Tramont Co is a listed company based in the USA and manufactures electronic devices. One of its devices, the X-IT, is produced exclusively for the American market. Tramont Co is considering ceasing the production of the X-IT gradually over a period of four years because it needs the manufacturing facilities used to make the X-IT for other products.

The government of Gamala, a country based in south-east Asia, is keen to develop its manufacturing industry and has offered Tramont Co first rights to produce the X-IT in Gamala and sell it to the USA market for a period of four years.

At the end of the four-year period, the full production rights will be sold to a government-backed company for Gamalan Rupiahs (GR) 450 million after tax (this amount is not subject to inflationary increases). Tramont Co has to decide whether to continue production of the X-IT in the USA for the next four years or to move the production to Gamala immediately.

Currently each X-IT unit sold makes a unit contribution of $20. This unit contribution is not expected to be subject to any inflationary increase in the next four years. Next year's production and sales estimated at 40,000 units will fall by 20% each year for the following three years. It is anticipated that after four years the production of the X-IT will stop.

It is expected that the financial impact of the gradual closure over the four years will be cost neutral (the revenue from sale of assets will equal the closure costs). If production is stopped immediately, the excess assets would be sold for $2•3 million and the costs of closure, including redundancy costs of excess labour, would be $1•7 million.

The following information relates to the production of the X-IT moving to Gamala.

The Gamalan project will require an initial investment of GR 230 million, to pay for the cost of land and buildings (GR 150 million) and machinery (GR 80 million). The cost of machinery is tax allowable and will be depreciated on a straight-line basis over the next four years, at the end of which it will have a negligible value.

Tramont Co will also need GR 40 million for working capital immediately. It is expected that the working capital requirement will increase in line with the annual inflation rate in Gamala. When the project is sold, the working capital will not form part of the sale price and will be released back to Tramont Co.

Production and sales of the device are expected to be 12,000 units in the first year, rising to 22,000 units, 47,000 units and 60,000 units in the next three years respectively.

The following revenues and costs apply to the first year of operation:

- Each unit will be sold for $70;
- The variable cost per unit comprising of locally sourced materials and labour will be GR 1,350, and;
- In addition to the variable cost above, each unit will require a component bought from Tramont Co for $7, on which Tramont Co makes $4 contribution per unit;
- Total fixed costs for the first year will be GR 30 million.

The costs are expected to increase by their countries' respective rates of inflation, but the selling price will remain fixed at $70 per unit for the four-year period.

The annual corporation tax rate in Gamala is 20% and Tramont Co currently pays corporation tax at a rate of 30% per year. Both countries' corporation taxes are payable in the year that the tax liability arises.

A bi-lateral tax treaty exists between the USA and Gamala, which permits offset of overseas tax against any USA tax liability on overseas earnings. The USA and Gamalan tax authorities allow losses to be carried forward and written off against future profits for taxation purposes.

Tramont Co has decided to finance the project by borrowing the funds required in Gamala. The commercial borrowing rate is 13% but the Gamalan government has offered Tramont Co a 6% subsidised loan for the entire amount of the initial funds required.

The Gamalan government has agreed that it will not ask for the loan to be repaid as long as Tramont Co fulfils its contract to undertake the project for the four years. Tramont Co can borrow dollar funds at an interest rate of 5%.

Tramont Co's financing consists of 25 million shares currently trading at $2•40 each and $40 million 7% bonds trading at $1,428 per $1,000. Tramont Co's quoted beta is 1•17. The current risk free rate of return is estimated at 3% and the market risk premium is 6%.

Due to the nature of the project, it is estimated that the beta applicable to the project if it is all-equity financed will be 0•4 more than the current all-equity financed beta of Tramont Co. If the Gamalan project is undertaken, the cost of capital applicable to the cash flows in the USA is expected to be 7%.

The spot exchange rate between the dollar and the Gamalan Rupiah is GR 55 per $1. The annual inflation rates are currently 3% in the USA and 9% in Gamala. It can be assumed that these inflation rates will not change for the foreseeable future. All net cash flows arising from the project will be remitted back to Tramont Co at the end of each year.

There are two main political parties in Gamala: the Gamala Liberal (GL) Party and the Gamala Republican (GR) Party. Gamala is currently governed by the GL Party but general elections are due to be held soon.

If the GR Party wins the election, it promises to increase taxes of international companies operating in Gamala and review any commercial benefits given to these businesses by the previous government.

Required:

(i) Prepare a report for the Board of Directors of Tramont Co that evaluates whether or not Tramont Co should undertake the project to produce the X-IT in Gamala and cease its production in the USA immediately. In the evaluation, include all relevant calculations in the form of a financial assessment and explain any assumptions made;

Note: it is suggested that the financial assessment should be based on present value of the operating cash flows from the Gamalan project, discounted by an appropriate all-equity rate, and adjusted by the present value of all other relevant cash flows. (27 marks)

(ii) Prepare a report for the Board of Directors of Tramont Co that discusses the potential change in government and other business factors that Tramont Co should consider before making a final decision. (8 marks)

Professional marks will be awarded in question 1 for the format, structure and presentation of the answer. (4 marks)