

AFM MOCK PAPER OVERALL COMMENTS ON STUDENT PERFORMANCE

Overall, the performance of the students was excellent and significantly better than in the actual exam. This was particularly good to see, although please see my caveat at the end of this commentary.

Question One

This was the 50-mark question in which the case study scenario focused on restructuring through a management buy-in (MBIs) and an acquisition. The computations, report and evaluation areas in the question involved estimating the additional value created by synergy benefits of the acquisition and how these synergies were shared out between the acquiring company's shareholders and the target company's shareholders. The final part of the question asked students to discuss the differences between an IPO and reverse takeovers when undertaking a listing.

Part a) asked students to distinguish between a management buy-out (MBO) and an MBI and discuss why a company may be sold through an MBI. The majority of the students did this part well, with many scoring full marks. A small number of students could not distinguish between MBOs and MBIs, or did not explain the preferred option of MBI fully.

Part b) initially asked students to explain what portfolio restructuring and organisational restructuring involve. Most students did this part well. Students were then asked to discuss possible reasons why a change in the type of shareholders may have made a company change its business focus. This was also well-answered by most, although a few students did not answer part b) at all.

Part c) (i) asked students to estimate the values of two companies individually and the estimate the value of the combined company. The majority of students did this part well, with many scoring full marks. This was pleasing. One or two students erroneously calculated the tax payable after adding back depreciation and other non-cash expenses.

Part c) (ii) asked students to estimate the percentage gain in value for the acquiring company shares and the target company shares under each of three methods: a cash payment, a share-for-share offer payment and a mixed offer payment. Many students did this part well often getting full marks. Where errors were made, these were mainly to do with how synergy benefits were divided between the two companies' shareholders and then the impact of this on value, and thereby the percentage gain. A minority of students did not attempt this part at all, or did not attempt parts of the question, in particular the share-for-share offer. One or two students only considered the gains to one company's shareholder and not both. This also limited their attempt to part c) (iii).

Part c) (iii) asked students to evaluate the likely reaction of both companies' shareholders to the acquisition offers. The answers given by students for this part were mixed. Some students answered the question really well and got all or the majority of the salient evaluative points. Other students repeated the outcomes of calculations,

and commented on the assumptions made, which was not really what was asked, but said little more. A small minority of students did not attempt this part or made a brief attempt. The brief attempts were made in incomplete sentences and in point form, and therefore contained little evaluation. It is important that students take the number of marks into consideration for any evaluative/discursive/explanatory part and then frame their answers appropriately. Good time management is critical here.

In terms of professional marks, many students provided a well-presented and well-structured report. The report contained an appropriate introduction, a good flow in the narrative with headings used as signposts, an appropriate conclusion and appropriate use of appendices for the detailed calculations. Some professional marks were not gained where one or more of these were missing. A few students included part d) in the report, although the report was only applicable to part c). A few students did not frame their answer in a report format at all. One such student, has a marginal fail mark. With an appropriately structured report, this would have been a marginal pass.

Part d) asked students to distinguish between an IPO and a reverse takeover, and to discuss whether either method was appropriate for a company to obtain a listing. Most students did this part well, gaining between 6 and 8 marks depending on the detail of the answers. But often answers did not distinguish the reverse takeover process fully. A few students used the 7 years as the timeframe for the IPO process. This is not accurate, just because the intent is to go for a listing in 7 years' time, it does not mean that the IPO process should start immediately.

Question Two

In part a) this question asked students to evaluate whether futures contracts or options contracts would result in higher receipts and the scenarios when the options would and would not be exercised. Students' answers for part a) were variable in that the use of options was demonstrated well but the use of futures less well, nonetheless many students got a good mark. Common errors included errors in calculating the futures price based on the remaining basis, not stating that the company should sell futures and calculating the income received using forwards when the question scenario did not require this. Forwards were only needed to calculate the unhedged balance. The majority of students did not present the scenarios at which the options would be exercised and not exercised.

Part b) asked students to compare over-the-counter options with forwards, and why the company may want to use exchange-traded derivatives. The majority of students provided very good answers to this part, but a common error was the confusion between exchange traded and over-the-counter options.

Part c) asked students to explain the mark-to-market process using the initial and maintenance margins, and to illustrate the process, via calculations, using the information provided. The majority of students did this part well. However, in many cases the explanation lacked sufficient detail about the margin accounts. And sometimes the calculations were not given for illustration purposes and occasionally they weren't provided for all 98 contracts, and thereby the full cash shortfall that needed to be made-up for the maintenance margin, was not determined.

Question Three

This question asked students to undertake an adjusted present value (APV) computation and conclude on whether to undertake the project in part a) and then discuss the long-term finance policy and factors causing a change to this in part b).

In part a) the calculations required for the base case net present value (NPV) were mostly done well. Errors included not calculating the additional working capital requirements but instead calculating full working capital amount and, on one occasion, the market return was treated like the risk premium. The calculations relating to the financing side effects proved more challenging. The majority of students were not able to deal with a loan payable in equal instalments. Other financing side effects were done well.

In part b), most students were able to achieve a good mark for the factors which determine the long-term financing policy and factors which cause the policy to change. The common limitation for this part was that in many cases the points made were not sufficient in number. It is important, as before, that students consider the marks available for each part to frame their answers. Brief answers, in bullet form, incomplete sentences will not gain many marks.

Caveat and conclusion

A few answers provided here were better than what candidates produced for a strong pass in the actual exam in December 2018. The answers achieving the highest marks, gave the impression that some students did not undertake this exam under tight, time-constrained, closed-book conditions. Rather it would seem that these students produced answers, having had full sight of the model solutions.

Whilst it is important that students should have access to and make use of model solutions, it is important that these are used strategically to maximise learning and to help prepare students for the actual exam. Solutions should not be looked at before attempting the exam, nor be referred to while the students prepare their answers. Instead, the most effective form of learning will occur when students attempt the paper as an unseen exam, to test their knowledge and feel free to make mistakes. Then to reflect on the mistakes made, understand gaps in their knowledge and use their tutor and learning resources to plug those gaps.

Nonetheless, where students have attempted the paper unseen and achieved a good mark, then they are displaying a good level of knowledge and are preparing well for the AFM paper. Where students haven't quite achieved a pass, they should reflect on the errors made and plug these knowledge, understanding and application gaps.