Section A – This ONE question is compulsory and MUST be attempted

1 The eight-member board of executive directors (BoD) of Chrysos Co, a large private, unlisted company, is considering the company's long-term business and financial future. The BoD is considering whether or not to undertake a restructuring programme. This will be followed a few years later by undertaking a reverse takeover to obtain a listing on the stock exchange in order to raise new finance. However, a few members of the BoD have raised doubts about the restructuring programme and the reverse takeover, not least the impact upon the company's stakeholders. Some directors are of the opinion that an initial public offering (IPO) would be a better option when obtaining a listing compared to a reverse takeover.

Chrysos Co was formed about 15 years ago by a team of five senior equity holders who are part of the BoD and own 40% of the equity share capital in total; 30 other equity holders own a further 40% of the equity share capital but are not part of the BoD; and a consortium of venture capital organisations (VCOs) own the remaining 20% of the equity share capital and have three representatives on the BoD. The VCOs have also lent Chrysos Co substantial debt finance in the form of unsecured bonds due to be redeemed in 10 years' time. In addition to the BoD, Chrysos Co also has a non-executive supervisory board consisting of members of Chrysos Co's key stakeholder groups. Details of the supervisory board are given below.

Chrysos Co has two business units: a mining and shipping business unit, and a machinery parts manufacturing business unit. The mining and shipping business unit accounts for around 80% of Chrysos Co's business in terms of sales revenue, non-current and current assets, and payables. However, it is estimated that this business unit accounts for around 75% of the company's operating costs. The smaller machinery parts manufacturing business unit accounts for the remaining 20% of sales revenue, non-current and current assets, and payables; and around 25% of the company's operating costs.

The following figures have been extracted from Chrysos Co's most recent financial statements:

Profit before depreciation, interest and tax for the year to 28 February 2017

	$m
Sales revenue	16,800
Operating costs	(10,080)
Profit before depreciation, interest and tax	6,720

Financial position as at 28 February 2017

	$m
Non-current assets	
Land and buildings	7,500
Equipment	5,400
Current assets	
Inventory	1,800
Receivables	900
Total assets	15,600
Equity	
Share capital ($1 par value per share)	1,800
Reserves	5,400
Non-current liabilities	
4·50% unsecured bonds 2026 (from the VCOs)	4,800
Other debt	1,050
Current liabilities	
Payables	750
Bank overdraft	1,800
Total equity and liabilities	15,600

Corporate restructuring programme

The purpose of the restructuring programme is to simplify the company's gearing structure and to obtain extra funding to expand the mining and shipping business in the future. At present, Chrysos Co is having difficulty obtaining additional funding without having to pay high interest rates.

Machinery parts manufacturing business unit

The smaller machinery parts manufacturing business unit will be unbundled either by having its assets sold to a local supplier for $3,102 million after its share of payables have been paid; or

The smaller machinery parts manufacturing business unit will be unbundled through a management buy-out by four managers. In this case, it is estimated that its after-tax net cash flows will increase by 8% in the first year only and then stay fixed at this level for the foreseeable future. The cost of capital related to the smaller business unit is estimated to be 10%. The management buy-out team will pay Chrysos Co 70% of the estimated market value of the smaller machinery parts manufacturing business unit.

Mining and shipping business unit

Following the unbundling of the smaller machinery parts manufacturing business unit, Chrysos Co will focus solely on the mining and shipping business unit, prior to undertaking the reverse takeover some years into the future.

As part of the restructuring programme, the existing unsecured bonds lent by the VCOs will be cancelled and replaced by an additional 600 million $1 shares for the VCOs. The VCOs will pay $400 million for these shares. The bank overdraft will be converted into a 15-year loan on which Chrysos Co will pay a fixed annual interest of 4·50%. The other debt under non-current liabilities will be repaid. In addition to this, Chrysos Co will invest $1,200 million into equipment for its mining and shipping business unit and this will result in its profits and cash flows growing by 4% per year in perpetuity.

Additional financial information

Chrysos Co aims to maintain a long-term capital structure of 20% debt and 80% equity in market value terms. Chrysos Co's finance director has assessed that the 4·50% annual interest it will pay on its bank loan is a reasonable estimate of its long-term cost of debt, based on the long-term capital structure above.

Although Chrysos Co does not know what its cost of capital is for the mining and shipping business unit, its finance director has determined that the current ungeared cost of equity of Sidero Co, a large quoted mining and shipping company, is 12·46%. Chrysos Co's finance director wants to use Sidero Co's ungeared cost of equity to calculate its cost of capital for the mining and shipping business unit.

The annual corporation tax rate on profits applicable to all companies is 18% and it can be assumed that tax is payable in the year incurred. All the non-current assets are eligible for tax allowable depreciation of 12% annually on the book values. The annual reinvestment needed to keep operations at their current levels is equivalent to the tax allowable depreciation.

Details of the supervisory board

The non-executive supervisory board provides an extra layer of governance over the BoD. It consists of representatives from the company's internal stakeholder groups including the finance providers, employees and the company's management. It ensures that the actions taken by the BoD are for the benefit of all the stakeholder groups and to the company as a whole. Any issues raised in board meetings are resolved through negotiation until an agreed position is reached.

Required:

(a) **Explain what a reverse takeover involves and discuss the relative advantages and disadvantages to a company, such as Chrysos Co, of obtaining a listing through a reverse takeover as opposed to an initial public offering (IPO).** (9 marks)

(b) **Prepare a report for the board of directors of Chrysos Co which includes:**

(i) **An extract of the financial position and an estimate of Chrysos Co's value to the equity holders, after undertaking the restructuring programme.** (18 marks)

(ii) **An explanation of the approach taken and assumptions made in estimating Chrysos Co's value to the equity holders, after undertaking the restructuring programme.** (5 marks)

(iii) **A discussion of the impact of the restructuring programme on Chrysos Co and on the venture capital organisations.** (10 marks)

Professional marks will be awarded in part (b) for the format, structure and presentation of the report. (4 marks)

(c) **Discuss why the attention Chrysos Co pays to its stakeholders represented on the supervisory board may change once it has obtained a listing.** (4 marks)

(50 marks)