CIMA F3 Financial Strategy

Mock exam: 60 questions in 90 minutes, with an answer key and explanations

How to use this mock

- Set a timer for **90 minutes** and answer every question without notes. Write your answers in the grid on the next page.
- Mark your answers using the answer key, then read the explanation for every question you got wrong or guessed.
- The questions cover every section of the syllabus, in proportion to the GoQualified question bank for F3.
- Prefer to sit it on screen? The **Exam Sim** on **goqualified.co.uk/cima/f3/** times you, marks the paper and shows your weakest section.
- All questions are original GoQualified practice questions, not past exam questions.

Free from GoQualified. Questions start on page 3; the answer key and explanations follow them. Download the latest version from goqualified.co.uk/cima/f3/.

Your answers

1 _____	13 _____	25 _____	37 _____	49 _____
2 _____	14 _____	26 _____	38 _____	50 _____
3 _____	15 _____	27 _____	39 _____	51 _____
4 _____	16 _____	28 _____	40 _____	52 _____
5 _____	17 _____	29 _____	41 _____	53 _____
6 _____	18 _____	30 _____	42 _____	54 _____
7 _____	19 _____	31 _____	43 _____	55 _____
8 _____	20 _____	32 _____	44 _____	56 _____
9 _____	21 _____	33 _____	45 _____	57 _____
10 _____	22 _____	34 _____	46 _____	58 _____
11 _____	23 _____	35 _____	47 _____	59 _____
12 _____	24 _____	36 _____	48 _____	60 _____

Questions

Question 1

A finance director asks for advice on the scope of environmental, social and governance (ESG) reporting. Which statement best describes what ESG reporting covers and why companies increasingly produce it alongside traditional financial statements?

A ESG reporting is limited entirely to a company's carbon emissions, and has no social or governance dimension

B ESG reporting communicates a company's performance across environmental factors (e.g. emissions, resource use), social factors (e.g. employee welfare, community impact, human rights in the supply chain) and governance factors (e.g. board structure, executive remuneration, ethics), reflecting growing investor, regulatory and stakeholder demand for non-financial performance information alongside the financial statements

C ESG reporting is a purely voluntary marketing exercise with no connection to investor decision-making or capital markets

D ESG reporting replaces financial reporting entirely, since financial statements are no longer required once a company reports on ESG

Question 2

Modigliani and Miller's dividend irrelevance proposition concludes that, under certain assumptions, a company's dividend policy has no effect on its share price. Which assumption is essential to this conclusion?

A All shareholders prefer cash dividends over capital gains regardless of their own personal tax circumstances

B Perfect capital markets exist, with no taxes, no transaction costs, and equal investor access to information

C The company operates in a market with significant information asymmetry between managers and investors

D Dividends are taxed at a higher rate than capital gains in every jurisdiction without exception

Question 3

In a jurisdiction where capital gains are taxed at a lower rate than dividend income, and are only taxed when realised, tax preference theory predicts which investor behaviour?

A All investors, regardless of tax position, will prefer the highest possible dividend payout

B Tax rates on dividends and capital gains have no bearing on investor preferences for shares

C Companies should always pay 100% of earnings as dividends to satisfy tax preference theory

D Some investors prefer low payout ratios, since retained earnings become capital gains taxed later and at a lower rate

Question 4

A company unexpectedly increases its interim dividend by 20%, and its share price rises sharply on the announcement, even though no new financial information about profitability has otherwise been released. Signalling theory would explain this reaction as arising because:

A The dividend increase mechanically increases the intrinsic value of the company's underlying assets and operations

B Managers have private information about future prospects, and the dividend rise signals confidence in sustaining higher cash flows

C Investors are legally required under securities law to revalue shares upward whenever a dividend increases

D The increase proves that the company has no positive net present value investment opportunities available

Question 5

A listed company has paid a dividend that has grown steadily by 3-5% every year for the past decade, even in a year when earnings temporarily fell due to a one-off restructuring charge. This behaviour is most consistent with which dividend policy?

A A progressive (stable growth) dividend policy with dividend smoothing, where dividends are only adjusted gradually and are not cut for temporary earnings dips

B A strict residual dividend policy, where the dividend exactly tracks the year's earnings after funding investment

C The Modigliani and Miller irrelevance approach, under which the level of dividend is deliberately randomised

D A zero-dividend policy typical of high-growth technology start-ups

Question 6

A company wants to report its sustainability performance using a well-established, widely recognised voluntary framework. Which of the following best describes the Global Reporting Initiative (GRI) Standards?

A A set of legally binding international accounting standards that replace IFRS for any company reporting on sustainability

B A credit-rating methodology used exclusively by banks to price corporate loans, unrelated to public disclosure

C A widely used, voluntary set of standards and disclosures that provides a common structure and set of metrics for organisations to report their economic, environmental and social impacts, intended to improve comparability between organisations

D A UN treaty requiring member states to impose identical sustainability taxes on all companies

Question 7

According to pecking order theory, when a company needs to raise finance for a new investment, in what order will it generally prefer to source funds?

A New equity issuance first, then debt, and retained earnings only as a last resort

B Debt finance first, then new equity, with retained earnings never used for investment

C Internally generated retained earnings first, then debt finance, and new equity issuance only as a last resort

D All sources are used in exactly equal proportions regardless of cost or information asymmetry

Question 8

A CFO is deciding whether to invest in more comprehensive ESG reporting and the underlying data systems needed to support it. From a financial strategy perspective, which of the following is a genuine potential benefit of doing so?

A It has no link whatsoever to the cost or availability of capital, since lenders and investors only ever consider historical financial statement figures

B Improved ESG disclosure can support access to a broader investor base (including funds with ESG-focused mandates), potentially lower the cost of debt or equity where lenders and investors price ESG risk into their required returns, and provide better risk information to support strategic and operational decisions

C ESG reporting guarantees a reduction in the company's corporation tax liability, regardless of jurisdiction

D Investing in ESG reporting systems is required only for companies that have already breached environmental regulations, as a form of penalty

Question 9

A company has a return on equity (ROE) of 18% and pays out 35% of its earnings as dividends, retaining the rest. Assuming no new external equity is raised and the capital structure and ROE remain constant, what is the company's sustainable growth rate?

A 18.0%

B 6.3%

C 11.7%

D 35.0%

Question 10

A company obtaining a stock market listing sells new shares directly to a small number of institutional investors selected by its sponsoring broker, rather than offering shares to the general public. Which listing method does this describe?

A A public offer for subscription

B A placing

C An introduction

D A rights issue

Question 11

Which of the following best describes an Initial Public Offering (IPO)?

A The process by which a listed company issues new shares to its existing shareholders only
B The process by which a company repurchases all of its shares and goes private
C The process by which a private company first sells shares to the public and obtains a listing on a stock exchange
D The process by which a company merges with another already-listed company

Question 12

Which statement correctly describes a key characteristic of cumulative irredeemable preference shares as a source of long-term finance?

A Preference dividends are a tax-deductible expense in the same way that debt interest is
B Preference shareholders always have full voting rights equal to ordinary shareholders
C Preference shares rank below ordinary shares on liquidation and receive nothing until ordinary shareholders are paid
D Unpaid dividends accumulate and must be paid before any ordinary dividend, but there is no obligation to ever repay the capital

Question 13

A company's loan notes have a nominal value of $100, pay an annual coupon of 7%, and are redeemable at par in exactly 3 years. Investors now require a return of 9%. What is the theoretical market value per $100 nominal, to two decimal places?

A $100.00
B $94.94
C $77.22
D $17.72

Question 14

A convertible bond currently trades in the market at $105, while its conversion value (based on the current share price and conversion ratio) is $90. What does the difference between these two figures represent?

A A pricing error that will immediately be arbitraged away with no economic explanation
B The redemption value the bond will pay investors at maturity, unrelated to conversion
C The coupon rate expressed in dollar terms, i.e. the periodic interest payment
D The conversion premium, reflecting the bond's downside protection plus the future option to convert

Question 15

A company issues bonds that pay no annual interest at all but are issued at a substantial discount to their nominal (redemption) value. What type of bond is this, and what is the main attraction to the issuing company?

A A convertible bond; converting into equity would eliminate the redemption obligation
B A zero coupon bond; the whole return comes from the issue-to-redemption discount, avoiding periodic interest cash outflows
C A eurobond; it must always be denominated in a currency other than the issuer's home currency
D An irredeemable bond; interest is paid indefinitely and the principal is never repaid

Question 16

A bank lending long-term finance to a company includes a condition in the loan agreement restricting the company from taking on any further secured borrowing without the bank's consent. What type of loan covenant is this?

A A positive covenant, requiring the company to take a specific action
B A financial covenant based on a profitability ratio
C A conversion clause allowing the loan to be converted into equity
D A negative covenant, restricting specific actions the company may take

Question 17

A high-growth, early-stage company with no track record of profits and no assets to offer as security is seeking substantial equity finance to fund expansion. Which source of finance is most likely to be appropriate?

A A public bond issue, since bond investors specialise in funding unproven, high-risk early-stage businesses
B An irredeemable preference share issue to retail investors on the open market
C A conventional secured bank loan, since banks specialise in funding businesses with no assets or track record
D Venture capital, which provides equity finance to higher-risk, high-growth businesses for a shareholding and board involvement

Question 18

The existing management team of a division being sold by its parent group arranges finance (often a mix of equity and significant debt) to acquire the division themselves. What is this transaction commonly known as?

A A management buyout (MBO)
B A rights issue
C A scrip dividend
D An initial public offering

Question 19

Under a murabaha financing arrangement, a bank buys an asset that a company wishes to acquire and then sells it on to the company at a pre-agreed mark-up, payable in instalments. Why is this structured as a sale transaction rather than a loan with interest?

A Because it allows the bank to legally avoid any form of regulatory or Sharia-board oversight entirely
B Because it is cheaper for the company in every case than a conventional interest-bearing loan
C Because Sharia law prohibits interest (riba), so the bank earns a permissible profit margin on a genuine underlying sale
D Because the company retains no obligation at all to make any future scheduled instalment payments

Question 20

A company raises finance that ranks below its senior secured bank debt but above ordinary equity on liquidation, carries a higher interest rate than senior debt to compensate for this lower ranking, and sometimes includes an equity conversion feature or warrants. What type of finance is this?

A Senior secured debt, which always ranks above all other forms of finance on liquidation
B An irredeemable preference share, which is legally classified as senior debt in every jurisdiction
C Subordinated (mezzanine) debt, which sits between senior debt and equity in the capital structure and risk/return hierarchy
D A eurobond, defined specifically by being denominated in a foreign currency

Question 21

A company builds a new manufacturing facility in a designated regional development area and receives a non-repayable cash grant from the government to help fund the project, in exchange for creating a target number of new local jobs. What is the main strategic financing benefit of this type of finance compared with debt or equity?

