number of transactions listed below the cash settlement of which will be due in six months:

Receipts from US	US$6M
Payment to US	US$10M

The CEO of the company would like to hedge its US$ exposure by either a forward contract or money market hedge. Relevant information is provided below:

(i) US$/£ rate:
Spot:1.5580

(ii) 6 month forward rate: 1.5000

(iii) 6 month interest rates to DEF:

	Borrow (%)	Investing (%)
£	6.5	5
US$	6.0	4

<u>Required:</u>

Assume you are the CFO of DEF:

(a) Advise the CEO which alternative should be used. Show all relevant calculations.

(10 marks)

(b) The company is also considering using options to hedge its exposure going forward. Discuss the advantages and disadvantages of currency options as a hedging tool compared with forward contracts.

(5 marks)

* * * END OF EXAMINATION PAPER * * *