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

1 Conejo Co is a listed company based in Ardilla and uses the $ as its currency. The company was formed around 20 years ago and was initially involved in cybernetics, robotics and artificial intelligence within the information technology industry. At that time due to the risky ventures Conejo Co undertook, its cash flows and profits were very varied and unstable. Around 10 years ago, it started an information systems consultancy business and a business developing cyber security systems. Both these businesses have been successful and have been growing consistently. This in turn has resulted in a stable growth in revenues, profits and cash flows. The company continues its research and product development in artificial intelligence and robotics, but this business unit has shrunk proportionally to the other two units.

Just under eight years ago, Conejo Co was successfully listed on Ardilla's national stock exchange, offering 60% of its share capital to external equity holders, whilst the original founding members retained the remaining 40% of the equity capital. The company remains financed largely by equity capital and reserves, with only a small amount of debt capital. Due to this, and its steadily growing sales revenue, profits and cash flows, it has attracted a credit rating of A from the credit rating agencies.

At a recent board of directors (BoD) meeting, the company's chief financial officer (CFO) argued that it was time for Conejo Co to change its capital structure by undertaking a financial reconstruction, and be financed by higher levels of debt. As part of her explanation, the CFO said that Conejo Co is now better able to bear the increased risk resulting from higher levels of debt finance; would be better protected from predatory acquisition bids if it was financed by higher levels of debt; and could take advantage of the tax benefits offered by increased debt finance. She also suggested that the expected credit migration from a credit rating of A to a credit rating of BBB, if the financial reconstruction detailed below took place, would not weaken Conejo Co financially.

Financial reconstruction

The BoD decided to consider the financial reconstruction plan further before making a final decision. The financial reconstruction plan would involve raising $1,320 million ($1·32 billion) new debt finance consisting of bonds issued at their face value of $100. The bonds would be redeemed in five years' time at their face value of $100 each. The funds raised from the issue of the new bonds would be used to implement one of the following two proposals:

(i) Proposal 1: Either buy back equity shares at their current share price, which would be cancelled after they have been repurchased; or

(ii) Proposal 2: Invest in additional assets in new business ventures.

Conejo Co, Financial information

Extract from the forecast financial position for next year

	$m
Non-current assets	1,735
Current assets	530
Total assets	2,265
Equity and liabilities	
Share capital ($1 per share par value)	400
Reserves	1,700
Total equity	2,100
Non-current liabilities	120
Current liabilities	45
Total liabilities	165
Total liabilities and capital	2,265

Conejo Co's forecast after-tax profit for next year is $350 million and its current share price is $11 per share.

The non-current liabilities consist solely of 5·2% coupon bonds with a face value of $100 each, which are redeemable at their face value in three years' time. These bonds are currently trading at $107·80 per $100. The bond's covenant stipulates that should Conejo Co's borrowing increase, the coupon payable on these bonds will increase by 37 basis points.

Conejo Co pays tax at a rate of 15% per year and its after-tax return on the new investment is estimated at 12%.

Other financial information

Current government bond yield curve

Year	1	2	3	4	5
	1·5%	1·7%	1·9%	2·2%	2·5%

Yield spreads (in basis points)

	1 year	2 years	3 years	4 years	5 years
A	40	49	59	68	75
BBB	70	81	94	105	112
BB	148	167	185	202	218

The finance director wants to determine the percentage change in the value of Conejo Co's current bonds, if the credit rating changes from A to BBB. Furthermore, she wants to determine the coupon rate at which the new bonds would need to be issued, based on the current yield curve and appropriate yield spreads given above.

Conejo Co's chief executive officer (CEO) suggested that if Conejo Co paid back the capital and interest of the new bond in fixed annual repayments of capital and interest through the five-year life of the bond, then the risk associated with the extra debt finance would be largely mitigated. In this case, it was possible that credit migration, by credit rating companies, from A rating to BBB rating may not happen. He suggested that comparing the duration of the new bond based on the interest payable annually and the face value in five years' time with the duration of the new bond where the borrowing is paid in fixed annual repayments of interest and capital could be used to demonstrate this risk mitigation.

Required:

(a) **Discuss the possible reasons for the finance director's suggestions that Conejo Co could benefit from higher levels of debt with respect to risk, from protection against acquisition bids, and from tax benefits.** (7 marks)

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

(i) **Estimates, and briefly comments on, the change in value of the current bond and the coupon rate required for the new bond, as requested by the CFO;** (6 marks)

(ii) **Estimates the Macaulay duration of the new bond based on the interest payable annually and face value repayment, and the Macaulay duration based on the fixed annual repayment of the interest and capital, as suggested by the CEO;** (6 marks)

(iii) **Estimates the impact of the two proposals on how the funds may be used on next year's forecast earnings, forecast financial position, forecast earnings per share and on forecast gearing;** (11 marks)

(iv) **Using the estimates from (b)(i), (b)(ii) and (b)(iii), discusses the impact of the proposed financial reconstruction and the proposals on the use of funds on:**

- **Conejo Co;**
- **Possible reaction(s) of credit rating companies and on the expected credit migration, including the suggestion made by the CEO;**
- **Conejo Co's equity holders;**
- **Conejo Co's current and new debt holders.** (16 marks)

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

(50 marks)