A It must always be repaid with interest once the project becomes profitable, exactly like a conventional bank loan
B Reduces the overall investment cost with no repayment obligation or dilution, though usually conditional on criteria like job creation targets
C It dilutes existing shareholders' ownership in the same way that issuing new equity would
D It is available to any company regardless of location or project characteristics, with no conditions attached

Question 22

Why is financing new investment from retained earnings generally considered cheaper, in practical terms, than raising an equivalent amount through a new issue of ordinary shares?

A Retained earnings have a required return of exactly 0%, since shareholders expect no return at all on funds the company retains

B A new equity issue never incurs any issue costs whatsoever, making it identical in cost to using retained earnings

C Retained earnings can only ever be used to repay existing debt, and never to fund any new investment project

D Retained earnings involve no issue costs and no negative market signal, though the required return shareholders expect is conceptually similar to new equity

Question 23

Ranking typical sources of long-term finance from lowest to highest cost/risk to the company (ignoring company-specific circumstances), which of the following orderings is most consistent with conventional financial theory?

A Ordinary equity (lowest cost/risk), then preference shares, then subordinated debt, then senior secured debt (highest cost/risk)

B All sources of long-term finance carry exactly the same cost to the company, regardless of ranking or risk

C Senior secured debt (lowest cost/risk), then subordinated/mezzanine debt, then preference shares, then ordinary equity (highest cost/risk)

D Preference shares are always the cheapest source of finance available to any company

Question 24

A company evaluating whether to fund a project through a rights issue or a bank loan finds that the rights issue carries significant issue costs (underwriting and advisory fees) that reduce the net proceeds available, while the bank loan carries negligible arrangement costs. How should this difference in raising costs be treated in the financing decision?

A Issue costs should always be ignored in financing decisions, since they are a one-off cost with no bearing on the choice between financing sources

B Issue costs make a rights issue automatically cheaper than a bank loan in every case, since they are paid once rather than annually

C Issue costs are irrelevant because Modigliani and Miller's theory proves that the financing decision has no effect on firm value in any real-world scenario

D Issue costs are a real cash outflow reducing net funds available for investment, and should be weighed against the ongoing cost of capital of each financing option

Question 25

A company's treasury function identifies exposure to changes in borrowing costs, exposure to movements in currency exchange rates on overseas trade, and exposure to counterparties failing to pay amounts owed. Which three categories of financial risk does this describe, respectively?

A Interest rate risk, foreign exchange risk, and credit (counterparty) risk

B Business risk, operational risk, and reputational risk

C Systematic risk, unsystematic risk, and liquidity risk

D Inflation risk, political risk, and agency risk

Question 26

A listed company has an equity beta of 1.50, a market value of equity of $80 million, a market value of debt of $20 million, and pays corporation tax at 25%. What is the company's asset (ungeared) beta, to two decimal places?

A 1.26

B 1.50

C 1.20

D 1.78

Question 27

A company is considering significantly increasing its level of gearing to fund a large acquisition. Under Modigliani and Miller's theory with tax, and using CAPM to estimate the cost of equity, what is the expected effect on the company's equity beta and cost of equity as gearing rises?

A The equity beta and cost of equity are expected to fall, because more debt always reduces a company's overall risk

B The equity beta will fall while the cost of equity remains completely unchanged

C Both equity beta and cost of equity are expected to rise, as gearing adds financial risk on top of existing business risk

D Neither the equity beta nor the cost of equity is affected by a change in gearing under any circumstances

Question 28

A company knows it will need to borrow a fixed amount of cash in three months' time for a six-month period, and wants to lock in the interest rate now without entering into the loan itself yet. Which instrument allows it to fix the effective borrowing rate for this specific future period?

A A Forward Rate Agreement (FRA), fixing the interest rate on a specified notional loan amount over a future period, cash-settled against the reference rate on that date

B A currency forward contract, which fixes an exchange rate for a future date, not an interest rate applicable to a future loan

C An interest rate swap, which exchanges fixed for floating payments over the entire remaining life of an existing loan

D A share option, which gives the right to buy or sell shares at a fixed price, unrelated to interest rate risk management

Question 29

A UK parent company has a foreign subsidiary; when the subsidiary's results are translated into GBP for the group's consolidated financial statements, movements in the exchange rate change the reported GBP value of the subsidiary's net assets, even though no cash has actually been exchanged. What type of foreign exchange exposure does this describe?

A Transaction exposure, which arises from a specific contractual cash flow due in a foreign currency

B Translation exposure — affects the reported value of foreign assets, liabilities and results on consolidation, without a direct cash flow

C Economic exposure, which reflects the long-term impact of exchange rate movements on the competitive position and future cash flows of the business

D Credit exposure, which arises from a counterparty's risk of default

Question 30

A UK company must pay a US supplier $816,000 in 6 months. It decides to hedge using a money market hedge: borrow GBP now, convert to USD at the spot rate, and deposit the USD so that it grows (with interest) to exactly $816,000 in 6 months. The USD deposit rate is 4% per annum (2% for 6 months) and the spot rate is $1.28/£. How much GBP must the company borrow today?

A £800,000

B £637,500

C £816,000

D £625,000

Question 31

A UK company has a long-term US dollar loan and wants to convert both the interest and principal cash flows into sterling for the entire remaining life of the loan, without repaying the original USD loan. Which instrument is most appropriate?

A A single forward contract, which can only fix the exchange rate for one specific date, not an entire multi-year cash flow stream

B A currency swap, which exchanges a stream of cash flows (interest and, typically, principal) in one currency for equivalent cash flows in another currency over an agreed period

C An interest rate cap, which manages exposure to interest rate levels within a single currency, not exposure between two currencies

D A scrip dividend, which relates to how dividends are paid to shareholders and has no currency hedging function

Question 32

The current spot exchange rate is $1.5000/£. The UK 1-year interest rate is 3% and the US 1-year interest rate is 5%. Using interest rate parity, what is the theoretical 1-year forward rate, in $/£, to 4 decimal places?

A $1.4714/£

B $1.5750/£

C $1.5291/£

D $1.5000/£

Question 33

An investor requires a real rate of return of 3%, and expected inflation over the coming year is 5%. Using the Fisher equation, what nominal rate of return should the investor require, as a %, to two decimal places?

A 8.15%

B 8.00%

C 1.94%

D 5.00%

Question 34

A company's board debates whether to hedge a significant foreign currency receivable due in six months, or leave it unhedged and hope the exchange rate moves favourably. Which statement best reflects sound financial risk management policy?

A The decision should follow the company's formal risk policy, weighing hedging cost against risk appetite and potential impact of adverse movements, not a speculative rate view

B The company should always hedge 100% of every exposure, regardless of cost, since any unhedged position is automatically bad management

C The company should never hedge, since hedging always eliminates the possibility of a favourable outcome and is therefore value-destroying

D The decision should be made by whichever individual manager personally believes they can predict the future exchange rate most accurately

Question 35

A company expects a foreign currency it needs to pay in three months to weaken against its home currency, so it deliberately delays the payment for as long as its supplier agreement allows, hoping to pay less in home currency terms when it eventually settles. What technique is this, and what is its main drawback?

A A forward contract; its main drawback is that it always guarantees a worse outcome than doing nothing

B Multilateral netting; its main drawback is that it can only be used between subsidiaries of the same group

C A currency option; its main drawback is that it always requires an upfront premium regardless of outcome

D Lagging a payment relies on a view of future currency movements — if wrong, the company could pay more, and it risks damaging the supplier relationship

Question 36

A company holds a trading portfolio currently valued at $10,000,000. The daily standard deviation of portfolio returns is 1.5%, and the company wants to calculate the 1-day Value at Risk (VaR) at the 95% confidence level (Z-score of 1.65). What is the 1-day VaR, in $, to the nearest whole dollar?

A $247,500
B $150,000
C $16,500,000
D $1,650,000

Question 37

MM's theory with tax implies that a company should gear up as much as possible, since the tax shield on debt continuously increases firm value. Why do companies not, in practice, take on the maximum possible level of debt?

A In practice, rising financial distress, bankruptcy and agency costs of debt eventually outweigh the tax benefit as gearing rises, creating a practical trade-off
B Because corporation tax does not actually make interest a tax-deductible expense in any real-world jurisdiction at all
C Because MM's theory with tax proves that debt is always more expensive than equity in every circumstance
D Because increasing debt always immediately reduces a company's total market value with no offsetting benefit at all

Question 38

A company has a market value of equity of $60 million and a market value of debt of $40 million. Its cost of equity is 12% and its post-tax cost of debt is 6%. What is the company's weighted average cost of capital (WACC), as a %, to one decimal place?

A 9.0%
B 9.6%
C 18.0%
D 6.0%

Question 39

When valuing a company on an asset basis, a valuer must choose between using replacement cost and net realisable (liquidation) value for the underlying assets. In which scenario would net realisable value typically be the more appropriate basis?

A Where the company is expected to cease trading and sell assets individually, since realisable value reflects what could actually be recovered
B Where the company is a thriving, growing business intending to continue using its assets to generate future operating cash flows indefinitely
C Where the valuation is being prepared purely for internal management reporting with no intention of ever selling any assets
D Net realisable value is never an appropriate basis for any valuation purpose

Question 40

A company has just paid a dividend of $0.20 per share, which is expected to grow at a constant rate of 4% per year indefinitely. Shareholders require a return of 10%. Using the dividend valuation model (Gordon growth model), what is the theoretical value of one share, in $, to two decimal places?

A $2.00
B $5.00
C $3.33
D $3.47

Question 41

How does free cash flow to equity differ from free cash flow to the firm, and which discount rate is appropriate for each?

A Free cash flow to equity and free cash flow to the firm are identical figures and are always discounted at the same rate

B Free cash flow to equity should be discounted at the WACC, while free cash flow to the firm should be discounted at the cost of equity

C Neither measure requires any adjustment for debt-related cash flows of any kind

D FCFE is FCFF less after-tax interest and net debt repayments, discounted at the cost of equity; FCFF itself is discounted at the WACC

Question 42

In evaluating a proposed acquisition, the acquirer estimates the standalone value of the target, then separately estimates additional value expected from cost savings and revenue enhancements achievable only once the two businesses are combined. What is this additional value called, and how should it influence the maximum price the acquirer should be willing to pay?

