

Question 5 (15 MARKS)

5.1 Memorandum to management

TO: Management team

FROM: CFO ✓p

DATE: 30 November 2014

RE: Risk and interest

Dear Directors

This memorandum is for information purposes and to explain some financial risks and terms to you before deciding on the new source of funding for the new investments.

(a) Relationship between risk and return:

There is always a **direct correlation** between risk and return. If the **risk of default on a loan is high** then the **required return is higher**. Therefore interest rates differ for different companies and different individuals.

(1)

(b) Three general factors that will impact the interest rate: (any 3)

- i. Inflation
- ii. Preference for liquidity
- iii. Demand for credit
- iv. Exchange rates
- v. Monetary policy of the SARB/repo rate
- vi. Trends in international interest rate

(3)

Question 5 (continued)

(c) Three factors that will impact the interest rate to a specific customer: (any 3)

- i. Risk of default on repayment of loan (higher risk = higher rate)/risk profile
- ii. Secured / unsecured loan (secured decrease rate)
- iii. Term of the loan (longer loan decrease the rate)
- iv. The amount borrowed
- v. The interest yield curve

(3)

(d) Hedging techniques to reduce the interest rate risk: (any 2)

- i. Maintaining a portfolio of interest bearing debt and interest bearing investments
- ii. Maintaining a mix of floating and fixed rate debt
- iii. Pooling of cash within a group of companies at a central business unit (treasury)

(2)

Yours sincerely

CFO

Note: bonus mark for presentation (memo format)

**Maximum (9)
Format (1)
(10)**

Question 5 (continued)

5.2 Number of new shares

The shareholder holds 11 000 shares in Toys4U.

$$\text{Number of 200 share bundles} = 11\,000/200 \quad \checkmark$$

$$= 55$$

$$\text{Number of scrip shares} = 55 \times 5 \text{ shares} \quad \checkmark$$

$$= 275$$

The fractions will be converted to cash credits

Therefore the shareholder will be entitled to 275 new shares. \checkmark

Maximum (3)

5.3 Forward rate by means of the purchasing power parity theory

$$\text{Forward rate} = \text{spot rate} \times \frac{(1 + \text{inflation rate in reference currency})^3}{(1 + \text{inflation rate in base currency})^3}$$

$$= R18,1527 \times \frac{(1,063)^3}{(1,025)^3} \quad \checkmark \checkmark$$

$$= R18,1527 \checkmark \times 1,1154$$

$$= R20,2475$$

Maximum (3)

Total (16)