National University of Science and Technology
Think in Other Terms

FACULTY OF COMMERCE
DEPARTMENT OF FINANCE
BACHELOR OF COMMERCE (HONOURS) FINANCE
PART IV 2nd SEMESTER FINAL EXAMINATION–MAY 2014
<u>CORPORATE FINANCIAL STRATEGY & RESTRUCTURING [CFI 4201]</u>

TIME ALLOWED: THREE (3) HOURS

<u>INSTRUCTIONS TO CANDIDATES</u>

1. Answer **Question One** and any other **THREE (3)** Questions.
2. Write neatly and legibly.

<u>INFORMATION TO CANDIDATES</u>

1. This paper contains **<u>FIVE (5)</u>** Questions.
2. Section One is compulsory and it carries **40 marks.**
3. Other questions carry a total of **20 marks**
4. This paper contains **<u>FIVE (5)</u>** printed pages.
5. The businesses and persons in this question paper are intended to be fictitious.

QUESTION ONE (COMPULSORY)

THE STORY OF BERKSHIRE HATHAWAY

Do any companies in America make decisions consistent with all ten shareholder value principles?BerkshireHathaway, controlled by the legendary Warren Buffet, may come the closest.Not only is Buffet the company's largest shareholder,but he is also in the rare position of viewing the drivers of shareholder value through the eyes of a major investor and executive.He observes, "I'm a better businessman because I am an investor and a better investor because I am a businessman.If you have mentality of both ,it aid you in each field".

In Berkshire's communications,for example, Buffet makes it clear that the company does not "follow the usual practice of giving earnings 'guidance'", recognising that "reported earnings may reveal relatively little about our true economic performance". Instead, the company vows to be "candid in our reporting to you, emphasizing the pluses and minuses important in appraising business value.Our guideline is to tell you the business facts that we would want to know if our positions were reversed.We own you no less".

Berkshire's capital allocation decisions,especially when earnings growth and value creation conflict, are also consonant with the shareholder value principle.Writes buffet, "Accounting consequences do not influence our operating or capital allocation decisions.When acquisition costs are similar,we much prefer to purchase $2 of earnings that are not reportable by us under standard accounting principles than to purchase $1 of earnings that is reportable".

Shareholder value companies recognise the importance of generating long tern cash flows and hence avoid actions designed to boost short term performance at the expense of long term view .Berkshire's 2005 annual report explains the company's position: "if a management makes bad decisions in order to hit short term earnings targets,and consequently gets behind the eight –ball …., no amount of subsequent brilliance will overcome the damage that has been inflicted".

Berkshire is also exceptional with regard to its corporate governance and compensation .There's no doubt that Buffet's wealth and that of the company's vice chairman, Charlie Munger,rises and falls with that of other shareholders: Berkshire stock represents the vast majority of their substantial net worth. As Buffet notes, "Charlie and I cannot promise you results.But we can guarantee that your financial fortunes will move in lockstep with ours for whatever period of time you select to be our partner".

The company's compensation approach is also consistent with the shareholder value principle and stands in stark contrast to common U.S. compensation practices .Buffet's

$100,000 annual salary places him in the cellar of Fortune 500 CEO pay ,where median compensation exceeds $8 million.Further,Berkshire is the rare company that does not grant any employee stock options or restricted stock.Buffets is not against equity based pay per se,but he does argue that too few companies properly link pay and performance.

Buffet uses Geico,Berkshire’s auto insurance business,to illustrate the company’s compensation philosophy.The goals of the plan,Buffet explains, “should be tailored to the economics of the specific operating business; simple in character so that the degree to which they are being realised can be easily measured; and directly related to the daily activities of plan participants”. He state the “we shun ‘lottery ticket’ arrangements ….whose ultimate value…is totally out of control of the person whose behaviour we would like to affect”

So far, Berkshire looks like a complete level 10 value creation company –one that applies all ten principles.But it doesn’t closely adhere to the principle of carrying only assets that maximise value and has never acted on returning cash to shareholders.In both cases,however,Buffet and Munger’s writings and comments suggest that Berkshire evaluates its investments in light of theseprinciples even if it doesn’t directly apply them to itself.