A Terminal value; it should be ignored entirely when setting the maximum acquisition price, regardless of the target's specific growth prospects

B Net asset value; it should always be subtracted from the standalone value of the target, regardless of the target's actual profitability

C Synergy value; the maximum price is the standalone value plus the expected synergies net of integration costs, and paying more destroys value for its shareholders

D A minority discount; it reduces, rather than increases, the maximum price the acquirer should pay

Question 43

In the context of business valuation (rather than financial reporting), how is goodwill best understood?

A A specific physical asset that can be individually identified, measured and sold separately from the rest of the business, like a machine

B A liability representing amounts a business expects to pay out to a third party at some point in the future

C An amount that is always exactly equal to a company's total issued share capital, regardless of its trading performance

D The excess of a business's overall value over its identifiable net asset value, reflecting reputation, customer relationships and workforce quality not separately recognised

Question 44

When valuing shares in a private (unlisted) company using methods calibrated against listed comparables, why is a marketability discount typically applied to the resulting valuation?

A Because private company shares can't be readily traded on an active public market, making them less liquid and less attractive to hold, all else equal

B Because private companies always have higher earnings growth than listed companies, requiring a downward adjustment

C Because private companies are legally prohibited in every jurisdiction from ever being sold to any third party

D Because a marketability discount is only ever applied to listed companies, and never to private ones at all

Question 45

A technology company generates most of its value from proprietary software, customer data and brand recognition, with relatively few physical assets on its statement of financial position. Why is an asset-based valuation approach generally considered unsuitable as the primary method for valuing this type of business?

A Asset-based valuation focuses on recognised assets, and likely understates a business whose worth lies in unrecognised software, data, brand and relationships

B Asset-based valuation always overstates the value of any technology business, regardless of its underlying assets or actual earning capacity

C Asset-based valuation cannot be mathematically calculated at all for any company that happens to own any intangible assets

D Technology companies are specifically and legally prohibited from ever being valued using an asset-based approach

Question 46

A company is evaluating a project that will be financed with a capital structure very different from its existing (and fairly stable) mix, making a single constant WACC difficult to justify for discounting. Which valuation approach separates the value of the project's operating cash flows from the value of the specific financing side effects (such as the tax shield on any new debt)?

A The dividend valuation model, which values a share based purely on its expected stream of future dividends alone

B The Adjusted Present Value (APV) approach — values the project as all-equity financed, then adds the present value of financing side effects like the tax shield

C The net asset value approach, which values a whole business based on the fair value of its recognised net assets

D The P/E ratio method, which applies a comparable company's earnings multiple to the target's profit

Question 47

A company has net operating profit after tax (NOPAT) of $12 million, invested capital of $80 million, and a weighted average cost of capital of 9%. What is the company's Economic Value Added (EVA), in $ million?

A $12.0m

B $7.2m

C $19.2m

D $4.8m

Question 48

A valuer applying the Gordon growth dividend valuation model is concerned that a small change in the assumed long-term dividend growth rate could have a disproportionately large effect on the resulting share valuation. Why does this sensitivity arise, and why is it more pronounced when the assumed growth rate is closer to the required rate of return?

A The Gordon growth model produces a value that is completely insensitive to the growth rate assumption used

B Sensitivity to the growth assumption only arises if the dividend is expected to be cut to zero in the very next period

C Because the denominator is (Ke - g), a small rise in g causes a much larger rise in value as g nears Ke, since the denominator shrinks toward zero

D The required rate of return, not the growth rate, is the only variable that affects the sensitivity of the valuation

Question 49

A DCF valuation of a business is highly sensitive to the WACC used to discount its forecast cash flows, particularly for cash flows expected far into the future or for a high terminal value. What practical step should a valuer take in light of this sensitivity?

A Always use the lowest possible WACC estimate available, since this produces the highest valuation and is therefore the most favourable to the seller

B Ignore the WACC assumption entirely, since DCF valuations are not materially affected by the discount rate used

C Replace the DCF valuation with an asset-based valuation whenever the WACC is difficult to estimate precisely

D Perform sensitivity analysis across a reasonable range of WACC estimates, to show how the value range changes rather than presenting one false-precise figure

Question 50

A UK company is valuing a proposed acquisition of a US target using a DCF approach, forecasting the target's cash flows in US dollars and discounting at a dollar-denominated WACC, before converting the resulting dollar valuation into sterling at the current spot rate. What is the main risk of this approach if UK and US inflation rates are expected to diverge significantly over the forecast period?

A Exchange rates and inflation rates have no relationship to each other, so this approach carries no additional risk from diverging inflation rates

B The valuation must always be performed entirely in sterling from the outset, since valuing in a foreign currency is never an acceptable approach

C If the dollar cash flows and the dollar discount rate are not based on consistent assumptions about US inflation, the dollar value, and so the sterling value at today's spot rate, will be misstated

D Purchasing power parity guarantees that the current spot rate will remain exactly unchanged throughout the entire forecast period

Question 51

A DCF or multiple-based valuation produces an enterprise value of $100 million for a company. The company has total debt of $30 million and cash and cash equivalents of $5 million. What is the resulting equity value, in $ million?

A $100m

B $130m

C $75m

D $25m

Question 52

The pro-rata value of a 20% minority shareholding in a private company, based on a 100%-control valuation of $50 million, is $10 million (20% x $50m) before any discounts. A minority discount of 25% is applied first, followed by a marketability discount of 20% applied to the result. What is the final value of the minority shareholding, in $ million, to one decimal place?

A $7.5m

B $6.0m

C $5.5m

D $10.0m

Question 53

In a major acquisition, the target company's board commissions an independent financial adviser to provide a formal opinion on whether the price being offered is fair to shareholders from a financial point of view. What is this document known as, and why is it obtained?

A A prospectus, which is a legal document required only when a company is seeking a new stock exchange listing

B A trust deed, which sets out the specific terms of a bond issue for the legal protection of bondholders

C A fairness opinion — gives the board independent expert support for its recommendation and helps show it met its fiduciary duty in assessing the offer

D A rights issue circular, which is sent to shareholders specifically in connection with a new equity issue

Question 54

During due diligence on a proposed acquisition, the buyer discovers the target is a defendant in an ongoing lawsuit with an uncertain but potentially significant financial outcome. How is this type of issue typically addressed in the valuation and negotiation of the purchase price?

A Contingent liabilities are always fully excluded from any consideration in a valuation, since they have not yet been confirmed as an actual liability

B The buyer must always proceed at the originally agreed price with no adjustment, regardless of any contingent liabilities discovered during due diligence

C Contingent liabilities can only ever be addressed by cancelling the transaction entirely, with no other negotiation options available

D The contingent liability is factored into negotiation — through a price reduction, an escrow holdback, or indemnities/warranties protecting the buyer if it crystallises

Question 55

For which type of valuation scenario is the Adjusted Present Value (APV) approach generally preferred over a standard WACC-discounted DCF valuation?

A Where the company's capital structure is expected to remain completely constant and unchanged over the entire life of the investment, with no debt used at any point

B APV should always be used instead of WACC-based DCF in absolutely every valuation scenario, without any exception whatsoever

C Where the project's or acquisition's capital structure changes significantly, or differs substantially from the acquirer's normal mix, making one constant WACC unreliable

D APV can only ever be applied to companies that have no corporation tax liability at all in any jurisdiction

Question 56

A buyer negotiating to acquire a private company faces greater information asymmetry than when buying shares in a listed company, since the private target has no public disclosure history or analyst coverage. How does this typically affect the valuation and negotiation process?

A Information asymmetry has no bearing whatsoever on how any private company acquisition is negotiated, priced or structured

B Private companies should always be valued at a premium to comparable listed companies, to compensate the seller for the information asymmetry

C Buyers are legally prohibited in every jurisdiction from requesting any warranties or indemnities when acquiring a private company

D The buyer typically needs more due diligence and may seek greater price protection (warranties, indemnities, or an earn-out) for the added uncertainty and information asymmetry involved

Question 57

A valuer is comparing a target company against listed comparables that have very different levels of gearing from each other and from the target. Why might EV/EBITDA be a more suitable comparison basis than P/E in this situation?

A P/E ratios are completely unaffected by a company's level of gearing at all, making the two measures equally suitable for this comparison

B EV/EBITDA is a pre-interest measure largely unaffected by capital structure, making it more comparable across gearing levels than P/E, measured after interest

C EV/EBITDA cannot be calculated at all for any company that carries any amount of debt in its capital structure whatsoever

D Differences in gearing between comparable companies are entirely irrelevant to any valuation exercise of any kind

Question 58

A valuer applying the Gordon growth model to a company notes that its dividend cover (earnings divided by dividends) has been falling steadily for several years, even as the assumed constant dividend growth rate remains high. Why should this trend concern the valuer?

A Dividend cover has no relevance whatsoever to the assumptions used in a dividend valuation model of any kind

B A falling dividend cover always indicates that a company is about to increase its growth rate even further in future years

C A persistently falling dividend cover suggests dividends are outpacing earnings; the valuer should question whether the high growth rate can really be sustained

D The dividend valuation model does not require the assumed growth rate to bear any relationship to a company's actual earnings performance at all

Question 59

A valuer's DCF model assumes a terminal (long-run) growth rate of 6% per year forever, in an economy where long-run nominal GDP growth is expected to average around 3% per year. Why should this assumption be treated with caution?

A A perpetual growth rate that permanently exceeds the wider economy's long-run growth implies the company eventually outgrows the entire economy — generally unrealistic as a forever assumption

B A terminal growth rate has no logical upper limit and can reasonably be assumed at any level the valuer chooses, regardless of the wider economy

C Terminal growth rates must always be set at exactly 0% for every company, regardless of its specific circumstances

D The relationship between a single company's terminal growth rate and overall economic growth is entirely irrelevant to a DCF valuation's credibility

Question 60

Trade-off theory suggests that companies should aim for an optimal capital structure. How does this optimal point arise, according to the theory?

A The optimal capital structure is always 100% debt, since debt is cheaper than equity and there is no offsetting cost to consider

B The optimal capital structure is always 100% equity, since any use of debt finance should never be considered under any circumstances

C Trade-off theory concludes there is no such thing as an optimal capital structure for any company, regardless of its situation

D The optimal capital structure is where the marginal tax benefit of extra debt (the interest tax shield) is exactly offset by the marginal rise in expected distress and bankruptcy costs

Answer key

1 B	**13** B	**25** A	**37** A	**49** D
2 B	**14** D	**26** A	**38** B	**50** C
3 D	**15** B	**27** C	**39** A	**51** C
4 B	**16** D	**28** A	**40** D	**52** B
5 A	**17** D	**29** B	**41** D	**53** C
6 C	**18** A	**30** D	**42** C	**54** D
7 C	**19** C	**31** B	**43** D	**55** C
8 B	**20** C	**32** C	**44** A	**56** D
9 C	**21** B	**33** A	**45** A	**57** B
10 B	**22** D	**34** A	**46** B	**58** C
11 C	**23** C	**35** D	**47** D	**59** A
12 D	**24** D	**36** A	**48** C	**60** D

Score: count your correct answers out of 60. Then work through the explanations below.

Answers and explanations

Question 1: B ESG reporting communicates a company's performance across environmental factors (e.g. emissions, resource use), social factors (e.g. employee welfare, community impact, human rights in the supply chain) and governance factors (e.g. board structure, executive remuneration, ethics), reflecting growing investor, regulatory and stakeholder demand for non-financial performance information alongside the financial statements

ESG reporting spans three connected dimensions: environmental (emissions, resource and energy use, waste, biodiversity impact), social (employee welfare, health and safety, community relations, human rights within the supply chain) and governance (board composition and independence, executive remuneration structure, business ethics, anti-corruption controls). Companies increasingly report on all three because investors, lenders, regulators and other stakeholders now routinely factor non-financial performance into capital allocation, credit, and engagement decisions — it is not limited to emissions alone, is not merely a marketing exercise disconnected from capital markets, and sits alongside financial statements as a complement to them, not a replacement.

Section A, ESG reporting — principles and scope · Ref A1c · f3003

Question 2: B Perfect capital markets exist, with no taxes, no transaction costs, and equal investor access to information

The MM dividend irrelevance proposition rests on perfect capital market assumptions: no taxes, no transaction costs, no issue costs, symmetric information, and rational investors who can freely trade shares. Under these conditions, investors can create their own 'homemade dividends' by selling shares for cash if the company pays too little, or reinvesting excess cash dividends themselves, so the actual dividend paid does not affect wealth or share price. Assuming a uniform shareholder preference for cash dividends contradicts MM's own conclusion that policy is irrelevant to investors given homemade dividends. Information asymmetry is precisely what MM's perfect-market assumptions rule out; introducing it is what gives rise to signalling theory, a real-world critique of MM. Differential taxation of dividends versus capital gains is also excluded by the no-tax assumption; in practice such tax differences are a key argument against irrelevance.

Section A, MM dividend irrelevance theory — assumptions · Ref A2a · f3006

Question 3: D Some investors prefer low payout ratios, since retained earnings become capital gains taxed later and at a lower rate

Tax preference theory argues that when capital gains are taxed more favourably than dividends (lower rate, and deferred until the gain is realised), rational investors — particularly those in higher tax brackets — will prefer companies that retain earnings and grow share value rather than distribute cash dividends, because this reduces and defers their tax liability. This directly contradicts the idea that all investors want maximum dividends. It also shows that tax rules do influence share preferences, tying into the clientele effect, where investors self-select shares matching their tax position. Tax preference theory does not prescribe a universal 100% payout; if anything it points toward lower payout ratios for tax-sensitive investors.

Section A, Tax preference theory and clientele effect · Ref A2b · f3009

Question 4: B Managers have private information about future prospects, and the dividend rise signals confidence in sustaining higher cash flows

Signalling theory rests on information asymmetry: managers know more about the firm's true prospects than external investors. Because paying a higher dividend is costly to reverse (cutting dividends later sends a strongly negative signal), an unexpected increase is seen as a credible, costly signal that management is confident future cash flows will support the higher payout, so the market revises its expectations upward and the share price rises. The dividend itself does not mechanically change the value of underlying assets — it is the change in market expectations that moves the price. There is no legal requirement to revalue shares on a dividend change. While a higher payout does imply less cash retained for reinvestment, signalling theory's explanation is about the information conveyed regarding future prospects, not a claim that no positive NPV projects exist.

Section A, Signalling theory of dividends · Ref A2c · f3010

Question 5: A A progressive (stable growth) dividend policy with dividend smoothing, where dividends are only adjusted gradually and are not cut for temporary earnings dips

A progressive or stable dividend policy aims for steady, predictable dividend growth over time, and companies following this approach (often modelled on Lintner's partial adjustment process) smooth dividends by not cutting them in response to a temporary earnings dip, protecting the signal of stability that income-seeking investors value. A residual policy would instead cause the dividend to fluctuate directly with earnings and investment needs each year, which does not match this steady-growth description. MM's theory does not prescribe or predict any deliberate randomisation of dividends — that mischaracterises the theory. A zero-dividend policy is the opposite of what is described, since a dividend is being paid and grown every year.

Section A, Stable and progressive dividend policy; dividend smoothing · Ref A2d · f3013

Question 6: C A widely used, voluntary set of standards and disclosures that provides a common structure and set of metrics for organisations to report their economic, environmental and social impacts, intended to improve comparability between organisations

The GRI Standards (which replaced the earlier GRI guidelines from 2016) are among the most widely adopted voluntary sustainability reporting standards globally, providing standardised disclosures and metrics so that organisations' economic, environmental and social impacts can be reported in a structured, comparable way across companies and sectors. They are not mandatory accounting standards replacing IFRS, a bank-only credit tool, or a government treaty imposing taxes — they are a reporting framework that companies choose (increasingly under stakeholder and market pressure) to adopt for their own sustainability disclosures.

Section A, ESG reporting — the Global Reporting Initiative (GRI) · Ref A1c · f3018

Question 7: C Internally generated retained earnings first, then debt finance, and new equity issuance only as a last resort

Pecking order theory, associated with Myers and Majluf, argues that because of information asymmetry between managers and outside investors, companies prefer to finance investment first from internally generated funds (retained earnings), which involve no issue costs and no negative signal to the market. If external finance is needed, debt is preferred next because it is less sensitive to information asymmetry and cheaper to issue than equity. New equity is used only as a last resort, because issuing shares can be interpreted by the market as a signal that management believes the shares are overvalued, depressing the share price. The other orderings reverse or misstate this preference hierarchy, and the theory does not predict equal, cost-independent use of all sources.

Section A, Pecking order theory · Ref A4a · f3019

Question 8: B Improved ESG disclosure can support access to a broader investor base (including funds with ESG-focused mandates), potentially lower the cost of debt or equity where lenders and investors price ESG risk into their required returns, and provide better risk information to support strategic and operational decisions

A growing base of investors, and increasingly lenders, factor ESG performance into their capital allocation and pricing decisions — some funds have explicit ESG-linked mandates, and ESG-linked loans and bonds now price margin adjustments off sustainability performance metrics. Better ESG disclosure can therefore widen access to capital and, in some cases, reduce the cost of debt or equity where providers of finance price ESG risk into their required return, alongside providing management with better internal risk information. It is not a universal guarantee of lower tax (unrelated mechanisms entirely), and it is a proactive, forward-looking strategic choice rather than something only imposed as a penalty after a regulatory breach.

Section A, ESG reporting — rationale linked to financial strategy · Ref A1c · f3022

Question 9: C 11.7%

The sustainable growth rate is the rate at which a company can grow using only internally generated funds (retained earnings), without issuing new equity and while holding its capital structure and profitability constant. It is calculated as ROE x retention ratio. The retention ratio is 1 - payout ratio = 1 - 0.35 = 0.65 (65%). Sustainable growth rate = 18% x 0.65 = 11.7%. 18.0% incorrectly ignores the payout ratio entirely, effectively assuming 100% retention. 6.3% mistakenly uses the payout ratio (0.35) as the retention ratio instead of 1 minus the payout ratio (18% x 0.35 = 6.3%). 35.0% simply restates the payout percentage and applies no calculation at all.

Section A, Sustainable growth rate · Ref A5a · f3023

Question 10: B A placing

A placing involves shares being sold directly to a limited number of institutional investors identified by the sponsoring broker, which is faster and cheaper than a full public offer because it avoids the marketing and administrative costs of soliciting the wider public. A public offer for subscription invites applications from the general public at a fixed price, which is a broader and more expensive process than a placing. An introduction is used when a company already has a sufficiently wide spread of shareholders (e.g. following a demerger) and simply obtains a listing without raising any new capital or selling shares. A rights issue is a method of raising further capital from a company's existing shareholders after it is already listed, not a method of obtaining an initial listing.

Section B, Listing methods — placing vs public offer vs introduction · Ref B1c · f3029

Question 11: C The process by which a private company first sells shares to the public and obtains a listing on a stock exchange

An IPO is the process through which a previously private company offers its shares for sale to the public for the first time and becomes listed on a stock exchange, widening its shareholder base and typically raising significant new capital. Issuing new shares only to existing shareholders describes a rights issue, which applies to an already-listed company, not a first-time public sale. A company buying back all its shares to go private describes a 'take-private' or delisting transaction, the reverse of an IPO. Merging with an already-listed company to obtain a listing indirectly describes a reverse takeover, a distinct alternative route to listing, not an IPO itself.

Section B, IPO process · Ref B1c · f3030

Question 12: D Unpaid dividends accumulate and must be paid before any ordinary dividend, but there is no obligation to ever repay the capital

Cumulative preference shares carry a fixed dividend rate; if the company cannot pay the dividend in a given year, it accumulates as an arrear that must be paid, along with the current year's dividend, before any dividend can be paid to ordinary shareholders. Being irredeemable, there is no obligation to repay the capital, making this a hybrid instrument between debt and equity. Unlike debt interest, preference dividends are a distribution of profit and are not tax-deductible, which increases their effective cost to the company relative to debt. Preference shareholders typically have limited or no voting rights except in specific circumstances (such as when their dividend is in arrears), unlike ordinary shareholders. Preference shares rank above ordinary shares (though below debt) on liquidation, not below them.

Section B, Preference shares — characteristics · Ref B1d · f3031

Question 13: B $94.94

The value of redeemable debt is the present value of the interest annuity plus the present value of the redemption amount, both discounted at the investors' required return. PV of the interest annuity = $7 x 2.5313 (3-year annuity factor at 9%) = $17.72. PV of the redemption value = $100 x 0.7722 (year-3 discount factor at 9%) = $77.22. Total value = $17.72 + $77.22 = $94.94. As the required return (9%) exceeds the coupon rate (7%), the notes trade below par, which is why $100.00 is incorrect. $77.22 only captures the present value of the redemption amount and omits the coupon stream entirely. $17.72 only captures the present value of the interest annuity and omits the redemption amount entirely.