Principle four advises selling operations if a buyer offers a meaningful premium to estimated value.Buffet states flatly.“Regardless of price, we have no interest at all in selling any good business that Berkshire owns”, noting that this attitude “hurts our financial performance”.

And despite sitting on more than $40 billion in excess cash at year end 2005, Berkshire has not returned any cash to its shareholders to date.However, the company does apply a clear test to determine the virtue of retaining, versusdistributing, cash:Management assesses “whether retention,over time,delivers shareholders at least $1 retained”. Thistest, of course is a restatement of the core shareholder value concept that all investments should generate a return in excess of the cost of capital.Consistent with the returning cash to shareholders when there is no credible value creating opportunities to invest in the business,Buffet is clear about the consequence of failing the test.He says, “if we reach a point that we can’t create extra value by retaining earnings ,we will pay them out and let our shareholders deploy the funds”.

Buffet’s influence extends beyond Berkshire to companies for which he has served as a board member.For example, theWashington Post and Coca-Cola were among the first companies to voluntarily expense employee stock options in 2002.Companies with which Buffet has been involved also have a history of repurchasing stock.

The article was done by **Michael J. Mauboussin**. *Michael is the chief investment strategist at Legg Mason Capital Management, based in Baltimore.He is a shareholder in Berkshire Hathaway. Adopted from the Harvard Business Review.*

a) Explain any five (5) ways of creating shareholder value highlighted in this case. **[10 marks]**

b) Evaluate the principle of not returning cash to shareholders in relation to dividend theories. **[6 marks]**

c) How does Buffet's statement, "Regardless of price, we have no interest at all in selling any good businesses that Berkshire owns", contradict principles of value creation? **[5 marks]**

d) How can mergers and acquisitions create value for shareholders in light of the principle of acquiring companies that maximise expected value even at the expense of lowering near term earnings? **[5 marks]**

e) What's the importance of requiring senior executives to be bear risks of ownership just as shareholders do? **[5 marks]**

f) Clearly articulate the importance of providing value relevant information to shareholders as a source of value. **[5 marks]**

g) Justify the choice of stock repurchases over paying out cash dividends. **[4 marks]**

Total [40 marks]

QUESTION TWO

a) Briefly, discuss the critical assumptions of the Modigliani – Miller (proposition 1) Capital Structure Theory. **[5 marks]**

b) Show that,given the assumptions in a), the value of a firm is independent of its capital structure. **[9 marks]**

c) Briefly, discuss Perking Order Hypothesis and Signalling Model of Capital Structure. **[6 marks]**

Total[20 marks]

QUESTION THREE

a) Discuss the desirable relationship between business and financial risk under Optimal Corporate Financial Strategy for companies. Discuss in the context of the interest of shareholders and lenders. **[8 marks]**

b) Suppose that Venture Company has made an offer for Rapture Company that consists of the purchase of 2 million shares at $10 per share. The value of

Rapture Company stock before the bid was made public was $8 per share. Venture Company stock is trading at $20 per share, and there are 10 million shares outstanding. Venture Company estimates that it is likely to reduce costs through economics of scale with this merger of $1.5 million per year, forever. The appropriate discount rate for these gains is 12%.

i. What are the synergistic gains from this merger? **[3 marks]**
ii. What is the share of the parties, if any, in these gains? **[5 marks]**
iii. What is the estimated value of the Big Company post-merger? **[4 marks]**

Total [20 marks]

QUESTION FOUR

a) Demonstrate how stages of the Product Life Cycle [PLC] are linked to the Boston Consulting Group [BCG] Matrix **[8 marks]**
b) Discuss the Agency Problem in the context of Mergers and Acquisitions **[6 marks]**
c) Explain three (3) motives of mergers and acquisitions in relation to shareholder value maximising. **[6 marks]**

Total[20 marks]

QUESTION FIVE

a) Evaluate the importance of dividend stability. **[6 marks]**
b) Discuss two (2) reasons why mergers fail. **[4 marks]**
c) Giving examples, explain two (2) factors that influence capital structure decision in made by companies listed on the Zimbabwe Stock Exchange. **[6 marks]**
d) Examine one (1) tactic of defending against hostile take overs and how it affects shareholder value. **[2,2 marks]**

Total [20 marks]

END OF EXAMINATION PAPER