Section B, Redeemable debt valuation · Ref B2a · f3033

Question 14: D The conversion premium, reflecting the bond's downside protection plus the future option to convert

The conversion premium is the amount by which the market price of a convertible bond exceeds its current conversion value, reflecting the value investors place on the bond's downside protection (its floor value as a straight bond, since it continues to pay interest and can be redeemed even if the share price falls) combined with the upside potential of converting into shares later if the share price rises. It is not a pricing anomaly to be arbitraged away — it is a rational reflection of the option value embedded in the convertible instrument. It has no direct relationship to the redemption value at maturity, which is a separate, fixed figure. It is also unrelated to the coupon rate expressed in dollars, which is simply the periodic interest payment.

Section B, Convertible bonds — conversion premium · Ref B2b · f3035

Question 15: B A zero coupon bond; the whole return comes from the issue-to-redemption discount, avoiding periodic interest cash outflows

A zero coupon (deep discount) bond pays no periodic interest; the investor's entire return comes from the difference between the discounted issue price and the full redemption value paid at maturity. This is attractive to the issuer because it avoids regular cash interest payments, which can help manage cash flow, though the full redemption amount must still be found at maturity. A convertible bond is a different instrument tied to a conversion option into shares and does not by itself remove the redemption obligation. A eurobond is defined by being issued in a currency other than that of the country where it is issued, which is a different characteristic unrelated to the coupon structure described. An irredeemable bond pays interest indefinitely with no redemption at all, which is the opposite structure to the discount-then-redemption pattern described here.

Section B, Deep discount and zero coupon bonds · Ref B2d · f3037

Question 16: D A negative covenant, restricting specific actions the company may take

A negative covenant restricts the company from taking certain actions without lender consent — here, prohibiting further secured borrowing, which would otherwise dilute the existing lender's security position. A positive covenant, by contrast, requires the company to actively do something, such as maintaining insurance or providing regular financial information, which is not what is described here. A financial covenant based on a profitability ratio (e.g. a minimum interest cover or maximum gearing ratio) is a different, numerically-defined type of restriction, not the qualitative restriction on further borrowing described. A conversion clause is a feature of convertible debt allowing conversion into equity, which is unrelated to a covenant restricting further borrowing.

Section B, Loan covenants · Ref B3a · f3039

Question 17: D Venture capital, which provides equity finance to higher-risk, high-growth businesses for a shareholding and board involvement

Venture capital firms specialise in providing equity finance to higher-risk, high-growth companies that lack the track record or assets needed to access conventional debt or public capital markets, typically in exchange for a shareholding, board representation, and an active role in strategic decision-making, with an expectation of an eventual exit (e.g. sale or IPO) to realise their return. A public bond issue requires an established credit profile and disclosure history that an early-stage, unproven company is unlikely to have, and bond investors are not generally suited to bearing this level of risk. Marketing preference shares to retail investors is unusual for an unproven early-stage business and does not match how such finance is typically sourced. A conventional secured bank loan specifically requires security and a track record to assess creditworthiness, which is precisely what this company lacks.

Section B, Venture capital financing · Ref B4a · f3043

Question 18: A A management buyout (MBO)

A management buyout occurs when a company's existing management team raises finance — typically a combination of their own equity, private equity investment and significant debt (often described as a leveraged buyout when debt-heavy) — to purchase the business or division they currently manage from its parent or owners. A rights issue is a method of raising further equity capital from existing shareholders of an already-listed or established company, unrelated to an ownership-change transaction like this. A scrip dividend is a form of dividend distribution paid in shares rather than cash, unrelated to an acquisition. An initial public offering is the process of a private company first selling shares to the public, which is the opposite direction of transaction to a buyout that typically takes a business out of a group structure (and sometimes private).

Section B, Private equity and buyouts · Ref B4a · f3044

Question 19: C Because Sharia law prohibits interest (riba), so the bank earns a permissible profit margin on a genuine underlying sale

Murabaha is structured as a cost-plus sale (the bank buys the asset and resells it to the client at a disclosed, pre-agreed mark-up, paid in instalments) specifically because Sharia law prohibits earning a return through interest on a loan (riba); a mark-up on a genuine trade of an asset is a permissible way for the financier to earn a return instead. It is not designed to avoid regulatory oversight — Islamic finance institutions are typically regulated in the same way as conventional ones, often with an additional Sharia supervisory board. There is no general rule that murabaha is always cheaper than conventional lending; its cost depends on the negotiated mark-up, which can be comparable to conventional interest rates in commercial terms. The company remains obliged to pay the agreed instalments over time, just as it would under a loan, so payment obligations are not eliminated.

Section B, Islamic finance — murabaha and ijara · Ref B4b · f3046

Question 20: C Subordinated (mezzanine) debt, which sits between senior debt and equity in the capital structure and risk/return hierarchy

Subordinated (mezzanine) debt ranks below senior secured debt but above ordinary equity in a company's capital structure and on liquidation, and because lenders accept this lower-priority, higher-risk position, they demand a higher interest rate than senior lenders, often combined with additional upside such as an equity conversion option or attached warrants — a hybrid instrument bridging the gap between straight debt and equity. Senior secured debt is, by definition, the instrument that ranks above subordinated debt, not the one described in the scenario, which explicitly ranks below senior debt. Preference shares are an equity-type instrument, not senior debt, in essentially all jurisdictions, and typically rank below all debt (including subordinated debt) on liquidation. A eurobond is defined purely by its currency of denomination relative to the country of issue, an entirely different characteristic from ranking or subordination.

Section B, Subordinated (mezzanine) debt · Ref B2e · f3101

Question 21: B Reduces the overall investment cost with no repayment obligation or dilution, though usually conditional on criteria like job creation targets

Government grants are typically non-repayable, do not carry interest, and do not dilute existing shareholders, making them an attractive source of partial project funding when a company's plans align with government objectives (such as regional development or job creation) — but they are usually conditional, and the company will need to meet specified criteria (e.g. minimum job creation, investment thresholds, or time limits) or risk clawback of the grant. It is not the case that grants must be repaid with interest — that description applies to loans, not grants, which is the whole point of this type of finance. Grants involve no share issuance at all, so they do not dilute ownership in the way an equity issue would. Grants are not universally available with no conditions; they are typically targeted at specific regions, industries, or types of project meeting defined policy objectives, and companies must usually apply and qualify.

Section B, Government grants and regional assistance · Ref B3c · f3104

Question 22: D Retained earnings involve no issue costs and no negative market signal, though the required return shareholders expect is conceptually similar to new equity

While the underlying required rate of return that shareholders expect on retained earnings is conceptually the same as their required return on newly invested equity capital (an opportunity cost, since shareholders could otherwise have received the earnings as a dividend and invested it themselves), using retained earnings avoids the practical issue costs of a new share issue (underwriting, legal and advisory fees) and avoids the negative signalling effect a new issue can have on the share price, making it the practically cheaper and generally preferred source under pecking order theory. Retained earnings do not have a zero required return — shareholders still have an opportunity cost of foregone dividends and expect the retained funds to be invested to earn at least their required rate of return. New equity issues do typically incur real issue costs, so it is incorrect to claim they are identical in cost to retained earnings on this basis. Retained earnings can be used to fund any value-creating use, including new investment projects, not solely debt repayment.

Section B, Cost of retained earnings vs new equity issue · Ref B4c · f3106

Question 23: C Senior secured debt (lowest cost/risk), then subordinated/mezzanine debt, then preference shares, then ordinary equity (highest cost/risk)

Conventional theory ranks the cost of capital broadly in line with the risk borne by each type of provider: senior secured debt is generally the cheapest, since lenders have the strongest security and priority claim; subordinated/mezzanine debt costs more, reflecting its lower priority; preference shares cost more still, since dividends are discretionary and not tax-deductible, though they still rank ahead of ordinary shares on liquidation; and ordinary equity is generally the most expensive, since ordinary shareholders bear the residual risk and rank last. Reversing this ordering (equity cheapest, debt most expensive) directly contradicts the risk-return relationship underpinning the cost of capital, since it would mean the riskiest capital provider demands the lowest return, which is inconsistent with financial theory. It is not correct that all sources cost the same — the whole basis of capital structure decisions is that different sources have materially different costs, reflecting their different risk profiles. Preference shares are not generally the cheapest source; they typically cost more than any form of debt because dividends are discretionary and non-tax-deductible, even though they are usually cheaper than ordinary equity.

Section B, Cost ranking of financing sources · Ref B4c · f3109

Question 24: D Issue costs are a real cash outflow reducing net funds available for investment, and should be weighed against the ongoing cost of capital of each financing option

Issue costs are a genuine cash cost of raising finance through a particular route; they reduce the net proceeds actually available for investment (or mean a larger gross amount must be raised to achieve the required net funding), and this practical cost should be weighed alongside the ongoing cost of capital (interest, dividend expectations) of each financing option when choosing between them — a full comparison needs to consider both the upfront raising cost and the ongoing cost of the capital raised. It would be poor financial management to ignore a real cash cost simply because it is one-off rather than recurring; one-off costs still affect the net funds available and the overall cost-effectiveness of a financing route. Higher issue costs on their own do not make an option automatically cheaper — quite the opposite, higher one-off costs work against, not for, the option that bears them, so this reasoning is reversed. MM's theorem is a simplified model based on perfect-market assumptions with no issue costs; in the real world, financing choice clearly does have practical cost implications, which is precisely why issue costs must be considered rather than dismissed by an idealised theory.

Section B, Rights issue costs and financing decisions · Ref B1e · f3110

Question 25: A Interest rate risk, foreign exchange risk, and credit (counterparty) risk

Interest rate risk is the exposure to changes in the cost of borrowing or return on investments due to interest rate movements. Foreign exchange risk is the exposure to changes in exchange rates affecting the value of overseas transactions or assets. Credit (counterparty) risk is the exposure to a customer or counterparty failing to meet its payment obligations. Business, operational and reputational risk are broader enterprise risk categories not specifically about financial instruments or rates. Systematic and unsystematic risk relate to investment portfolio theory, not directly to the three specific exposures described. Inflation, political and agency risk are relevant financial strategy considerations but do not match the three exposures described in the scenario.

Section C, Types of financial risk · Ref C1a · f3049

Question 26: A 1.26

The ungearing (asset beta) formula adjusts the equity beta to remove the effect of financial gearing: Ba = Be x [Ve / (Ve + Vd x (1-T))]. Substituting: Ba = 1.50 x [80 / (80 + 20 x 0.75)] = 1.50 x [80/95] = 1.50 x 0.8421 = 1.26 (to 2dp). 1.50 is simply the original equity beta, unadjusted for gearing, and would ignore the presence of debt entirely. 1.20 would result from omitting the (1-T) tax adjustment on the debt term entirely (using 80/(80+20) = 0.80, then 1.50 x 0.80 = 1.20). 1.78 would result from inverting the ratio inside the brackets (using 95/80 instead of 80/95, then 1.50 x 1.1875 = 1.78).

Section C, Ungearing beta (Hamada equation) · Ref C2b · f3053

Question 27: C Both equity beta and cost of equity are expected to rise, as gearing adds financial risk on top of existing business risk

As gearing increases, the financial risk borne by equity holders rises (since fixed interest obligations increase the volatility of returns available to shareholders), which increases the equity beta via the regearing (Hamada) relationship, and — under CAPM — a higher beta directly increases the required cost of equity. It is not correct that more debt always reduces overall risk; rather, gearing shifts and typically increases the risk borne specifically by equity holders, even while overall firm risk (asset beta) is unchanged. A falling beta with an unchanged cost of equity does not reflect the direction of the regearing relationship, which shows beta rising with gearing. Gearing changes are a core driver of changes to equity beta and cost of equity under this framework, so claiming no effect under any circumstances is incorrect.

Section C, Impact of gearing on WACC via CAPM · Ref C2c · f3055

Question 28: A A Forward Rate Agreement (FRA), fixing the interest rate on a specified notional loan amount over a future period, cash-settled against the reference rate on that date

An FRA is an over-the-counter agreement that fixes the interest rate applicable to a notional amount over a specified future period (e.g. a '3v9' FRA covers a 6-month period beginning in 3 months), without any actual exchange of principal — it is cash-settled based on the difference between the agreed rate and the actual reference rate on the settlement date. A currency forward contract fixes an exchange rate, not an interest rate, and is irrelevant to this borrowing-rate hedging need. An interest rate swap typically exchanges fixed and floating interest payments over the life of an existing loan or exposure, rather than fixing a rate for a single specific future period on a loan not yet drawn. A share option is an equity derivative unrelated to interest rate risk management.

Section C, Forward Rate Agreements (FRAs) · Ref C3a · f3057

Question 29: B Translation exposure — affects the reported value of foreign assets, liabilities and results on consolidation, without a direct cash flow

Translation exposure arises purely from the accounting process of converting the financial statements of a foreign subsidiary into the parent's reporting currency; it changes reported figures (and can affect gearing ratios or covenant compliance) but does not itself represent an actual cash inflow or outflow. Transaction exposure specifically relates to a contracted cash flow in a foreign currency (e.g. an invoice to be paid or received), which is a real cash-based exposure, unlike the scenario described. Economic exposure is a broader, longer-term concept concerning how exchange rate movements affect a company's future competitiveness and cash flows, rather than the mechanical restatement of historical financial statements on consolidation. Credit exposure relates to counterparty default risk and is unrelated to currency translation.

Section C, Foreign exchange exposure types · Ref C4a · f3066

Question 30: D £625,000

A money market hedge for a future foreign currency payment works by depositing enough foreign currency today (earning interest) to exactly cover the future payment. The USD amount needed today is $816,000 / 1.02 = $800,000 (this is the amount that will grow to $816,000 after 6 months' interest at 2%). This $800,000 is then obtained today by converting GBP at the spot rate: $800,000 / 1.28 = £625,000, which is the amount the company must borrow (in GBP) today. £800,000 is the intermediate USD deposit figure and has not yet been converted into GBP. £637,500 would result from converting the full future payment at the spot rate without first discounting for the 6 months' USD deposit interest: $816,000 / 1.28 = £637,500. £816,000 simply restates the future USD payment figure without any conversion or discounting applied.

Section C, Money market hedge · Ref C4b · f3068

Question 31: B A currency swap, which exchanges a stream of cash flows (interest and, typically, principal) in one currency for equivalent cash flows in another currency over an agreed period

A currency swap is specifically designed to exchange a series of cash flows (interest payments and, where agreed, the principal amounts) in one currency for equivalent cash flows in another currency over an extended period, making it the appropriate instrument for converting the full remaining exposure of a long-term USD loan into sterling without needing to repay and refinance the original loan. A single forward contract only fixes the rate for one transaction on one future date, so a whole series of forwards (one for each payment date) would be needed to replicate what a single currency swap achieves in one agreement. An interest rate cap manages the level of interest rates within a single currency and does not address the cross-currency conversion of cash flows at all. A scrip dividend is entirely unrelated, being a method of paying dividends in shares rather than cash.

Section C, Currency swaps · Ref C4d · f3070

Question 32: C $1.5291/£

Interest rate parity states that the forward exchange rate should adjust to offset the interest rate differential between the two currencies, so that no risk-free arbitrage profit is available. Since the US interest rate (5%) is higher than the UK rate (3%), the dollar is expected to depreciate against sterling in the forward market — meaning more dollars are needed to buy one pound forward. Forward rate = 1.5000 x (1.05/1.03) = 1.5000 x 1.019417 = 1.5291 (to 4dp). 1.4714 incorrectly inverts the interest rate ratio (1.5000 x 1.03/1.05), which would apply if the currencies' relative rates were reversed. 1.5750 would result from simply adding the 5% rate onto the spot rate rather than applying the correct parity ratio. 1.5000 assumes no change at all, ignoring the interest rate differential entirely.

Section C, Interest rate parity · Ref C5a · f3071

Question 33: A 8.15%

The Fisher equation links nominal and real rates of return via expected inflation: (1 + nominal rate) = (1 + real rate) x (1 + inflation rate) = 1.03 x 1.05 = 1.0815, so the nominal rate is 8.15%. 8.00% is the simple sum of the real rate and inflation rate (3% + 5%), which ignores the compounding (cross) term between the two rates and is only an approximation, not the precise Fisher result. 1.94% would result from dividing the inflation factor by the real-return factor instead of multiplying them (1.05/1.03 - 1 = 1.94%). 5.00% simply restates the inflation rate on its own, ignoring the real rate of return entirely.

Section C, Fisher effect · Ref C5b · f3073

Question 34: A The decision should follow the company's formal risk policy, weighing hedging cost against risk appetite and potential impact of adverse movements, not a speculative rate view

Sound financial risk management follows a considered, policy-driven approach: assessing the exposure, the cost of available hedging instruments, and the company's risk appetite and capacity to absorb adverse movements, rather than either blanket hedging or speculating on rate movements. Hedging is a risk management tool, not a return-generating speculation, so it should not be based on someone's view of where rates will go. Always hedging 100% regardless of cost ignores that hedging itself has a cost (premiums, spreads, administrative burden) and may not be proportionate to the size or materiality of the exposure. Never hedging, on the basis that it removes upside potential, ignores that the purpose of hedging is to reduce the volatility of outcomes and protect against adverse scenarios, not to maximise the potential for a lucky favourable outcome. Basing hedging decisions on one individual's personal forecasting confidence introduces speculation and key-person risk into what should be a governed, policy-based treasury decision.

Section C, Risk management policy — to hedge or not to hedge · Ref C1b · f3074

Question 35: D Lagging a payment relies on a view of future currency movements — if wrong, the company could pay more, and it risks damaging the supplier relationship

Lagging involves deliberately delaying a foreign currency payment (or leading involves accelerating a receipt or payment) in anticipation of a favourable exchange rate movement. Unlike a genuine hedge, this is a speculative technique based on a view of future currency movements: if the view turns out to be wrong, the company could end up paying more in home currency terms, and delaying payment can also strain the relationship with the supplier or counterparty. A forward contract is a hedging instrument, not a speculative delay technique, and does not have a general rule that it 'always' produces a worse outcome — its purpose is to remove uncertainty, not to guarantee a particular direction of outcome. Multilateral netting offsets intra-group balances; it is not the technique described. A currency option does require a premium, but this describes an entirely different instrument from the delayed-payment technique in the question, so it does not correctly identify what is being described.

Section C, Leading and lagging · Ref C4b · f3077

Question 36: A $247,500

Value at Risk estimates the maximum expected loss on a portfolio over a given time horizon, at a given confidence level, under normal market conditions. Using the parametric approach: VaR = Portfolio value x Z-score x standard deviation = $10,000,000 x 1.65 x 0.015 = $247,500. This means the company can be 95% confident that its portfolio will not lose more than $247,500 in a single day under normal market conditions. $150,000 would result from omitting the Z-score entirely (simply $10,000,000 x 0.015). $16,500,000 incorrectly multiplies the portfolio value by the Z-score alone, ignoring the standard deviation. $1,650,000 would result from misplacing the decimal point on the standard deviation (using 10% rather than 1.5%: $10,000,000 x 1.65 x 0.10).

Section C, Value at Risk (VaR) · Ref C5b · f3078

Question 37: A In practice, rising financial distress, bankruptcy and agency costs of debt eventually outweigh the tax benefit as gearing rises, creating a practical trade-off

While MM's tax-adjusted model suggests value rises continuously with gearing due to the tax shield, this is recognised as a theoretical extreme; in practice, higher gearing increases the probability and expected cost of financial distress and bankruptcy, along with agency costs (such as stricter covenants and monitoring), which eventually outweigh the tax benefit — this trade-off is the basis of the more realistic 'trade-off theory' of capital structure, explaining why companies target a more moderate level of gearing rather than the theoretical maximum. Corporation tax does, in most real jurisdictions, treat interest as a deductible expense, which is precisely the mechanism generating the tax shield in the first place — this option misstates the premise. MM's tax-adjusted model does not conclude that debt is always more expensive than equity; if anything, the tax shield makes debt more attractive at the margin, up to the point where distress costs dominate. The theoretical MM-with-tax model predicts increasing, not decreasing, value from additional gearing (before considering distress costs), so a claim of an immediate reduction with no offsetting benefit misstates the theory itself.

Section D, MM with tax — implications and limitations · Ref D1b · f3082

Question 38: B 9.6%

WACC is the weighted average of the cost of equity and the post-tax cost of debt, weighted by their respective proportions of total market value: (60/100 x 12%) + (40/100 x 6%) = 7.2% + 2.4% = 9.6%. 9.0% would result from a simple, unweighted average of the two rates ((12%+6%)/2), which ignores the actual proportions of equity and debt in the capital structure. 18.0% incorrectly adds the two cost-of-capital rates together without applying any weighting at all. 6.0% simply restates the cost of debt on its own, ignoring the equity component entirely.

Section D, WACC calculation · Ref D1c · f3083

Question 39: A Where the company is expected to cease trading and sell assets individually, since realisable value reflects what could actually be recovered

Net realisable (liquidation) value is most appropriate when a company is expected to cease trading and its assets will actually be sold individually — often at a discount to their value in continued use, since a forced or piecemeal sale rarely captures the full operating value of an integrated business. Replacement cost, by contrast, is more relevant for a going concern that intends to continue operating and would need to replace its assets to sustain operations, as it reflects the cost of maintaining the business's productive capacity rather than a break-up scenario. Internal management reporting typically does not require either liquidation value or replacement cost specifically, and does not by itself justify choosing net realisable value over other bases. It is incorrect to say net realisable value is never appropriate; it is a recognised and specifically useful basis precisely in going-concern-doubt or liquidation scenarios.

Section D, Asset-based valuation — replacement cost vs realisable value · Ref D2a · f3086

Question 40: D $3.47

The Gordon growth (dividend valuation) model values a share as the present value of a perpetually growing dividend stream: Po = D0 x (1+g) / (Ke - g) = 0.20 x 1.04 / (0.10 - 0.04) = 0.208 / 0.06 = $3.47 (to 2dp). $2.00 would result from valuing the share as a level (non-growing) perpetuity, D0/Ke = 0.20/0.10, ignoring the growth rate entirely. $5.00 would result from dividing the dividend by the growth rate alone (0.20/0.04), omitting the required return entirely. $3.33 would result from omitting the (1+g) growth adjustment to next year's dividend, using 0.20/0.06 instead of 0.208/0.06.

Section D, Dividend valuation model (Gordon growth) · Ref D2c · f3089

Question 41: D FCFE is FCFF less after-tax interest and net debt repayments, discounted at the cost of equity; FCFF itself is discounted at the WACC

Free cash flow to the firm is the cash available to all capital providers before financing flows; free cash flow to equity narrows this down to what remains specifically for shareholders after interest (net of the tax shield) and net debt repayments (or plus net new borrowing) have been deducted. Because free cash flow to equity is specifically a shareholder-level cash flow, it should be discounted at the cost of equity, whereas free cash flow to the firm, being available to all providers of capital, should be discounted at the WACC. The two measures are not identical — they differ by the debt-related cash flows described — and using the same discount rate for both would be inconsistent with what each cash flow represents. Option B reverses the correct discount rates: equity-level cash flow requires the cost of equity, not WACC, precisely because it isolates the shareholder claim. Adjustment for debt-related cash flows is exactly what distinguishes free cash flow to equity from free cash flow to the firm, so it is incorrect to say no such adjustment is needed.

Section D, Free cash flow to equity vs free cash flow to firm · Ref D2e · f3093

Question 42: C Synergy value; the maximum price is the standalone value plus the expected synergies net of integration costs, and paying more destroys value for its shareholders

Synergy value is the additional value expected to be created specifically by combining the two businesses — through cost savings, revenue enhancements, or other efficiencies not achievable by either company independently. The maximum the acquirer should pay is the target's standalone value plus the expected synergies, net of integration costs; paying more than that destroys value for the acquirer's own shareholders, a common failing in M&A. In practice the acquirer will negotiate to pay as little of the synergy value to the seller as possible, so the price agreed is usually below this ceiling. Terminal value is a distinct DCF valuation concept relating to cash flows beyond an explicit forecast period, not the specific value created by combining two businesses, and it should not simply be ignored in acquisition pricing generally. Net asset value is an asset-based valuation approach, unrelated to the concept of combination-specific synergy value, and there is no rule that it should be subtracted from a target's standalone value. A minority discount relates to the reduced value of a non-controlling shareholding, an entirely different concept from synergy value created by an acquisition, and would not reduce the maximum acquisition price on this basis.

Section D, Synergy valuation in M&A · Ref D2f · f3096

Question 43: D The excess of a business's overall value over its identifiable net asset value, reflecting reputation, customer relationships and workforce quality not separately recognised

In valuation terms, goodwill represents the value of a business over and above the fair value of its separately identifiable net assets, capturing intangible factors such as brand reputation, customer relationships, staff expertise and other synergistic elements that are not individually recognised or measured as distinct assets. It is not itself a discrete, separately saleable physical asset — it exists only as a residual value attached to the business as a whole. It is not a liability; it represents a positive element of value, not an obligation to pay anything out. It also bears no fixed or defined relationship to share capital, which is an entirely separate figure reflecting the nominal value of shares issued.

Section D, Goodwill as a valuation concept · Ref D2g · f3097

Question 44: A Because private company shares can't be readily traded on an active public market, making them less liquid and less attractive to hold, all else equal

A marketability discount is applied because shares in a private company cannot be quickly bought or sold through an active public market the way listed shares can; this reduced liquidity makes them less attractive to hold, all else being equal, so investors require a lower price (equivalently, a discount) to compensate for the extra time, cost and uncertainty involved in eventually realising their investment. There is no general rule that private companies always have higher earnings growth than listed comparables — growth prospects vary company by company and are a separate consideration from marketability. Private companies are not legally prohibited from being sold; ownership can typically be transferred, just less readily and without a ready public market, which is exactly the liquidity issue the discount addresses. The marketability discount is applied to private, unlisted shares precisely because they lack the ready market that listed shares benefit from — the opposite of what this option claims.

Section D, Private company valuation — marketability discount · Ref D2g · f3098

Question 45: A Asset-based valuation focuses on recognised assets, and likely understates a business whose worth lies in unrecognised software, data, brand and relationships

Asset-based valuation captures the value of a business's identifiable (and often only tangible or specifically recognised) assets, but many of the most valuable elements of a technology or service business — internally generated software, proprietary data, brand reputation, customer relationships and workforce know-how — are typically not separately recognised on the statement of financial position, meaning this approach is likely to significantly understate such a business's true value; earnings- or cash-flow-based methods (P/E, DCF) are generally more appropriate as the primary valuation approach in these cases. It is not correct that asset-based valuation always overstates value for technology businesses — if anything, the opposite bias (understatement) is the well-recognised limitation. The method can still technically be calculated for any company, including one with intangible assets; the issue is one of relevance and completeness of the resulting value, not an inability to calculate a figure at all. There is no legal prohibition on using asset-based valuation for technology companies — it is a matter of professional judgement about which method is most informative, not a legal restriction.

Section D, Limitations of asset-based valuation for intangible-heavy businesses · Ref D2a · f3111

Question 46: B The Adjusted Present Value (APV) approach — values the project as all-equity financed, then adds the present value of financing side effects like the tax shield

APV is specifically designed for situations where a single, constant WACC is difficult to justify — such as a project or acquisition with a capital structure that changes significantly or differs materially from the company's normal mix. It works by first valuing the project's operating cash flows as if financed entirely by equity (discounted at the ungeared cost of equity, reflecting only business risk), and then separately adding the present value of financing side effects, most commonly the tax shield arising from any debt used to fund the project, along with other financing-related costs or benefits (such as issue costs or subsidised loan benefits). The dividend valuation model is a share (equity) valuation approach based on expected dividends and is unrelated to separating operating value from financing effects in a project appraisal context. The net asset value approach values a business from its statement of financial position and has no mechanism for separating operating cash flows from financing side effects. The P/E ratio method applies a market-based earnings multiple and likewise does not decompose value into operating and financing components.

Section D, Adjusted Present Value (APV) approach · Ref D2d · f3112

Question 47: D $4.8m

Economic Value Added measures the value created by a business over and above the return required to compensate its capital providers, calculated as NOPAT minus a capital charge (WACC multiplied by invested capital): $12m - (0.09 x $80m) = $12m - $7.2m = $4.8m. A positive EVA indicates the business is generating returns above its cost of capital, creating genuine economic value. $12.0m simply restates NOPAT and ignores the capital charge entirely, as if the cost of capital were zero. $7.2m is only the capital charge itself, not the residual value created after NOPAT covers that charge. $19.2m would result from incorrectly adding the capital charge to NOPAT rather than subtracting it, reversing the direction of the calculation.

Section D, Economic Value Added (EVA) · Ref D2h · f3114

Question 48: C Because the denominator is (Ke - g), a small rise in g causes a much larger rise in value as g nears Ke, since the denominator shrinks toward zero

In the Gordon growth model, value is inversely related to the denominator (Ke - g); as the assumed growth rate g gets closer to the required return Ke, this denominator shrinks towards zero, meaning even a small increase in g produces a disproportionately large increase in the calculated value — this mathematical sensitivity is a well-recognised practical limitation of the model, requiring the valuer to justify the chosen growth assumption carefully, particularly when g and Ke are close together. It is incorrect to say the model is insensitive to growth — the growth rate is one of the two key drivers of value in the formula, alongside the required return. The sensitivity issue arises specifically from the growth rate approaching the required return, not only in the extreme case of a dividend cut to zero, which is a different scenario entirely. Both Ke and g jointly determine the sensitivity through their difference in the denominator; it is incorrect to say only the required return matters, since the growth assumption is equally central to the effect described.

Section D, Sensitivity of DVM valuation to growth assumption · Ref D2c · f3117

Question 49: D Perform sensitivity analysis across a reasonable range of WACC estimates, to show how the value range changes rather than presenting one false-precise figure

Because DCF valuations, especially those with a large terminal value, are highly sensitive to the WACC assumption, good practice is to perform sensitivity analysis — recalculating the valuation across a reasonable range of plausible WACC estimates — to understand and communicate the resulting range of values, rather than presenting a single, precise-looking figure that may convey false confidence. Deliberately selecting the lowest possible WACC purely because it inflates the valuation would be poor and potentially misleading practice, not a genuine attempt to estimate fair value, and does not reflect sound analytical judgement. It is factually incorrect to claim DCF valuations are not materially affected by the discount rate — sensitivity to WACC is one of the most well-documented limitations of the method, which is precisely why the sensitivity is being raised in the question. Switching entirely to an asset-based valuation does not solve the underlying uncertainty problem and would likely produce a valuation basis unsuited to a going concern's true earning potential; sensitivity analysis on the DCF itself is the more appropriate response.

Section D, Sensitivity of DCF valuation to WACC assumption · Ref D1c · f3118

Question 50: C If the dollar cash flows and the dollar discount rate are not based on consistent assumptions about US inflation, the dollar value, and so the sterling value at today's spot rate, will be misstated

Valuing in dollars at a dollar discount rate and converting the resulting present value at today's spot rate is a sound approach: the spot rate is the right rate for converting a present value. The risk is inconsistency. If the dollar cash flows do not reflect expected US inflation, or the dollar WACC assumes a different inflation rate from the cash flows, the dollar present value is wrong and the sterling value is wrong with it (option C). The alternative method, forecasting exchange rates using purchasing power parity and converting each year's cash flow into sterling before discounting at a sterling rate, should in theory give the same answer when the assumptions are consistent. Exchange rates and inflation are linked through purchasing power parity, so A is wrong. Valuing in the target's own currency is legitimate, so B is wrong. Purchasing power parity predicts that exchange rates move with inflation differentials, not that they stay unchanged, so D is wrong.

Section D, Cross-border valuation and purchasing power parity · Ref D2j · f3121

Question 51: C $75m

Enterprise value represents the value of the whole business available to all capital providers (debt and equity); to derive the value attributable specifically to shareholders (equity value), net debt (total debt less cash) must be deducted: $100m - ($30m - $5m) = $100m - $25m = $75 million. $100m simply restates the enterprise value without adjusting for the company's net debt position at all. $130m incorrectly adds the debt back onto the enterprise value rather than subtracting net debt. $25m is simply the net debt figure itself, not the resulting equity value after deducting it from enterprise value.

Section D, Enterprise value to equity value bridge · Ref D2k · f3126

Question 52: B $6.0m

Both discounts reduce the pro-rata value sequentially: first the minority discount is applied to reflect the lack of control ($10m x 0.75 = $7.5m), and then the marketability discount is applied to that already-discounted figure to reflect the lack of a ready market for the shares ($7.5m x 0.80 = $6.0m). $7.5m only reflects the minority discount and omits the further marketability discount that should also be applied. $5.5m would result from incorrectly adding the two discount percentages together and applying them as a single 45% discount to the original $10m, rather than applying them sequentially, which produces a different (and here, larger) total reduction than two sequential percentage discounts. $10.0m is simply the undiscounted pro-rata value, ignoring both discounts entirely.

Section D, Applying minority and marketability discounts sequentially · Ref D2f · f3129

Question 53: C A fairness opinion — gives the board independent expert support for its recommendation and helps show it met its fiduciary duty in assessing the offer

A fairness opinion is an independent assessment, typically from an investment bank or specialist adviser, stating whether a proposed transaction price is fair to shareholders from a financial point of view; boards commonly obtain one to support their recommendation to shareholders and to help demonstrate that they have exercised appropriate care and independent judgement in evaluating the offer, which can also provide some protection against later claims that the board failed in its duties. A prospectus is a distinct legal disclosure document required for a public offering of securities or a new listing, not an opinion on the fairness of a specific acquisition price. A trust deed is a legal document governing the terms and protections of a bond issue for bondholders, unrelated to assessing the fairness of an acquisition price. A rights issue circular is a shareholder communication specific to a rights issue of new equity, an entirely different type of document and transaction from an M&A fairness opinion.

Section D, Fairness opinions in M&A · Ref D2l · f3134

Question 54: D The contingent liability is factored into negotiation — through a price reduction, an escrow holdback, or indemnities/warranties protecting the buyer if it crystallises

A material contingent liability identified in due diligence is typically addressed through the negotiated deal terms rather than ignored: common mechanisms include reducing the purchase price to reflect the risk, using an escrow arrangement to hold back part of the consideration until the matter is resolved, or including specific warranties and indemnities in the sale and purchase agreement that require the seller to compensate the buyer if the liability materialises after completion. It would be poor practice to exclude a known, material contingent liability from consideration entirely simply because its outcome is uncertain — due diligence exists precisely to identify and address such risks before completion. Buyers are not obliged to proceed at an unadjusted price once a material issue is discovered; renegotiation of price or terms is a standard and expected response to significant due diligence findings. Cancelling the transaction entirely is only one of several possible responses and is not the only, nor the most common, way of addressing a contingent liability — renegotiating terms is usually preferred if the underlying deal still makes strategic sense.

Section D, Contingent liabilities and negotiated purchase price · Ref D2l · f3135

Question 55: C Where the project's or acquisition's capital structure changes significantly, or differs substantially from the acquirer's normal mix, making one constant WACC unreliable

APV is particularly useful when the capital structure of a project or acquisition changes significantly over its life, or differs materially from the acquirer's normal, relatively stable financing mix — in such cases, a single constant WACC (which implicitly assumes a stable capital structure) becomes an unreliable discount rate, whereas APV separates the operating value (discounted at the ungeared cost of equity) from financing side effects, which can be modelled explicitly period-by-period as the capital structure changes. A standard WACC-based DCF is generally perfectly adequate, and often simpler, for a company with a genuinely stable, constant capital structure over the investment's life — this is exactly the scenario where APV's added complexity is least necessary, not most needed. It is not correct that APV should always replace WACC-based DCF in every scenario; the choice depends on whether capital structure stability can reasonably be assumed, and WACC-based DCF remains widely used and appropriate for many valuations. APV's financing side effects specifically include the tax shield generated by debt interest, so the approach is directly relevant to, not restricted away from, companies that do pay corporation tax — a company with no corporation tax liability would have no tax shield to model in the first place, undermining rather than supporting the case for APV in that scenario.

Section D, Choosing between WACC-based DCF and APV · Ref D1c · f3138

Question 56: D The buyer typically needs more due diligence and may seek greater price protection (warranties, indemnities, or an earn-out) for the added uncertainty and information asymmetry involved

Because a private target lacks the public disclosure history, audited track record of ongoing scrutiny, and analyst coverage that a listed company has, the buyer typically faces greater uncertainty about the true state of the business, prompting more extensive due diligence and a greater emphasis on price protection mechanisms — warranties, indemnities, escrow arrangements, or earn-out structures linking part of the consideration to the target's future performance — to manage the risk that undisclosed issues emerge after completion. It is incorrect to say information asymmetry has no effect on the process; it is one of the central practical considerations shaping how private company acquisitions are structured and negotiated. If anything, information asymmetry and reduced marketability tend to support a valuation discount for private companies relative to comparable listed peers (as reflected in the marketability discount), not a premium, so this option reverses the expected direction of the effect. Buyers are not legally prohibited from requesting warranties or indemnities — these are standard, commonly negotiated features of private company sale and purchase agreements specifically designed to address this kind of risk.

Section D, Information asymmetry and private company valuation · Ref D2n · f3139

Question 57: B EV/EBITDA is a pre-interest measure largely unaffected by capital structure, making it more comparable across gearing levels than P/E, measured after interest

Because EBITDA is measured before interest (as well as tax, depreciation and amortisation), it strips out the effect of how a company is financed, making EV/EBITDA multiples more directly comparable across companies with different levels of gearing. P/E, by contrast, is based on earnings after interest, so a more highly geared company will have relatively lower earnings (all else equal) purely due to its financing structure, distorting P/E comparisons between companies with materially different gearing levels. It is incorrect that P/E is unaffected by gearing — the deduction of interest before arriving at earnings is exactly why P/E is sensitive to capital structure differences, which is the core issue in this scenario. EV/EBITDA can be, and routinely is, calculated for companies with debt in their capital structure — the enterprise value figure itself explicitly incorporates the market value of that debt as part of the valuation bridge. Differences in gearing between comparables are highly relevant to multiple selection, precisely because they can distort comparability if not handled appropriately, which is the reasoning behind preferring EV/EBITDA in this scenario.

Section D, Choosing between P/E and EV/EBITDA given capital structure differences · Ref D2b · f3141

Question 58: C A persistently falling dividend cover suggests dividends are outpacing earnings; the valuer should question whether the high growth rate can really be sustained

A falling dividend cover indicates dividends are growing faster than earnings, meaning an increasing share of profit is being distributed; this pattern cannot continue indefinitely (cover would eventually fall below 1, implying dividends exceeding earnings), so a valuer should question whether the assumed constant, high dividend growth rate underpinning a Gordon growth valuation is realistically sustainable, or whether growth is more likely to slow as the payout ratio approaches its practical limit. It is incorrect to say dividend cover has no bearing on the model's assumptions — since the model relies entirely on a credible, sustainable growth assumption, indicators like a deteriorating dividend cover are directly relevant evidence a careful valuer should investigate. A falling dividend cover reflects dividends outpacing earnings currently; it does not itself predict that growth will accelerate even further — if anything, it is a warning sign that current growth may not be sustainable, the opposite implication. While the model is a mathematical formula that can technically be run with any assumed growth rate, sound valuation practice requires that assumption to be grounded in a realistic view of the company's actual earnings capacity — an assumption disconnected from earnings performance would produce an unreliable valuation, not a valid application of the model.

Section D, Dividend cover and sustainability of growth assumptions · Ref D2c · f3142

Question 59: A A perpetual growth rate that permanently exceeds the wider economy's long-run growth implies the company eventually outgrows the entire economy — generally unrealistic as a forever assumption

A terminal growth rate is, by construction, assumed to continue forever; if it permanently exceeds the growth rate of the wider economy, the mathematics implies the company would eventually grow to represent an ever-larger, and ultimately impossible, share of total economic activity — a well-recognised sanity check is therefore to ensure the assumed terminal growth rate does not persistently exceed a reasonable long-run estimate of nominal GDP growth (or inflation, at a minimum, for a mature business). It is not correct that a valuer can reasonably assume any terminal growth rate with no reference to the wider economy — doing so undermines the credibility and internal consistency of the valuation, which is exactly the concern being raised here. There is no rule requiring terminal growth to be set at exactly 0% for every company; a reasonable terminal growth rate broadly in line with long-run inflation or GDP growth is commonly used, but zero is not a universal requirement. The relationship between a company's assumed terminal growth and overall economic growth is highly relevant to assessing whether a DCF valuation's key long-term assumption is credible, not an irrelevant detail to be ignored.

Section D, Sanity-checking the terminal growth rate assumption · Ref D2d · f3144

Question 60: D The optimal capital structure is where the marginal tax benefit of extra debt (the interest tax shield) is exactly offset by the marginal rise in expected distress and bankruptcy costs

Trade-off theory holds that companies balance the tax advantages of debt (the interest tax shield) against the increasing costs of financial distress and bankruptcy risk that arise as gearing rises; the theoretical optimal capital structure occurs where the marginal benefit of one more unit of debt (additional tax shield) exactly equals the marginal cost (the additional expected distress cost that extra debt introduces) — beyond this point, further debt destroys, rather than adds, value. It is not correct that 100% debt is optimal — this ignores the escalating distress and bankruptcy costs that trade-off theory specifically identifies as the counterbalancing force to the tax benefit. Similarly, 100% equity is not generally optimal either, since it forgoes the valuable tax shield benefit of at least some debt, which trade-off theory recognises as a genuine advantage up to a point. It is a mischaracterisation of the theory to say it concludes there is no optimal structure at all — trade-off theory's entire purpose is to explain how and why an interior optimal level of gearing (between 0% and 100% debt) can exist for a company.

Section D, Trade-off theory and optimal capital structure · Ref D1b · f3147